



FAIRMONT
EQUITIES

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Stock Market Outlook

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MONTHLY INVESTMENT OUTLOOK

MAIN THEMES

- Base case strategy is rate cut playbook 101
- Stocks well supported, but on borrowed time
- Gold to continue to perform
- Global cyclical sectors appear to be pricing a possible growth trough
- Market internals are supportive of a rally, for the time being

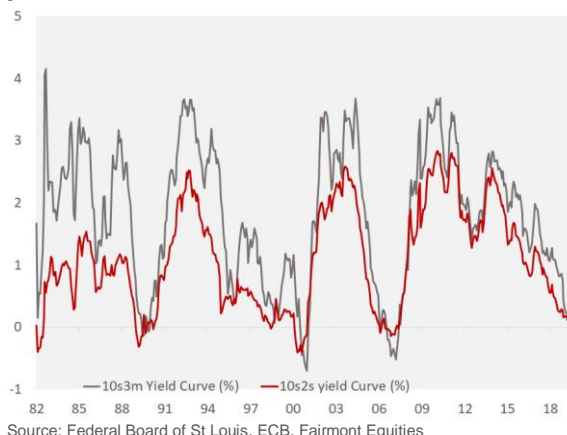
POLICY, POLICY, POLICY

GDP growth estimates have been progressively paired back during 1H/2019. Global growth is now expected to come in at 2.6% for 2019, and a marginal uptick to 2.7% in 2020 according to World Bank. Expectations were previously for about 90bps higher than this heading into 2Q/2019, yet, the outlook isn't necessarily consistent with recession.

Interestingly, the 10 year minus 2-year (10s2s) yield curve appears to have just turned up and crossed over the 10 year minus 3-month (10s3m) curve. Some use the 10s2s as an economic indicator and the 10s3m curve as a policy benchmark, suggesting a very strong message from the market that short rates in the US remain too high and inconsistent with the growth and inflation outlook.

Equity markets are not the only market to be heavily impacted by policy developments over 2H/2019. Indeed, the policy impact could well be felt even more heavily in the commodity markets in the ECB eases policy more aggressively than the Fed.

10s2s Yield Curve Crosses above the 10s3m yield curve

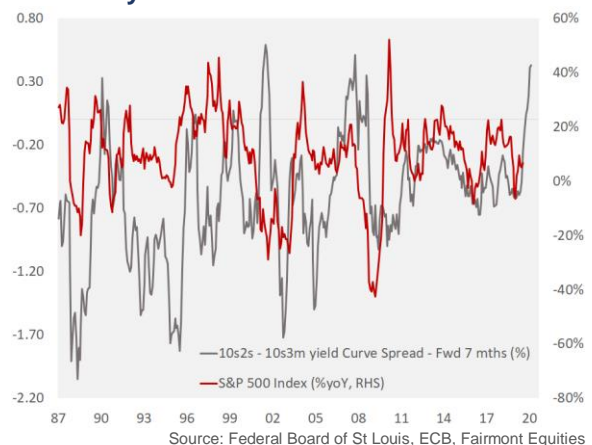


Current expectations for a growth differential between Europe and the US suggest the US dollar could well end up strengthening given how attractive US yields remain on a global basis. The US administration will of course weigh in with an attempt to weaken the US dollar via trade rhetoric.

GLOBAL EQUITIES BEGINNING TO PRICE A GROWTH TROUGH

While the 10s2s – 10s3m curve spread could lead equities still further higher, cyclical sector relative performance also suggests a more positive outlook with easing monetary and fiscal policies by global central banks.

10s2s – 10s3m Yield Spread leads US equity returns by 7 months



GLOBAL ECONOMIC OUTLOOK

Cyclical trough but not recession

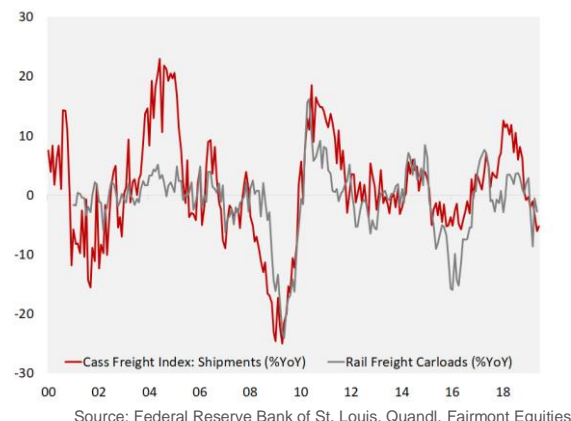
Cycle indicators potentially troughing

- Much has been made of cycle indicators such as the Cass Freight Index turning negative. However, that index, along with Rail freight carload and truck load freight data suggest a potential bottoming.
- Elsewhere, data suggests a pick-up in activity. Both US and European exports to China appear to have bottomed and the OECD China leading indicator is turning upwards.

Central bank policy the key focus

- Fed policy is the key focal point for the remainder of 2019 and heading into 2020. There is potential for the fed governors to be split between a 25 bp or 50 bp cut, and whether or not the Fed continues its measured pace of “insurance” cuts or turns to an aggressive easing cycle.
- As expectations on the FOMC have increased, markets could be disappointed if the tone of the communications and the rate cut do not reflect strong and rapid action.
- The ECB changed its inflation target of 2% in favour of an approach based on symmetry and opened the door to rate cuts in September. Quantitative easing (QE) could be relaunched if necessary and is likely to include a broader universe of assets being bought. A new full monetary package is expected in September.

Cass Freight index negative, but at cyclical trough



OECD China LEI and exports from the US and Europe to China are recovering



World Bank Global GDP Growth Forecasts

(PERCENT CHANGE FROM PREVIOUS YEAR)	% DIFFERENCE FROM JANUARY 2019 FORECAST										
	2015	2016	2017	2018e	2019f	2020f	2021f	2018e	2019f	2020f	2021f
WORLD	2.9	2.6	3.1	3.0	2.6	2.7	2.8	0.0	-0.3	-0.1	0.0
ADVANCED ECONOMIES	2.3	1.7	2.3	2.1	1.7	1.5	1.5	-0.1	-0.3	-0.1	0.0
UNITED STATES	2.9	1.6	2.2	2.9	2.5	1.7	1.6	0.0	0.0	0.0	0.0
EURO AREA	2.1	2.0	2.4	1.8	1.2	1.4	1.3	-0.1	-0.4	-0.1	0.0
JAPAN	1.2	0.6	1.9	0.8	0.8	0.7	0.6	0.0	-0.1	0.0	0.0
EMERGING MARKETS	3.8	4.1	4.5	4.3	4.0	4.6	4.6	-0.1	-0.3	0.0	0.0
EAST ASIA AND PACIFIC	6.5	6.3	6.5	6.3	5.9	5.9	5.8	0.0	-0.1	-0.1	0.0
CHINA	6.9	6.7	6.8	6.6	6.2	6.1	6.0	0.1	0.0	-0.1	0.0

Source: World Bank, Fairmont Equities

GLOBAL ECONOMIC OUTLOOK

2016 style growth slowdown?

Confidence is solid

- Consumer confidence measures in the US economy remain at elevated levels, which should help support a trough in cyclical indicators.
- Hours worked typically signal improvement before other follow through data delivers more concrete evidence of activity levels. With hours worked at levels consistent with reversals in 2016, 2005, 2003 and 1998, there is potential for confidence to support a shallow growth trough.
- This could signal a turnaround in other domestic activity indicators in the US, gradually broadening the case for an improved corporate profits outlook during 2H/2020 / 1H/2021.

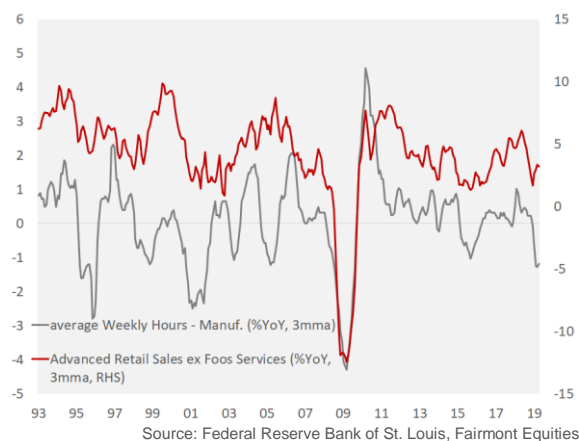
US dollar will be a target for the US administration

- The US administration wants a lower US dollar heading into the 2020 US election. This will help spur US competitiveness and support inflation.
- Efforts to push the dollar down will face a stiff headwind in the relatively attractive bond yield spread of the US over Europe, particularly heading into another round of monetary easing as the ECB delivers their new monetary package in September.

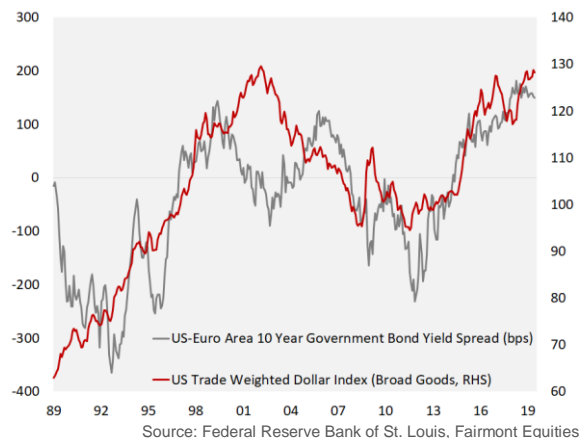
Current inflation outlook is muted

- Current expectations for forward inflation remain low. The 10-year breakeven rate and the 5-year – 5-year inflation rate (5-year inflation expectations starting 5 years from now) continue to come down.
- The Fed knows all too well that corporate America needs inflation to assist activity, feed through to margins and support earnings growth.
- Aggressive talk to lower the US dollar is expected for this reason. Lowering the dollar would raise import inflation (albeit marginally).

Troughing manufacturing hours could be a signal of a shallow growth bottom



US-Euro area yield spread could support the US dollar



Fed needs to assist inflation and activity



GLOBAL POLICY OUTLOOK

Central Banks and Governments to Align

Geopolitical risk has posed a very real threat to the growth outlook

- Fed funds futures moved aggressively to price a rate cut in July, particularly ahead of G20. While pricing appears to have eased marginally since G20, expectations remains high with an 80% probability of a July rate cut.
- Rate cut expectations now total 75bps by April 2020.

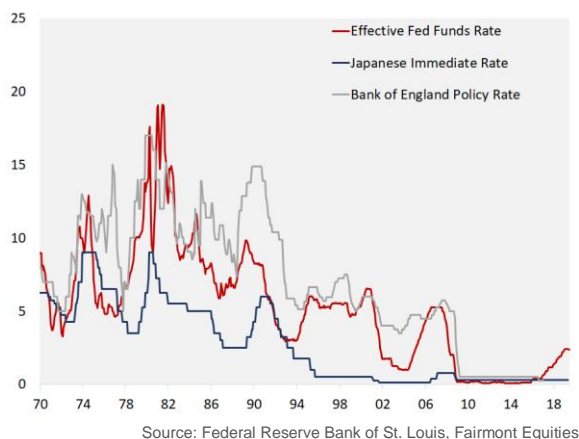
Monetary policy response could add significant support to risk assets

- The current Fed Chairman Powell is fully aware that he has not been as visible, nor as communicative as the previous Fed Chairman. There is a risk in maintaining the perception of independence.
- Given the extent of Fed cuts now factored in, the Fed needs to be careful of an equity market disappointment by a perceived lack of action to support cycle extension. Consequences could spread from market disappointment to economic weakness.

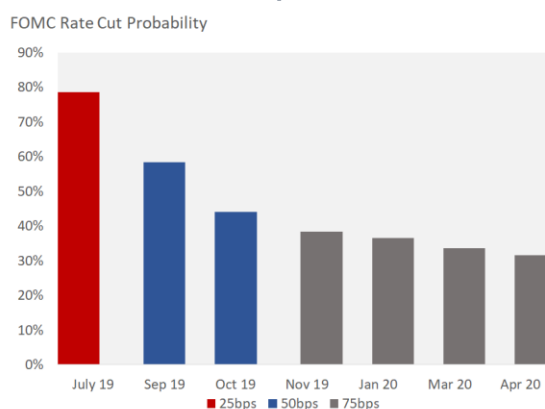
Expansionary fiscal policy likely to augment monetary stimulus

- Additional support should come from expansionary fiscal policy in a more coordinated fashion. With the German fiscal surplus among the highest in Europe, the European policy mix could be the most supportive of equities since the GFC.
- Fiscal tightening appears the current outlook. Yet, persistently low (zero) interest rates in Japan would allow expansionary fiscal policy without debt/GDP rising even further. Such low-cost fiscal expansion would make sense for Japan given monetary policy is exhausted at zero interest rates.
- Chinese policy support of domestic demand has helped counter the trade war impact on manufacturing with domestic data improving. Financial support of the private sector and SMEs, along with local government bond issuance to support infrastructure investment will continue.

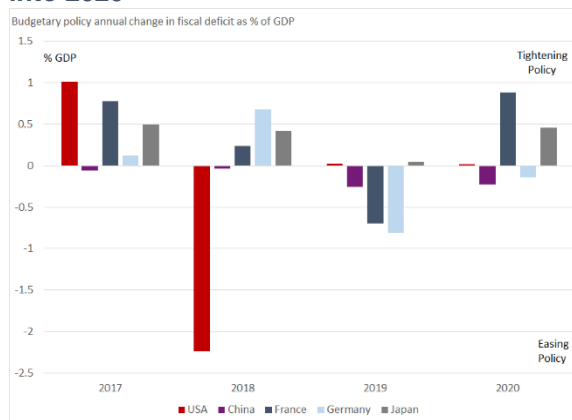
The US Fed is clearly the most restrictive central bank and has some work to do



Three 25bp rate cuts being priced by Fed Fund Futures out to April 2020



Global budgetary policy likely to add support into 2020



COMMODITY OUTLOOK

Growth outlook not supportive, yet

Metals

- Base metals typically underperform precious metals as growth cycles accelerate downward. Indeed, peaking growth and a lack of progress on China trade negotiations have hampered the base metals year-to-date.
- The base metals / precious metals ratio suggests the outlook for growth to contract is more likely than an extended growth cycle.
- Base metals breadth is low and the current reading of our base metals breadth model suggests a flat outlook for prices of copper and other correlated metals.
- Base metal positioning is now net short. Growth bottoming and then recovering would be needed to see metals recover.

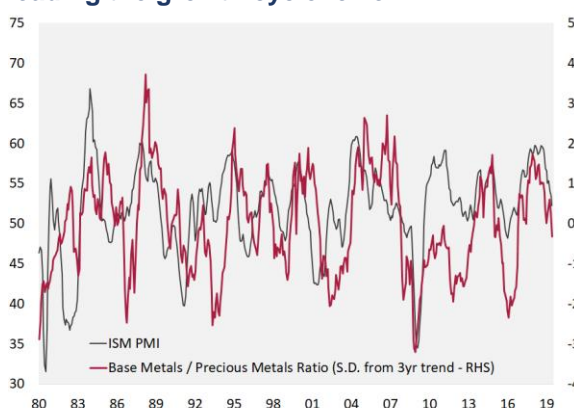
Energy

- Oil prices are not reacting to risk events within the energy sector in a typical manner. The seizure of two British-operated tankers by Iran in the Strait of Hormuz should have seen oil prices react strongly. US crude inventory data

recently also showed a solid net inventory withdrawal.

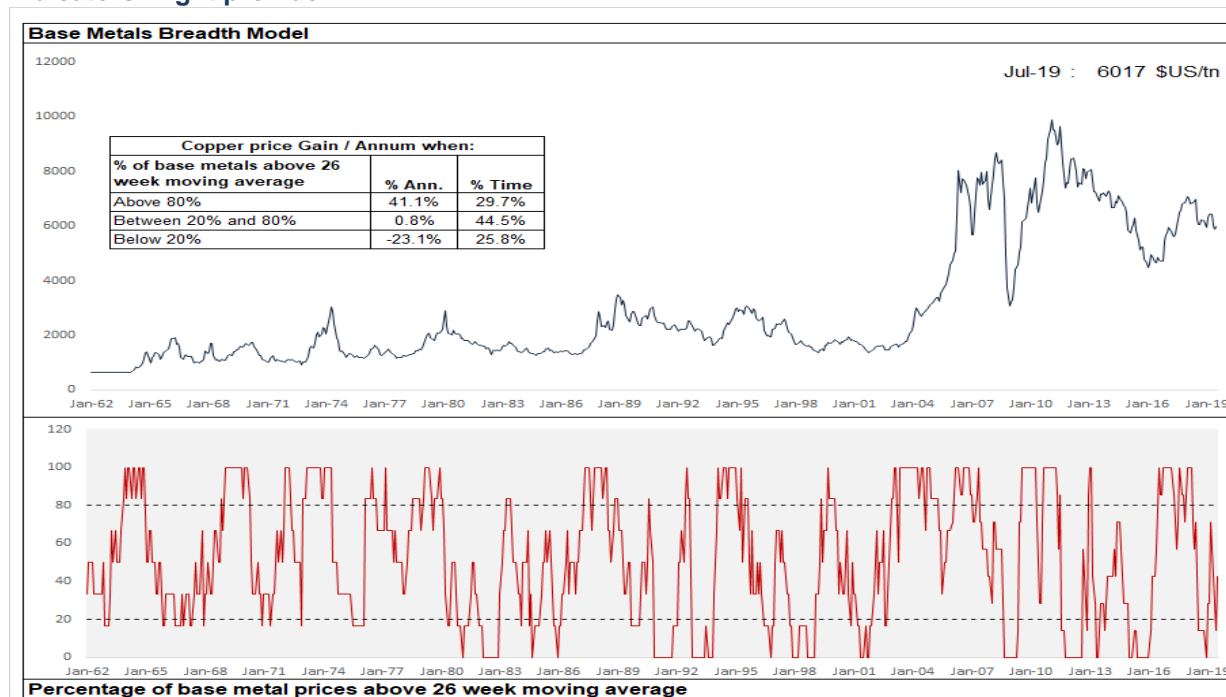
- We'd expect geopolitical risk to be supportive of higher oil prices. However, efforts to support further engagement between the US and Iran could see possible relaxation of sanctions on Tehran. This could result in Iranian crude supply hitting the market. As such, caution is warranted for the time being.

Base metals / precious metals ratio is leading the growth cycle lower



Source: World Bank, Fairmont Equities

Base metals breadth is poor and needs an improved growth outlook which troughing cycle indicators might provide



Source: World Bank, Fairmont Equities

COMMODITY OUTLOOK

Extension of business cycle is needed

- While OPEC has tightened supply by 1.2 million barrels a day in 2018, and is likely to maintain production restrictions into 2020, the US administration clearly wants lower oil prices heading into the US Presidential Election. Iranian supply would help achieve that.

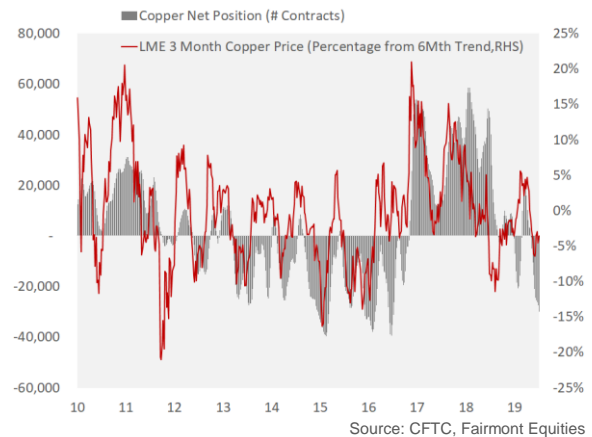
Like gold more than gold stocks

- For the past several years until recently gold prices have traded in a range bound by US\$1,150 on the downside and US\$1,400 on the upside.
- The stance of global central banks will be key, given they hold the most significant gold reserves globally. Russia's central bank has been actively buying gold over the past few years.
- Australian dollar gold is already at record highs and US dollar gold will likely reach new highs over the next year or two. Indeed, lower US real rates should support higher gold prices into 2020.

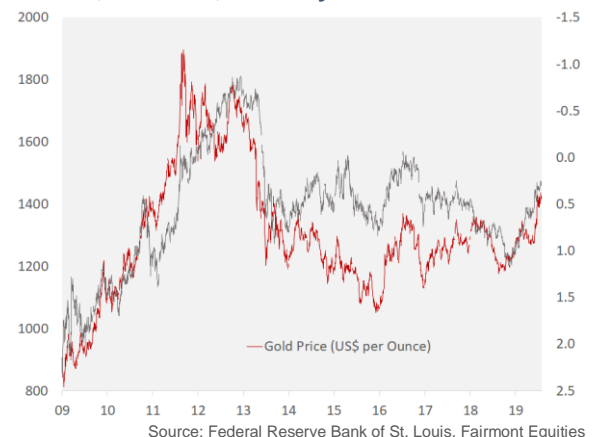
Global policy mix could support the US Dollar

- While the market is pricing multiple interest rate cuts from the Fed, other major central banks are likely to maintain very accommodative monetary policy.
- BoJ Governor Kuroda is committed to supporting the Japanese economy and will ease monetary policy as needed. In Europe, the ECB is likely to continue to drive rates lower. This could help maintain, or expand the US-Euro rate spread.
- Currently at around 150bps, the yield spread between the US and Europe remains attractive in favour of the US. Under this scenario, the A\$ gold price should continue to strengthen.
- A stronger US dollar would clearly be unsupportive of commodity prices. In this case we would favour gold over other commodities into 2020.

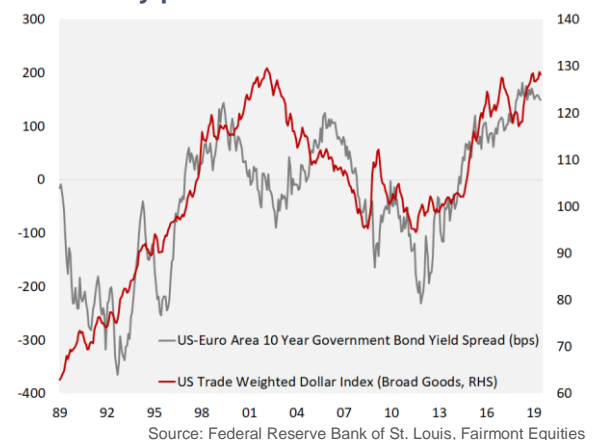
Base metals positioning is net short



Lower real interest rates will help gold rally further, to USD1,800/Troy ounce



US-Euro area yield spread could support the US dollar – potentially a negative for commodity prices



GLOBAL EQUITY MARKET OUTLOOK

US equities lead the way

Equities see rate cuts as positive

- Global equity markets are likely to continue to perform solidly as global rate cuts progress.
- Equity markets will interpret rate cuts as being the main driver towards stronger GDP growth and higher corporate profits. Rate cut cycles are simplistically interpreted by equity markets as being positive.
- Bond markets will normally question the severity of the growth shortfall central banks expect – that is, how bad do central banks believe the outlook really is? The second order considerations would then be whether the current outlook requires lower rates or are they likely to trigger an even worse outcome (albeit with a delay), and whether current rate cut projections will be enough to prevent a severe slowdown.

Performance aligned with rate cuts

- Global sectoral performances have been dominated by US equities. Cyclical tech, consumer cyclical, and industrial sector performances have been strong.
- The basic materials stocks have been weighed upon by global growth concerns and trade war fears, but prospects for relative outperformance should improve as rate cuts flow through and cycle indicators trough.
- European equities will begin to look more attractive relative to US equities given more supportive policy environment from the ECB we expect ahead.
- Japanese equities could also perform very well given their history of leading global relative strength rankings amid reflationary environments.

Market internals supportive

- Presently US equities are tracking in Phase 2 of our triple momentum model. This model takes the average of 5, 15, and 25-week momentum and breaks this up into four phases. Phase 1 is the strongest momentum reading over the three time frames. Phase 4 is the weakest.

Global Sector returns – Last 6 months (USD)

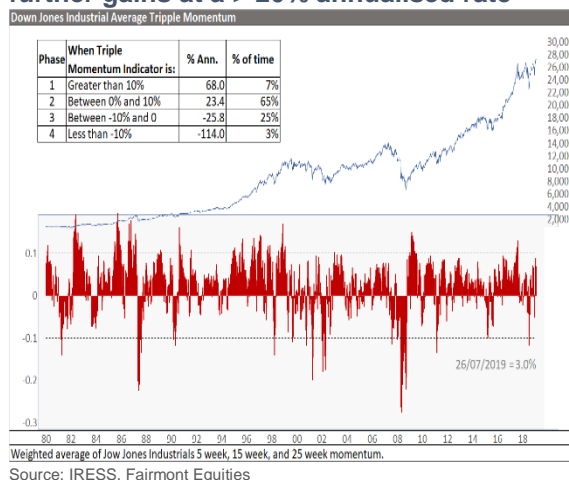
GLOBAL SECTOR	GLOBAL EX US	GLOBAL	US DIFF.
GLOBAL TITAN 50	15.2%		
BASIC MATERIALS	-0.4%	1.5%	1.9%
CONSUMER CYCLICAL	3.6%	10.1%	6.5%
WORLD HEALTHCARE	4.4%	2.3%	-2.1%
CONS. NON-CYCLICAL	5.7%	6.9%	1.2%
ENERGY	-1.7%	-2.3%	-0.5%
FINANCIAL	1.6%	5.9%	4.3%
INDUSTRIAL	5.7%	9.2%	3.5%
TECHNOLOGY	8.5%	16.4%	7.9%
UTILITIES	0.8%	4.8%	4.0%
WORLD TELECOMM'S	1.8%	4.0%	2.2%

Source: IRESS, Fairmont Equities

Japanese equities lead reflation – potential for a 1Q/2020 growth trough



Triple momentum model supportive of further gains at a > 20% annualised rate



GLOBAL EQUITY MARKET OUTLOOK

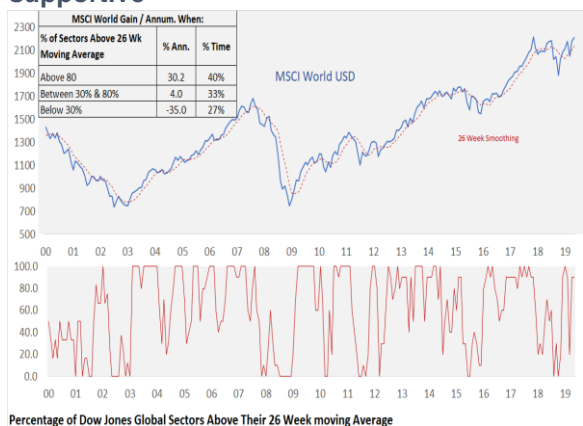
Market pricing cyclical trough in early 2020

- ❑ Over time, when US equities were tracking in phase 1, where momentum is the strongest, the annualised gains have been the highest.
- ❑ Phase 2 is still consistent with solid returns on a momentum basis, and the prospects for global coordinated easing, fiscal support, and troughing cyclical indicators reconcile well with the current momentum readings.
- ❑ Our global sector breadth model measures the proportion of sectors trading above their respective 26 week moving average as a breadth measure of trend. The more uniform sector performance is, the stronger the trend.
- ❑ Currently, this model is in Phase 1 where more than 80% of sectors are trading above their respective 26 week moving averages.
- ❑ The performance table within the chart shows the annualised returns associated with the 3 different phases of the model. Phase 1 currently is supportive of further market gains.

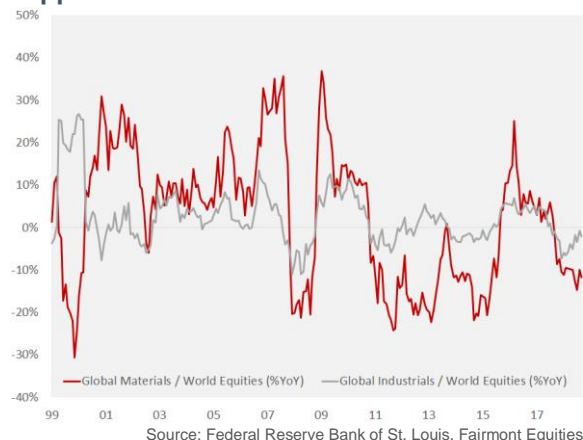
Cyclical sectors are pricing a stronger outlook

- ❑ While the basic materials sector has been impacted by the US-China trade war and growth concerns, on a 12-month rolling basis and when compared to global equities, global basic materials stocks appear to be troughing and look set to begin outperforming.
- ❑ Other cyclical sectors such as Industrials are highly correlated with global growth. US exports to China appear to have bottomed. Global industrials are outperforming global equities.
- ❑ Cyclical sectors appear to be pricing a trough in growth around 1Q/2020 but not a recession.

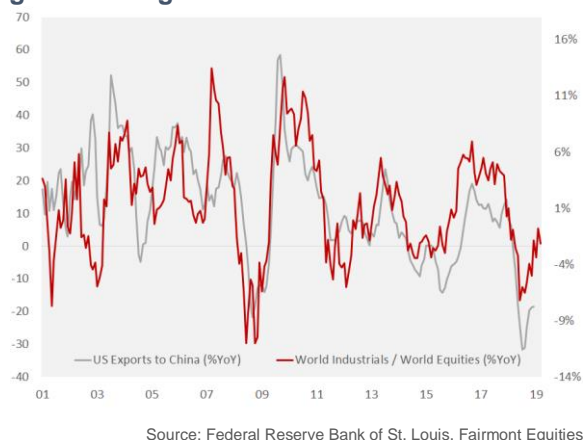
Global sector breadth model remains supportive



Global sector breadth model remains supportive



Global cyclical sectors are already pricing a growth trough



AUSTRALIAN EQUITY MARKET OUTLOOK

Rally continues

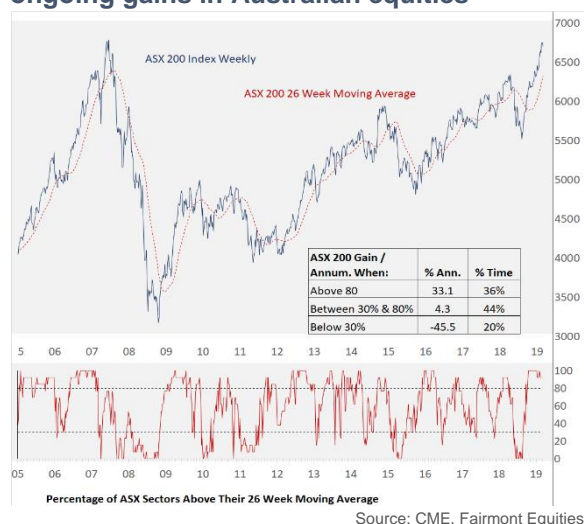
Volatility compression continues

- Similar to the global equity market, Australian equities expect lower rates to fuel further gains. Volatility has compressed absolutely, but also relative to bond volatility as we expected and wrote about in our June 2019 Quarterly Outlook, but is approaching lows, driving aggressive hedging activity.
- Australian equities are performing solidly when compared to world equities in US dollar terms. Historically, Australian equity performance relative to global equities correlates closely with basic materials sector relative performance. Australian equities appear to be moving earlier to price recovery.
- Market internals remain supportive of further upside as US rate cuts progress. Our sector breadth model shows more than 80% of sectors are trending well.

Sector performance

- Australian cyclicals have been weighed upon by global growth concerns and fears of a trade war. Energy has also been vulnerable to the prospects for lower oil prices. We'd avoid energy stocks given oil's inability to price risk escalation and the chance of a US-Iran deal on sanctions.

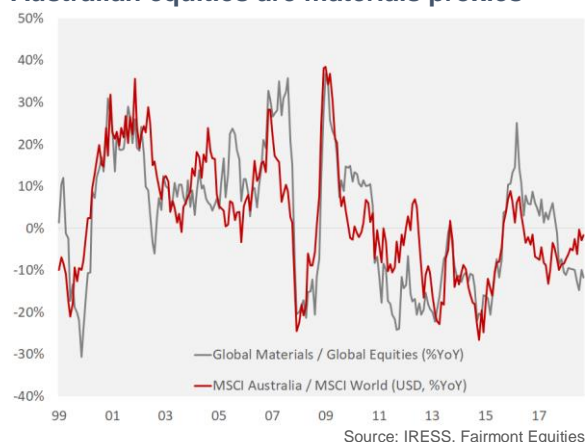
ASX sector breadth model consistent with ongoing gains in Australian equities



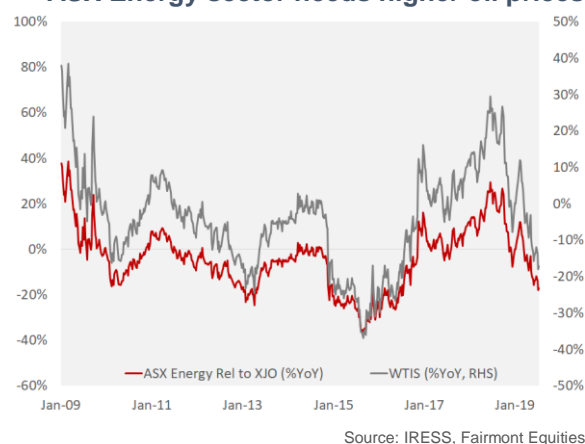
Volatility compression with the rally



Australian equities are materials proxies



ASX Energy sector needs higher oil prices



AUSTRALIAN EQUITY MARKET OUTLOOK

Reporting season could be a risk

Valuations are not stretched

- The rally has seen valuation multiples expand somewhat in Australia. Yet, when compared to prior cyclical peaks, valuations continue to appear reasonable and do allow for further upside during 2H/2019.
- Sector valuation dispersion has compressed to average levels. This suggests more attractive stock valuations are to be found at the stock specific level on a sector neutral basis. Being cautious of heavy commodity exposures at this time, we favour select opportunities to hunt for value in healthcare, infrastructure, and even some parts of IT.

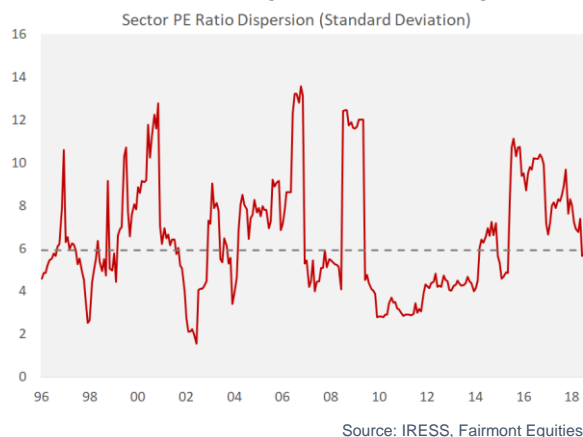
Selectively cautious ahead of reporting season

- Reporting season brings single-stock volatility risk. Already in 2019, we have seen numerous risk events on earnings related announcements. RMD, COH, MQG, TNE, IRI come to mind as a few examples of severe reactions.
- We believe stocks that outperform into results, are trading at premium valuations and have higher than market volatility are most at risk to adverse price reactions to results announcements.
- While not a guarantee, we would limit our holdings of stocks over result risk events to the high-quality core holdings we have in our Core Portfolio (see next page).

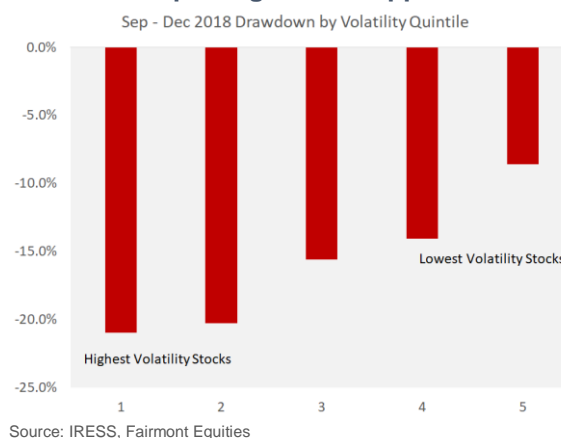
Valuations remain below cyclical extremes



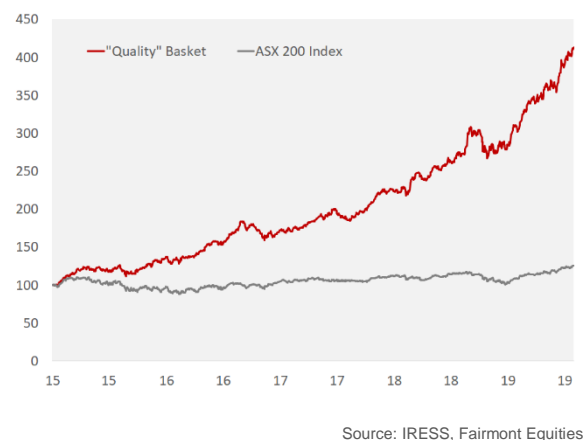
Sector valuation dispersion has compressed



High volatility stocks should be treated with caution as reporting season approaches



Limit risk exposure to core holdings during reporting season – they tend to do best over time



PORTFOLIO REVIEW

Core Portfolio

- From early February we began the process of building “core” exposures in a portfolio of companies we consider to be among the highest quality listed on the ASX.
- On July 2nd, 2019, we began publishing the Fairmont Equities Core Portfolio. The holdings are considered core longer term holdings that should form the backbone of equity portfolios.
- The broad selection criteria for the Core Portfolio include, but are not limited to:
 - Best in industry business. Dominant market share and high-quality product.
 - Highest franchise value – broad recognition of quality by public and customers.
 - High quality management.
 - High and consistent profitability ratios and margins.
 - Strong balance sheet and disciplined debt management.
 - Stable share price volatility profile to assist smooth portfolio equity curve over time.
- As a group, our recommended core holdings have outperformed the S&P/ASX 200 by a significant margin over the past several years, reflecting their high-quality attributes. The current core portfolio holdings are shown in the portfolio table summary below.

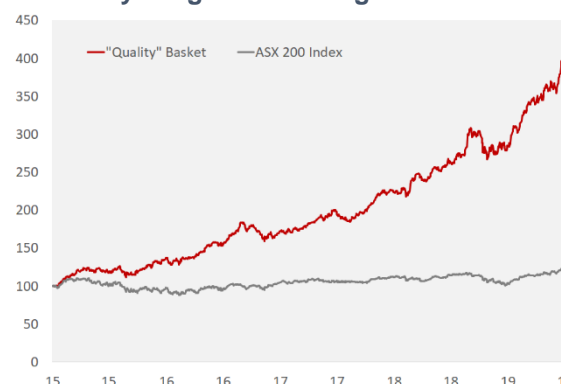
- This portfolio has returned 2.1% since July 2nd, 2019, or an annualised rate of about 26%. This is consistent with this groups historical record in the table below.

Core “Quality” stock basket performance since 2014

	CORE	ASX 200	REL PERF.
YTD	36.1%	17.2%	18.9%
2018	25.6%	-6.9%	32.5%
2017	30.1%	7.0%	23.0%
2016	29.6%	13.2%	16.4%
2015	39.2%	-2.1%	41.3%
2014	23.5%	1.1%	22.4%
	Average Outperformance		25.7%

Source: IRESS, Fairmont Equities

Core quality stocks have outperformed the market by a significant margin over time



Source: IRESS, Fairmont Equities

Core Portfolio – Initiated on 2 July 2019

CODE	NAME	SUB INDUSTRY	DATE ENTERED	ENTRY PRICE	RETURN (%)	POSITION (AUD)	PORTFOLIO WEIGHT
GMG	Goodman Group	Industrial REITS	2/07/2019	15.21	-2.0	97,968	12%
CIP	Centuria I REIT	Industrial REITS	2/07/2019	3.11	2.3	102,250	12%
RMD	ResMed Inc.	Health Care Equipment	2/07/2019	17.60	7.4	80,576	10%
COH	Cochlear Limited	Health Care Equipment	2/07/2019	212.17	6.0	79,407	9%
CSL	CSL Limited	Biotechnology	2/07/2019	218.44	5.2	78,797	9%
MQG	Macquarie Group	Diversified Capital Markets	2/07/2019	127.95	0.6	50,345	6%
TNE	Technology One	Application Software	2/07/2019	8.30	-6.2	70,345	8%
CWY	Cleanaway Waste	Environmental & Facilities	2/07/2019	2.37	3.6	103,586	12%
PME	Pro Medicus	Health Care Technology	11/07/2019	28.71	7.8	83,437	10%
ALU	Altium Limited	Application Software	11/07/2019	36.56	2.3	90,782	11%
	Initial Investment	1,000,000		Current Holdings		837,048	100%
	Cash Available	184,049		Total Capital		1,021,097	
				Return		2.1%	

Source: IRESS, Fairmont Equities

MONTHLY INVESTMENT OUTLOOK

MAIN

RECOMMENDATIONS

- **Maintain equity market exposure as policy easing begins**
- **Focus on Core and Trading portfolios**
- **Use reporting season to raise core holding exposures while lightening stock holding with unreasonable expectations**
- **Maintain a sector neutral strategy with the exception of commodities until prospects for cycle extension become explicit**
- **Maintain select gold exposure while global real rates compress**
- **Fade the consensus – use the expectation of recession to find stocks whose share price trends are independent of the cycle**

□ **Maintain Exposure as policy easing begins.** Policy easing phases of the business cycle are initially supportive of risk assets. Maintain equity exposure as rate cutting progresses.

□ **Focus on core and trading portfolios.** While policy easing should support risk assets initially, the economic impact of easing will only become apparent looking into 2020. As such, we advocate isolating high quality, core holdings from trading positions. Core holdings should align with our Core Portfolio of high quality businesses outlined on the previous page to include some combination of healthcare (COH, CSL, RMD, PME), property (GMG and CIP), select industrials (CWY), IT (TNE & ALU), and select financials (MQG).

Trading positions should be managed in a disciplined manner using trailing exits to avoid periods of excessive volatility typically associated with market weakness. As the impact of easing filters through to economic data, trading opportunities will arise.

□ **Use reporting season to raise core holdings while trading other holdings.** Reporting season brings with it stock specific risk in stocks that disappoint expectations. Stocks that outperform into results, are trading at premium valuations and have higher than market volatility are most at risk to adverse price reactions to results announcements. We

recommend lightening non-core holdings prior to results if expectations appear unreasonable.

□ **Maintain a sector neutral strategy with the exception of commodities.** Cycle risk remains until we have explicit evidence of recovery and the efficacy of easing. We'd remain cautious on commodity exposures given the dependency on economic growth for now. Elsewhere, a sector neutral approach is warranted.

Focusing on high return generators with businesses that are somewhat insulated from the business cycle. Trading opportunities on strong technical profiles in these areas would be a focus for trading positions.

□ **Maintain select gold exposure while global real rates compress.** Pure gold exposure is preferred given the absence of stock-specific risk associate with production reports and results. Otherwise, focus on leading gold names such as NCM.

□ **Fade the consensus.** Currently recession appears to be a widely held view. We would look for evidence to the contrary to isolate aggressive trades in areas not obvious to the consensus at this time. Being patient for evidence will be key.

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