# Quarterly Commentary as at 30 June 2018

MelvilleDouglas
A Member of Standard Bank Group

# Melville Douglas

## Income Fund Ltd - GBP Class

### Fund Review

The objective of the Class Fund is to provide a return in excess of its benchmark in Sterling, whilst seeking to maintain a high degree of capital preservation, by investing primarily in quality global fixed interest securities, and, where in the opinion of the Investment Manager, direct investment in fixed interest securities will not achieve sufficient diversification to achieve the Class Fund's objective, in other collective schemes, money market instruments and cash that will maximise total returns in Sterling. The Fund's performance for the period was 0.71% versus the Fund's benchmark return of 0.39%.

### Market Overview

Global bond markets continue to be buffeted by trade tensions and whilst the final outcomes and subsequent net effect on growth conditions remain uncertain, the immediate negative impact on sentiment has been enough to keep a lid on the yield normalisation process in the quarter. In addition, questions about the sustainability of the global growth path continue to be asked given its long tenure and recent soft patch. However, we remain constructive as global Purchasing Manager Indices (PMI's) are consistent with a global growth rate of 3% this year and if anything, a natural softening in the data reduces the near term risk of overheating, allowing the long-held goldilocks recovery to live on – not too hot, not too cold.

Most Central Banks remain keen to press on with withdrawing the massive stimulus measures enacted since the Credit Crisis, the challenge is for this to be achieved at a pace that does not derail growth. It is worth remembering that monetary conditions, even after seven interest rate hikes in the US, remain extremely accommodative by historical measures. The length of the economic expansion in the US is within a whisker of an all-time record and for that reason alone, some will be tempted to pre-emptively throw in the 'risk' towel and allocate to medium to long-dated government yields at current levels. For us, many measures still suggest it is too early to adopt that strategy as ten-year UK yields at 1.28%, or more alarmingly, ten-year German yields at 0.30%, remain unfavourable from a risk/reward perspective.

### Looking Ahead

In contrast to the healthy employment market, economic conditions in the UK are now firmly below trend and point to a very subdued interest rate normalisation process. An increased three members of the Monetary Policy Committee (MPC) recently voted in favour of a hike and whilst this raises the possibility of a tightening in August, we see little merit in such action whilst the economy continues to struggle under the weight of numerous BREXIT uncertainties and lacklustre growth. Despite our sanguine outlook for the UK, we are mindful of the strong correlation between developed government bond markets and our ongoing expectations for higher yields in both the US and Eurozone are sufficient for us to err on the side of caution and maintain a defensive duration strategy within the Fund.

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Within the Fund, we still consider it prudent to maintain a moderate level of foreign currency exposure. Sterling's decent gains up to mid-April quickly evaporated as it became clear that the almost fully discounted base rate hike in May wasn't going to happen. For much of the quarter, a blend of weaker than expected domestic economic data and broad based rally in the US Dollar have combined to weigh on the currency. Looking ahead, it is hard to argue against the theory that much of the bad news is priced in but the BREXIT countdown remains a very real potential source of two-way volatility and on that front we have long held the view that the UK does not have the upper hand in the negotiations.

The Fund's strategy remains one of limiting potential downside risk in an environment where we expect yields to continue to rise in the coming quarters. Ongoing global growth, less accommodative central bank policies and increased inflationary pressures should ensure that global government bond yields continue to normalise. Our intention is to gradually increase the duration of the Fund at more attractive yield levels as this process unfolds.

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