Quarterly Commentary as at 30 September 2018

MelvilleDouglas
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Melville Douglas

Income Fund Ltd - USD Class

Fund Review

The objective of the Class Fund is to provide a return in excess of its benchmark in US Dollars, 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 US Dollars.

The Fund's performance for the period was -0.14% versus the Fund's benchmark return of +0.09%.

Market Overview

Global economic growth may be less synchronised than in 2017 but in aggregate remains strong. The US economy continues to comfortably lead the pack, aided by the fiscal boost and a robust employment market. A stronger US Dollar and tighter liquidity, coupled with ongoing trade tensions have racked up some casualties – specifically emerging markets and to a lesser extent the Eurozone which is heavily export-reliant. However, whilst economic growth in the Eurozone has decelerated, overall conditions remain healthy, and sufficiently so for the European Central Bank (ECB) to halt quantitative easing at the end of the year with the view to start raising interest rates at some stage in 2019. The Bank of England raised rates by a quarter point to 0.75% in the summer, however, we don't think economic conditions warrant another hike until well into 2019, particularly as the twists and turns of BREXIT continue to dampen sentiment. Ultimately, most major global central banks continue to step away from the ultra-easy monetary policies of the 'post-crisis' years, albeit at varying degrees. As monetary policies normalise, so should bond markets and whilst yields have already started to rise, particularly in the US, we still believe they remain too low – we remain cautious.

Looking Ahead

Economic growth in the US remains above trend and many indicators suggest the economic expansion, whilst mature, still has room to run. Second quarter Gross Domestic Product at 4.2% can only be described as robust and although the pace will moderate in the third and fourth quarters, we still expect full year growth in the region of 3%. Inflation at target and a strong employment market, notably with wage increases now at levels last seen at the end of the recession in 2009, have proved sufficient enough for the US Federal Reserve to maintain their tightening cycle. Interest rates were raised for a third time this year in late September to 2.25% and we concur with 12 of the 16 Fed officials who expect another hike in December. Geo-political noise, trade war spats and weakness in emerging markets were enough to keep a ceiling on US government bond yields for much of the quarter, however, ten-year yields breached 3% again in September and we expect further normalisation in the coming months. Given our ongoing bearish outlook for the fixed income market and with almost no extra yield compensation for assuming more duration risk, our only conclusion can be to keep the Fund defensively positioned for now.

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The Fund remains overweight US Dollars with a 100% weighting. Whilst the currency has traded sideways for the period under review, it remains approximately 2.5% higher year-to-date in broad value terms. Favourable growth, interest rate and yield differentials continue to provide support for the currency although the longer term negative ramifications of President Trump's tax cuts and fiscal spending plans cannot be ignored. Over the short term, the uncertain outcome of ongoing trade war negotiations should continue to lend support to the US Dollar which appears to have regained its safe haven status. In addition, as the Federal Reserve push on with their interest rate hikes at a quarterly pace, Sterling and the Euro remain very far down the list for those seeking positive risk free rates of return.

The Fund's strategy remains committed to limiting downside in an environment where we forecast further yield normalisation. The duration strategy remains appropriately defensive but we are mindful that US government bond yields have been rising since mid-2016 and may soon be approaching levels that look attractive from a long term perspective. Our intention remains to gradually increase the maturity profile of the Fund as yields rise towards more attractive levels.