Quarterly Commentary as at 30 September 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 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

As widely anticipated, the Bank of England raised interest rates by 0.25% to 0.75% in August, but we believe that savers waiting for the next tightening will have to be patient, potentially well into 2019. More recently, some UK economic indicators have beaten expectations but overall growth conditions remain sanguine, particularly when compared to peers. Inflation has ticked marginally higher in the quarter, remaining heavily influenced by the direction of Sterling, which has fallen sharply against the US Dollar and Euro since mid-April. The BREXIT news flow is both relentless and unpredictable and therefore acting as a barrier to new investment – at least until a definitive outcome can be pinpointed. Despite this uncertainty, ten-year UK government bond yields have risen sharply in the quarter but we put this down to two key factors. Firstly, the market had discounted perhaps too much negative news when the yield dipped to 1.18% in July. Secondly, although at different levels, UK bond yields remain correlated to the direction of US government bond yields and when the tide rises in that market, it is powerful enough to take others with it.

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Whilst the Fund remains biased to base currency, we still consider it prudent to maintain an element of foreign currency exposure. Unsurprisingly, August's 0.25% hike in interest rates had minimal positive impact on Sterling as the future pace of tightening remains very uncertain. In fact, excluding inflation, many other key economic indicators are not suggestive of higher interest rates and 'real' inflation adjusted rates are likely to stay deeply negative for the foreseeable future. As mentioned above, BREXIT remains a constant source of uncertainty and we see little merit in attempting to second guess the myriad of possible outcomes.

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 UK 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.

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