Melville Douglas

Income Fund Ltd - USD Class

Quarterly Commentary

The economic backdrop of heightened inflationary concerns, ongoing synchronised growth in the global economy and less accommodative central bank policies continues to weigh on sentiment in the fixed income markets and unsurprisingly, most government bond yields have risen materially in the quarter. The US Federal Reserve remain committed to their withdrawal from ultra-easy monetary policies, sanctioning another 25 basis point rise in rates in March and expectations are for another two to three hikes before year-end. US inflation has yet to reach target but numerous underlying factors, most importantly the ongoing strength in the employment market, continue to point to higher prices in the coming months. Indeed, the US index-linked market, where the Fund retains its overweight allocation, has outperformed on a relative basis in the quarter.

Even allowing for the recent spike in yields, many technical indicators continue to suggest that US yields remain too low by historical metrics. Most notably, the current 'real return' on the ten-year US government bond remains far removed from historical averages and implies more upward pressure on yields over the medium term. With the Federal Reserve set to accelerate the pace of its balance sheet wind down to $50 billion per month by the fourth quarter at the same time as deficits, and therefore government borrowing, are increasing thanks to fiscal stimulus and tax breaks, we believe the Fund's ongoing defensive duration strategy is justified in the current environment.

Despite many supportive factors, the US Dollar has failed to make any gains in the quarter although following declines in January, it has remained in a relatively narrow trading range. Favourable, and rising, interest rate differentials have lent little support as the market continues to put more weight on the negative long term ramifications of rising deficits and the US administration's attitude towards protectionist policies. However, it would be remiss to rule out another short-lived bounce in the US Dollar just yet – the interest rate and yield pick up against peers is still considerable and the possibility remains that the Federal Reserve may tighten policy more than expected in the coming quarters. In addition, net short US Dollar positions in the market have risen to a near seven-year high which can often suggest a contrarian rebound in the currency. For now, the US Dollar remains range bound and until it breaks that cycle we are content to remain with the Fund's 100% allocation.

Overall, 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 synchronised global growth, less accommodative central bank policies and increased inflationary pressures should ensure that global government bond yields continue to normalise. We aim to continue to gradually increase the duration of the Fund at more attractive yield levels as this process unfolds.

This leaves something of a dilemma for currency investing, namely, is it wise to abandon US Dollar bond yields of circa 2% plus to allocate to Euros or Yen where yields and cash rates are more than often negative. Put simply, lack of, or indeed negative 'carry' in these currencies dictates that conviction levels, if allocating, need to be extremely high. We cannot argue that over the long haul, the prospects for the Euro are looking healthier but markets have a habit of front-loading good news and 2017's rapid appreciation may have just taken the Euro far enough for now. We may take advantage of any short term retracement in the Euro to begin building an allocation but for now, the Fund remains 100% invested in the US Dollar.

Overall, the strategy remains one of limiting downside risk in an environment where we continue to forecast higher yields in the coming quarters. Global synchronised growth patterns and less accommodative central bank policies should ensure that global government bond yields continue to normalise. We aim to continue to gradually increase the duration of the fund at more attractive yield levels as this process unfolds.

Melville Douglas
Melville Douglas Investment Management (Pty) Ltd is a subsidiary of Standard Bank Group Limited.
Melville Douglas Investment Management (Pty) Ltd (Reg. No. 1962/000738/06) is an Authorised Financial Services Provider. (FSP number 595)

Disclaimer
This summary brochure has been prepared for information purposes only and is not an offer (or solicitation of an offer) to buy or sell the product.

This document and the information in it may not be reproduced in whole or in part for any purpose without the express consent of Melville Douglas.

All information in this document is subject to change after publication without notice. While every care has been taken in preparing this document, no representation, warranty or undertaking, express or implied, is given and no responsibility or liability is accepted by Melville Douglas as to the accuracy or completeness of the information or representations in this document. Melville Douglas is not liable for any claims, liability, damages (whether direct or indirect, actual or consequential), loss, penalty, expense or cost of any nature, which you may incur as a result of your entering into any proposed transaction/s or acting on any information set out in this document.

Some transactions described in this document may give rise to substantial risk and are not suitable for all investors and may not be suitable in jurisdictions outside the Republic of South Africa. You should contact Melville Douglas before acting on any information in this document, as Melville Douglas makes no representation or warranty about the suitability of a product for a particular client or circumstance. You should take particular care to consider the implications of entering into any transaction, including tax implications, either on your own or with the assistance of an investment professional and should consider having a financial needs analysis done to assess the appropriateness of the product, investment or structure to your particular circumstances. Past performance is not an indicator of future performance.