MELVILLE DOUGLAS

Quarterly Commentary

Minimum Disclosure Document as at 31 March 2017

Melville Douglas
High Alpha Fund

The March quarter will have left most SA investors both shaken and stirred. The JSE delivered a reasonable return overall, led by industrials, but lagged global and emerging markets. The market surged in January, almost matching all-time highs, pushed by a favorable global backdrop, a better domestic outlook, and a diminishing risk of a credit rating downgrade. A fiscally credible but growth-dampening budget in February took some of the gloss off, as increased tax rates and fiscal drag took money away from households to fund existing government spending. The political environment also deteriorated, and at the end of the quarter the president replaced a large proportion of his cabinet, including firing the minister and deputy minister of finance. Rating agencies responded swiftly: just four days later, after the quarter ended, Standard and Poor's downgraded SA's foreign denominated government debt to sub-investment grade. Later in the same week, Fitch downgraded both the rand-denominated debt and the foreign debt to sub-investment grade. Moody's also announced a review, and a downgrade is likely, though this would leave the Moody's ratings still at investment-grade. The consequences of the downgrades will take some time to materialize, though the market impact had already been well priced in: pretty much since December 2015, when the president first fired a finance minister, SA's foreign debt was priced as if the downgrade had already taken place. Since the payment of interest is now the largest single budget item, and newly issued debt will all carry the higher interest rates involved, the fiscal position is weaker than before, and the budget targets will thus me more difficult to achieve. The new finance minister has committed to sticking to the fiscal plan, but may find it hard to achieve; and the downgrades are not only about the fiscal numbers but about the governance of government expenditure. The mooted nuclear power plan, considered by most as completely unaffordable, and thus pushed into the distant future by the previous minister, has now emerged as a more imminent issue and will require firm control of Eskom, the power utility, and at Treasury. Funding it will be a major undertaking and would certainly require additional government guarantees.

Fortunately for the economy at large, the global backdrop is about as favourable as it can be: the world is now entering a more synchronised growth phase, and notably in Europe the upswing is leading the monetary authorities to guide market expectations towards reduced monetary accommodation. In the US the debate is no longer about whether interest rates will rise, but by how much and how fast; in the US and the UK the inflation cycle is well under way. There are both geopolitical threats and domestic issues in Europe that pose risks to a smooth path, but equity markets are supported by policy and a rising earnings cycle, even though they appear highly priced by historical standards. The political scene in SA might not stabilise at least until the ANC's elective conference later in the year; so investors need to be cautious but also alert to the fact that there are counteracting forces for the economy and opportunities are likely to emerge. The downgrade is now a fact, but markets are forward looking.

The fund returned 1.8% against the benchmark of 3.0% for the quarter. Positive contributions in the fund over the period came from Hudaco, British American Tobacco, Richemont, Naspers and Santam. The healthcare and technology exposure continues to weigh on the portfolio returns. The fund remains defensively positioned and holds counters that we believed that can produce economic returns through a cycle.

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