Melville Douglas Balanced Fund Ltd - Balanced Class

Minimum Disclosure Document as at 31 December 2016

Quarterly Commentary

British Prime Minister Harold Macmillan was once asked what the most difficult aspect of his job is. "Events, dear boy, events" was his now famous reply. As with the year, the quarter was not short of geopolitical events.

A late run in equities following the outcome of the US presidential election in November - the "Trump rally" – meant many markets recorded reasonable returns for the year. The same, unfortunately did not hold true for Fixed Income investors as bonds sold off aggressively in anticipation of an improved growth outlook coupled with higher levels of expected inflation.

The fund outperformed its benchmark during the period, but this was largely attributable to the outperformance from the fixed income component in the portfolio where an underweight duration and overweight position to the US dollar paid handsome dividends. The equity component lagged the world index due to its more defensive (e.g. low weight to resources) and higher quality (e.g. no European Banks) skew. Cyclical Value strategies outperformed defensive strategies very significantly during the year.

The themes that characterized 2016 were not consistent: on the one hand "deglobalisation" and falling bond yields, and on the other rising commodity prices and reflation. Commodity prices bottomed out in January and then rose strongly, suggesting a cyclical recovery, but bond yields continued to decline, responding to weak growth signals, monetary accommodation and safe-haven demand. The year began with Japan announcing it would implement a negative policy rate, and the Japanese 10-year yield dipped below zero as a result. More unexpected was the response of the yen, which strengthened substantially against the US dollar, exactly the opposite of what was intended. The declining-yield phenomenon was eventually enough to push German 10-year bond yields into negative territory as well; and the final straw was Brexit.

The US will need to adjust short term interest rates to reflect the reality of a higher inflation rate and fuller employment; the impact of the Trump administration's growth policies could exaggerate the tension. The impact of higher US interest rates on other regions will also be an issue, unless growth accelerates to higher levels. More supportively, the global earnings cycle appears to have turned positive and should provide a stronger underpin. Bond yields are likely to rise further as growth and inflation push on. Europe in particular will remain a potential source of politically-generated volatility as the year goes on, since there are a number of upcoming elections (Germany, France, Netherlands) which may produce disruptive changes.

Political issues remain a potentially disruptive overlay and policy implementation will need to be properly executed. Investors will need to remain diversified and cautious, but at this point can be hopeful of a better, if not less volatile, year.