Quarterly Commentary as at 31 December 2017

Melville Douglas

Income Fund Ltd — GBP Class

Quarterly Commentary

Ten-year UK Gilt yields have trended lower in the quarter and end the year approximately 5 basis points down. The 0.25% hike in interest rates in November has done little to unnerve a market which remains firmly in the grip of BREXIT news flow be it good, bad or indifferent and was viewed merely as a reversal of last year's emergency rate cut. The market has begun to see past the current elevated level of inflation, expecting it to gradually drift lower as the painful decline of Sterling post the BREXIT Referendum outcome continues to impart less influence. Accordingly, we have sold the Fund's exposure to the UK inflation-linked market.

Economically, the UK is holding up better than many had expected but current GDP of circa 1.7% puts it firmly behind its peer group and with inflation eating into wages and savings, the outlook for consumer spending is tentative at best, unless borrowing accelerates further which never ends well. Monetary policy in the UK remains accommodative and frankly needs to be given the unpalatable trade negotiations ahead which have the propensity to seriously slow investment unless a friendly deal can be reached. Market implied rates suggest another 0.25% rate hike in 2018 but for now we have our doubts and even if wrong, monetary tightening will proceed at a snail's pace. Despite this, the Fund remains defensively positioned on the belief that UK government bond yields will not be immune to rising yields in global bond markets, predominantly in the US and Eurozone.

The Fund remains overweight investment grade credit relative to UK government debt. At current levels, credit spreads have limited upside, yet with yields still extremely low by historical standards, the additional yield over and above government bond yields remains attractive.

We remain cautious on Sterling over the medium term and expect increased volatility as trade negotiations with the EU twist and turn. Sterling's post-BREXIT decline in 2016 undoubtedly priced in much of the uncertainty but deeply negative real returns, an elevated current account deficit together with an economy trailing peers are not a perfect recipe for a sustained period of strength.

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.

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