Quarterly Commentary as at 30 September 2017

MelvilleDouglas
A Member of Standard Bank Group

Melville Douglas

Income Fund Ltd — GBP Class

Quarterly Commentary

Following a sharp spike in September, UK bond yields ended the quarter moderately higher. Despite upcoming BREXIT uncertainties, elevated inflation has prompted a more hawkish stance from the Bank of England and a 0.25% hike in interest rates is now expected in the fourth quarter. We doubt this marks the beginning of a sustained tightening cycle, rather, little more than a reversal of the cut sanctioned in August last year. Barring a collapse in Sterling, we believe inflation is approaching a ceiling level and have sold the Fund's exposure to the index-linked market.

The ongoing squeeze in 'real' earnings remains a significant hurdle for the UK economy and higher borrowing costs amid climbing household credit will do little to appease the recent dip in consumer confidence. The Fund's defensive strategy remains in situ but is driven predominantly by the belief that higher yields in the US and Eurozone will impart their influence on the Sterling bond market.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.

The Bank of England's recently broadcast hawkish tilt helped Sterling rally significantly in September and on a trade-weighted basis it is now slightly higher on the year, although remaining decisively below its pre-BREXIT levels. Deeply negative 'real returns' are an ongoing fact of life for Sterling depositors and we see little reprieve from this headwind in the quarters ahead even if, as we expect, inflation moderates somewhat. Sterling has benefited from weakness in the US Dollar this year as much as domestic factors, but we think at current levels has sufficiently factored in all, if not too much, of the limited positive news available. The Fund continues to hold US Dollars as a safeguard against anticipated weakness and we have recently introduced a Euro weighting, a position which may increase in the period ahead.

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.