Melville Douglas

Income Fund Ltd - USD Class

Quarterly Commentary

Duration positioning within the Fund remains defensive as we continue to expect higher government bond yields in the months ahead. Ten-year US treasury yields ended the year almost exactly where they started which is somewhat at odds with the solid economic backdrop and ongoing tighter monetary response from the Federal Reserve. The major theme of 2017 has been the significant flattening of the yield curve which historically has heralded the onset of an economic slowdown, and on the last seven occasions, a recession. However, this time, we think it remains too early to jump to these conclusions. Rising short-term yields are merely a response to the hikes in interest rates and the fact that longer-dated yields have not responded in a similar fashion can be explained by a number of factors. Most important amongst these is the current low level of inflation, which when combined with ongoing global demand for yield and low volatility has been more than sufficient to eradicate the term premium investors usually demand for holding more volatile longer-dated debt. The lack of inflation remains a conundrum, not least for the Federal Reserve whose best explanation remains to describe it as 'transitory' given its defiance of tested economic models such as the Phillips Curve (i.e. the relationship between falling unemployment and price growth). Without doubt, debt deleveraging, demographics, globalisation, technology 'et al' have played their part in subduing inflation but the ongoing strength of the economy and employment market continue to indicate higher inflation ahead – it will just take a while longer this time around. In anticipation of this outcome, the Fund remains overweight the index-linked market via a short-dated US Treasury issue.

Whilst virtually unchanged this year, ten-year yields remain some 1% higher than their recent lows seen in the third quarter of 2016. For the year ahead we expect this normalisation (higher yields) to continue, albeit in an ongoing sporadic fashion. The Federal Reserve appear committed to their tightening cycle and expectations are for three more 0.25% hikes in the year ahead. If the Fed sticks to its 'dot plot' then ten-year yields should move towards 3% in the coming quarters, hence our reticence to abandon our defensive strategy. The now agreed tax cuts should provide a short term boon for the economy and importantly, this will also translate into the need for much higher US Treasury sales in the year ahead at the same time as the Fed's balance sheet unwind gathers pace, both of which should lift yields. Taking a global perspective, economies around the world are finally experiencing synchronised growth and central banks are responding by moving away from the ultra-easy monetary policies that have supported bond markets since the global financial crisis that started a decade ago.

The Fund remains overweight investment grade credit relative to US government debt. At current levels, credit spreads have limited upside, yet with yields still low by historical standards, the additional yield over and above government bond yields remains attractive. Favourable interest rate and growth differentials failed to stem the decline in the US Dollar in 2017, particularly against the Euro which proved to be the stand-out currency of the year. Bull runs in the US Dollar, based on historical metrics, typically last around six years and given its ascent since 2011 it appears the market did not wish to test this trend. The US economy remains on a firm footing and further rate hikes in 2018 will add to the already wide and positive interest rate and yield differentials versus the Euro, Yen and Sterling. Under normal market conditions this should lend support to the US Dollar but given the extent of gains in the rear view mirror it is hard to argue against the fact that much has already been priced in.

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.