Melville Douglas

Global Balanced Fund Ltd

Quarterly Commentary

The fund's performance during the year was especially pleasing giving the strong return from global equity markets where returns in 2017 were high, buoyed by a combination of earnings growth and an increasing confidence that interest rates would not rise disruptively. The MSCI All-country World index returned almost 25%; calendar year returns have been higher on only three other occasions in the past thirty years, and two of those were years in which markets were starting from recession-hit bases (2003 and 2009). A large part of the return was attributable to expanding ratings: earnings growth surprised positively but benign inflation and central bank policy encouraged higher multiples.

The surprise of 2017 was that across the developed world, inflation remained subdued except in the UK. In particular, US inflation rates continue to track at post-crisis lows, even though a number of inflation drivers such as the labour market and the dollar were no longer the benign influences they had previously been. This allowed long bond yields to remain practically unchanged over the year, in spite of a few wobbles. But this is not to say that market interest rates didn't respond to more buoyant economic conditions, and short-term interest rates rose quite sharply. This will eventually have consequences for credit creation and provide a brake for excess demand, but for now the picture remains very benign. So what are the challenges for 2018?

The "exit path" from the complications of the financial crisis has by now become well-worn. The US has now moved into a very normal-looking late phase of the business cycle with low unemployment and above-trend growth. Of course, the aftermath of the crisis is felt still in high government debt and low inflation. But the normalization has finally created sufficient pull to allow the rest of the developed world (with aggressive monetary assistance) to follow on. Earnings growth remains on track to remain strong in 2018, but whether it can surprise is another question.

US tax adjustments may help internally, but the unintended consequences of the tax cuts have not been assessed. Almost certainly, the US budget deficit will expand, perhaps to 5% of GDP. That's a level of deficit funding that would normally be associated only with an attempt to mitigate the impact of a recession. How sensible is it to create a massive corporate tax cut at the peak of the earnings cycle, funded by government borrowing at a point where its debt burden is already the highest in history? The answer is that there is no justification, either in logic or fairness, and there is a bill that will have to be paid. Where that stress will fall is as yet unclear, and it is possible that only the next downturn will reveal what the side-effects will be. In the short run, however, the impact on equity markets will be largely favourable – though obviously more beneficial to some companies than to others.

But it may also be a source of disruption. Interest rate markets may be priced very complacently: they have behaved as if there is an endless source of nearly-free liquidity, with no inflationary consequences. Boosting deficits while the unemployment rate is so low is somewhat experimental, and interest rate markets will be more than sensitive to inflation rates and Federal Reserve policy. If there are inflationary consequences, the Fed can end up in a tangle because it will be behind the curve: in order to temper inflationary expectations it will need to ensure rising real interest rates, and as the inflation rate reaches or moves above target, interest rate increases will have to move faster. Rising real interest rates will be a genuine test for equity markets.

While global growth remains as high as it is, there is also a risk that some kind of commodity price shock could be disruptive. Typically this would be the oil price, which is embedded deeply in so many production and distribution costs. There is no sign of such a thing as yet, and up to now the supply balance has kept dollar prices in check. But it would be remiss not to note that a range of industrial commodity price rose quite sharply in 2017, and the residual impact of that on corporate costs and margins has yet to be seen.

Quarterly Commentary as at 31 December 2017

MelvilleDouglas
A Member of Standard Bank Group

Outlook

This may well prove the year in which the post-crisis monetary experiment is tested for robustness. The idea that central banks will have to adjust to a more proactive policy-setting mode has been clear for some time, but equity markets are now starting from a much higher rating level and resilience will therefore be much lower. As real interest rates start to rise across the globe, the pressure on market prices will rise, and so very likely will volatility and dispersion. The potential for disruptive price change is higher than it has been and the ability to recover from disruption is lower. Diversification is the answer: stretched valuations, whatever the apparent justification, are not likely to hold. As always, we will navigate the valuation waters with care and diligence.

Melville Douglas
Melville Douglas Investment Management (Pty) Ltd is a subsidiary of Standard Bank Group Limited.
Melville Douglas Investment Management (Pty) Ltd (Reg. No. 1962/000738/06) is an Authorised Financial Services Provider. (FSP number 595)

Disclaimer
This summary brochure has been prepared for information purposes only and is not an offer (or solicitation of an offer) to buy or sell the product.

This document and the information in it may not be reproduced in whole or in part for any purpose without the express consent of Melville Douglas.

All information in this document is subject to change after publication without notice. While every care has been taken in preparing this document, no representation, warranty or undertaking, express or implied, is given and no responsibility or liability is accepted by Melville Douglas as to the accuracy or completeness of the information or representations in this document. Melville Douglas is not liable for any claims, liability, damages (whether direct or indirect, actual or consequential), loss, penalty, expense or cost of any nature, which you may incur as a result of your entering into any proposed transaction/s or acting on any information set out in this document.

Some transactions described in this document may give rise to substantial risk and are not suitable for all investors and may not be suitable in jurisdictions outside the Republic of South Africa. You should contact Melville Douglas before acting on any information in this document, as Melville Douglas makes no representation or warranty about the suitability of a product for a particular client or circumstance. You should take particular care to consider the implications of entering into any transaction, including tax implications, either on your own or with the assistance of an investment professional and should consider having a financial needs analysis done to assess the appropriateness of the product, investment or structure to your particular circumstances. Past performance is not an indicator of future performance.