MelvilleDouglas
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Melville Douglas
Balanced Fund Ltd

Quarterly Commentary

The world this year has been remarkably benign. Strong economic growth, accommodative central banks, sustained recovery in corporate earnings and continued low interest rates have combined to produce strong results from equity markets and commodities. They have also provided resilience against more unstable geopolitics. Can it last?

The favourable macroeconomic environment this year has been remarkable. Not only has growth improved beyond expectation, it has broadened across much of the world, so that this year for the first time since the financial crisis, synchronized growth is a reality. The pull has exerted a strong force on commodities and emerging markets, but equities generally have benefited.

Rising commodity prices and buoyant emerging markets are typically signs of “above-trend” growth, and would usually be accompanied by higher inflation and rising interest rates. In this cycle, however, inflation has proven remarkably benign, and as a result, central banks have not been compelled to react very strongly. This is so even though real interest rates have been persistently low.

But now, central banks are starting to worry that as growth takes hold that there will come a point where inflation responds unexpectedly swiftly, and that markets are too complacent about the tightening of monetary policy. If an inflationary surge forced a sudden change, the disruption could be substantial and volatile. As a result, for most of this year, the rhetoric of central banks has changed from the post-crisis “whatever it takes” (to generate growth) to a series of warnings regarding the necessity of “normalizing” interest rates and how they propose to remove the extraordinary amount of monetary accommodation that has been provided.

As far as the long bond yield is concerned, it has more than just inflation to contend with. In the past months, geopolitical risks (mainly North Korea, but also Iran and other issues) have risen, which creates additional demand for “safe haven” assets. This may have held the long bond yield lower than it otherwise would have been. It certainly looks that way: as soon as geopolitical factors fade, long bond yields rise.

Meanwhile, equity markets are buoyed by a remarkable confluence of benign influences, without much evidence of structural stress. Not only have companies delivered strong earnings growth this year, but guidance has been sufficiently benign that analysts have not felt the need to adjust forecasts downwards, as in prior years. Furthermore, the growth is being delivered more from improved revenues, rather than just cost-cutting and financial engineering. Of course, this fact may also be a measure of improving pricing power and therefore impending inflation.

Quarterly Commentary as at 30 September 2017

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Outlook

Investors need to be aware that 2017 will prove to have been the point at which the “post-crisis” mode of policy-making and adjustment changed. The fact that the global environment has been so benign this year carries with it the seeds of further change, and it would be remiss to assume that 2018 will be a repeat. While central banks remain extremely vigilant, there are many things they don’t know. The messaging from them is changing from a mode of being “data-driven” (i.e. backward-looking) to something much more proactive, in an attempt to ensure that an inflation surprise can be dealt with without recourse to sudden changes of policy. The concern is that markets are not fully in agreement regarding the need for the change. And “gradual” policy change does not automatically guarantee gradual market adjustment. If there is a tension between the market view and the policy settings, the likelihood of a dislocation rises, and what causes it -a geopolitical event, a policy error (fiscal or monetary) or inflation - won’t matter in the short run.

The positioning in the fund favors equity, which is expected to outperform as the synchronized global economic backdrop provides a promising environment for companies to grow profits. Equities have performed strongly this year and valuations are no longer cheap, yet we are still finding more attractive opportunities in the asset class than cash and bonds where income yields are well below inflation.