Melville Douglas Select Fund Ltd Global Equity Class

Minimum Disclosure Document as at 31 December 2016

Quarterly Commentary

Investors greeted the New Year with a half full, rather than half empty, glass of bubbly. The final quarter of 2016 saw Wall Street reach new highs on the narrative of a US economic boom fuelled by the upcoming Trump administration's tax cuts and a fiscal spending spree.

The MSCI All Country World index was up +1.2% in the fourth quarter. The strength of the greenback meant the US was the only major market up in dollar terms (+3.4%). Cyclical sectors were the leaders, spearheaded by financials (+12.2%), energy (+7.4%) and materials (+3.1%). More defensive staples (-6.0%) and health care (-5.5%).

Geopolitical risk is unlikely to subside in the near future given protracted and antagonistic Brexit negotiations, the undefined Trump policy agenda, and elections across Europe (Holland, France and Germany). Although we can carefully assess scenarios, we would highlight that anticipating the reaction to the latest tweet from Trump or regime change in Europe is a strategy fraught with difficulty.

Some commentators suggest the positive reaction to the election of Trump and a Republican Congress is anticipating a return to the Reagan boom years. We would take care not to get carried away with this notion. When Reagan took office in 1981, Treasuries were yielding 12.5%, stock markets were cheap and the economy was in recession. Today we are in almost the opposite situation: 10-year Treasuries now yield a paltry 2.4%, stocks are expensive and there is far less slack in the economy given seven years of expansion and low unemployment (at below 5%, it is less than half the 2010 level). On balance, valuation alone is not a reason alone to reduce equity allocations, particularly given today's low and stable inflation. Expansion of the fiscal deficit could lead to higher inflation, higher rates and lower valuations. This risk needs to be tempered by the low starting point for interest rates and, US real yields (near zero) will probably remain at stimulative levels relative to history even if nominal rates were to see modest normalisation.

What are easier to detect and determine are the global trends of de-globalisation, de-regulation and re-expansion of government balance sheets. The noise surrounding the Trump victory merely magnified trends that have been brewing for months, quarters and years

De-globalisation, driven by voter dissatisfaction over wealth distribution and initiated at the ballot box by Brexit, is a reversal for the open movement of global capital and labour. Although some national industries may benefit, this is negative for global growth. Offsetting protectionism is deregulation and an increasing clamour to re-expand government balance sheets. On the latter, any fiscal multiplier effect on the economy will likely take time to filter through given the timescale of infrastructure spending, although tax cuts would have a more immediate, less targeted impact. Cheap money helps. For example, the Bank of Japan's policy to anchor Japanese government bond yields at zero effectively provides Abe's government with free funding.

During the quarter we added to existing holdings which would benefit from a modest recovery in US activity, primarily industrials (e.g. global chemicals distributor Brenntag) and US banks (e.g. Wells Fargo and JP Morgan), without being too impinged by what Trump will-or-will not do over global trade. US banks have performed very well, but there is plenty of gas left in the tank. Positives include sharply higher long term rates (a boon to banks' net interest margins), improved GDP trajectory (loan growth and higher fees due to more activity), and potential for corporate tax cuts under the new Trump regime. Should all or some of these factors materialize, it could lead to a 20% to 30% uplift in bank earnings, which is a significant disconnect with overly conservative consensus estimates revisions of only approximately 5% to 10%.

To conclude, 2017 will likely be another choppy year with higher growth expectations counterbalanced by the pressure on valuations from higher rates and political uncertainty. Whereas the incoming tide of central bank policy lifted all boats, only those companies which can deliver on growth will attract a premium at low tide.