Appendix 2

Third Quarter 2021 Investment Report

PREPARED FOR:

Derbyshire County Council Pension Fund: Pensions and Investment Committee Meeting

DECEMBER 2021

Investment Report for Derbyshire County Council Pension Fund

This report has been prepared by Anthony Fletcher "External Investment Advisor" of Derbyshire County Council Pension Fund (the Fund). At the request of the Pension and Investment Committee the purpose of the report is to fulfil the following aims: -

- Provide an overview of market returns by asset class over the last quarter and 12 months.
- An analysis of the Fund's performance by asset class versus the Fund specific benchmark for the last quarter and the last 12 months.
- An overview of the economic and market outlook by major region, including consideration of the potential impact on the Fund's asset classes
- An overview of the outlook for each of the Funds asset classes for the next two years; and recommend asset class weightings for the next quarter together with supporting rationale.

The report is expected to lead to discussions with the in-house team on findings and recommendations as required. The advisor is expected to attend quarterly meetings of the Pensions and Investment Committee to present his views and actively advise committee members. To the extent this report contains advice it is intended as strategic advice to inform the investment strategy statement rather than investment advice.

Meeting date 8th December 2021
Date of paper 25th November 2021

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1. Market Background (Third quarter 2021)

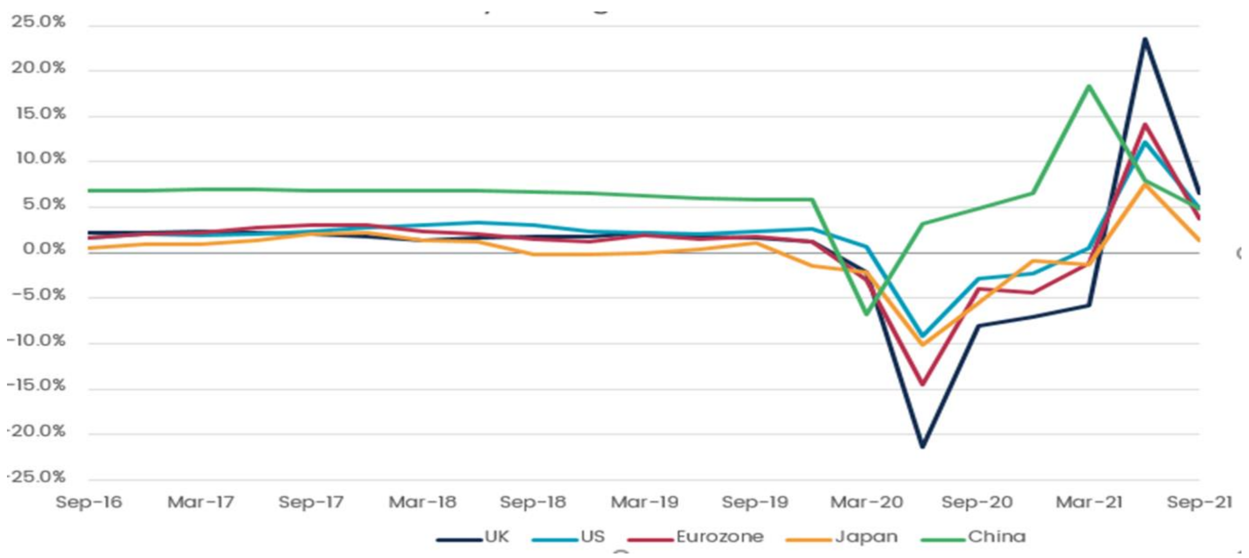
As I suggested in the outlook section of my last report, sentiment in the third quarter was being impacted by a number of "less" positive factors. Namely: the rising covid Delta variant infection rates in the Asia-pacific region; the decision by governments in the region to put in place local lockdown measures; further worsening the impact on already stretched global supply chains; and at the macro-economic level, a fear that inflation would morph from transitory into persistent inflation, and finally concerns that GDP growth rates had peaked. All contributed to much lower and more varied market returns than we have seen in previous quarters.

On the back of these concerns developed market equity performance was modest. Emerging Markets returns were disappointing, primarily the result of government interventions and high corporate debt in China. China's decision to reign in some of the excesses of recent growth and to roll out its policy of "shared prosperity" had a significant impact on certain sectors of the stock market. Its decision to pursue tighter credit conditions also impacted the property sector, which in my view has grown disproportionately in recent years and if it continued uncontrolled could have led to a wider contagion effect in the region.

Global supply shortages led to sharp price increases across energy and commodity markets. Government bond performance was mixed, the highly interest rate sensitive, UK conventional gilts saw the largest increases in yield, whereas index-linked gilts performed well on rising inflation expectations. Higher quality and longer duration Investment grade credit bonds were generally weaker, whereas higher yielding less interest rate sensitive, European and US high yield bonds outperformed despite a slight widening of spreads over the quarter.

While GDP growth understandingly slowed from the extremely positive second quarter bounce back last year, annualised growth rates remain well above the rates seen prior to the pandemic. However, growth is expected to slow further in the fourth quarter and into next year. This expectation is due to tight labour markets, supply constraints and the withdrawal of government emergency support packages.

Chart 1: - Annualised rates of quarter on quarter GDP growth.



Source: - Bloomberg

Table 1, below shows the total investment return in pound Sterling for the major asset classes, using FTSE indices except where noted; for the month of October 2021 and the 3 and 12 months to the end of September 2021.

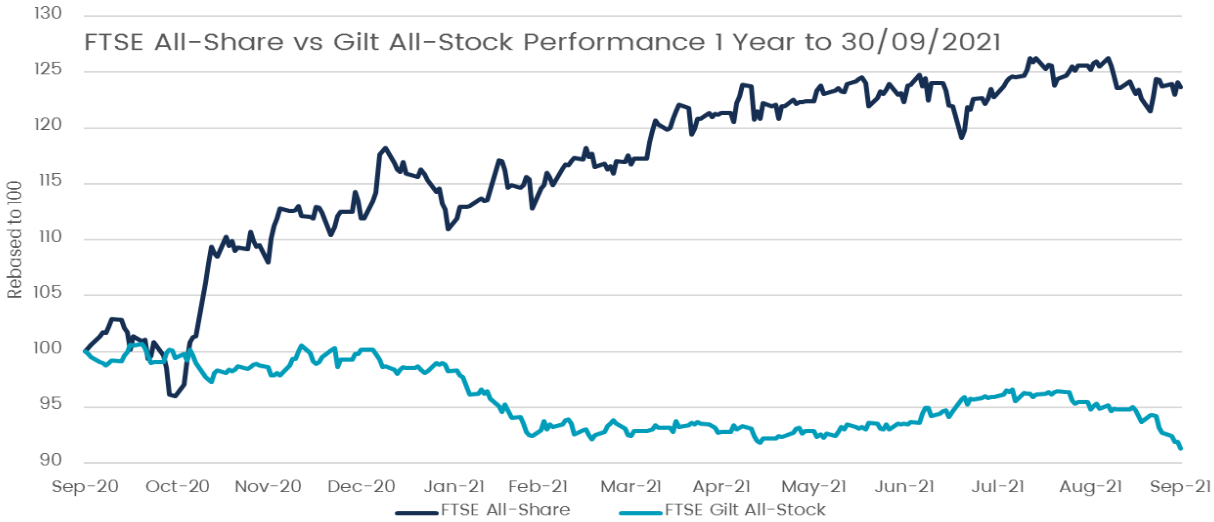
% TOTAL RETURN DIVIDENDS REINVESTED

MARKET RETURNS

		Period end 30th September 2021	
	October 2021	**3 months**	**12 months**
Global equity FTSE All-World	3.3	1.8	23.4
Regional indices			
UK All Share	1.8	2.2	27.9
North America	5.3	2.6	25.0
Europe ex UK	3.0	0.6	21.7
Japan	-5.0	7.0	16.9
Pacific Basin	0.0	-5.3	13.9
Emerging Equity Markets	-0.5	-4.4	13.8
UK Gilts - Conventional All Stocks	1.6	-1.9	-7.0
UK Gilts - Index Linked All Stocks	3.9	2.3	0.5
UK Corporate bonds*	0.1	-1.0	0.2
Overseas Bonds**	-0.3	0.0	-2.1
UK Property quarterly^	-	4.1	10.7
Sterling 7 day LIBOR	0.0	0.0	0.0

^ MSCI indices * ICE £ Corporate Bond; **ICE global government ex UK LOC

Chart 1: - UK bond and equity market returns - 12 months to 30th September 2021



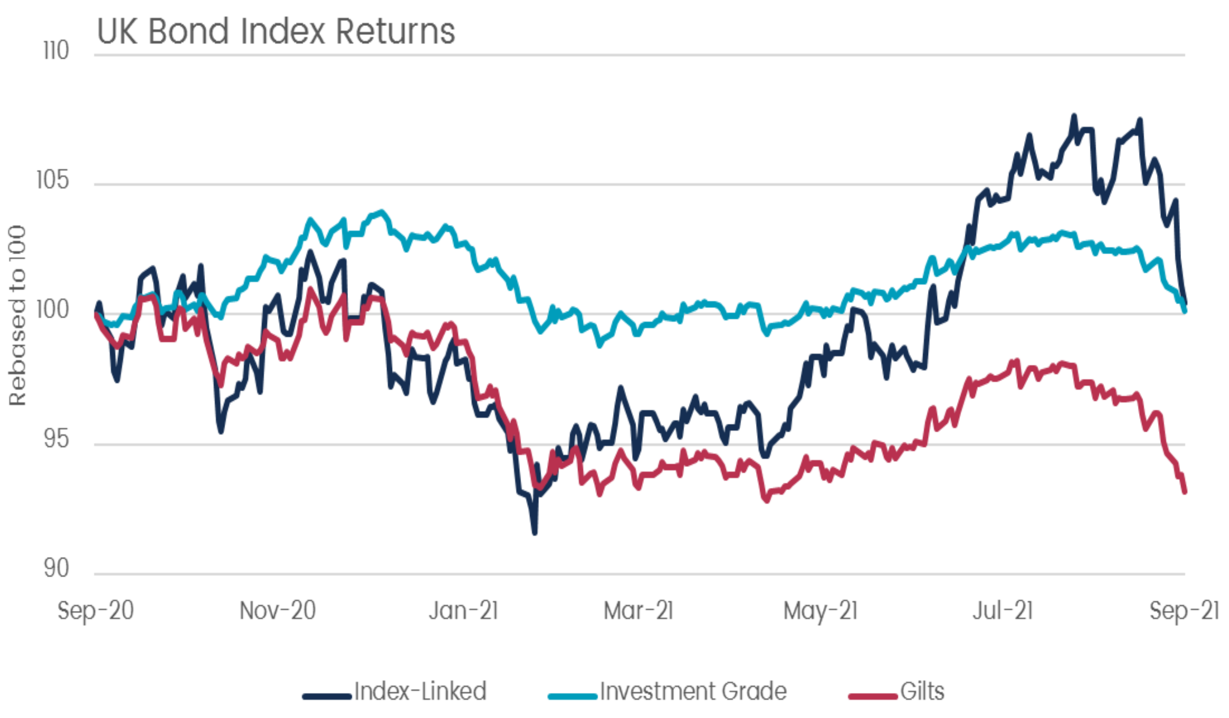
Source: - Bloomberg

Table 2: - Change in Bond Market yields over the quarter and 12 months.

BOND MARKET % YIELD TO MATURITY	30th June 2021	30th September 2021	Quarterly Change %	30th September 2020	Current 12th November 2021
UK GOVERNMENT BONDS (GILTS)					
10 year	0.72	1.02	**0.30**	0.23	0.91
30 year	1.24	1.37	**0.13**	0.78	1.06
All Stocks ILG	-2.37	-2.54	**-0.17**	-2.47	-2.84
OVERSEAS 10 YEAR GOVERNMENT BONDS					
US Treasury	1.47	1.49	**0.02**	0.68	1.57
Germany	-0.20	-0.19	**-0.01**	-0.52	-0.24
Japan	0.05	0.07	**0.02**	0.02	0.08
NON-GOVERNMENT BOND INDICES					
Global corporates	1.59	1.66	**0.07**	1.63	1.75
Global High yield	4.09	4.43	**0.34**	5.74	4.74
Emerging markets	3.56	3.77	**0.21**	3.76	3.80

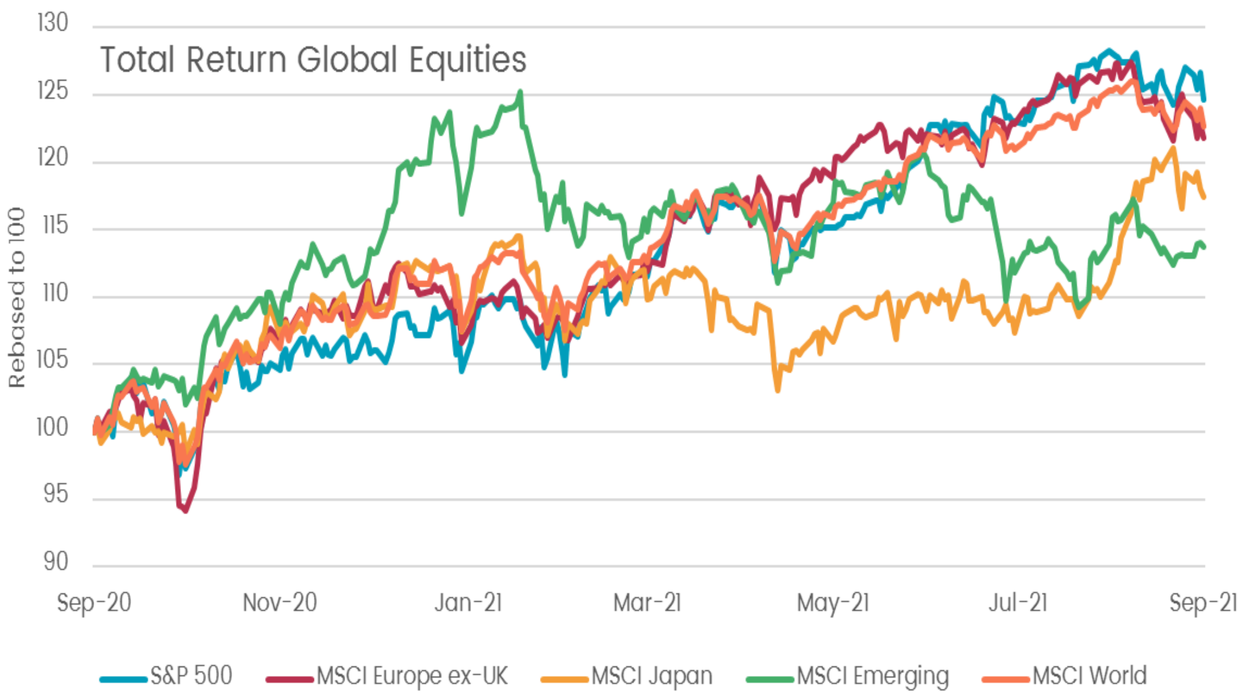
Source: - Trading economics and ICE Indices G0LI, G0BC, HW00, EMGB, 12th November 2021.

Chart 2: - UK Bond index returns, 12 months to 30th September 2021.



Source: - Bloomberg

Chart 3: **-** Overseas equity markets returns in Sterling terms, 12 months to 30th September 2021



Source: - Bloomberg

Recent developments (October and early November 2021)

After a weak start, equity markets regained momentum throughout October with many equity indices making new highs during the course of the month. US stocks were supported by a strong start to the Q3 earnings season. Chinese indices also rebounded, in part thanks to progress in the beleaguered property sector.

Bond markets were volatile. The combination of persistent bottlenecks in the global supply chain and booming energy prices added to concerns that inflation may be persistent rather than transitory. This was not helped by bad messaging from the Bank of England, suggesting they may raise rates in November, only for this not to happen. As a result, UK and US government bond yields made new post pandemic highs, only to fall after the respective central bank meetings in early November, thereafter rates were left unchanged. However, it has led to a marked flattening of yield curves, suggesting that bond investors believe we are closer to a rate hike.

The main feature of the quarter to date has been a combination of strong demand and supply constraints in energy markets, that has created price volatility and record highs in October and November. Demand has been driven by growth and supply has been impacted by a combination of the intermittency of renewables, lack of contingency planning and unhelpful regulation especially in the UK and Europe. In Asia, coal shortages induced many governments to take steps to ration energy supplies, especially in China.

Consumer Price Indices in all developed economies hit new highs in October and November with higher energy prices now the main contributor. Core inflation measures were also higher as bottlenecks in the supply of goods persist.

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2. Investment Performance

Table 3 shows the performance of the Derbyshire Pension Fund versus the Fund specific benchmark for the quarter and year to 30th September 2021. Over 12 months all the broad asset class categories and most of Derbyshire's selected asset managers outperformed their respective benchmarks.

Over 10 years the Fund has achieved a total return of 9.5% per annum, net of fees.

Table 3: - Derbyshire Pension Fund and Benchmark returns

% TOTAL RETURN (NET) 30TH SEPTEMBER 2021	3 MONTHS		12 MONTHS	
	Derbyshire Pension Fund	**Benchmark**	**Derbyshire Pension Fund**	**Benchmark**
Total Growth Assets	**2.5**	**1.6**	**25.5**	**23.5**
UK Equity	2.5	2.2	31.2	27.9
Total Overseas Equity	**1.7**	**1.3**	**21.2**	**21.1**
North America	2.5	2.6	25.6	25.0
Europe	0.6	0.6	21.6	21.7
Japan	5.9	7.0	14.2	16.9
Pacific Basin	-4.4	-5.3	14.5	13.9
Emerging markets	-4.3	-4.4	17.8	13.8
Global Sustainable Equity	3.0	1.8	24.5	23.4
Global Private Equity	10.6	2.5	47.0	28.9
Total Protection Assets	**0.3**	**0.0**	**-0.6**	**-1.9**
UK & Overseas Government	-1.3	-1.8	-5.0	-6.8
UK & Overseas Inflation Linked	2.6	2.3	1.3	0.5
Global Corporate bonds	-0.5	-0.6	1.4	0.8
Total Income Assets	**2.6**	**2.0**	**8.6**	**6.9**
Multi-asset Credit	1.5	0.7	8.2	6.9
Infrastructure	2.7	0.5	4.7	2.1
Property (all sectors)	3.4	4.3	12.6	11.8
Internal Cash	0.0	0.0	0.1	0.0
Total Fund	**2.0**	**1.4**	**15.7**	**14.4**

Total fund value on 30th September 2021 £6,110 million

The Fund remains overweight growth assets and underweight protection assets relative to the strategic benchmark which has made a positive contribution to total return over the last 3 and 12 months.

Growth assets – Equity performance

In the 3rd quarter of 2021, at the aggregate level, the equity portfolio outperformed its benchmark. Returns were generally lower and more mixed over 3 months especially compared to the exceptionally positive returns over 12 months. The only regional allocation to underperform its benchmark was Japan, with all other regional allocations either ahead or in-line with benchmarks in both periods. The poor performance of the Chinese equity market impacted the returns of the Pacific basin and emerging benchmarks either directly or via contagion, returns from these markets were negative over 3 months and lower than other markets over 12 months.

Over 3 years growth assets have delivered an aggregate return of 9.1% p.a., 0.9% more each year than the strategic benchmark, net of fees. Only the US, Japan and Emerging market equity portfolios underperformed their respective benchmarks. Over 10 years growth assets have returned on average 11.8% p.a. compared to 11% for the benchmark.

Protection assets - Fixed Income Performance

Over 3 months rising inflation expectations caused bond yields to rise, over 12 months the recovery of global growth was a greater influence. Stronger growth resulted in negative returns from highly interest rate sensitive conventional government bonds and investment grade credit, but higher inflation resulted in positive returns from Inflation linked government bonds both in the UK and the US. The Fund remains underweight its allocation to UK government bonds and has less interest rate sensitivity than the benchmark as a result the allocation outperformed the benchmark. Over 3 years protection assets have delivered 4.9% p.a. 0.5% more than the benchmark, over longer periods performance is slightly behind the benchmark.

Income assets – Property, Infrastructure and MAC

Over the year, the combined portfolio of income assets has outperformed the benchmark, mainly due to the strong performance of Direct Property and MAC. Infrastructure outperformed its benchmark but delivered much lower levels of absolute return than previously. Over 3 years Income assets have on average delivered 5.6% p.a. more than double the benchmark, over all longer time periods, infrastructure has delivered the highest absolute returns.

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3. Economic and Market outlook

Economic outlook

I continue to believe that while the pace of growth is likely to slow from the sharp rebound seen earlier in the year, growth will be higher this year and next than before the pandemic. This is because of the huge increase in government spending and super-easy monetary policy. These policies combined with excess savings accumulated by households during the pandemic remain the key forces driving growth.

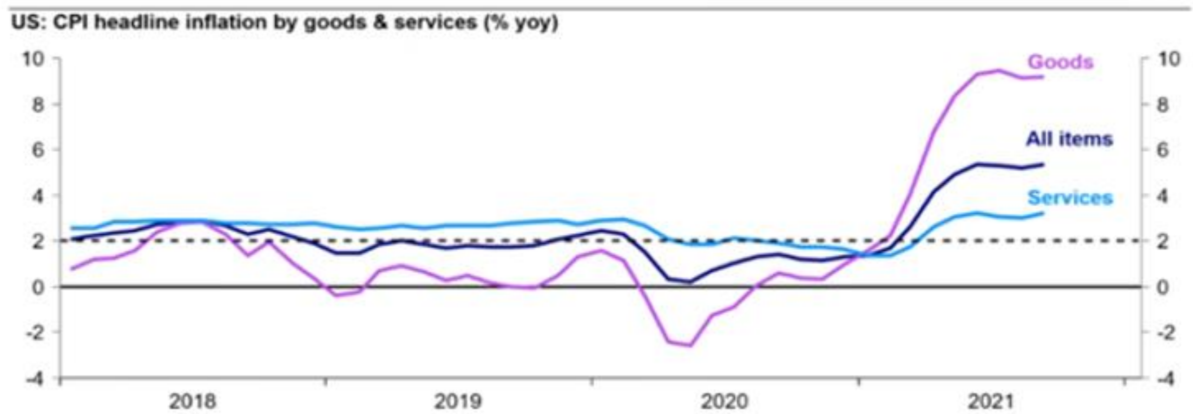
The unequal pressure on the demand for goods over services as led to higher prices especially for commodities and labour. In turn this is leading to sharply higher inflation especially compared to last year. I still believe this is transitory, inflation may run at the higher end of forecasts for another 6 months or so but I expect it to start to fall, from the middle of next year as the global economy and supply chains continue to get back to "normal" and discretionary spending between goods and services rebalances. Inflation could remain sticky, but by 2023, I expect inflation to be much closer to 2 % in the major economies than it is today.

The risks to this reasonably positive outlook remain a new covid variant or a waning of vaccination effectiveness or a failure to get vaccination levels high enough globally. The other high impact risk is higher energy prices leading to reduced consumption and ultimately an economic recession or stagflation. I believe the recession/stagflation risks are much smaller than the risks of covid changing in some way or much more likely an overly restrictive government response to rising infection rates which are not accompanied by higher hospitalisations and mortality.

Inflation

Inflation has picked up in all economies due to the impact of supply bottle-necks, higher energy prices, and the willingness of consumers to spend without too much concern for cost. As chart 4, shows US inflation increases have been led by goods prices not services, the EU and UK show a similar pattern.

Chart 4: **-** Inflation – Annual rate, all items and split by goods and services (2% = Central Bank Target rate).



Source: - BCPP November 2021

In September and October inflation in all major economies is higher after moderating during the summer. I still expect Inflation to be a "tax on growth" as non-discretionary spending eats into incomes and savings especially if energy costs continue to rise.

Central Banks

Over the quarter there were no actual policy changes by the major central banks, however in October as inflation data was starting to pick up again on higher energy prices, Andrew Bailey, governor of the Bank of England (BoE); appeared to suggest that the Base rate may be increased at the November monetary policy meeting. At the meeting the MPC voted 7 : 2 to leave rates and QE policy unchanged. With UK inflation now running at over 4% and expected to be 5% early next year the market is speculating that the BoE will raise rates in December 2021. I have no doubt that the BoE would like to raise rates but with the economy losing momentum after the sharp rebound earlier this year I suspect rates may not rise until the 1st quarter of 2022. In the US inflation is running at over 6% but full employment has not been reached and the Fed continues to buy bonds as part of its QE programme. This is clear sign to me that the Fed is still a long way from increasing US interest rates.

Politics

The only significant election in the last few months has been in Germany where the Federal election as expected produced no overall majority. Support for Mrs Merkel's Conservative party declined by 8.9%, far Left and Right parties also saw their share of the vote decline. The main beneficiaries of the change were the Social Democratic Party and the Greens which both increased their share of the vote by over 5%. There will now be months of negotiation on the shape of the new ruling coalition, which is expected to include the Greens as they are now the 3rd largest party by number of seats.

China continues to make life uncomfortable for Taiwan, with regular incursions of territory by sea and air. Russia also seems intent on raising tensions, through its ally Belarus along the border with Poland, indirectly in the Baltic states and directly through its military exercises close to the Ukrainian Border. It would also appear that Russia is manipulating the supply of gas to Western Europe via Ukraine and NordStream2 a new pipeline through the Baltic sea. Germany in particular is most vulnerable to the supply of gas from Russia as it has almost completely shut down its fleet of nuclear power stations and is also trying to reduce its dependence on coal fired generation to comply with plans to reduce greenhouse gas emissions. If the new coalition is with the Greens, then this pressure is likely to increase.

Some progress was made at COP26 in Glasgow, but not as much as hoped by the UK government ahead of the conference. Notable more by their absence, China, Russia and Saudi Arabia, undermined the possibility of a global and binding response. Based on the commitments made the planet is on a trajectory for +1.8 degrees of warming, somewhat higher than the +1.5 hoped for in Paris in 2015.

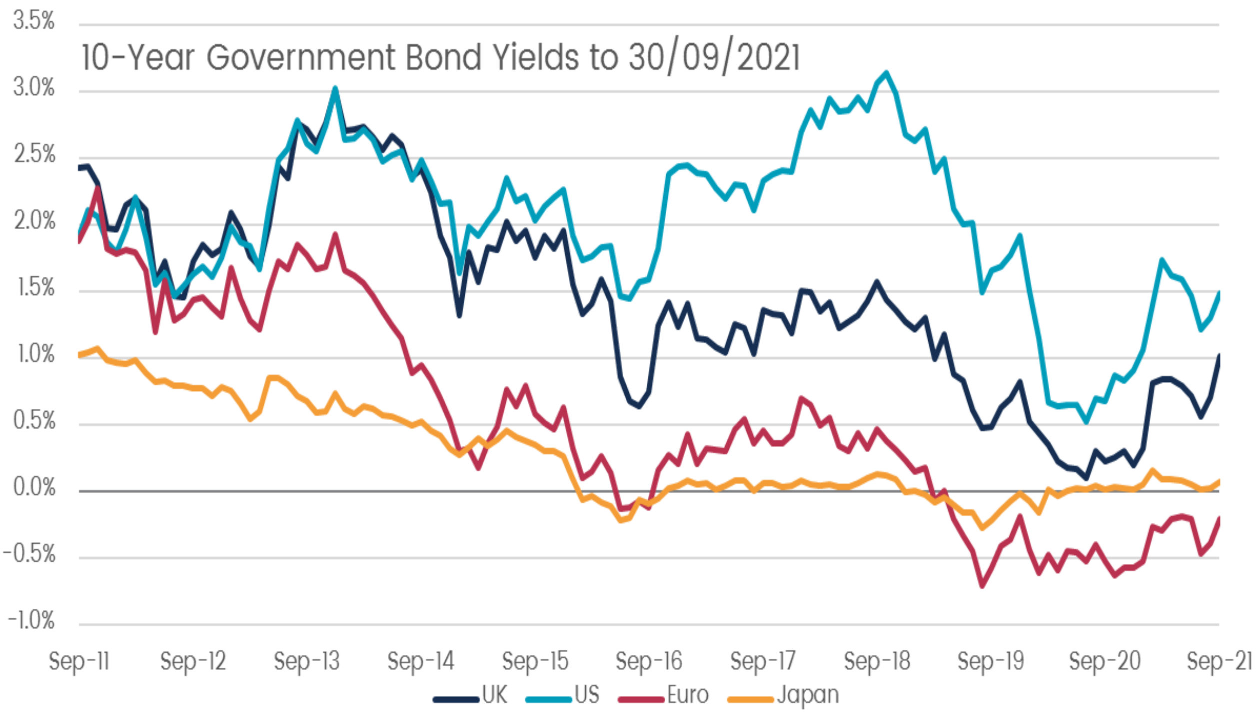
Government bonds

Government bond yields troughed in August and at the end of the quarter they were back up to the levels seen at the end of June in the US, Europe and Japan. In the UK conventional Gilt yields made new highs, because the BoE is expected to be the first major central bank to raise interest rates. Inflation Linked Gilt yields fell, because the increase in inflation expectations had a greater impact. Yields spiked even higher in the UK in October because the market thought the BoE was going to raise rates at the November MPC, when they didn't yields fell, but along with the rest of the worlds government bonds, yields are at the time of writing rising again. The increased expectations of central bank rate hikes has caused shorter maturity yields to rise more flattening the yield curve.

None of this news should come as a surprise to readers of this report as I have been predicting a medium term trend to increasing government bond yields for some time. I accept that I thought it was growth rather than inflation that would spook the bond markets, but the outcome is the same, yields are going to trend higher to levels that reflect the strength of the recovery and an end to the need for extraordinary levels of monetary stimulus.

I have not changed my view that it is highly likely that government bonds could deliver a near zero or even negative returns in the next 12 months. Notwithstanding this because of the way Scheme liabilities are calculated the Fund any such losses are likely to be more than offset by a reduction in Scheme liabilities, hence improving the funding position .

Chart 5: - Government bond yields, last 10 years.



Source: - Bloomberg

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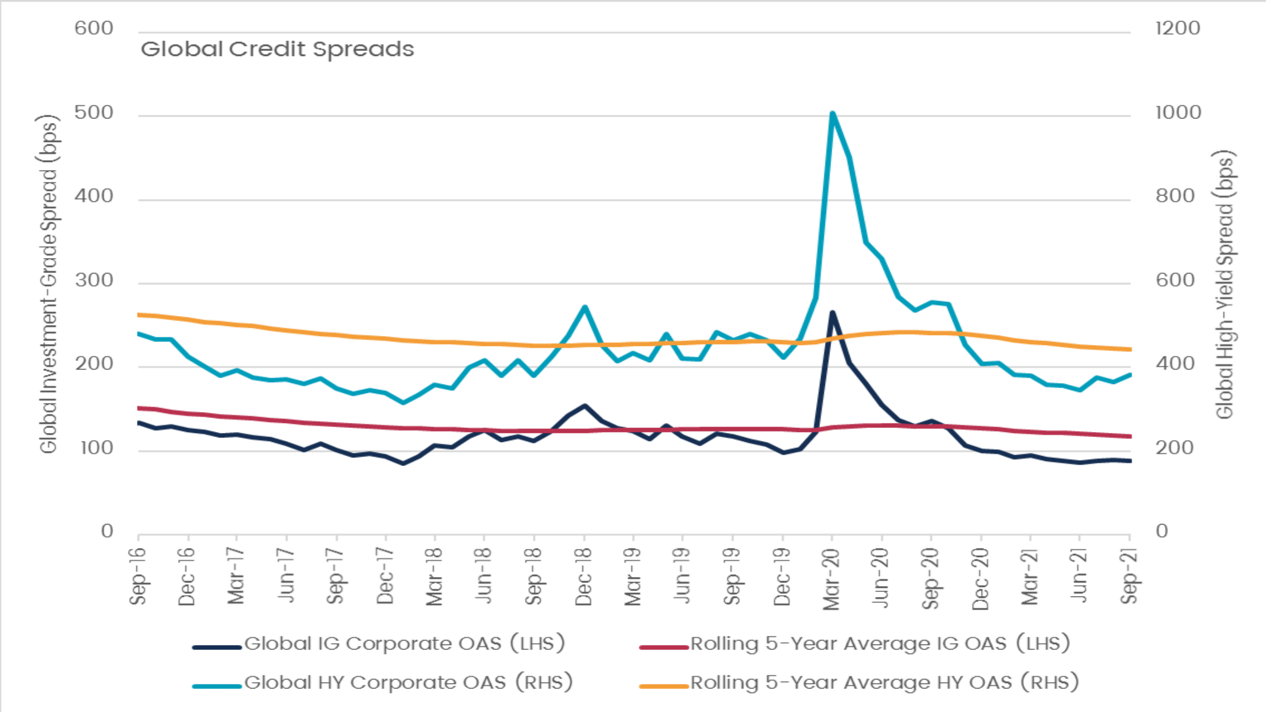
Non-government bonds

Chart 6 below, shows the excess yield spread for both investment grade non-government and high yield bonds. Over the quarter yield spreads widened from their lows, but because of their lower interest rate sensitivity and higher yield they outperformed government bonds. While these bonds are more sensitive to the economy, the key to success with this asset class is avoiding defaults, provided the economy continues to recover non-government bonds are likely to continue to outperform.

Chart 6: **-** Credit spreads, extra yield over government bonds, last 5 years.



Source: - Bloomberg

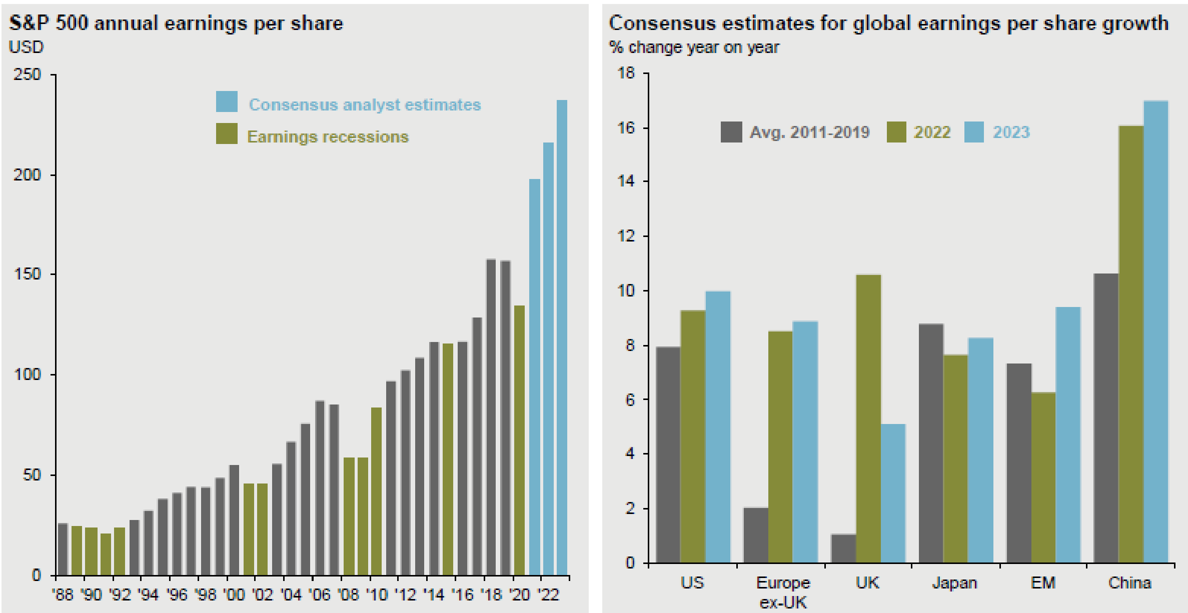
Equities

Market returns in the 3rd quarter were much more muted than over the previous 12 months, yet despite the supply side issues and the resurgence of covid infection rates, corporate profits are proving to be very strong in 2021. JP Morgan Asset Management estimate that worldwide in a good year company profits prior to the pandemic were US$ 2.3 trillion. In 2020, profits slumped to USD 2.0 trillion, but they are currently expecting profits of US$ 2.9 trillion in 2021, more than 25% higher than pre-pandemic level. These estimates are being revised higher each quarter, see chart 7 below.

However, this may be as good as it gets. So far, many companies have managed to mitigate the impact of covid and the bounce back in demand, but this is getting more difficult as cost pressures increase, (see chart 8) and the momentum of the bounce and government stimulus packages subside. Sectors that can continue to do well include industrials, commodities and financials. Outside the US where valuations appear especially stretched, multiples in Europe and Japan look closer to historical norms, and the recent poor performance of the Chinese market have left emerging markets appearing more attractive.

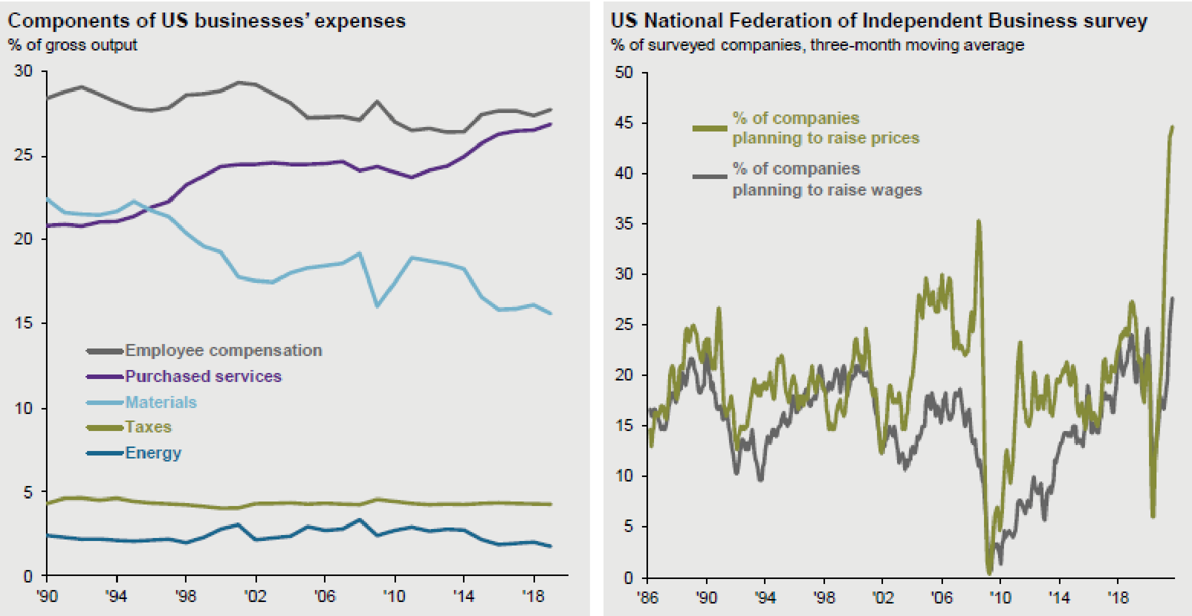
Looking at valuations by investment theme, the conclusion is that the price for investing in the fastest-growing companies remains very high. In contrast, value and quality stocks in aggregate are reasonably priced or cheap when compared to past averages. Meanwhile, some of the speculative excesses observed especially in the US are starting to fade after the unsustainable gains achieved in 2020. In the last 12 months markets have been exceptionally willing to embrace the riskiest names in many industries and this is starting to change with investors focussing on quality and sustainability.

Chart 7: **-** Analyst corporate earnings estimates



Source: - JP Morgan Asset Management

Chart 8: **-** Cost pressures may eat into Profitability



Source: - JP Morgan Asset Management

The left hand side of chart 8 above show the components of company costs in the US, all areas except taxes at the moment are experiencing upward pressure. As the right hand chart shows many companies are planning to raise the prices of their products to offset these increased costs. Price rises can be only be passed on if either incomes rise or savings are consumed, with higher energy prices running faster than higher incomes the risk is discretionary consumption falls.

Looking forward over the next 12 months, I expect to see more general equity market volatility due to macro factors like inflation and interest rates and more stock specific risk as investors focus on stock selection rather than just buying the market.

GDP

Table 4 shows the consensus forecasts for GDP growth in calendar 2021 and 2022 and my expectations in August and November 2021.

Table 4: - GDP forecasts - Consensus versus Advisor expectations.

% CHANGE YOY								
	2021				2022			
	AUGUST		NOVEMBER		AUGUST		NOVEMBER	
	Consensus	AF	Consensus	AF	Consensus	AF	Consensus	AF
US	6.2	**7.0**	5.5	**6.0**	4.4	**4.4**	4.0	**4.4**
UK	6.8	**6.0**	6.9	**6.0**	5.4	**5.4**	4.7	**5.0**
Japan	2.4	**2.6**	2.2	**2.4**	3.0	**3.0**	3.0	**3.0**
EU	4.6	**5.0**	5.0	**5.0**	4.3	**4.5**	4.2	**4.5**
China	8.6	**9.0**	8.0	**9.0**	5.6	**5.6**	5.1	**5.6**
SE Asia	4.0	**4.3**	3.3	**4.3**	5.5	**5.5**	5.3	**5.5**

Source: - Consensus Economics November 2021

Consensus forecasts for GDP growth have been revised lower for 2021 except in the UK and Europe, in 2022 growth has been revised lower in all regions outside of Europe and Japan where they are unchanged. This is consistent with the pro-cyclical nature of these economies where manufacturing dominates especially in Germany where it is estimated that the shortages of components have slowed growth by as much as 7% in the last year. The US and UK economies are much more dependent on personal consumption and services.

I still believe growth will most likely be stronger than the consensus for the following reasons: there is still some headroom for economies to grow beyond their pre-pandemic levels, I believe orders for manufactured goods will be filled, just later than anticipated, the impact of higher fiscal spending and finally because savings rates remain high enabling personal consumption activity to remain strong even against a backdrop of higher energy prices. The risks to this outlook, are that delayed orders get cancelled and inflation expectations increase discouraging consumption as real incomes fall and discretionary spending is curtailed.

The Chinese economy grew by 4.9% in the year to 30th September 2021, 3% slower than in the year the end of June. The headwinds to growth came from power shortages and supply chain bottlenecks, caused by bad weather and regional covid outbreaks and the government’s attempt to deflate a persistent property bubble. Domestic consumption dominated economic activity. While Exports surprised to the upside, industrial production slowed as power supplies had to be rationed, due to shortages of coal.

In the US, second quarter growth was confirmed at 6.7% and 3rd quarter growth estimated at only 2.0%, quite a bit weaker than expected. Personal consumption expenditures fell to 1.6% from 12% in the second quarter. As I noted in my last report increased covid infection rates and global supply constraints weighed on consumption and production. Over 12 months the annual rate of growth was 4.9%.

In the UK, 2nd quarter growth was revised higher from 4.8% to 5.5% driven by Hospitality and Arts and Recreational spending, following the further easing of covid related restrictions. The advance report of 3rd quarter growth was by contrast a much more muted 1.3%. The year over year growth rate was 6.6% down from 23.6%, in the 2nd quarter, the economy is still 2.1% smaller than it was before the pandemic.

The Japanese economy remains weak as fear of the Delta variant and a low vaccination rate kept consumers at home and cautious. First quarter growth was revised down to -1.1% from -0.9%, whereas second quarter growth was revised higher from +0.3% to +0.5%. It will be interesting to see if 3rd quarter growth enjoyed much of a benefit from the Olympic games. I suspect not given the lockdown conditions for most of the Athletes and the absence of international spectators. The Japanese economy is still 1% smaller than it was before the pandemic.

The Euro-area recovered from its confirmed “double-dip” recession with growth rising by 2.1% in the second quarter and 2.2% in the third quarter. Growth was mainly supported by strong domestic demand and exports, while supply chain disruptions, shortages of raw materials, and rising consumer prices weighed on the recovery. Among the bloc's biggest economies, France posted the fastest pace of expansion, advancing by 3.0 percent in the third quarter, followed by Italy (2.6 percent), Spain (2.0 percent), and Germany (1.8 percent). At the end of September 2021, the Euro-area economy is roughly the same size as it was before the pandemic.

Consumer Price Inflation

Table 5 shows the consensus forecasts for Consumer Price Inflation in calendar 2021 and 2022 and my expectations in August and November 2021.

Table 5: - Consumer Price Inflation forecasts - Consensus versus Advisor expectations

% CHANGE YOY	2021				2022			
	AUGUST		NOVEMBER		AUGUST		NOVEMBER	
	Consensus	AF	Consensus	AF	Consensus	AF	Consensus	AF
US	4.1	**4.3**	4.4	**5.0**	2.9	**2.5**	3.7	**4.0**
UK	2.2	**2.5**	2.4	**2.5**	2.2	**2.5**	3.7	**3.7**
Japan	0.1	**0.5**	-0.2	**0.5**	0.5	**0.8**	0.7	**0.8**
EU	2.1	**2.5**	2.4	**2.8**	1.7	**1.7**	2.3	**2.5**
China	1.4	**2.0**	1.0	**1.5**	2.3	**2.5**	2.1	**2.5**
SE Asia	2.2	**2.4**	2.0	**2.4**	2.4	**2.5**	2.5	**2.5**

Source: - Consensus Economics November 2021

Once again, the consensus forecasts for inflation in calendar 2021 and 2022 have been revised higher. As I said last quarter, I expect inflation reports over the next few months will be worryingly high. Due to the recovery and base effects from 12 months ago. But what seems to be becoming clear is the global supply chain was more disrupted than previously believed and regional increases in covid infection rates and restrictions "upstream" are extending the period of shortages in the supply of goods, services and workers. Add to this the sharp increase in global energy prices especially in October and it would appear inflation could be higher than even the forecasts above and may be longer in duration than previously expected. I still believe higher energy costs are more likely to have a negative impact on discretionary consumption, ie lead to lower growth, but the risks in the short term do seem to point to higher inflation than I previously expected. Once we are past the next 12 months, I continue to expect inflation to fall back to a level of 2% to 3% over the medium term somewhat higher than the 1% to 2% we have become accustomed to over the last 10 years, but still low.

The annual rate of US headline inflation surged to 6.2% in October after running at over 5% for the previous 4 months. While the increase over the summer could be explained by base effects and supply shortages caused by the rapid re-opening of the economy. October's price increases are the result of higher global energy costs driven by increased consumption, low inventories and lower oil and gas production levels, as a result the energy component was 30% higher. The supply side issues are still an influence but with energy costs consuming a greater amount of non-discretionary spending, price increases for most goods and services were subdued except for Used Car and Truck prices which are still seeing price increases of 26% compared to last year. Core inflation which excludes food and energy was 4.6% in October compared to an average of 4.2% over the summer months.

Euro Area headline inflation for October was 4.1% up from 3.4% in September and 2.2% in July, October's jump like the USA's was linked to energy prices. Core inflation which excludes food and energy was also higher at 2.1% compared to 0.7% in July.

The UK headline annual inflation rate (CPIH) which includes housing costs was 3.1% in September up from 2.5% in June and 1.5% in April. Transport, recreation and culture were the main drivers pushing up the inflation rate. I expect that October's rate of inflation will be somewhat higher due to higher global energy prices but also the phased increase in VAT on hospitality from 5% to 12%. Core inflation rate which excludes food, energy, alcohol and tobacco, was up from 2.3% in June to 2.9% in September.

Japan's headline inflation rate was revised down over the summer, while the September rate has been reported at +0.2%, Japan saw monthly deflation of between -0.3% and -1.2% in the previous 12 months. The main driver of September's increase was housing costs and food, but again just as with the GDP data mentioned above the changes were from small negative to small positive numbers. Core inflation which only excludes fresh food was +0.1% p.a. after 12 months of deflation.

4. The outlook for the securities markets

In my last report I suggested that the easy part of the recovery with rapid rebound in growth and securities markets is over. The economic recovery is underway and remains on track, but one cannot just turn off a “just in time” global supply chain dependent upon high and uniform levels of production and free flowing trade from one part of the globe to another and turn it back on again and expect everything to just return to normal immediately. And that is before one factors in the variation in the impact of covid, the time taken for the migration of covid variants to move around the world, the different responses (lockdown/vaccination) and the implications of these differences on logistics.

I believe we are approaching the end of the period of “super easy monetary policy” in the US and in the UK, but it is likely to continue in Europe for a bit longer because of the much smaller amounts of money being deployed and because of the scale of the issues outside of the EU’s northern block. This should have implications for government and higher quality non-government bonds which have become increasingly sensitive to interest rates. Inflation is clearly a cause for concern over the next 12 to 18 months but I still believe higher inflation is a “tax on growth” and that supply chain issues are temporary. I expect inflation will fall back to around 2% to 3% rather than the 1% to 2% we have become accustomed to over the last 10 years.

I do not expect equity markets to deliver the high double digit returns we have seen in the last 12 to 18 months but a more moderate pace of growth and inflation and a slowly rising interest rate environment in the medium term is constructive for equity markets. Some markets and sectors are clearly over valued and a rising interest rate environment is a head wind for growth stocks, but overall, I expect equity markets to be higher even if company and sector leadership is different.

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Bond Markets

In table 6, below I have set out my expectations for 3 month LIBOR interest rates and benchmark 10 year government bond yields, over the next 6 and 12 months. They are not meant to be accurate point forecasts, more an indication of the possible direction of yields from November 2021.

Table 6: - Interest rate and Bond yield forecasts

%	CURRENT	JUNE 2022	DECEMBER 2022
UNITED STATES			
3month LIBOR	0.15	0.25	0.25
10 year bond yield	1.56	2.0	2.25
UNITED KINGDOM			
3month LIBOR	0.11	0.25	0.50
10 year bond yield	0.92	1.25	1.50
JAPAN			
3month LIBOR	-0.09	-0.10	-0.10
10 year bond yield	0.08	0.10	0.10
GERMANY			
3month EURIBOR	-0.57	-0.50	-0.50
10 year bond yield	-0.26	0.0	0.0

Source: - Trading Economics; 12th November 2021

UK Government 10 year bond yields have been volatile since June, falling to a low of 0.5% in August before peaking at 1.2% in October and then falling back to 0.9% currently. 2 year yields have increased from 0.1% to a peak of 0.7% in October and they too have fallen back to 0.5%. The cause of the volatility and the overall increase in shorter dated yields is inflation and the poor messaging of the Bank of England governor, who suggested that a rate rise in November was likely. Outside of the UK, government yields and curve shapes in Europe and Japan are broadly unchanged, but significantly in the US the yield curve has also flattened implying that bond markets are now expecting interest rate hikes.

I mentioned in my last report that I expected government yields to increase and yield curves to potentially steepen as central bank interest rates would remain anchored until QE programmes were completely ended. I still believe this to be the case in US, as the Fed has a dual mandate of “Full employment and Stable inflation”. However, the BoE does not have that luxury and while it has adopted a more flexible approach to inflation, it only has an inflation target. Hence, I anticipate that the BoE could increase the base rate as early as it’s MPC meeting in February 2022, if not before unless they can see slower growth and moderating if still elevated inflation.

I have not changed my forecasts I still expect government bond yields to rise over the medium term but I believe at their current levels yields are just as likely to fall as they are to rise in the short term. I am also willing to stick with the risk that yield curves could steepen as the recovery continues.

Low, central bank policy rates, refinancing costs and government bond yields, all suggest the extra yield spread for non-government and high yield bonds and loans may be attractive, but spreads in aggregate are now back to the lows seen prior to the global financial crisis. These bonds have other attributes, their low interest rate sensitivity means the are less impacted by rate hikes and their linkage to the economic recovery means issuers should be better able to avoid default. Manager selection in this area is extremely important and the take on of these risks needs to be carefully balanced.

Bond Market (Protection Assets) Recommendations

The total allocation to Protection assets in the strategic benchmark is 18%. After the recent volatility in government bonds, I believe the direction is just as likely to be down in yield as up in yield. However, over the medium term still believe yields will rise hence I am happy to remain underweight protection assets. I continue to suggest 2% underweight gilts, in favour of holding a higher weight in cash. I would keep the weight to investment grade corporates neutral at 6% in recognition of the higher income and lower duration.

I recognise the benefit of holding government bonds as protection against a selloff in equity markets and to match the Scheme's liabilities but at their current low level of yield government bonds neither provide the income they did in the past whilst protection against falling interest rates is less of a benefit when yields are so low.

As usual in table 7 below I have updated the data and recalculated my estimates of the total return impact of rising yields for government and non-government bond indices based on their yield and interest rate sensitivity (Duration) over 3 and 12 months. The estimates show that there is very little income protection even for small increases in yield at current durations and spreads.

Table 7: **-** Total returns from representative bond indices

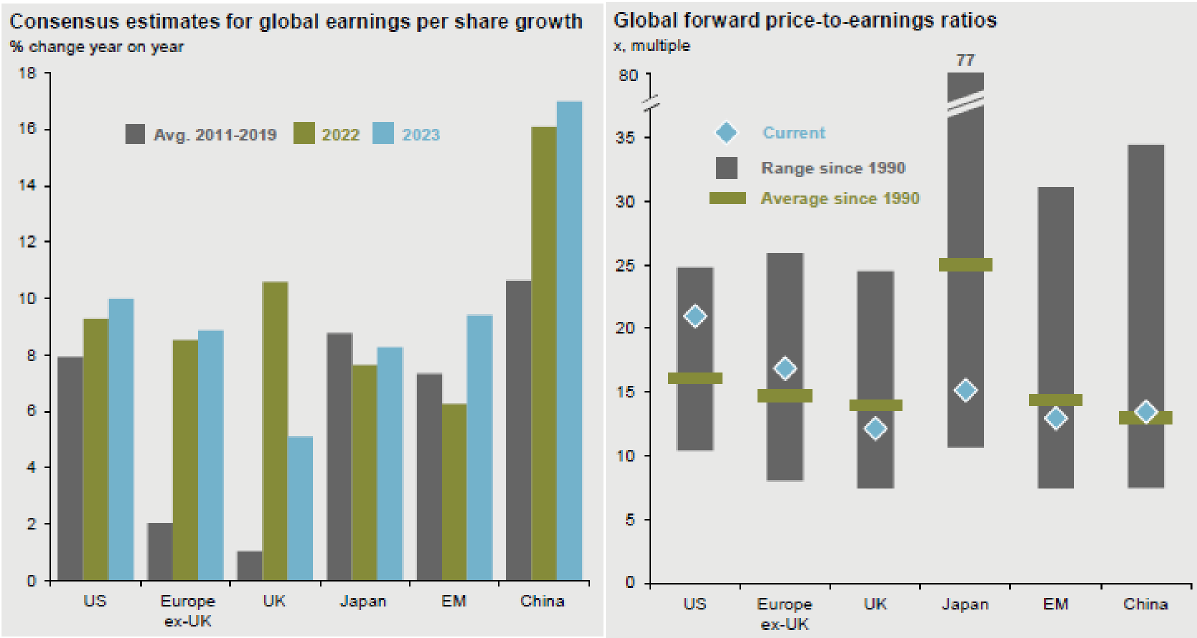
INDEX	YIELD TO MATURITY %	DURATION	YIELD INCREASE %	% TOTAL RETURN, HOLDING PERIOD	
				3 MONTHS	12 MONTHS
All Stock Gilts	0.86	13.0	0.5	-6.3	-5.6
All Stocks Linkers	-2.85	16.6	0.5	-8.2	-8.3
Global IG Corporate	1.76	7.3	0.5	-3.2	-1.9
Global High Yield	4.73	4.0	0.5	-0.8	+2.73

Source: - ICE Indices 12th November 2021

Equity Markets

Chart 9 below, left hand side, shows the consensus earnings per share growth estimates, for 2022 and 2023 compared to the annual average between 2011 and 2019. The right hand side shows, the current forward looking estimates of price / earnings ratio of the same market indices compared to the range and the average since 1990, except for China where the data only goes back to 1996, provided by JP Morgan Asset Management.

Chart 9: **-** LHS **-** Earnings per Share estimates, RHS **-** Price/Earnings Ratios, since 1990, China 1996



Source: - JPM Asset Management., October 2021

As can be seen earnings per share for the next couple of years is expected to be stronger or in-line with the average between 2011 and 2019 despite covid, and the recent supply side issues impacting the pace of recovery and causing higher energy and commodity prices. The right hand chart shows that p/e ratios are well above the 30 year average in the US, above average in Europe, fair value in emerging markets and China, with only the UK and Japan looking cheap.

If we focus on just the p/e ratios the chart suggests to me is that a lot of the good news on the earnings recovery is already in the price especially in the US. However, this is typical of the way equity markets perform after a shock as they move quickly to discount the future. What the left hand chart is suggesting is based on what equity analysts are hearing from companies, they can see earnings continuing to improve as the supply side disruptions dissipate. According to the equity analysts the expansion in the business cycle is currently described as “mid-cycle”. If this is the case then the equity markets can continue to perform well especially those which are pro-cyclical and /or cheap on p/e, valuation basis.

After a very strong 2nd quarter, US 3rd quarter earnings have again beaten expectations with more than 80% of companies outperforming analyst expectations. At the moment pent-up demand and excess savings means that companies are able to pass on the higher costs being caused by supply side disruptions and while order delivery times are being extended the orders are not being cancelled.

Ironically if inflationary expectations continue to increase, orders may rise in order to try and beat price increases, but there is also a tipping point beyond which higher non-discretionary spending eats into discretionary consumption. It's a bit more difficult to see that tipping point this time round because personal earnings have also risen faster, but also because we do not know how much the last 18 months has impacted consumers' willingness to save.

On balance I still believe there is upside in equity markets, but the returns will be harder won, with more volatility and lower aggregate returns to those we have seen over the last year. I believe it pays to look at valuations and earnings, both of which suggest to me there are easier gains to be had outside the US especially when the economic cycle is factored in. Finally, if the bond markets are right about the direction of interest rates sector leadership could change and this may favour "quality" companies, ie the stuff you have to buy, and at the margin lower leveraged "value" companies over highly levered "growth" companies.

Equity Market (Growth Assets), Recommendations

At the start of the 2021 substantial changes were made in the mix of growth assets to fit with the Fund's new Investment Strategy. The Fund is now approaching the time when the second part of the transition will be executed. From 1st January 2022 the Fund's Strategic Asset Allocation Benchmark will be as set out in column 2 of Table 8 below. Ultimately this change will see the complete disinvestment from the direct USA, European and Pacific Basin ex Japan portfolios and a further reduction in the allocation to UK equity, with an increased investment in Global Sustainable Equity. Once the transition is complete the combination of remaining regional and the new global funds will better match the Funds overall desired Strategic Asset Allocation to growth assets. The total allocation to Growth Assets will also fall by 1% in favour of increasing the exposure to Infrastructure in the Fund's Income Asset allocation.

While the In House Team (IHT] will be ready for this second stage of the transition it is likely that some of the new investment vehicles may not be available at the beginning of the year, hence the transition may take place later in the quarter. The size of the transition required is so significant that I would not propose making any tactical or temporary changes in the asset allocation, preferring instead to wait for the new vehicles to become available. This may have a positive or negative impact on the relative performance of the Fund compared to its benchmark in the short term, but I believe the transaction costs that may be associated with a temporary or tactical change in allocation could be larger and could also make the process more complicated to manage.

I would also suggest that if the transition needed to be phased over the quarter that sales and purchases should be executed in a proportional way. Rather than selling out of one region or fund before another.

Income Assets

Ideally, I would like the exposure to Income assets to be neutral to the strategic allocation. Looking at the current allocations Infrastructure remains the main underweight and this will increase when the benchmark changes in January 2022. Building the allocation to Infrastructure takes time and at the moment this asset class is attracting strong demand from investors, so I am happy that the IHT is not rushing to increase exposure, the appropriate returns are being sought and investment due diligence is being done.

The spread available from high yield bonds and loans, and emerging market debt has widened slightly again in the period to mid-November yet despite this the return has been better than conventional gilts and investment grade credit. This is because the income from these assets classes provides the majority of the return, I believe this will continue for some time so I am happy to suggest a neutral allocation to Multi-asset Credit.

The performance of the property allocation has proved to be resilient over the last 12 to 18 months despite the impact of covid. As could have been expected the direct property allocation has out-performed the indirect allocation. I would like to see the direct allocation increase funded using net sales from the in-direct exposure, but again as with infrastructure this needs to be done with caution as it is a very long term investment decision, and in the case of property transactions quite expensive.

As noted above in "protection assets" I would suggest a 2% overweight to cash from Gilts because of the extremely low yield and the high duration risk currently attached to the asset class. At the end of October, the Fund was holding around 5.5% in cash, but more than 3% of this figure is already promised for future private market investments. Given the current valuation of all investment markets I am not in hurry to reduce the cash allocation.

The asset allocation set out in table 8 below, shows the new Interim Benchmark and my suggested asset allocation weights relative to this benchmark as of the 18th August and 12th November 2021. These allocations represent an ideal objective for the Fund based on my expectations for economic growth and market performance, but they do not take into consideration the difficulty in reallocating between asset classes and the time needed by the In-house Team and their investment managers to find correctly priced assets for inclusion in the Fund.

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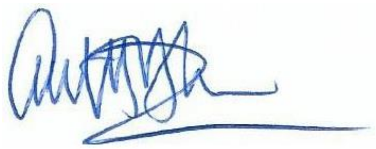
Table 8: - Recommended asset allocation against the Strategic Benchmark.

The 2 righthand columns show my suggested allocations relative to the interim benchmark that came into effect on the 1st January 2021. I have also included the new strategic benchmark that comes into effect on the 1st January 2022. This change completes for benchmarking purposes the migration to the new allocations for growth assets. Given the magnitude of the changes I do not propose taking a tactical position, other than to note the US remains expensive and the UK cheap on a relative valuation basis.

% ASSET CATEGORY	DERBYSHIRE STRATEGIC WEIGHT 1ST JANUARY 2021	DERBYSHIRE STRATEGIC WEIGHT 1ST JANUARY 2022	ANTHONY FLETCHER 18TH AUGUST 2021	ANTHONY FLETCHER 12TH NOVEMBER 2021
Growth Assets	**56**	**55**	**0**	**0**
UK Equity	**14**	**12**	**0**	**0**
Overseas Equity	**42**	**43**	**0**	**0**
North America	6	**0**	**0**	**0**
Europe ex UK	4	**0**	**0**	**0**
Japan	5	5	**0**	**0**
Pacific ex Japan	2	**0**	**0**	**0**
Emerging markets	5	5	**0**	**0**
Global Sustainable	16	**29**	**0**	**0**
Private Equity	4	4	**0**	**0**
Income Assets	**24**	**25**	**0**	**0**
Property	9	9	**0**	**0**
Infrastructure	9	**10**	**0**	**0**
Multi-asset Credit	6	6	**0**	**0**
Protection Assets	**18**	**18**	**-2**	**-2**
Conventional Gilts	6	6	**-1**	**-1**
UK index Linked	6	6	**-1**	**-1**
US TIPS	0	0	**0**	**0**
UK corporate bond	6	6	**0**	**0**
Cash	2	2	**+2**	**+2**



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Appendix

References

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- Derbyshire Pension Fund, PEL performance services
- FTSE and ICE Indices
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- Bloomberg, FactSet, Markit and Trading Economics
- Financial Times, Daily Telegraph, Wall Street Journal, New York Times, Washington Post