MJ HUDSON Allenbridge

First Quarter 2022 Investment Report

PREPARED FOR:

Derbyshire County Council Pension Fund: Pensions and Investment Committee Meeting

JUNE 2022

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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 June 2022
Date of paper 18th May 2022

1. Market Background (First quarter 2022)

The first quarter of 2022 started with investors facing rising inflation and tighter monetary conditions, the Chinese response to the Omicron variant, and the impact these headwinds would have on their investments. Bond yields were already rising and equity prices were falling accompanied by a pronounced rotation from more interest rate sensitive growth stocks to value stocks.

Then on the 24th February, Russia unexpectedly to most western governments, invaded Ukraine seeking to grab more land in the eastern part of the country, but more importantly to replace the perceived pro-western government by force, with a regime completely in the Russian "sphere of influence" like the government in Belarus.

Western governments quickly responded with a strong degree of unity, pledging support for Ukraine and imposing escalating sanctions on Russia including excluding its banks from the international payments system and freezing the international assets of the Russian Government, Officials and Oligarchs, linked to Russia.

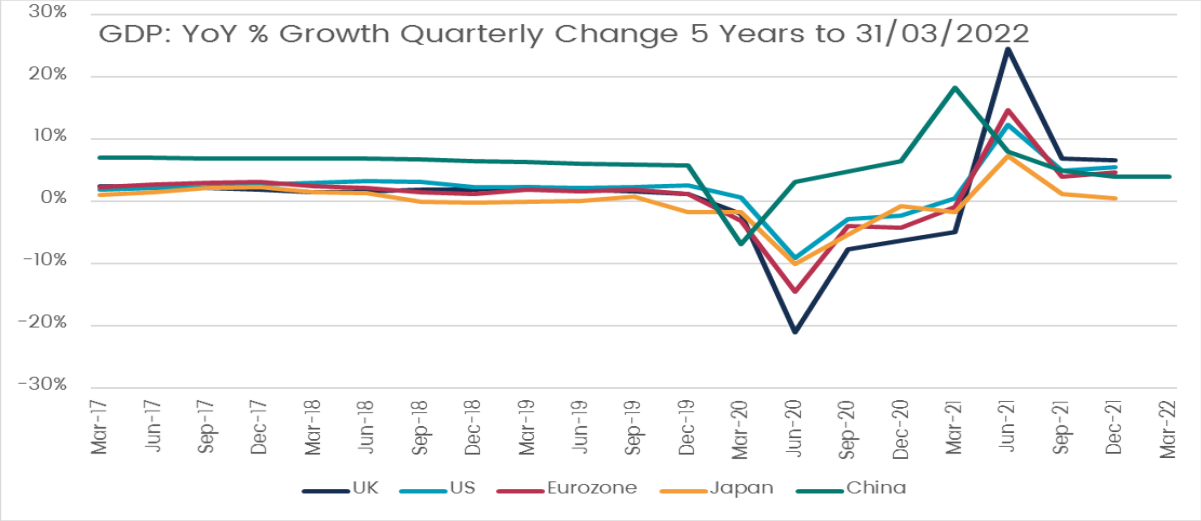
As can be seen in table 1 below, markets responded with a highly correlated broad based sell off with the most interest rate sensitive and over valued assets suffering the most. The worst performing region has been Europe, because of its dependence on Russian oil and gas and because many manufacturers have supply chains linked to Ukraine. From a sector point of view the rotation from growth to value was compounded by the invasion with Energy, Commodities and Materials outperforming and the Technology and Consumer Discretionary sectors underperforming.

From a Macro-economic point of view, developed economies were approaching full employment and due to supply chain disruption related to the post covid re-opening and already higher energy prices, inflation was rapidly increasing forcing central banks to act. During the quarter the US Fed raised interest rates for the first time since 2018 and announced a programme of balance sheet reduction also know as Quantitative Tightening (QT). The Bank of England also raised rates and the ECB suggested that its QE programme would end sooner than expected even suggesting that they may increase rates later this year.

Despite the strong fundamentals of excess savings and almost full employment global growth was already slowing due to higher energy prices and inflationary pressures on household spending. This has been compounded in the UK by the withdrawal of government support packages and higher taxes.

The war has increased and extended the period of higher inflation and already led to sharp falls in consumer sentiment and growth rates have also slowed further. All of which is likely to have a marked impact on discretionary spending over the rest of the year. The risk of recession especially in Europe has increased substantially.

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



Source: - Bloomberg

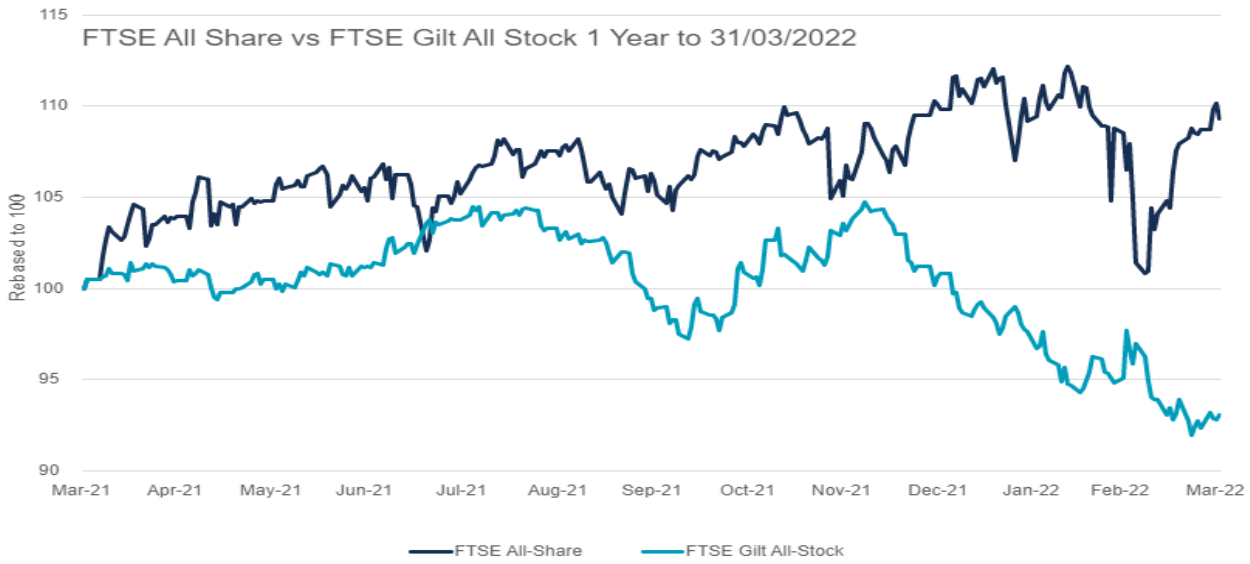
Table 1, below shows the total investment return in pound Sterling for the major asset classes, using FTSE indices except where noted; for the month of April 2022 and the 3 and 12 months to the end of March 2022.

% TOTAL RETURN DIVIDENDS REINVESTED

	MARKET RETURNS		
		Period end 31st March 2022	
	April 2022	**3 months**	**12 months**
Global equity FTSE All-World	-3.4	-2.4	12.8
Regional indices			
UK All Share	0.3	0.5	13.0
North America	-4.5	-2.0	19.7
Europe ex UK	-1.8	-7.2	6.2
Japan	-4.1	-3.5	-2.3
Pacific ex Japan	-0.5	-2.2	-4.3
Emerging Equity Markets	-0.6	-2.5	-3.5
UK Gilts - Conventional All Stocks	-3.0	-7.5	-5.3
UK Gilts - Index Linked All Stocks	-6.6	-5.7	4.6
UK Corporate bonds*	-3.2	-6.9	-5.4
Overseas Bonds**	-2.6	-4.5	-3.8
UK Property quarterly^	-	4.0	18.7
Sterling 7 day SONIA	0.0	0.1	0.1

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

Chart 2: - UK bond and equity market returns - 12 months to 31st March 2022



Source: - Bloomberg

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

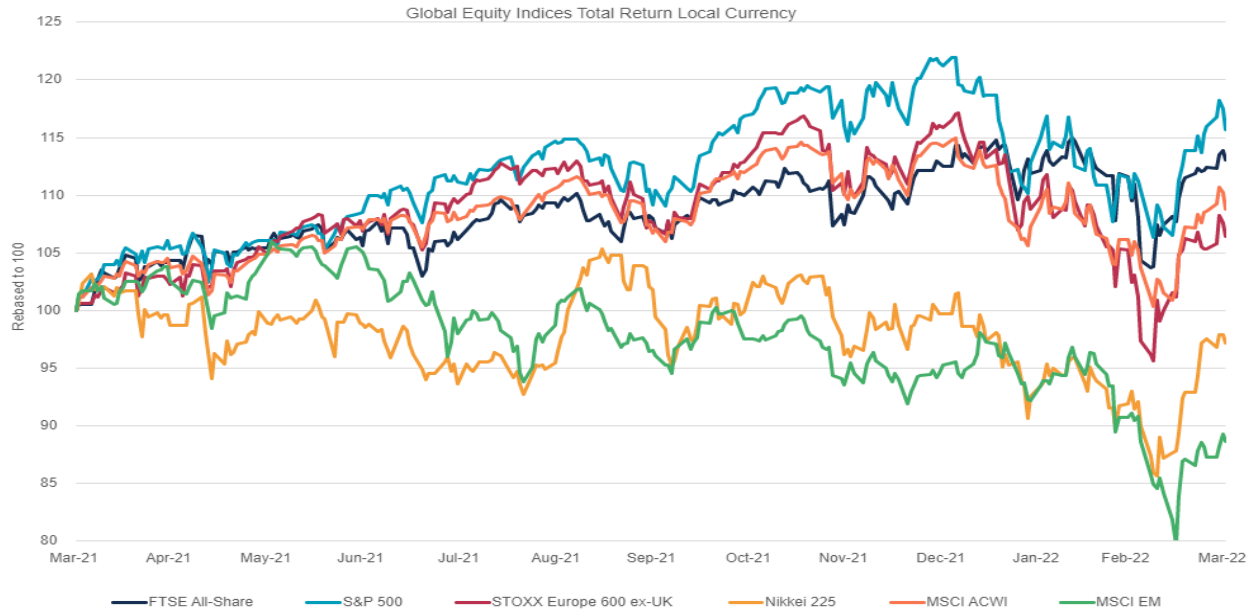
BOND MARKET % YIELD TO MATURITY	31st December 2021	31st March 2022	Quarterly Change %	31st March 2021	Current 17th May 2022
UK GOVERNMENT BONDS (GILTS)					
10 year	0.97	1.61	**+0.64**	0.85	**1.84**
30 year	1.12	1.74	**+0.62**	1.39	**2.04**
All Stocks ILG	-2.59	-2.38	**+0.21**	-2.31	**-2.27**
OVERSEAS 10 YEAR GOVERNMENT BONDS					
US Treasury	1.52	2.35	**+0.83**	1.75	**2.94**
Germany	-0.18	+0.55	**+0.73**	-0.18	**1.03**
Japan	0.07	0.21	**+0.14**	0.10	**0.24**
NON-GOVERNMENT BOND INDICES					
Global corporates	1.86	3.03	**+1.17**	1.75	**3.71**
Global High yield	4.60	6.02	**+1.42**	4.41	**7.49**
Emerging markets	4.05	5.23	**+1.18**	3.80	**6.38**

Source: - Trading economics and ICE Indices G0LI, G0BC, HW00, EMGB, 17th May 2022.

Chart 3: - UK Bond index returns, 12 months to 31st March 2022.

Source: - Bloomberg

Chart 4: - Global equity market returns in local currency, 12 months to 31st March 2022



Source: - Bloomberg

Recent developments (April and early May 2022)

The market weakness and correlated sell off in equities and bonds continued in April but there are signs in May that bond markets could be beginning to react differently. The war remained the main concern for the markets with global equities declining by another -3.4% and UK government bond markets also returning -3.0% in April. Month to date in May, while equity markets have shown further declines, bond yields could have peaked for now. Despite higher inflation data and stronger rhetoric, central bank actions have not been as aggressive as markets feared. Also, it is clear that the global economy is slowing and April's US core goods inflation may have peaked.

China's zero covid policy is also putting their 5.5% growth target at risk as Shanghai and now Beijing and several other major cities are in full lockdown as the authorities try to cope with the much more infectious Omicron variant and an ineffective vaccine. Fiscal and monetary policy has been eased to provide an offset, but Chinese and Asian equity markets continue to fall as weaker growth and the potential for further supply chain disruption is priced in.

The US dollar continues to strengthen against all currencies, most notably versus the Yen and the Euro, partly due to the war but also because of higher US bond yields and interest rates. Oil and gas price increases moderated in April and May as demand fell and the US released oil from its strategic reserves.

In France Emmanuel Macron was re-elected as French President for another 5 year term defeating Marine Le-Pen in a repeat of the 2017 election, but with a smaller majority. In the UK Brexit tensions have become more prominent with the election in Northern Ireland returning for the first time a nationalist majority and the Unionist party refusing to enter the power sharing executive while the NI/EU trade protocol remains in place. This raises the prospect of further trade issues between the UK and EU.

Looking forward over the next 12 months, it is clear that the war in Ukraine has increased uncertainty and market volatility, but in the past markets have shown resilience and the ability to adapt to geopolitical events with surprising speed. While the magnitude of this event cannot be ignored, in Europe, involving a nuclear armed autocratic power on the border with NATO, we may have already seen the majority of the price moves.

I expect to see more general equity and bond market volatility due to the changed geopolitical situation as well as macro factors like inflation and interest rates and more stock specific risk as investors focus on stock selection rather than just buying the market.

2. Investment Performance

Table 3 shows the performance of the Derbyshire Pension Fund versus the Fund specific benchmark for the quarter and year to 31st March 2022. Over 12 months, the broad asset class categories outperformed, but individual manager performance was much more mixed when compared to their respective benchmarks.

Over 10 years the Fund has achieved a total return of 8.4% per annum, net of fees.

Table 3: - Derbyshire Pension Fund and Benchmark returns

% TOTAL RETURN (NET) 31ST MARCH 2022	3 MONTHS		12 MONTHS	
	Derbyshire Pension Fund	**Benchmark**	**Derbyshire Pension Fund**	**Benchmark**
Total Growth Assets	**-3.8**	**-2.0**	**9.8**	**9.8**
UK Equity	-0.6	0.5	12.0	13.0
Total Overseas Equity	**-5.7**	**-2.8**	**5.9**	**8.7**
North America	-2.0	-2.0	17.9	19.7
Europe	-7.1	-7.2	6.4	6.2
Japan	-6.0	-3.5	-5.1	-2.3
Pacific ex Japan	-8.6	-2.2	-11.7	-4.3
Emerging markets	-6.9	-2.5	-6.4	-3.5
Global Sustainable Equity	-6.8	-2.7	10.1	13.4
Global Private Equity	1.9	-2.5	40.6	10.4
Total Protection Assets	**-5.9**	**-6.5**	**-1.5**	**-1.6**
UK & Overseas Government	-5.8	-7.2	-4.4	-5.1
UK & Overseas Inflation Linked	-4.6	-5.5	5.5	5.1
Global Corporate bonds	-7.0	-6.7	-5.1	-4.9
Total Income Assets	**2.0**	**1.6**	**10.9**	**8.4**
Multi-asset Credit	-0.3	-0.2	4.1	2.2
Infrastructure	2.2	0.6	9.5	2.2
Property (all sectors)	4.0	3.9	18.8	19.5
Internal Cash	0.1	0.1	0.1	0.1
Total Fund	**-2.7**	**-1.9**	**7.6**	**7.3**

Total fund value on 31st March 2022 £6,104 million

The Fund remains slightly overweight growth assets and underweight protection and income assets relative to the strategic benchmark. Over the first quarter of 2022, the Fund underperformed mainly due to stock selection decisions made by our managers. The sector rotation in equities which started

towards the end of 2021 continued to have a negative impact mainly on growth stocks. Over 12 months the Fund is 0.3% ahead of benchmark, protection and income asset classes outperformed and while growth assets in total matched the benchmark, regional equity performance was extremely mixed with Pacific ex-Japan and Japan performing poorly compared to developed equity markets.

Over 3 years since the last Triennial valuation point, the Fund has outperformed in all asset classes and the total return is 7.4% p.a. compared to the benchmark return of 6.9% p.a.

Growth assets – Equity performance

In the first quarter of 2022, at the aggregate level, the equity portfolio underperformed its benchmark. Absolute returns from growth assets were negative in all regions except the UK and unusually all of Derbyshire's active managers except Wellington responsible for the North American portfolio underperformed their respective benchmarks. Investments in global private equity funds delivered a positive return and outperformed the benchmark.

Over 12 months the total portfolio of growth assets produced a strong positive return in line with the benchmark but again there was a lot of regional variation. Japan, Pacific ex-Japan and emerging equities produced negative returns that were also below benchmark, whereas UK, US and global sustainable equity produced positive absolute returns, but these were also behind benchmark. The European assets are managed passively, performance was positive and in line with market returns. Global private equity returns were outstanding, as valuations caught up public market equivalents.

The main drivers of poor performance over the last 12 months have been in South-east Asian equity, the impact of a changed regulatory environment in China and its zero covid policy, and the contagion these policies have caused in the region. In Japan, the very slow recovery from covid. In the equity portfolio more generally, the sector rotation from growth to value stocks that started in late 2021 has continued year to date driven by higher interest rates, inflation, and the war in Ukraine.

Over 3 years growth assets have delivered an aggregate return of 10% p.a., 0.3% more each year than the strategic benchmark, net of fees. Over 10 years growth assets have returned on average 10.2% p.a. compared to 9.7% p.a. for the benchmark.

Protection assets - Fixed Income Performance

Rising inflation, interest rates and the war, caused bond yields to rise significantly over the quarter delivering negative returns. Re-establishing the trend seen over the year where bond markets sought to price in the strong economic recovery leading to negative returns from the most interest rate sensitive long maturity sectors. The Fund remains underweight its allocation to UK government bonds and has less interest rate sensitivity than the benchmark. As a result, the government bond portfolio outperformed the benchmark over 3 and 12 months. Global corporate bonds underperformed as yields increased and credit spreads also widened.

Over 3 years protection assets have delivered 1.8% p.a. 0.5% p.a. more than the benchmark. Over 10 years protection assets have on average returned 4.2% each year compared to the benchmark return of 4.4%.

Income assets – Property, Infrastructure and MAC

Over the quarter and the year, the combined portfolio of income assets has outperformed the benchmark, mainly due to the strong performance of Infrastructure and MAC. Over 12 months a better period for measuring returns in this asset class the direct property portfolio outperformed, whereas the funds in the in-direct portfolio underperformed.

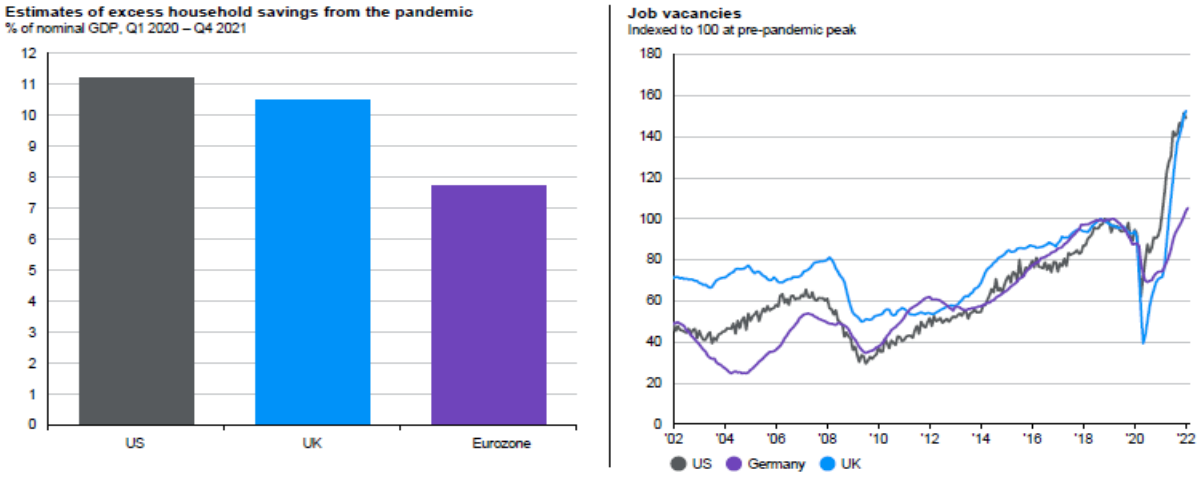
Over 3 years Income assets have on average delivered 6.6% p.a. 2.3% p.a. more than the benchmark. Over 10 years Income assets have on average returned 9.5% each year compared to the benchmark return of 4.8%.

3. Economic and Market outlook

Economic outlook

The global economy started the year in reasonably good health, the residual tail winds of very strong jobs growth and excess household savings and strong corporate earnings providing a good support for global growth. These factors remain, but higher inflation and the war have reduced their impact.

Chart 5: - Excess savings and Job Vacancies

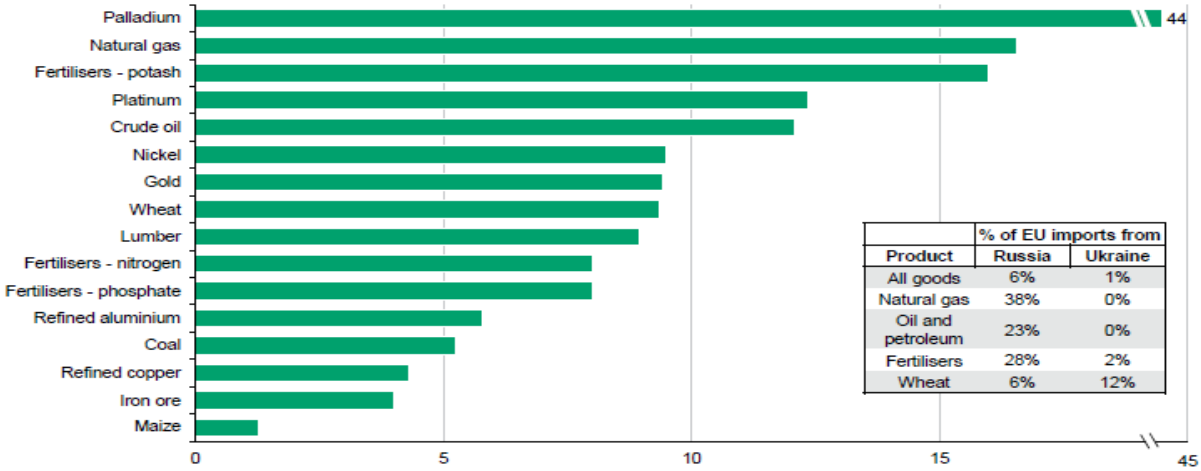


Source: - JPMorgan Asset management

Consumers have responded by becoming much more cautious, and companies and governments are starting the process of moving away from the dependence on Russian sourced commodities. Add to this the lockdowns in China and it would seem reasonable to expect the global economy to slow more than expected and for inflation to remain higher for longer.

The proximity of Europe to the conflict and it reliance particularly on Russian gas suggests that the risk of recession has significantly increased. Higher energy prices and the cost of living crisis in the UK has also increased the chance of negative growth. The US and economies further afield may avoid recession but a period of extended lower growth and higher inflation cannot be discounted.

Chart 6: - Russian commodity production as a % of global production in 2020.



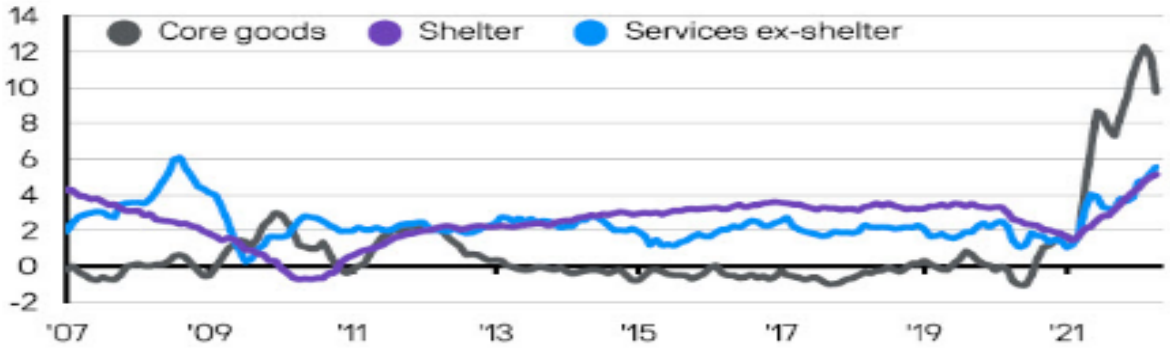
Source: - JPMorgan Asset management

As can be seen in chart 6 above Russia is a major supplier of commodities to the global economy. Ukraine and the western part of Russia are also important exporters of grain and other important foodstuffs. While the harvest from last year is in storage, the ports and ships that are required to enable it to be exported to the rest of the world have been blockaded. If another route out of the region cannot be found there will be a significant problem with this year's harvest which will be starting in July. This has important implications for global food prices, especially in poorer countries as the UN World Food Programme is also a major buyer and distributor of Ukrainian wheat.

Inflation

As mentioned in my last report and above, inflation is running very hot at the moment and is likely to remain high for some time even if the rate has started falling. Chart 7 shows the latest Inflation data from the US, which indicates that in April headline inflation fell to 8.3% from 8.5% in March and that core inflation excluding food and energy fell from 6.5% to 6.2%, led by the goods component which had been the main driver of US inflation due to supply bottlenecks since the summer of last year.

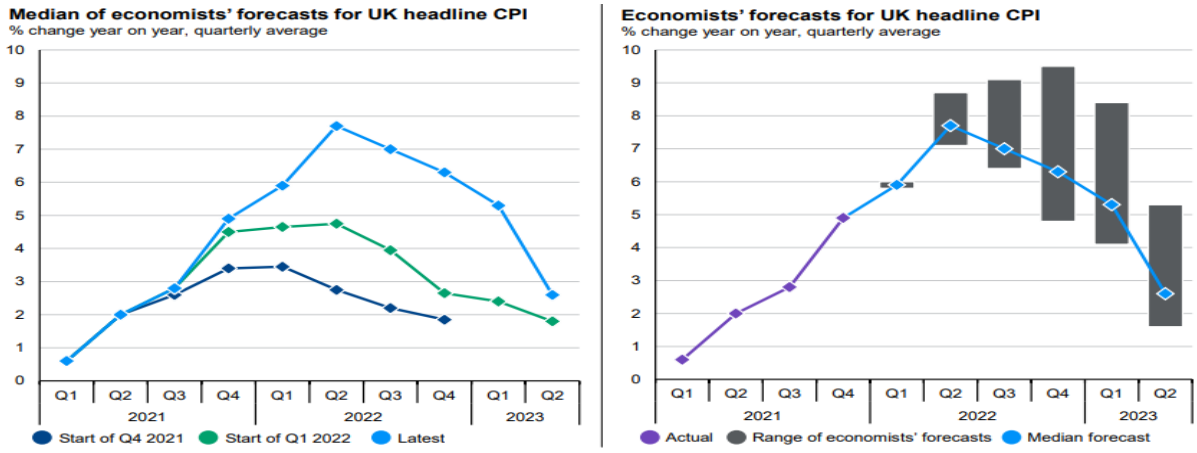
Chart 7: - Inflation – year over year change in selected components of US headline inflation.



Source: - JPMAM 13th May 2022

Chart 8 below show the revised median forecasts for UK inflation and the range of possible outcomes over the next 5 quarters. Economists have been playing catch up with the actual rate and extending the period of higher inflation, but the direction of inflation is expected to be lower by the second half of 2022, although as can be seen from the range of forecasts, uncertainty is high.

Chart 8: - Economists' forecasts of UK headline CPI.



Source: - JPMAM April 2022

On balance the experience of the last 20 years is that higher inflation reduces discretionary consumption and reduces economic growth. The trick for the central banks will be to increase interest rates sufficiently to reduce the level of inflation without crashing the economy. A problem made more difficult by supply shocks which they have no control over and is currently the main driver of higher inflation.

Central Banks

Since the beginning of the year central banks have become more aggressive in their rhetoric around inflation and interest rates and they have not yet been deflected from increasing rates despite the weaker outlook and the impact of the war in Ukraine. In February the US Fed started raising rates and in May announced a programme of QT will start in June gradually increasing over the summer. This time QT will be double the pace of the Fed's last programme and will start from September onwards involve selling each month US$ 60 billion of US Treasuries and a further US$ 35 billion of MBS, back to the market. Having increased rates by only 0.25% in February the Fed increased by 0.5% in May and suggested that the next 2 rate hikes could also be 0.5% each.

At its meeting in May the Bank of England again raised rates by 0.25% to 1%, the BoE has also started reducing its balance sheet by not replacing the £28 billion of gilts that matured in March. Unlike the Fed the BoE has no plans at the moment to sell bonds back to the market, based on the current schedule of redemptions the BoE will have reduced its £875 billion balance sheet by around £230 billion by the end of 2025.

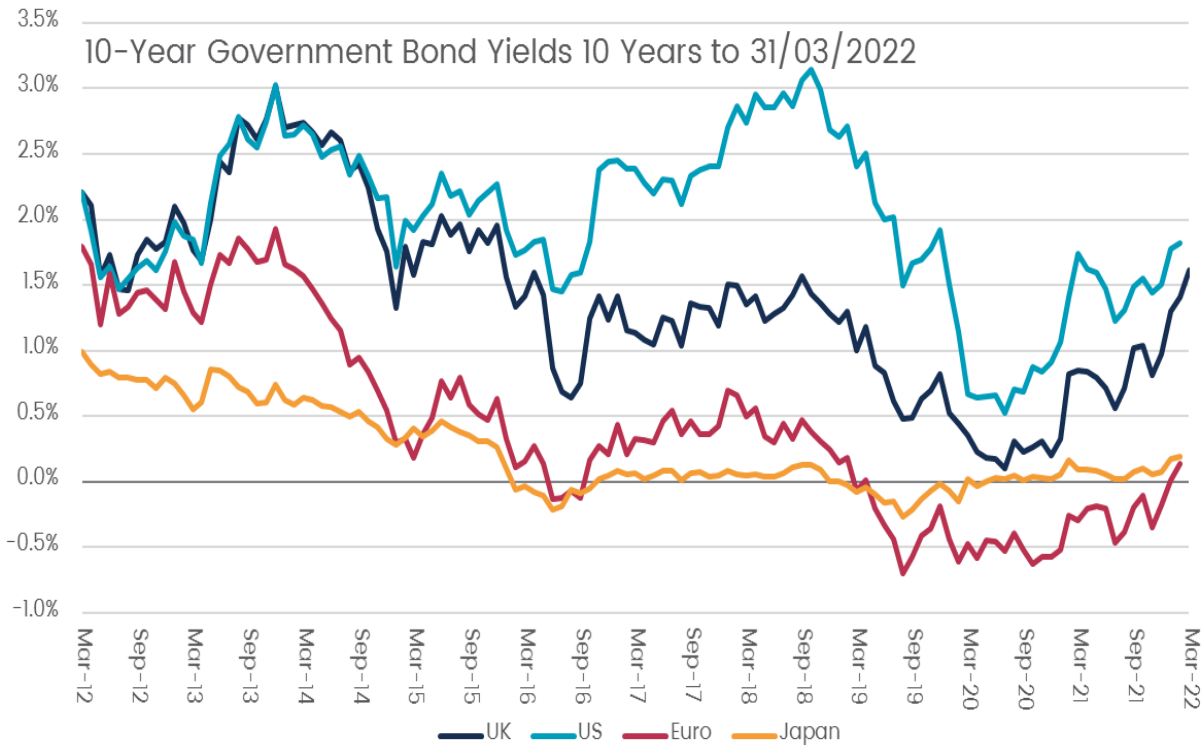
The ECB has also indicated that it will end its QE programme in June and may be willing to start increasing rates from July. Only the Bank of Japan has stuck to its easy money policy. At its meeting in April the BoJ confirmed that it will leave short term policy rates at -0.1% and will offer to buy unlimited amounts of bonds to defend an implicit 0.25% yield cap for 10 year JGB's.

Government bonds

Government bond yields ended the quarter at new highs for the last 12 months and their highest level since before the pandemic. As mentioned in my last report the negative returns provide a warning to investors that in times of higher interest rates and heightened inflationary risks, long duration government bonds may provide less protection to portfolios than in times of recessionary risk. As can be seen in Table 2 above, all bond yields have increased since the beginning of the year, but it is the longer duration government and investment grade non-government bonds that have delivered the worst returns as show on Table 1 above.

I have not changed my medium term view that government bonds yields could rise and deliver a near zero or even negative returns in the next 12 months. Especially if central banks continue to respond more to the inflationary risks than the increasing recession risk. However, I believe that markets may have started to focus more on the recessionary risks, hence they now believe central banks may not be so aggressive on rate increases. Which suggests at their current level with the increased uncertainty around the outlook for growth, yields may have risen enough for now to price in higher interest rates even though inflation has clearly not yet peaked.

Chart 9: - Government bond yields, last 10 years.



Source: - Bloomberg

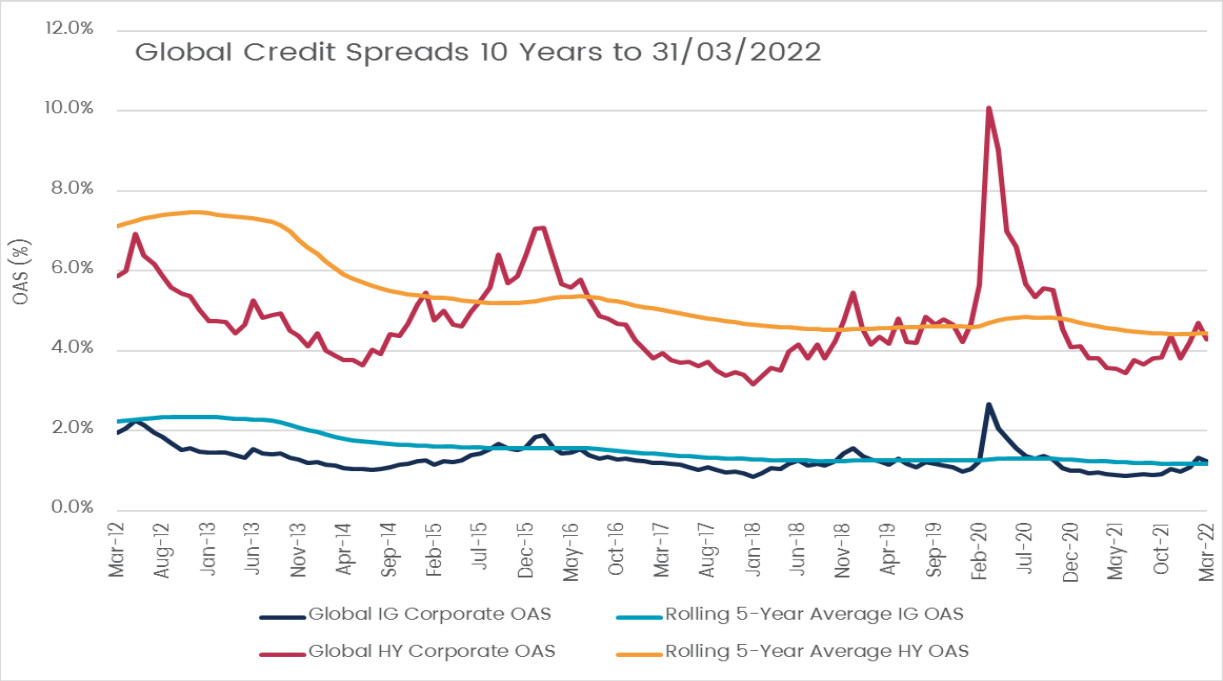
Non-government bonds

Chart 10 below, shows the excess yield spread for both investment grade non-government and high yield bonds to the end of the first quarter. As can be seen from the chart spreads have widened from their lows in the summer of last year and although they dipped at the end of the quarter they are as can be seen on table 2 above wider at the current time.

The Derbyshire Pension Fund (DPF) owns investment grade non-government bonds as part of its Protection Assets allocation, (global corporate bonds) the spread of which is represented by the blue lines below. While their spread has not widened by much these bonds have longer duration, as a result their performance has matched the negative returns of government bonds. The DPF's high yield bonds and loans are owned as part of its Income Assets allocation, (Multi-asset Credit) the spread of which is represented by the red and yellow lines. Because these assets have lower interest rate sensitivity (duration), much higher yields, and because may have floating rather than fixed coupons they have produced smaller negative returns, outperforming both government and investment grade non-government bonds.

High yield assets are more sensitive to the economy, so the expected slowdown in economic growth has increased the risk of default especially for more leveraged parts of the economy. At these higher levels of yield, I still expect Multi-asset Credit funds with their mix of low duration bonds and floating rate loans to outperform both government and investment grade non-government bonds. Provided the pace of downgrades and defaults does not increase significantly, as the key to success with this asset class is picking managers with the skill to avoid defaults.

Chart 10: - Credit spreads, extra yield over government bonds, last 5 years.



Source: - Bloomberg

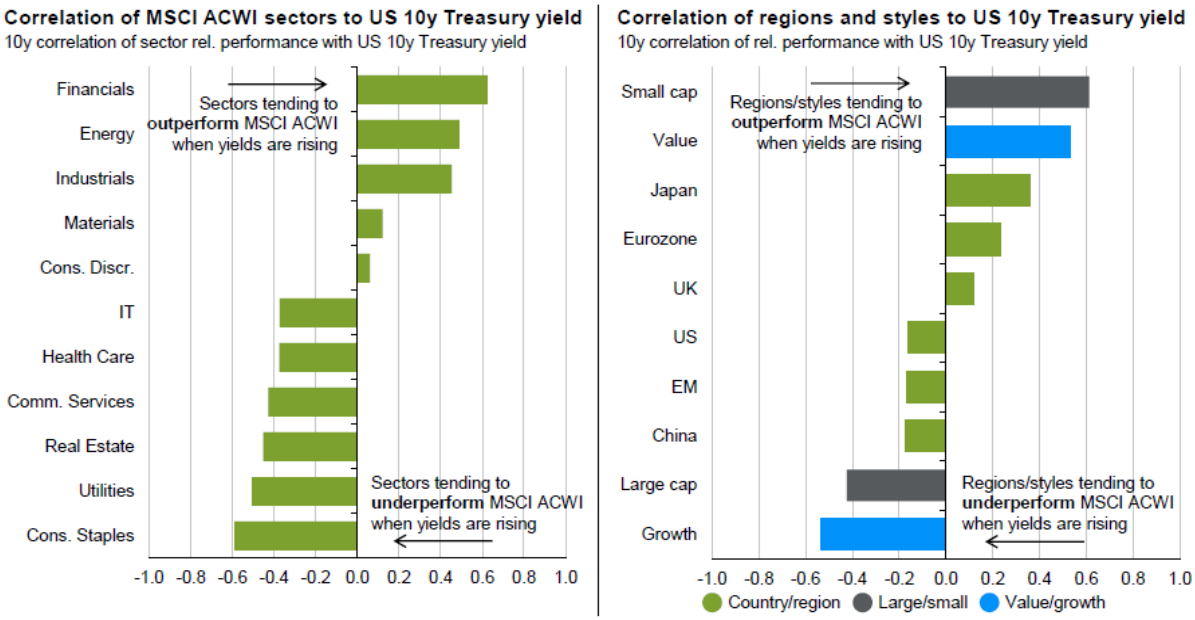
Equities

Despite rising interest rates, much higher than expected inflation and the invasion of Ukraine, in aggregate global equity market returns for the last 12 months at +12.8% are very good. Japan and developing markets have had a much more difficult time than developed markets. Japan because of the Olympics and a much worse covid induced slowdown in activity. Emerging and Pacific ex-Japan equity markets were impacted by contagion from the economic and social reforms in China which caused a major re-rating of Chinese equity markets.

All regional equity markets except the UK produced negative returns in the first quarter of 2022. The impact of higher interest rates, inflation and the uncertainty generated by the war has increased equity market volatility and markets have continued to fall in the second quarter. At the time of writing the major regional market indices are down between -8 and -15% year to date. The only exception to this is the UK where broad equity market indices are still up around +2%.

What these regional market results mask, is a major sector driven rotation on 2 levels, the first out of sectors where the "weight of money" flowing into businesses significantly increased their valuation and the second which has been discussed here and can be seen in chart 11 below, where higher interest rates change their attractiveness. On the latter point in a rising interest rate environment growth stocks with low or no dividends are less attractive than value stocks where dividends are typically high and the businesses tend to be more defensive. Turning to the first point about the weight of money, growth stocks have also been beneficiaries of this tailwind along with ESG and Sustainability themed stocks. However, while these themed stocks are subject to a potential higher cost of capital, the medium to long term trend for carbon transition and sustainability has not gone away. Hence any de-rating of these businesses should make them more attractive compared to the recent past and should not over the medium term overly impact the stock specific characteristics of the investment.

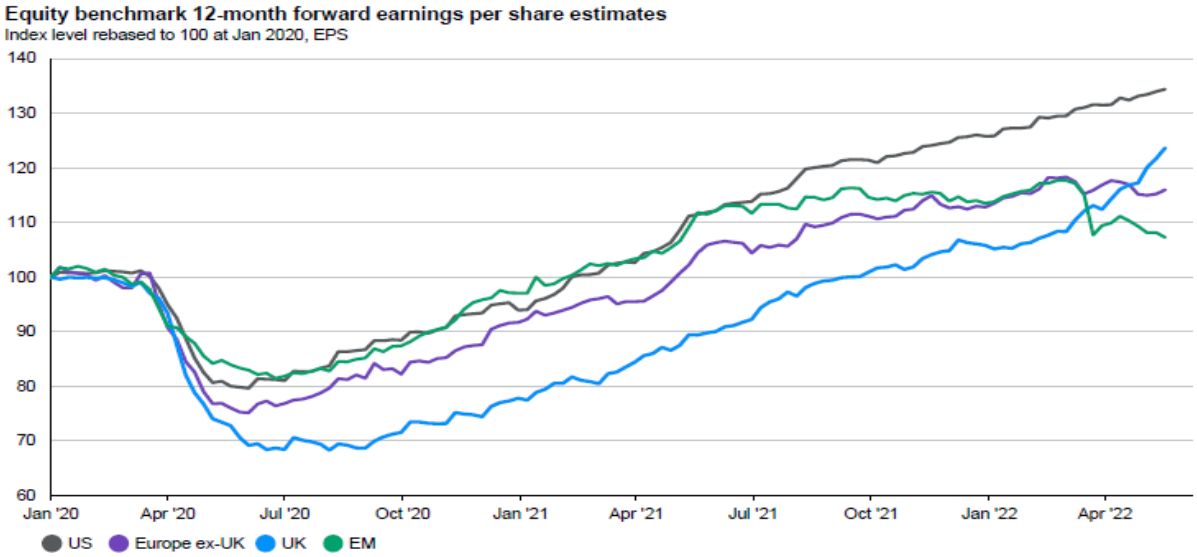
Chart 11: - Global Equity Sector, Regional and Investment Style performance variation in a rising US bond yield (interest rate) environment.



Source: - JP Morgan Asset Management January 2022

Chart 11 above shows the correlation between the change in US 10 year government bonds and the change in various sectors and regions of the MSCI global index. Looking at the price changes year to date they have been dramatic, in terms of "style" value is down -5% whereas growth -22%; the MSCI Energy sector is up +29% whereas Technology and Consumer discretionary are down -23% and -24% respectively.

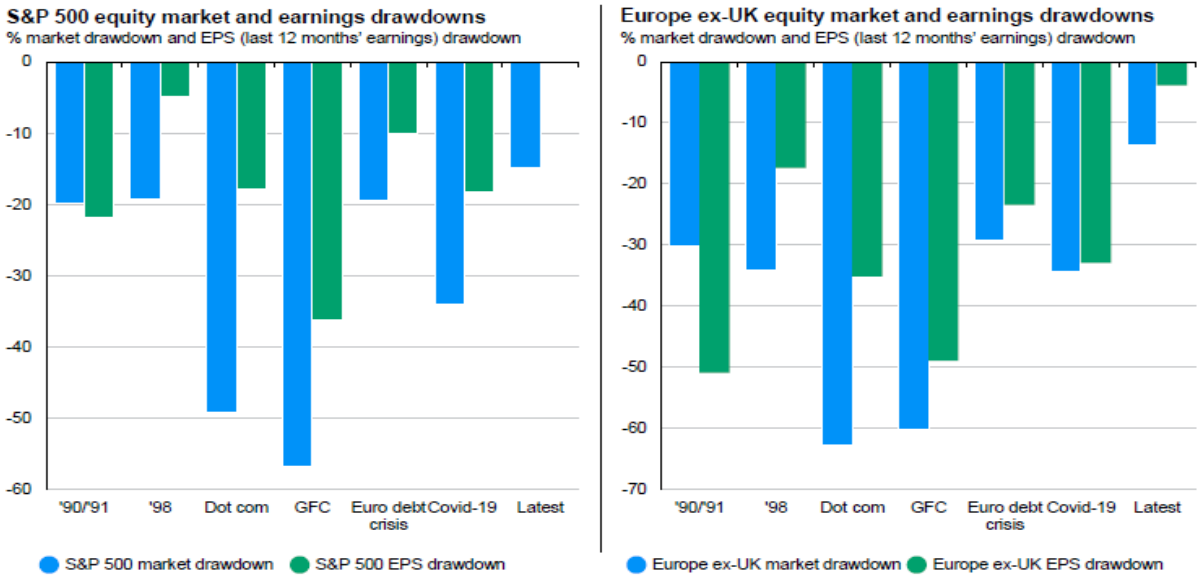
Chart 12: - Earnings expectations faltering in Europe ex-UK and Emerging Markets.



Source: - JP Morgan Asset Management 17th May 2022

Thus far the outlook for company earnings has not materially changed as can be seen in chart 12 above earnings estimates are holding up even if there is some understandable regional variation related to the war in Ukraine and policy actions in China. Taken together with chart 14 on page 25, below which shows robust 2022 and 2023 earnings growth forecasts in excess of their history prior to covid and the lower price/earnings ratios, it could be argued that equities are looking more attractive and as chart 13 below suggests the market price may already be sufficiently discounted for the potential impact on earnings of higher rates, inflation and the war.

Chart 13: - What's already in the price of markets? Macro shocks and recessions in the last 30 years.



Source: - JP Morgan Asset Management 17th May 2022

GDP

Table 4 shows the consensus forecasts for GDP growth in calendar 2022 and 2023 and my expectations in January and May 2022.

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

% CHANGE YOY								
	2022				2023			
	JANUARY		MAY		JANUARY		MAY	
	Consensus	**AF**	Consensus	**AF**	Consensus	**AF**	Consensus	**AF**
US	3.9	**3.6**	2.8	**2.5**	2.6	**2.6**	2.1	**2.0**
UK	4.3	**4.0**	3.8	**3.5**	2.2	**2.2**	1.0	**1.0**
Japan	3.1	**2.7**	2.0	**1.5**	1.5	**1.5**	1.9	**1.5**
EU	4.0	**3.7**	2.8	**2.0**	2.6	**2.6**	2.3	**2.0**
China	5.0	**4.7**	4.7	**5.0**	5.3	**5.6**	5.1	**5.5**
SE Asia	5.4	**5.0**	5.1	**5.2**	5.2	**5.5**	5.0	**5.3**

Source: - Consensus Economics May 2022

Between January and May consensus forecasts for GDP growth in 2022 and 2023 have been revised lower in all regions. Growth in the UK and especially in Europe is being more directly impacted by the war between Russia and the Ukraine. However, the "zero covid" policy being pursued by the Chinese is also having an impact on global trade flows and growth. At the same time the central banks of the developed economies have changed from easy to tighter monetary policy to try and combat inflation, much of which is beyond the domestic control of those same central banks. As a result, I believe growth this year and next may be lower than the consensus expectations. In 2022 the developed economies are still benefitting from the tailwinds of post covid, re-opening and the government stimulus packages, but the benefit of these is receding. The war, higher inflation, tighter monetary conditions and lower discretionary spending has increased the risk of a period of negative growth and even a recession in Europe and possibly the UK.

The exceptions to this are in China and the South-east Asian economies and commodity rich emerging economies. In China because this year is a "5 year congressional" meeting year and President Xi needs a strong economy to maintain his dominant position in the Chinese Communist Party, and because the Chinese central bank can ease monetary policy to help stimulate the growth. A stronger Chinese economy will be supportive of growth elsewhere in the region. The Oil and Gas rich emerging economies will benefit from higher prices and demand substitution in Europe away from Russian supplies.

The Chinese economy expanded 4.8% yoy in Q1 of 2022, above market consensus of 4.4% and faster than a 4.0% growth in the previous period. However, the economy is at risk of a sharp slowdown in the coming months caused by widespread covid lockdowns, falling retail sales and a weaker jobs market. The government has targeted economic growth of around 5.5% in 2022, in support of achieving its target so far this year, Beijing has launched more fiscal stimulus, including stepping up

local bond issuance to fund infrastructure projects and reducing taxes for businesses. The PBoC also announced measures to ease monetary policy.

The US economy contracted in the first quarter of 2022 bringing the annual growth rate down to 3.4% compared to 5.7% in calendar 2021, a fall in exports, lower inventory investment growth and lower government spending were the main drivers of the weakness. Offsetting the weakness, consumer spending the largest component of the US GDP and non-residential fixed investment, both increased.

The UK economy expanded 8.7% year-on-year in the first quarter of 2022, above 6.6% in Q4 but slightly below forecasts of 9%. The services sector expanded 9.9%, production 2% and construction 7.4%. GDP is now 0.7% above its pre-pandemic level. However, a slowdown is expected in the coming months due to the impact of the war in Ukraine and as rising inflation hurts consumers' purchasing power, the economy has already contracted 0.1% in March, and is expected to be flat in the second quarter of the year.

The Japanese economy advanced 4.6% on an annualised basis in fourth quarter of 2021, compared with preliminary estimates of 5.4%, recovering from a revised -2.8% contraction in third quarter. The rebound marked the strongest pace of expansion since Q4 2020, as covid infection rates fell and vaccination rates increased. Household consumption rebounded sharply, increasing the most in five-quarters; business investment bounced back; and net exports contributed further to GDP, with lower imports and exports recovering from a decline in the third quarter.

The Euro Area economy expanded by 0.2% in the first three months of 2022, the lowest rate of growth since the bloc exited a recession earlier last year and below market expectations of a 0.3% advance. Growth in Spain (0.3%) and Germany (0.2%) more than offset a contraction in Italy (-0.2%) while the French economy stalled. Preliminary Eurostat data indicated the war and related commodity price spikes cut the zones growth rate by 0.1% in the first quarter of 2022. Over 12 months, Euro area GDP expanded at 5%, accelerating from an upwardly revised 4.7% increase in fourth quarter.

Consumer Price Inflation

Table 5 shows the consensus forecasts for Consumer Price Inflation in calendar 2022 and 2023 and my expectations in January and May 2022.

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

% CHANGE YOY								
	2022				2023			
	JANUARY		MAY		JANUARY		MAY	
	Consensus	**AF**	Consensus	**AF**	Consensus	**AF**	Consensus	**AF**
US	4.8	**5.0**	7.2	**7.0**	2.6	**2.5**	3.3	**3.0**
UK	4.6	**5.0**	7.8	**7.5**	2.5	**2.4**	4.3	**4.0**
Japan	0.8	**1.0**	1.7	**1.5**	0.7	**0.5**	1.1	**1.0**
EU	2.9	**3.5**	6.6	**6.6**	1.8	**1.5**	2.9	**3.0**
China	2.2	**2.5**	2.2	**2.5**	2.3	**2.3**	2.3	**2.3**
SE Asia	2.6	**2.8**	3.9	**4.0**	2.6	**2.6**	3.0	**3.0**

Source: - Consensus Economics May 2022

Once again, the consensus forecasts for inflation in calendar 2022 have been revised higher. I have not changed my view that I expect inflation reports over the next few months will be worryingly high. But I believe we may be experiencing the highest levels of inflation over the next few months and by the fourth quarter of 2022 inflation rates could be falling. Over the summer we could experience a perfect storm in inflation rates for all the reasons I reported in my report; the economic recovery base effects from 12 months ago, global supply chain disruption, regional increases in covid infection rates and restrictions "upstream", all of which are extending the period of shortages in the supply of goods, services and workers. On the other hand, there is continued evidence that "supplier lead times" are shortening as global trade and supplier substitution picks up. Also, the most recent goods price inflation in the US at least may have rolled over. Some of the current uncertainty is being driven by the war in Ukraine, how much does the cost of oil and gas substitution by Europe keep the global price of energy elevated? and how much does the dislocation in basic foods from Ukraine and Russia effect global food prices?

I still believe higher energy costs are a "tax on growth" leading to lower discretionary consumption, as incomes fail to keep up with prices. As a result, I am comfortable to suggest that actual inflation may be lower than the consensus other than in Europe. Once we are past the next 18 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 inflation rate in the US slowed to 8.3% in April from a 41-year high of 8.5% in March. Energy prices increased by less, but food prices rose at their highest pace since April 1981. While used car prices fell slightly, new vehicle prices increased by 13.2%. On a monthly basis, consumer prices were up 0.3%, but below the 16-year high of 1.2% recorded in March, mainly driven by lower gasoline prices. Despite the slowdown in April which suggests that inflation may have peaked,

inflation is unlikely to fall to pre-pandemic levels any time soon and will remain above the Fed's 2% target for some time as supply disruptions persist and energy and food prices remain elevated. The annual core inflation rate in the US which excludes prices of food and energy, eased to 6.2% in April of 2022 from a 40 year high of 6.5% in March.

The annual inflation rate in the UK jumped to 9% in April from 7% in March, the highest level since 1982, the price rises were broad based impacting the whole economy, because they were related to changes in the prices for energy. Following the increase in the Ofgem cap on domestic energy prices, Electricity prices soared 53.5%, gas 95.5% and liquid fuels 113.9%. Energy prices in the rest of the economy also increased. The cost of transport increased 13.5%, with average petrol prices reaching a record of 161.8 pence per litre in April, compared with 125.5 pence per litre a year earlier. Inflation also accelerated for restaurants and hotels 7.9% and food and non-alcoholic beverages 6.7%. The Core inflation rate that excludes energy, food, alcohol, and tobacco increased by 6.2% from 5.7% in March.

The annual inflation rate in the Euro Area rose to a fresh record high of 7.5% in April from 7.4% in March, as the war in Ukraine and sanctions on Russia continued to push prices of commodities higher, preliminary estimates showed. The inflation rate is now more than three times above the ECB target of 2%. Prices advanced faster for food, alcohol & tobacco, non-energy industrial goods and services. Energy price increases slowed but remained extremely high. Core inflation that excludes energy, food, alcohol, and tobacco went up to 3.5% from 2.9%.

After a long period of deflation in Japan consumer prices rose by 1.2% yoy in March 2022, the highest rate since October 2018, after a 0.9% gain a month earlier. The latest figure marked the 7th straight month of annual inflation, with food prices rising at the fastest pace in over 5 years. Additional upward pressures were broad based, but as elsewhere driven mainly by higher energy prices. Core consumer prices went up 0.8% yoy, the 7th consecutive month of rises and the most since January 2020.

4. The outlook for the securities markets

My last report was written just a few days before Russia invaded Ukraine and while I have noted Russia as a geopolitical risk in my reports and presentations in the past. I had not believed President Putin felt so insecure in his position that he would attempt further incursions into Ukrainian territory and the replacement of the Ukrainian government by force.

Like covid 2 years ago the weight that can be given to these events in a probability based analysis of how to invest is low but their impact can be high and long lasting. Unlike covid, the impact of war cannot be easily offset by fiscal and monetary policy, and the development of a vaccine. Nonetheless the political response by western governments to act with varying degrees of unity to impose sanctions and to freeze the overseas assets of the Russian government and Oligarchs alike is impressive. The adjustment from here is rather more difficult to achieve, Russia and Ukraine are major sources of energy, commodities and food to the rest of the world and in particular gas to Europe. Substitution of these important commodities is a long term issue which needs to be addressed by markets as unless the war ends soon and there is the removal of Putin's regime, the west cannot go back to business as usual with Russia.

The good news is that the global economy was strong on back of a re-opening post covid, the latent impact of fiscal spending, high household savings, strong consumer demand and low interest rates. What the war has done is increase uncertainty, reduce consumer sentiment and increase the length of the period of higher inflation. All of which will reduce economic activity and make life very difficult for central banks. As they cannot push rates up high enough to choke off inflation without the risk of pushing the economy into recession.

As I mentioned in my last report, I believe we are right in the middle of the bad news for inflation. As a result, it is entirely likely that over the next 6 to 12 months, the year over year inflation reports will be higher and this will make equity and bond markets more volatile as they see the inflation data and worry about how the central banks will respond on monetary policy. The Fed in particular is making it clear that while it will tighten monetary policy through higher interest rates and QT it will only do so if growth remains strong. By the end of 2022, I believe inflation will be heading lower but so could growth.

Higher inflation is a "tax on growth". The transmission mechanism is the reduction of discretionary spending and poorer consumer sentiment caused by earnings not keeping up with higher prices. Base effects from lower inflation and growth 12 months ago also have and influence. In turn this leads to lower inflation data hence inflation could be falling back closer to 3% in a year or so's time. While this is higher than the 1% to 2% we have become accustomed to over the last 10 years, this is not a cause for concern. If I and long term market inflation expectations are wrong, it will be because income growth manages to outpace the rate of inflation.

While higher interest rates and inflation are bad news for longer duration bond markets, they are not necessarily a bad outcome for equity markets. But it can be bad news for growth stocks, thus far this year the MSCI AC world "growth index" is down -22% whereas the equivalent "value index" is only down -5%. This could continue for a while longer as the valuations of "growth" companies come down to more normal levels. Going forward, I expect more subdued returns and greater volatility from markets in general.

Bond Markets

In table 6, below I have set out my expectations for 3 month SONIA 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 May 2022.

Table 6: - Interest rate and Bond yield forecasts

%	CURRENT	DECEMBER 2022	JUNE 2023
UNITED STATES			
3month SONIA	1.44	2.75	3.0
10 year bond yield	2.92	3.25	3.50
UNITED KINGDOM			
3month SONIA	1.26	2.0	2.25
10 year bond yield	1.81	2.5	2.75
JAPAN			
3month SONIA	-0.02	0.0	0.0
10 year bond yield	0.24	0.25	0.25
GERMANY			
3month SONIA	-0.45	0.25	1.0
10 year bond yield	1.01	1.30	1.75

Source: - Trading Economics; 17th May 2022

Central banks have become much more aggressive with their rate increases and up until now their rhetoric on the direction of interest rates, with the aim of re-assuring the markets that they will do what they can to keep inflation under control. While the Bank of England remained hawkish on rates at their meeting in May, they only increased the base rate by 0.25% to 1.0%. The US Fed did increase rates by 0.5%, less than the 0.75% the market had feared, to a range of 0.75% - 1.0% and announced a programme of monthly asset sales to reduce the size of its balance sheet (aka QT).

However, on the economic front, the Fed noted that the invasion of Ukraine and related events are creating additional upward pressure on inflation and are likely to weigh on economic activity. In addition, covid related lockdowns in China are likely to exacerbate supply chain disruptions. Thereby flagging that they were not going to choke off the economic recovery with higher interest rates if other factors beyond their control were causing growth to slow.

Needless to say, the interest rate and bond markets have reacted poorly to the invasion of Ukraine, the lockdowns in China and the already baked in increases inflation resulting from higher energy prices and the costs related to the re-opening of the US and pan-European economies post covid. As can be seen in Tables 2 and 6 above all bond market yields have risen with the most interest rate sensitive components producing the largest negative returns. As can been seen in table 6 above I continue to expect that bond yields will rise with interest rate sensitive assets classes producing negative returns or at underperformance over the medium term.

Bond Market (Protection Assets) Recommendations

As can be seen in chart 8 and table 5 above the median forecast of economists expectations is that inflation will be on a falling trend by the end of the year. Although the range of forecasts is very wide and the BoE has suggested that inflation could hit 10% later in the year. There are however straws in the wind that suggest goods inflation may have peaked in the US and it is clear that growth and sentiment indicators have weakened. I believe that central banks are just as focussed on growth as they are inflation and do not want higher interest rates to drive the economy into recession.

Higher inflation and rising interest rates will continue to put negative pressure on bond market returns, but on balance from here I believe yields for even government bonds and for investment grade non-government bonds are sufficiently attractive to reduce the 4% underweight to protection assets I suggested in my last report.

On balance, I am happy to remain 2% underweight, 1% underweight each to conventional gilts and corporate bonds, because of the very high interest rate sensitivity of these assets. I propose using cash to reduce this underweight and maintain my suggested + 2% overweight to Multi-asset Credit. High yield spreads have also become more attractive and because corporate fundamentals remain strong, default rates are likely to remain low for well-managed portfolios. Also, because many of these securities have floating rather than fixed interest rates, they are less interest rate sensitive, which is ideal in a rising yield environment.

I remain uncomfortable with the extremely high duration, negative yield and over-valuation of index linked gilts, and while I have consistently recommended an underweight allocation in the past in the current period of rising inflation, I would not seek to reduce the position further.

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 except in high yield bonds.

Table 7: - Total returns from representative bond indices

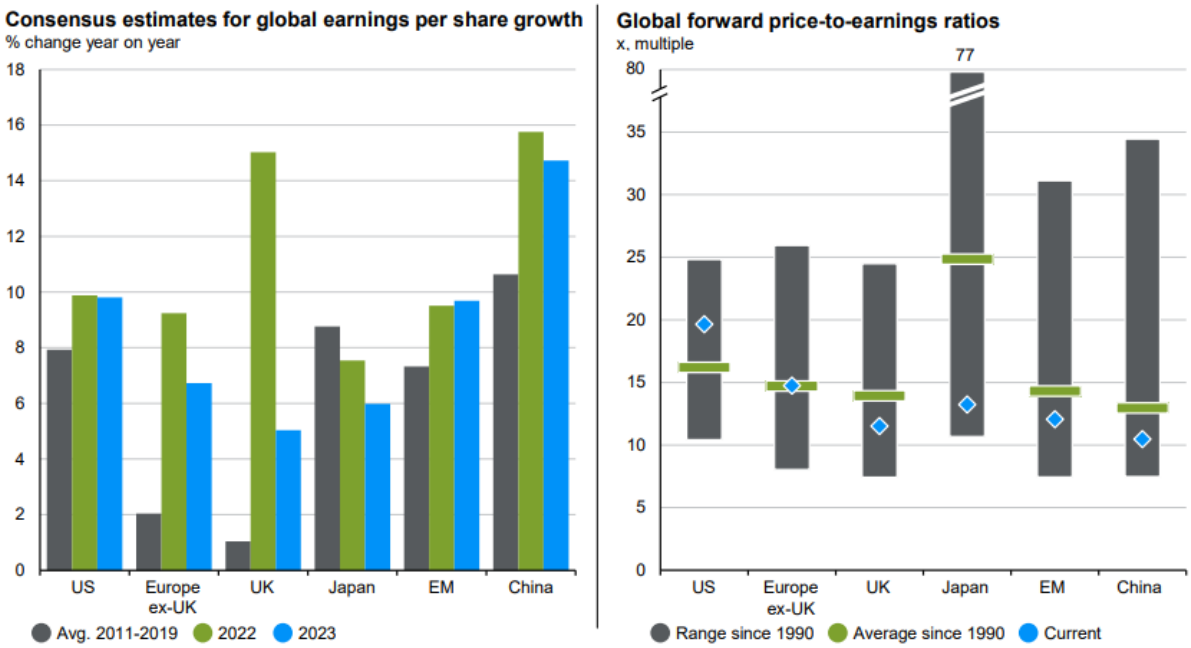
INDEX	YIELD TO MATURITY %	DURATION	YIELD INCREASE %	% TOTAL RETURN, HOLDING PERIOD	
				3 MONTHS	12 MONTHS
All Stock Gilts	1.69	11.8	0.5	-5.5	-4.2
All Stocks Linkers	-2.27	18.5	0.5	-9.2	-9.0
Global IG Corporate	3.71	6.5	0.5	-2.3	+0.5
Global High Yield	7.5	4.2	0.5	-0.2	+5.4

Source: - ICE Indices 17th May 2022

Equity Markets

Chart 14 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 14: - LHS - Earnings per Share estimates, RHS - Price/Earnings Ratios, since 1990, China 1996



Source: - JPM Asset Management., May 2022

At almost halfway through the year and despite a weaker and more uncertain macro-economic outlook, equity analyst earnings per share forecasts for 2022 have been revised higher. With the exception of Japan analysts are expecting earnings to be stronger in 2022 than the average between 2011 and 2019. It should be noted however that expectations for 2023 are unchanged to slightly lower in Europe and Japan. The recent weakness of equity markets has made all markets look cheaper using forward price to earnings ratios. Therefore, if earnings can be maintained, on this measure it would suggest equity markets are more attractive. As has been noted here for some time equity valuations based on the price earnings ratios remain high especially in the US compared to the rest of the world, despite the more aggressive selloff in so called tech and consumer discretionary stocks.

On balance unlike for bond markets higher inflation is not universally negative for equity markets but higher interest rates will have an uneven impact on sectors and companies. 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 in recent years. 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. As suggested in my last

report, sector leadership has already started to shift with the more interest rate sensitive sectors underperforming less leveraged sectors of the equity markets. I also believe that the uncertainty created by the war in Ukraine will have a greater impact on European equity markets.

Equity Market (Growth Assets), Recommendations

After making a substantial increased allocation to sustainable equity from the legacy regional equity markets in January the in-house team (IHT) have paused further changes. Partly due to the performance of the asset class which has a higher concentration of growth stocks, but also due to the correlation of the performance of managers in the strategy. In light of these outcomes, I believe it is prudent in the short term to wait and see how markets develop and the managers perform in the current more challenging market conditions.

Income Assets

As mentioned above in protection assets I propose that the allocation to protection assets should be reduced by 2% and the allocation to Income assets and specifically MAC be increased by 2%. The widening of spreads for sub-investment grade bonds and the floating rate nature of loans and asset backed securities have increased the attractiveness of the asset class. MAC also benefits from a lower interest rate sensitivity so provided default rates do not increase significantly, MAC can continue to deliver better returns in a rising inflation and interest rate environment than investment grade bonds and conventional gilts.

Looking at the current allocations Infrastructure remains underweight but this has been reduced by a new allocation in April, property is now the largest underweight. Building the allocation to Infrastructure and property takes time and at the moment infrastructure in particular is attracting strong demand from investors. 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. I would like to see the direct property 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 transaction costs are expensive.

As noted above in “protection assets” I would suggest that cash is used to reduce the underweight allocation to Gilts and Investment grade credit from a combined -4% to -2%, as the recent sharp selloff in both asset classes has increased their relative attractiveness.

The asset allocation set out in table 8 below, shows the New Benchmark and my suggested asset allocation weights relative to this benchmark as of the 11th February and the 17th May 2022. 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 and costs 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.

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

The 2 righthand columns show my suggested allocations relative to the new strategic benchmark that came into effect on the 1st January 2022. This change completes for benchmarking purposes the migration to the new allocations of growth assets.

% ASSET CATEGORY	NEW DERBYSHIRE STRATEGIC WEIGHT 1ST JANUARY 2022	ANTHONY FLETCHER 11TH FEBRUARY 2022	ANTHONY FLETCHER 18TH MAY 2022
Growth Assets	**55**	**0**	**0**
UK Equity	**12**	**0**	**0**
Overseas Equity	**43**	**0**	**0**
North America	**0**	**0**	**0**
Europe ex UK	**0**	**0**	**0**
Japan	5	**0**	**0**
Pacific ex Japan	**0**	**0**	**0**
Emerging markets	5	**0**	**0**
Global Sustainable	**29**	**0**	**0**
Private Equity	4	**0**	**0**
Income Assets	**25**	**+2**	**+2**
Property	9	**0**	**0**
Infrastructure	**10**	**0**	**0**
Multi-asset Credit	6	**+2**	**+2**
Protection Assets	**18**	**-4**	**-2**
Conventional Gilts	6	**-2**	**-1**
UK index Linked	6	**0**	**0**
US TIPS	0	**0**	**0**
UK corporate bond	6	**-2**	**-1**
Cash	2	**+2**	**0**

Anthony Fletcher

Senior Adviser

anthony.fletcher@mjhudson.com

Appendix

References

Source material was provided by, including but not limited to, the following suppliers: -

- Derbyshire Pension Fund, PEL performance services
- FTSE and ICE Indices
- JP Morgan, Asset Management
- Bank of England, UK Debt Management Office, UK OBR, UK Treasury, ONS
- US Bureau of Labour Statistics, US Commerce Dept. The US Federal Reserve.
- Bank of Japan, Japan MITI
- ECB, Eurostat
- Bloomberg, FactSet, Markit and Trading Economics
- Financial Times, Daily Telegraph, Wall Street Journal, New York Times, Washington Post