Appendix 2

Second Quarter 2022 Investment Report

PREPARED FOR:

Derbyshire County Council Pension Fund: Pensions and Investment Committee Meeting

SEPTEMBER 2022

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 7th September 2022
Date of paper 15th August 2022

1. Market Background (Second quarter 2022)

The market weakness and correlated sell off in equities and bonds continued throughout the second quarter. At the start of the quarter the war in Ukraine remained the main concern for the markets but by the end of the quarter more aggressive central bank action and rapidly rising inflation, with the increased risk of an economic slowdown was as much of a concern. As a result, global equities declined by another -6.9% and UK government and non-government bond markets returned -7.9%, returns from the much more interest rate sensitive Index Linked bond market were down -18%.

The pace of price declines were beginning to moderate as I mentioned in my last report, then on the 15th June the US Fed increased rates by 0.75%, indicating that they were likely to do the same again in July and this seems to have calmed the markets. Despite the stronger rhetoric on the need to tackle inflationary pressures, higher actual inflation and weaker growth data, global equity and bond market prices started to stabilise and have finished the quarter above their lows.

As can be seen in table 1 below over 3 months to the end of June all asset prices were lower and over 12 months only UK equity and Property markets have delivered a positive return. The markets change of direction has continued quarter to date with all asset prices showing positive returns in the month of July. The markets now appear to believe that central banks will not be increasing rates beyond what is currently priced and hence the next change is more likely to be unchanged or even a cut in rates as central banks respond to the depth of the coming recession.

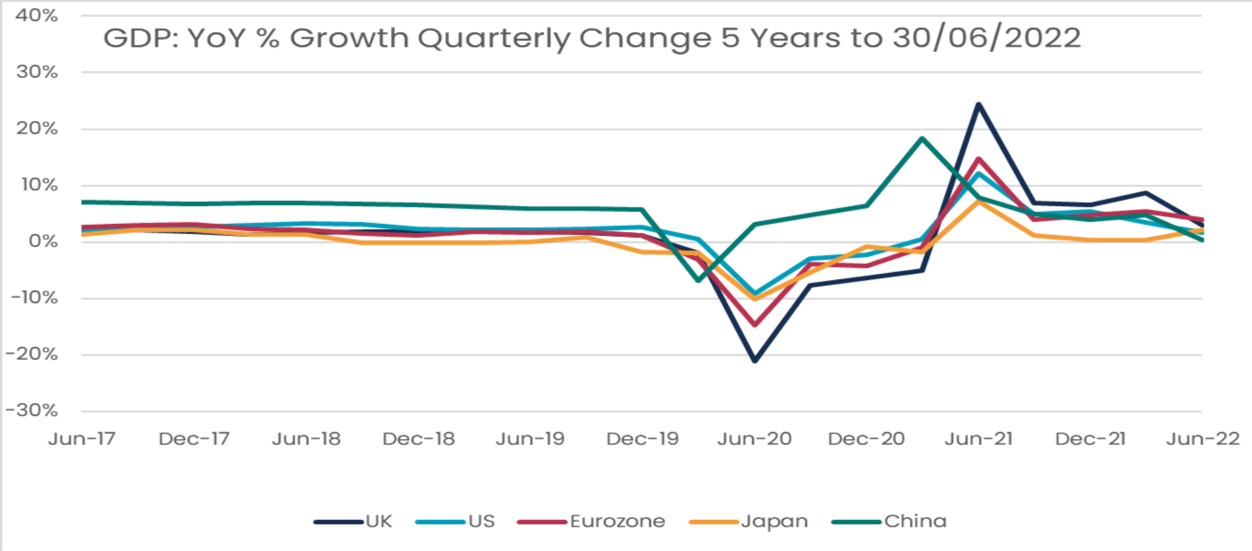
China remains caught in a situation of its own making as the authorities dealt with the much more infectious Omicron variant, a low vaccination rate, especially in its older population and an apparently less effective vaccine. This has put its 5.5% growth target at risk as several major cities were placed in full lockdown. As a result, China has had to ease fiscal and monetary policy to try and provide an offset to the current weakness.

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. Most "hard" commodity prices continued to decline over the quarter as demand slowed on weaker expected economic growth. Oil and Grain prices also fell towards the end of quarter having spiked higher in late May. As Russian oil supplies were substituted and hopes of deal on resuming the supply of grain from Ukraine increased. Natural gas prices continued to increase despite the seasonal fall in demand as Russia closed Nord stream 1 for "routine maintenance", but once reopened restricted supply to 20% of normal, effectively preventing Europe from topping up storage for the winter at reasonable prices.

The war, higher inflation and interest rates are leading to further falls in consumer sentiment and growth as household incomes are squeezed by falling real incomes and a drawdown of savings accrued during the pandemic. The risk of recession especially in Europe has increased substantially.

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 quality of earnings and resilience of companies rather than on prospects for growth alone.

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 July 2022 and the 3 and 12 months to the end of June 2022.

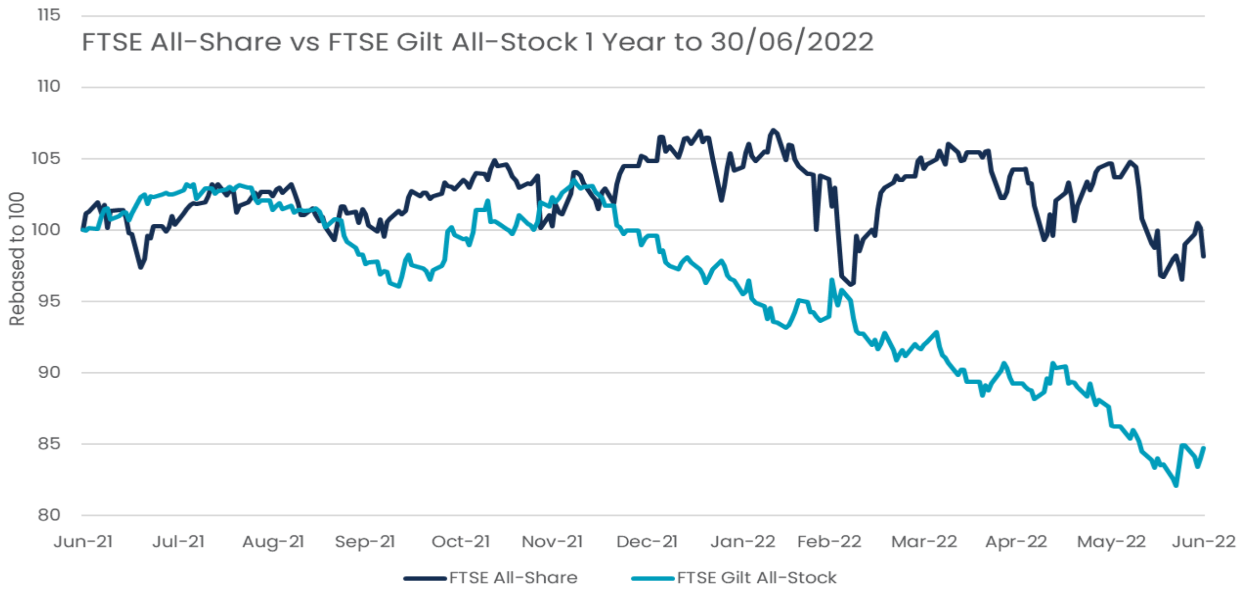
% TOTAL RETURN DIVIDENDS REINVESTED

MARKET RETURNS

		Period end 30th June 2022	
	July 2022	**3 months**	**12 months**
Global equity FTSE All-World	+6.7	-6.9	-3.6
Regional indices			
UK All Share	+4.4	-5.0	+1.6
North America	+8.8	-9.5	-0.4
Europe ex UK	+5.1	-8.8	-10.4
Japan	+5.3	-6.8	-8.5
Emerging Equity Markets	-0.9	-2.7	-10.6
UK Gilts - Conventional All Stocks	+2.7	-7.9	-14.3
UK Gilts - Index Linked All Stocks	+5.6	-18.1	-17.3
UK Corporate bonds*	+3.3	-7.8	-14.5
Overseas Bonds**	+2.1	-4.1	-8.5
UK Property quarterly^	-	+3.4	+19.9
Sterling 7 day SONIA	0.0	+0.2	+0.3

^ MSCI indices * ICE £ Corporate Bond, UC00; **ICE global government ex UK LOC, N0L1

Chart 2: - UK bond and equity market returns - 12 months to 30th June 2022



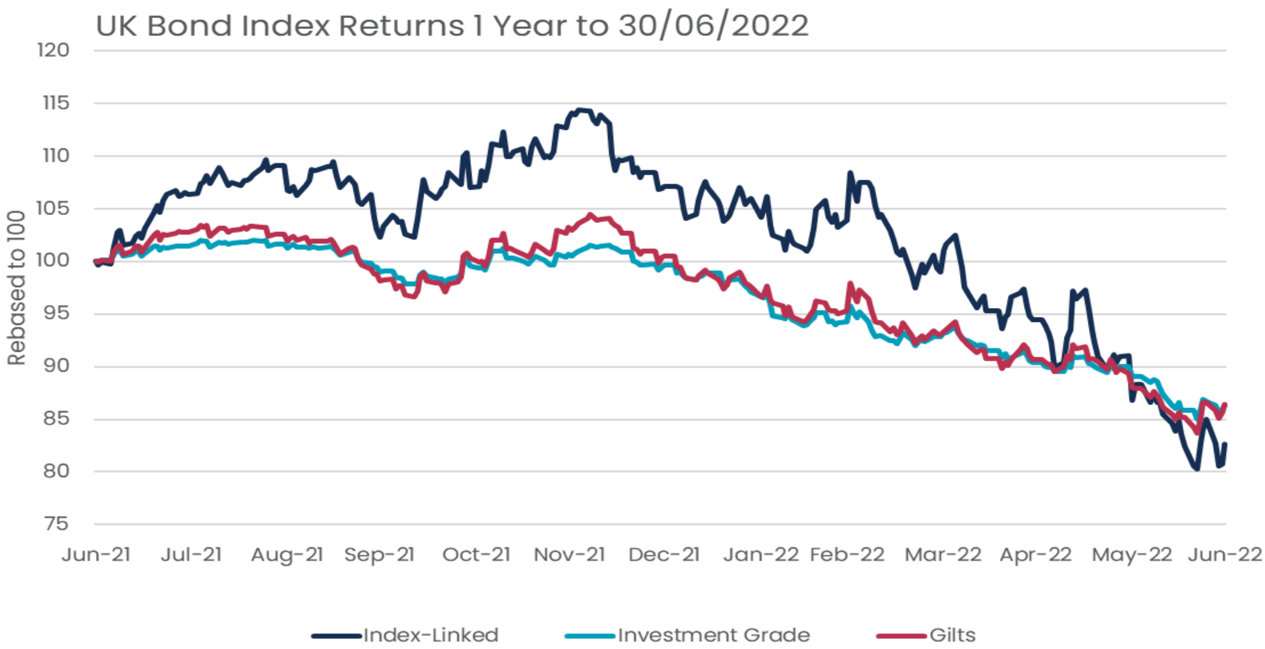
Source: - Bloomberg

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

BOND MARKET % YIELD TO MATURITY	31st March 2022	30th June 2022	Quarterly Change %	30th June 2021	Current 10th August 2022
UK GOVERNMENT BONDS (GILTS)					
10 year	1.61	2.24	**+0.63**	0.71	**1.95**
30 year	1.74	2.58	**+0.84**	1.24	**2.34**
All Stocks ILG	-2.38	-1.14	**+1.24**	-2.37	**-1.43**
OVERSEAS 10 YEAR GOVERNMENT BONDS					
US Treasury	2.35	2.97	**+0.62**	1.47	**2.78**
Germany	0.55	1.37	**+0.82**	-0.20	**0.89**
Japan	0.21	0.23	**+0.02**	0.05	**0.19**
NON-GOVERNMENT BOND INDICES					
Global corporates	3.03	4.22	**+1.19**	1.59	**3.98**
Global High yield	6.02	9.00	**+2.98**	4.09	**7.68**
Emerging markets	5.23	7.03	**+1.80**	3.56	**6.45**

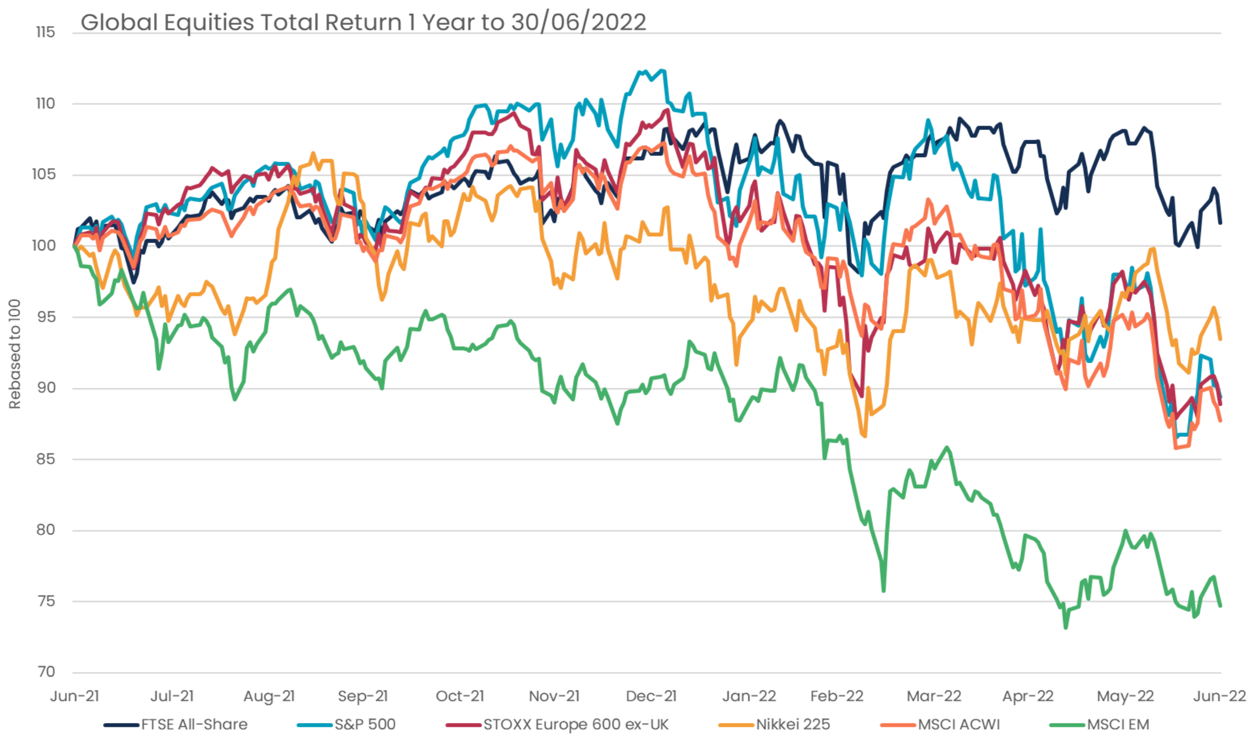
Source: - Trading economics and ICE Indices G0LI, G0BC, HW00, EMGB, 10th August 2022.

Chart 3: - UK Bond index returns, 12 months to 30th June 2022.



Source: - Bloomberg

Chart 4: **-** Global equity market returns in local currency, 12 months to 30th June 2022



Source: - Bloomberg

Recent developments (July and August 2022)

The key development in the quarter to date has been the more aggressive action of the major central banks. The Fed, the Bank of England and the ECB have all tightened monetary policy. The BoE and ECB are also talking openly about the possibility of a period of recessionary growth linked to the price of energy and the expected sharp falls in real household incomes (cost of living crisis). While the Fed has discounted the idea that the US economy is in recession, despite a negative annualised growth rate in the first half of 2022, because of the strength of the labour market. It has suggested that the pace of future rate hikes will be "data dependent".

The markets have taken the view that this means there will be no more rate hikes than are currently priced in and by extrapolation that the next move will be a change in direction to lower rates. As can be seen in Table 1 above in July all asset prices increased and this has continued into August. Recent growth data and forward looking indicators are confirming weaker prospects for the economy and ironically this is providing confirmation of the markets view that the Fed is more focussed on weak growth than higher inflation.

While the war in Ukraine appears to be is grinding to a stage of attrition, Russia has tightened its grip on gas supplies and as a result prices in Europe are rising dramatically. At the same time the UK and European governments are scrambling to reopen coal and oil fired power stations and extend the life of nuclear generation capacity that was hitherto either mothballed or about to be decommissioned in a belated attempt to genuinely diversify electricity supply generation. They are also trying to substitute Russian supplies of gas with LNG from the USA and Qatar which is further driving up the price.

Boris Johnson was removed from office in July, which triggered a full Tory leadership competition run by the membership. Members will have to choose between the final 2 candidates Rishi Sunak and Liz Truss, with the result being announced on 5th September. With Parliament in recess the summer is always a quiet period but this year with so much going on internationally it feels even more so. A round of trade disputes with the EU that have been on the back burner because of the Northern Ireland elections are about to boil over and the flow of trade and people from the UK to the EU is about to be made even more onerous as new regulations come into effect.

And finally, if geopolitical tensions were not already high enough the Speaker of the US House of Representatives Nancy Pelosi, decided to visit Taiwan during her tour of Asia and Japan in early August, raising tensions with China at a time when US / Chinese diplomatic relations are already pretty low.

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 June 2022. Over 12 months, Growth assets underperformed whereas Income and Protection assets outperformed. All the individual active Growth asset managers underperformed their respective benchmarks, with the exception of Private Equity.

Over 10 years the Fund has achieved a total return of 8.0% per annum, net of fees.

Table 3: **-** Derbyshire Pension Fund and Benchmark returns

% TOTAL RETURN (NET) 30TH JUNE 2022	3 MONTHS		12 MONTHS	
	Derbyshire Pension Fund	**Benchmark**	**Derbyshire Pension Fund**	**Benchmark**
Total Growth Assets	**-7.1**	**-6.9**	**-4.7**	**-3.5**
UK Equity	-5.7	-5.0	-0.2	+1.6
Total Overseas Equity	**-8.5**	**-7.3**	**-9.4**	**-5.1**
North America	-9.7	-9.5	-1.7	-0.4
Europe	-8.7	-8.8	-10.2	-10.4
Japan	-8.4	-6.8	-13.0	-8.5
Emerging markets	-3.1	-2.7	-14.5	-10.6
Global Sustainable Equity	-9.8	-8.2	-8.9	-3.1
Global Private Equity	+1.0	-8.0	+25.1	-4.0
Total Protection Assets	**-10.3**	**-10.9**	**-13.8**	**-14.3**
UK & Overseas Government	-6.2	-7.4	-11.6	-13.6
UK & Overseas Inflation Linked	-14.9	-17.5	-13.3	-16.3
Global Corporate bonds	-9.1	-7.5	-15.7	-13.9
Total Income Assets	**+0.3**	**+0.7**	**+8.3**	**+7.9**
Multi-asset Credit	-4.1	-3.4	-2.1	-2.5
Infrastructure	+1.8	+0.7	+10.1	+2.4
Property (all sectors)	+2.3	+3.4	+16.1	+19.9
Internal Cash	+0.1	+0.2	+0.2	+0.3
Total Fund	**-5.6**	**-5.6**	**-3.2**	**-2.8**

Total fund value on 30th June 2022 £5,794 million

At the end of the second quarter the Fund was slightly underweight growth assets, 2% underweight protection assets and just over 1% overweight income assets relative to the strategic benchmark.

Over the second quarter of 2022, the absolute return of the Fund was negative but it was in line with the strategic benchmark. Mainly due to the outperformance of the Fund's portfolio of Government bonds which are part of the Protection assets allocation, which delivered a smaller negative return than the benchmark. While Income assets underperformed the benchmark their absolute return in aggregate were positive. Growth assets in aggregate underperformed, delivering a greater negative return than the benchmark 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 returned -3.2% and was 0.4% behind benchmark. The underperformance was again caused by the weaker relative performance of Growth assets, with the allocation to both Income and Protection assets outperforming on a relative basis. Demonstrating the importance of diversification and active management.

Over 3 years, the Fund has outperformed in all asset classes and the total return was 4.1% p.a. compared to the benchmark return of 3.8% p.a.

Growth assets – Equity performance

In the second quarter and the 12 months to the end of June 2022, at the aggregate level, the equity portfolio underperformed its benchmark. Absolute returns from growth assets were negative in all regions and unusually all of Derbyshire's active managers except Private Equity underperformed their respective benchmarks.

Nearly all the Fund's underperformance has arisen in 2022, the increase in energy prices, the invasion of Ukraine and the impact of higher and more persistent inflation as well as a more aggressive central bank policy actions have all played their part in producing the negative absolute return. Relative underperformance comes mainly from the recent poor performance of the sustainable equity funds.

Over 10 years growth assets have returned on average 9.8% p.a. compared to 9.3% p.a. for the benchmark.

Protection assets - Fixed Income Performance

Rising inflation, interest rates and the war, caused bond yields to rise significantly again in the second quarter delivering negative returns. Continuing 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 significantly outperformed the benchmark over 3 and 12 months. Global corporate bonds underperformed as yields increased and credit spreads also widened.

Over 10 years protection assets have on average returned 2.8% each year compared to the benchmark return of 3.0%.

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. Over 12 months a better period for measuring returns Infrastructure and MAC outperformed and while the aggregate property portfolio underperformed, on a relative basis the direct property portfolio outperformed the funds in the in-direct portfolio.

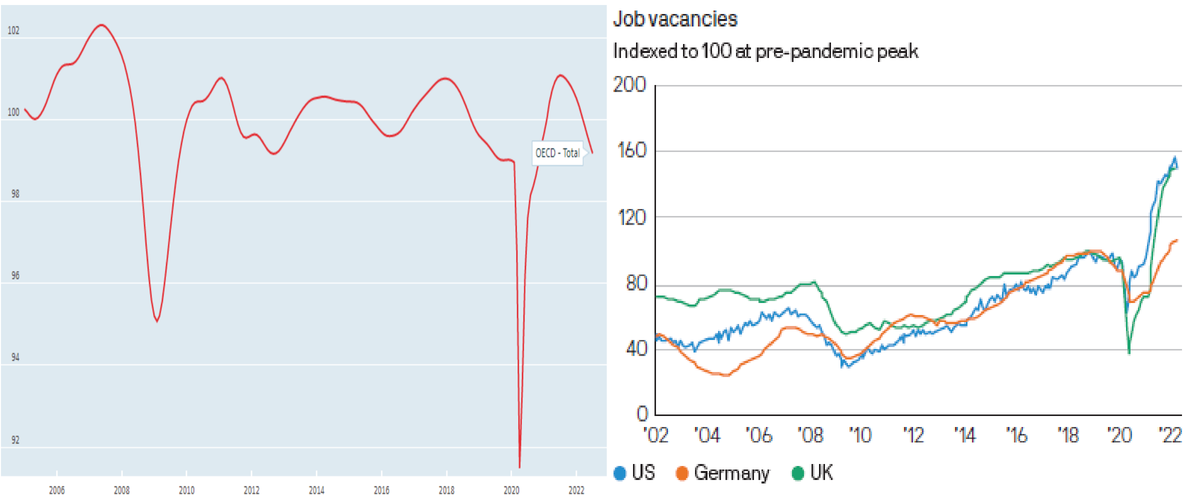
Over 10 years Income assets have on average returned 10.4% each year compared to the benchmark return of 5.1%.

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. But the pace of growth has been slowing as higher interest rates and inflation, and the war in Ukraine have impacted activity. Data released in July provided further evidence of a slowing global economy. The OECD global composite leading indicator shows economic activity losing momentum. The only bright spot remains labour markets, with a tight jobs markets driving nominal wage growth but the impact of much higher inflation, means that real wage growth is now sharply negative.

Chart 5: **-** Composite Leading indicators and Job Vacancies



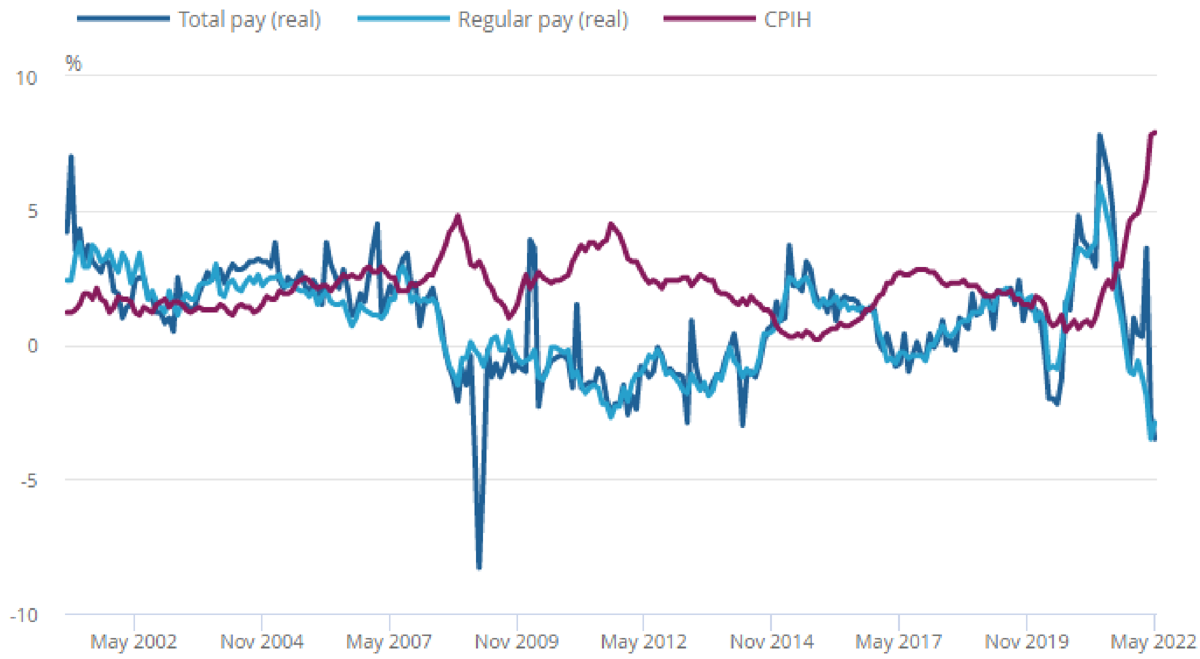
Source: - Leading indicators OECD, Job Vacancies JPMorgan Asset management July 2022.

As a result, consumers and companies have responded by becoming much more cautious, with consumer confidence and purchasing manager surveys both moving into contractionary territory. As mentioned in my last report China’s zero covid policy is still leading to lockdowns, potentially slowing growth even as the authorities try to stimulate activity by easing monetary and fiscal policy. Against this backdrop it would seem reasonable to expect the global economy to continue to slow.

A recession in Europe and the UK is now expected even if the central banks do not continue to tighten aggressively, high energy prices will have a significant impact on discretionary spending as real household Incomes fall, see chart 6 below. The US has already experienced two quarters of negative growth which means it is already technically in recession but the strength of the labour market means the National Bureau of Economic Research is unlikely to formally declare one at this stage.

Chart 6: **-** Real Household income growth in the UK

Real average weekly earnings single-month annual growth rates in the UK, seasonally adjusted, and CPIH annual rate, January 2001 to May 2022



Source: - ONS July 2022

Inflation

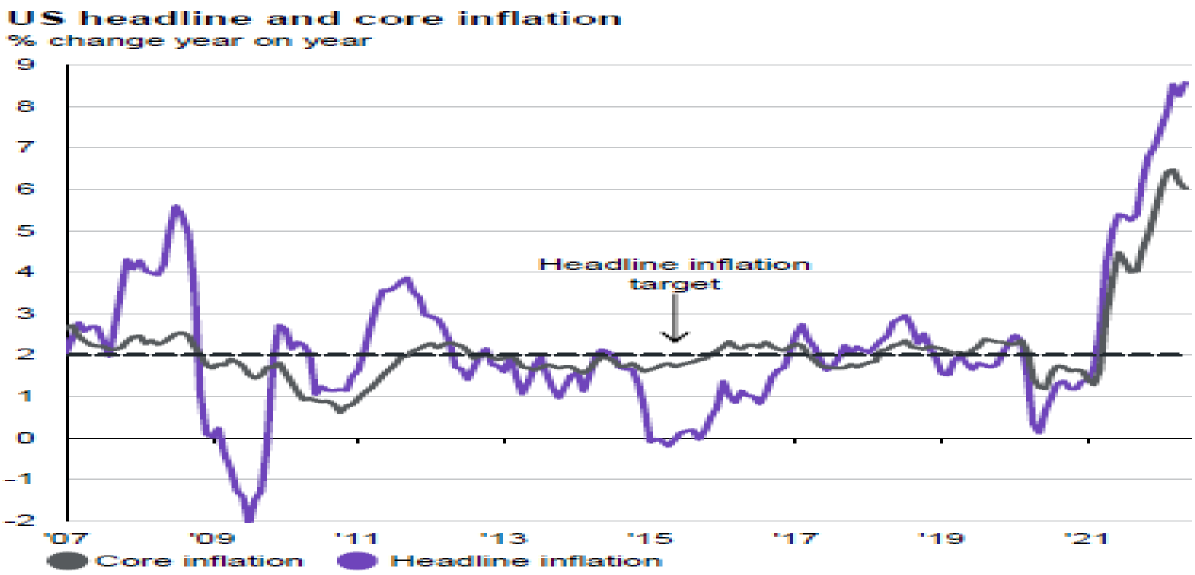
I expect the rate of inflation to vary significantly between regions. While energy prices are going to be the biggest driver of the outcome everywhere, it is how the countries deal with the shock and the underlying resilience of their economy and energy policy that will cause the variance. The US is relatively immune from higher gas prices because of its abundant supply enabling it to be a net exporter and may even benefit from exporting LNG to Europe.

The UK and then Europe are probably most exposed to this risk. The UK, because of its reliance on the spot market for the supply of energy and Europe because of its reliance on supply of gas from Russia. While there will be some mitigation in the form of imports of LNG from the US and Qatar, and increased use of coal, oil and nuclear to generate electricity. Once again, the UK is poorly positioned, having planned to eliminate generation supply from coal and oil, and at the same time failed to invest in nuclear and gas storage to offset the intermittency of renewables, we had better hope for a warm and windy winter.

There is some good news on inflation, global trade in goods is improving despite the covid related disruption in China, Supplier delivery times are falling and global shipping container rates, while still elevated are down 30% since the peak in 2021. Commodity prices are also falling from elevated levels, base metals prices have fallen between 15% and 25% from their peak in the last year. How much of this is a repair of global production and supply chains and how much is falling demand is uncertain at this stage. More directly related to the war in Ukraine, oil prices are down 25% from the post invasion peak as Russian supply has been substituted and wheat prices have also fallen 40% on the resumption of exports by sea from Ukraine.

Chart 7 shows the core and headline Inflation data from the US to June, which shows that headline inflation ticked up again in May and June. However, July data shows it fell from 9.1% in June back to 8.5% in July the same level as in March. The July data also shows that core inflation excluding food and energy continues to fall from 6.5% in March to 5.9% in July.

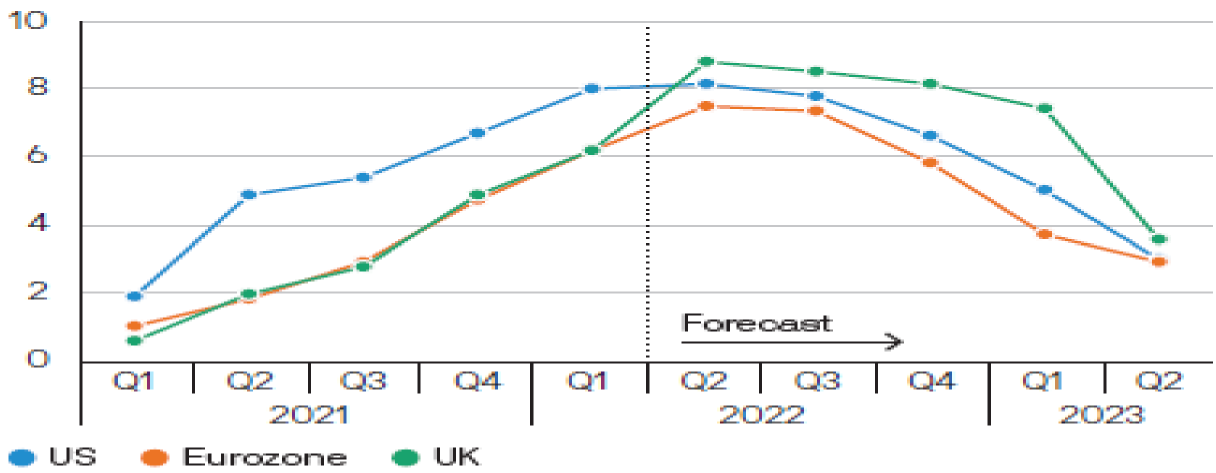
Chart 7: **-** Inflation – year over year change in US headline and core inflation.



Source: - JPMAM 30th June 2022

Unfortunately, the situation in the UK and Europe is not yet improving, with July reporting CPI increasing to 10.1% in the UK and 8.9% in the Euro Area, and the BoE and economists falling over themselves to predict higher inflation outcomes later in 2022. Chart 8 below shows the revised median forecasts for inflation over the next 5 quarters.

Chart 8: **-** Economists' median forecasts of headline CPI, in the US, UK and Europe

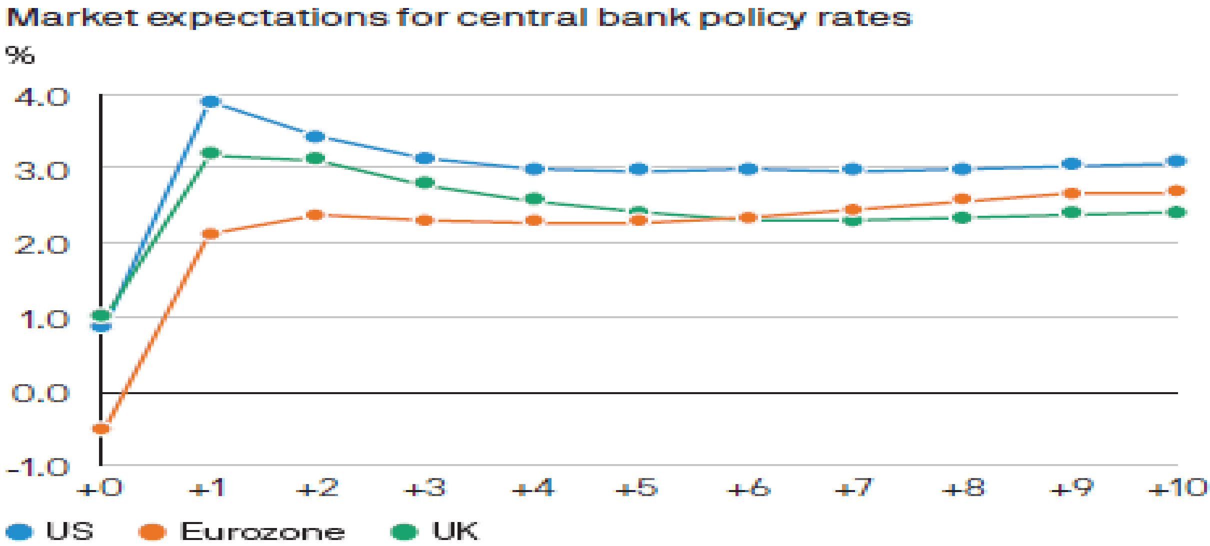


Source: - JPMAM June 2022

Central Banks

In June and July, the Fed finally started to move aggressively increasing rates by 0.75% at each meeting. The Fed Funds rate now stands at 2.75% and it is widely expected to be increased again by 0.5% at the next meeting in September, which will be their last opportunity to increase rates before the US mid-term congressional elections in November. Having said that their QT programme starts in September and on a monthly basis this will be a net tightening of monetary policy as it involves the sale of both US Treasury and Mortgage-backed bonds from the Fed's balance sheet to the market.

Chart 9: **-** Market expected level of central bank interest rates in the US, UK and Europe from June 2022, yearly for the next 10 years.



Source: - JPMAM June 2022

As can be seen from chart 9 above the interest rate futures market is expecting US rates to continue to rise for the next 12 months before falling in the second half of 2023. Whereas expectations for UK and Europe suggest rates will not be falling until 2024.

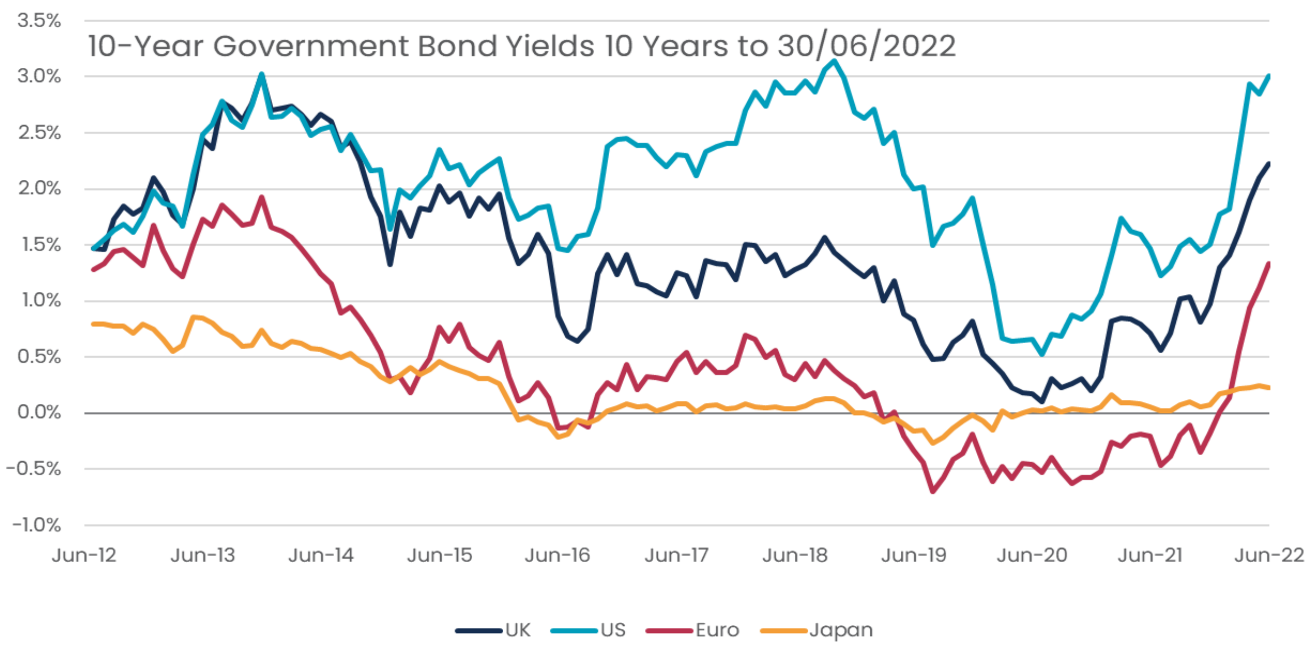
At its meeting in August the Bank of England raised rates by 0.5% to 1.75% and increased its forecast rate of inflation to over 13% in October when the next increase in the cap on energy prices to be announced on 26th August 2022, comes into effect. They also forecast virtually no growth in calendar 2023 although they continue to expect inflation to be falling later next year due to economic weakness and base effects. The ECB raised its 3 key interest rates by 0.5% at its July meeting, the first increase since 2011, ending eight years of negative rates, in an attempt to reduce the inflationary pressures. The main refinancing rate is now 0.5%, the marginal lending facility 0.75% and the deposit rate 0.00%. The ECB also said that further normalisation of interest rates will be appropriate at upcoming meetings. Because of the fragility of a number of peripheral European bond markets the ECB has established the Transmission Protection Instrument (TPI) which aims to reduce bond yield volatility. The scale of TPI purchases depends on the severity of the risks and are not restricted. 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 in all cases above the levels seen prior to the pandemic. However, as can be seen in table 2 above since the end of the quarter yields have fallen significantly as bond markets believe the full extent of interest rate rises have been discounted into current bond yields and hence the next directional move in central bank rates will be lower.

While I suggested in my last report that bond yields may have moved too far too fast, I expected them to stabilise before moving higher, I did not believe that they were about to fall significantly. The recent sharp fall in yields leads me to the conclusion that the next move is more likely to be higher. I accept that recessionary risks have increased but until inflation has demonstrably peaked, I believe bond markets are more vulnerable to bad inflation news than bad news on growth. As chart 9 above shows interest rates are expected to go higher over the next 12 months.

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



Source: - Bloomberg

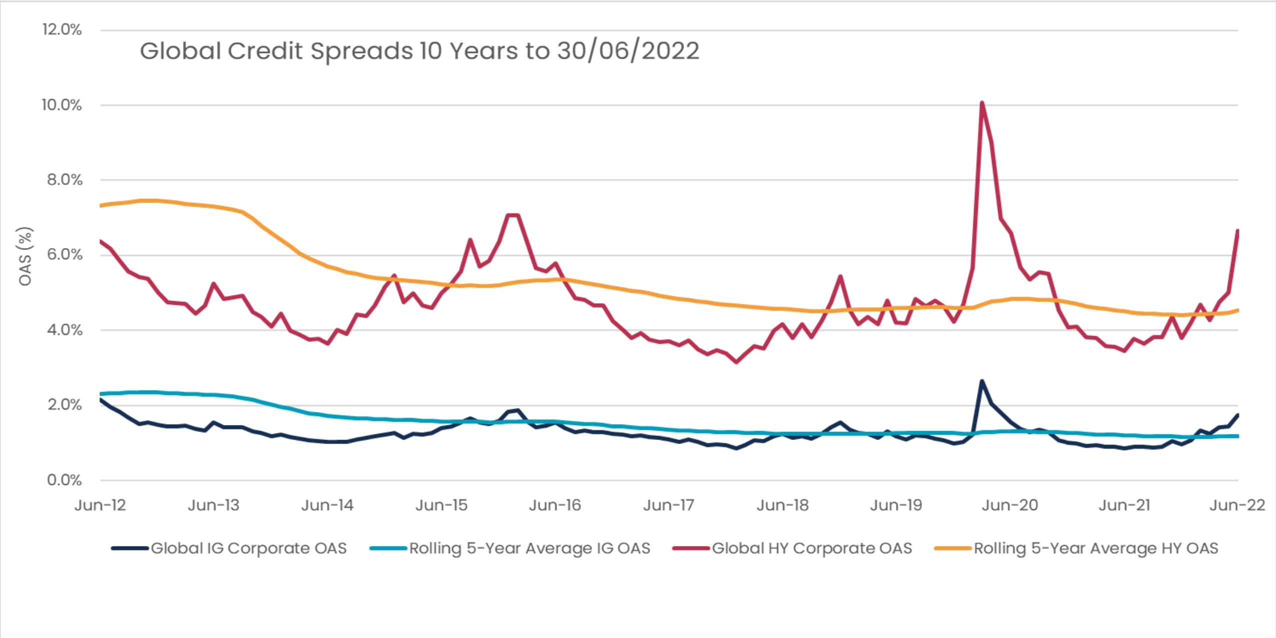
Non-government bonds

Chart 11 below, shows the excess yield spread for both investment grade non-government and high yield bonds to the end of the quarter. As can be seen from the chart spreads continued to widen from their lows in the summer of last year but just like government yields, they have fallen significantly since the end of the quarter as can be seen on table 2 above, high yield spreads narrowed the most.

The fall in yields and spreads since the end of the second quarter means that non-government bonds have delivered strong positive returns. But like government bonds I believe investment grade non-government bonds are now more likely to produce negative returns. However, I still expect high yield bonds and loans owned as part the Multi-asset Credit allocation to deliver better returns. These assets have lower interest rate sensitivity (duration), much higher yields, and because many have floating rather than fixed coupons, they can continue to benefit from rising interest rates.

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. However, 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 11: - Credit spreads, extra yield over government bonds, last 5 years.



Source: - Bloomberg

Equities

All regional equity markets except the UK produced negative returns in the quarter and the year to the end of June 2022. The impact of higher interest rates, inflation and the uncertainty generated by the war has increased equity market volatility and markets continued to fall in the second quarter. However, at the time of writing all the major regional market indices except emerging markets are now between +5% and +10% higher in the third quarter to date.

Against a weaker growth backdrop, markets have priced in interest rate cuts from the US Fed in 2023. This anticipation of a policy pivot has driven the strong performance of equity and credit markets since the end of the quarter. Perhaps not surprisingly global growth stocks benefited most, delivering an 11.5% total return in July, recouping some of their heavy year-to-date losses. The US equity market with its strong growth tilt delivered the best returns in local currency. The strength of the US dollar has not helped emerging equity markets in general, and a strong performance from Indian and South Korean markets, and commodity rich countries was offset by continued Chinese real estate weakness. China's heavy weight in the index means aggregate returns from emerging market equities continue to disappoint.

In my last report I suggested that. just as was the case for bonds. maybe equity prices were oversold in the short term and that prices could stabilise or even start to recover. The strength of the recovery since the middle of June when interest rates were raised more aggressively and economic data showed weakness leaves no cushion in prices for future disappointment on growth and inflation. It should also be remembered that interest rates are still expected to go higher over the next 12 months. As a result, I believe equity markets are now more vulnerable to disappointment and are just as likely to produce negative returns as they are to produce a positive return. There is likely to be marked regional variation because as noted elsewhere in this report the UK and Europe especially are more vulnerable to higher gas prices and the impact of falling household incomes (cost of living crisis) than the US.

GDP

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

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

% CHANGE YOY								
	2022				2023			
	MAY		AUGUST		MAY		AUGUST	
	Consensus	AF	Consensus	AF	Consensus	AF	Consensus	AF
US	2.8	**2.5**	1.7	**1.5**	2.1	**2.0**	0.7	**0.5**
UK	3.8	**3.5**	3.4	**3.0**	1.0	**1.0**	0.1	**0.0**
Japan	2.0	**1.5**	1.4	**1.4**	1.9	**1.5**	1.6	**1.4**
EU	2.8	**2.0**	2.8	**2.0**	2.3	**2.0**	1.4	**1.0**
China	4.7	**5.0**	3.7	**5.0**	5.1	**5.5**	5.4	**5.4**
SE Asia	5.1	**5.2**	5.3	**5.3**	5.0	**5.3**	4.6	**4.6**

Source: - Consensus Economics August 2022

Between May and August consensus forecasts for GDP growth in 2022 and 2023 have been revised lower in all regions. For the same reasons explored in my last report, growth in the UK and especially in Europe is being more directly impacted by the war in Ukraine and in China by its "zero covid" policy. A further tightening monetary policy the US, UK and Europe is also having an impact as central banks respond to higher inflation caused mainly by higher energy prices. While I do not know how weak GDP growth will be over the balance of 2022 and into 2023, I believe the outcome will be weaker than the consensus and we could very likely see an extended period of zero growth and even a recession in Europe and the UK. The US with access to abundant gas supplies may see a better outcome than the rest of the developed world, but even here the last 2 quarters of growth has been much slower.

As mentioned last time the exceptions to this weaker growth outlook are China and the South-east Asian economies and commodity rich emerging economies. Chinese monetary and fiscal policy is being used to offset the impact of its "zero covid" policy helping to support growth in the region.

The Chinese economy expanded by only 0.4% yoy in Q2 of 2022, below the market consensus of 1% and a marked slowing from the 4.8% growth seen in the first quarter of 2022. The economic weakness was the result of China's "zero covid" policy, the country is struggling to contain the milder but much move infectious Omicron variant, leading to shrinking domestic demand. China's statistics agency also noted the "risk of stagflation in the world economy and tighter monetary policies overseas" as contributors to lower GDP growth. The government has targeted economic growth of around 5.5% in 2022, in support of achieving this target, Beijing continues to roll out more fiscal stimulus, including reducing business taxes and increased funding for Infrastructure projects. The PBoC also announced further measures to ease monetary policy in light of falling credit demand.

The US economy contracted again by -0.9% in the second quarter after a fall of -1.6% in the first quarter of 2022 bringing the annual growth rate down to 1.6% in the year to June compared to 3.5% in the year to March 2022. Investment and Consumption were both lower due to higher prices and interest rates, the much smaller export component of GDP increased by 18% probably due to increased exports of LNG. While 2 quarters of negative growth suggest the economy in recession Federal Reserve Chairman Jerome Powell pointed to the strength of the Labour market as evidence of the latent strength of the economy.

The UK economy contracted by 0.1% in the three months to June of 2022, preliminary estimates showed. Services went down by 0.4%, with the largest negative contribution from human health and social work activities, reflecting a reduction in coronavirus activities. On the other hand, there were positive contributions from consumer-facing services, including travel agencies and tour operators as covid restrictions eased on the tourism industry, accommodation and food services, arts, entertainment and recreation activities. On the consumption side, household spending fell 0.2%, as the cost of living increased offsetting a positive contribution from net trade, over 12 months the economy grew by 1.9%.

The Japanese economy grew by 2.2 percent on an annualised basis in Q2 of 2022, the third straight quarter of expansion. It followed a revised 0.1% rise in Q1 when surging covid cases hurt spending with some reports saying that the latest GDP figure has reached the level that it was before the pandemic started. There was an acceleration in both private consumption and government spending while capital expenditures bounced back sharply. Public investment grew after falling in the previous five quarters. Net exports contributed positively to the GDP, as exports increased while imports fell.

The Eurozone economy expanded 0.7% in the three months to June of 2022, following a downwardly revised 0.5% growth in Q1. This was the strongest performance in three quarters, prompted by the easing of covid restrictions and the summer tourism season in southern countries. Spain, Italy and France grew at a strong and upbeat pace while the German economy stalled and growth in some countries including Portugal, Lithuania and Latvia contracted, a worrying sign that a recession may be right around the corner. At the same time, the energy crisis and the war in Ukraine are far from over, and natural gas supply cuts from Russia threaten the outlook for the winter, further pressuring the inflation and consequently interest rate outlook. The annual growth rate of the Euro Area economy was 4% in the 12 months to the end of June, down from 5.4% in the 12 months to March 2022.

Consumer Price Inflation

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

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

% CHANGE YOY								
	2022				2023			
	MAY		AUGUST		MAY		AUGUST	
	Consensus	AF	Consensus	AF	Consensus	AF	Consensus	AF
US	7.2	**7.0**	8.1	**8.0**	3.3	**3.0**	3.8	**4.0**
UK	7.8	**7.5**	9.1	**10.0**	4.3	**4.0**	6.7	**7.0**
Japan	1.7	**1.5**	2.0	**1.5**	1.1	**1.0**	1.4	**1.5**
EU	6.6	**6.6**	7.8	**9.0**	2.9	**3.0**	4.1	**5.0**
China	2.2	**2.5**	2.4	**2.4**	2.3	**2.3**	2.5	**2.5**
SE Asia	3.9	**4.0**	4.6	**4.6**	3.0	**3.0**	3.5	**3.5**

Source: - Consensus Economics August 2022

As the consensus plays catch up with the outcome, forecasters have again revised their inflation expectations higher. As mentioned last time I expect inflation reports over the next few months will be worryingly high and while it possible in the UK and Europe that gas prices will continue to rise into the first quarter 2023, inflation in aggregate may be falling in 12 months' time, due to the impact of falling household incomes and a weaker economy. The impact of higher gas prices is less felt in the US because of abundant supply and in China and Asia because of much less reliance on gas for electricity generation and household heating.

Outside of energy prices which feed directly into the price of everything the global goods supply chain continues to improve despite covid induced disruption in China. As shown in table 4 above global growth is slowing and real household incomes are falling faster. These factors are taking the heat out the economy and hence should lead to less demand pressure on prices. The substitution of Russian oil supply and the resumption of exports of grains from Ukraine have also recently taken the top off the prices of these commodities.

The outlook for inflation remains uncertain and it will be higher than we have been used to over the last 10 years but I still believe we will be past the current peak in a years' time.

The headline annual rate of CPI in the US slowed to 8.5% in July from an over 40-year high of 9.1% in June. Energy prices increased 32.9% but this was much lower than the 42 year high of 41.6% in June, mainly due to a big slowdown in prices rises for petrol, fuel oil and natural gas. Other components like new vehicle prices that had been putting pressure on inflation moderated somewhat as did airline fares. However, food price inflation continued to move higher up 10.9%, the largest increase since May of 1979, housing costs increased 5.7% and used cars and truck prices were also higher. Core inflation which excludes food and energy was steady at 5.9%, lower than expectations of 6.1%, and offering some support that inflation may have peaked.

The annual rate of CPI in the UK increased to 10.1% in July from 9.4% in the year to June 2022. It was the highest reading since February 1982, as prices rose faster for housing & utilities, recreation & culture, food & non-alcoholic beverages, and restaurant & hotels, transportation costs eased slightly. Annual core consumer price increases that had eased slightly in May and June rebounded to 6.2% July.

Annual inflation in the Euro Area was confirmed at a new record high of 8.9% in July, compared to 8.6% in June and 2.2% a year earlier. Prices accelerated for food, alcohol & tobacco, non-energy industrial goods and services, while the cost of energy eased slightly. Core inflation that in the Euro Area excludes the cost of energy, food, alcohol & tobacco went up to 4% from 3.7%.

The annual inflation rate in Japan rose to 2.6% in July from 2.4% in June. This was the 11th month of increasing consumer prices and the fastest rate since April 2014, the weakness of the Japanese yen had a large influence on fuel and food costs, with all components of inflation increasing except transportation and medical care. Core consumer prices increased 2.4% year over year, again at the highest rate since December 2014.

4. The outlook for the securities markets

As mentioned above prices in the securities markets turned in mid-June after the central banks delivered more decisive changes in interest rates. At the time of writing nearly all asset markets have posted positive returns quarter to date. This leaves me feeling that from here the news is just as likely to lead to a fall in price at least in the short term as it is to a further rise in prices. I accept that markets were probably ahead of the data and potentially oversold but that does not remove the fact that inflation is going to be higher for a while longer and even though I expect it to be falling in 12 months' time it will be above a level we are used to. Interest rates are also still expected to increase over the next 12 months which along with falling incomes caused by higher energy prices increases the downward pressure on discretionary spending, corporate earnings and economic activity.

It has dropped out of the top stories on mainstream media but there is still a war in Ukraine and Russia despite its reported near economic collapse continues to pursue its "harrowing policy" in the east and south of the country supported by higher receipts from oil and gas exports. Add to this China's increased irritation with the US over Taiwan, leading to increased geopolitical risk that should be enough to raise the uncertainty and risk premia for investors.

My main themes have not changed, I do not believe central banks want a deep recession, but it is higher energy prices and falling household incomes that will decide how deep the recession is.

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 should make equity and bond markets more volatile especially as markets have now priced in rate cuts rather than increases. By the end of 2022, I believe inflation could be heading lower but so could growth.

As I have said before higher interest rates and inflation are bad news for longer duration bond markets, but they are not necessarily a bad outcome for equity markets in aggregate. The recent rally in growth stocks makes them more vulnerable in the short term and investors need to remain disciplined in their approach seeking the longer term opportunities of sustainability and resilience.

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 August 2022.

Table 6: - Interest rate and Bond yield forecasts

%	CURRENT	MARCH 2023	SEPTEMBER 2023
UNITED STATES			
3month SONIA	2.92	4.0	4.0
10 year bond yield	2.84	3.5	3.5
UNITED KINGDOM			
3month SONIA	2.15	3.0	3.0
10 year bond yield	2.08	2.5	2.5
JAPAN			
3month SONIA	-0.01	0.0	0.0
10 year bond yield	0.20	0.25	0.25
GERMANY			
3month SONIA	+0.04	2.0	2.0
10 year bond yield	0.96	1.5	1.5

Source: - Trading Economics; 15th August 2022

Over the last few months central banks implemented a much more aggressive pace of rate increases, with the aim of re-assuring the markets that they will do what they can to keep inflation under control. In July the US Fed increased the Fed funds rate to 2.75%, the second time it has raised rates by 0.75% in this cycle. During its regular press conference, Chair Jerome Powell in a break with the past, said he could not predict monetary policy range for next year and that next decisions will be data dependent. He also said the central bank will be looking for moderately restrictive level of interest rates by the end of the year, which the market has interpreted as meaning a 3% to 3.5% level for the Fed funds rate. This would suggest that the Fed does not believe rates are high enough, despite the US economy already being in a "technical recession" having recorded a negative growth rate in the first and second quarters of 2022.

At its meeting in August the Bank of England increased rates to 1.75%, the first time in 27 years that rates have been increased by 0.5%. While this was expected the Bank also forecasted that inflation could hit 13.3% in October this year at the same time it suggested that the economy will enter a shallow but prolonged period of contraction lasting most of 2023. It sighted the impact of higher energy prices as being the main reason for both higher inflation and weaker growth going forward.

10 year US and UK Government and global non-government bond yields increased by 0.6% and 1.2% respectively in the second quarter as it became clear that interest rates and inflation would be higher than expected. Ironically, bond yields have fallen by around 0.2% since the Fed implemented its first

0.75% increase in the Fed funds rate at its June meeting and bond markets are now talking about the idea of the Fed pivoting to a more "Dovish" policy!

Bond Market (Protection Assets) Recommendations

In my last report I suggested that the Fund could consider reducing its underweight to government and corporate bonds as I believed that markets had priced in a lot of bad news. But even I had not expected the marked re-pricing in such a short period of time. As a result, I now believe bond yields are just as likely to rise from here as they are to fall but not by much in either direction in the short term. However as can been seen in table 6 above I continue to expect that government bond yields could increase and as a result highly interest rate sensitive government bonds may deliver negative returns over the medium term. High inflation over the next 12 months means that real returns even at my expected levels of yield will be negative for some time.

I have not changed my allocation and 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 and maintain my suggested + 2% overweight to Multi-asset Credit. High yield spreads remain 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 coupons, they are less interest rate sensitive, which is ideal in a rising yield environment.

The yield on Index Linked Gilts has increased significantly in the last year hence their extremely negative return. Despite this I believe they remain over-valued, and while I have consistently recommended an underweight allocation at the current time, 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

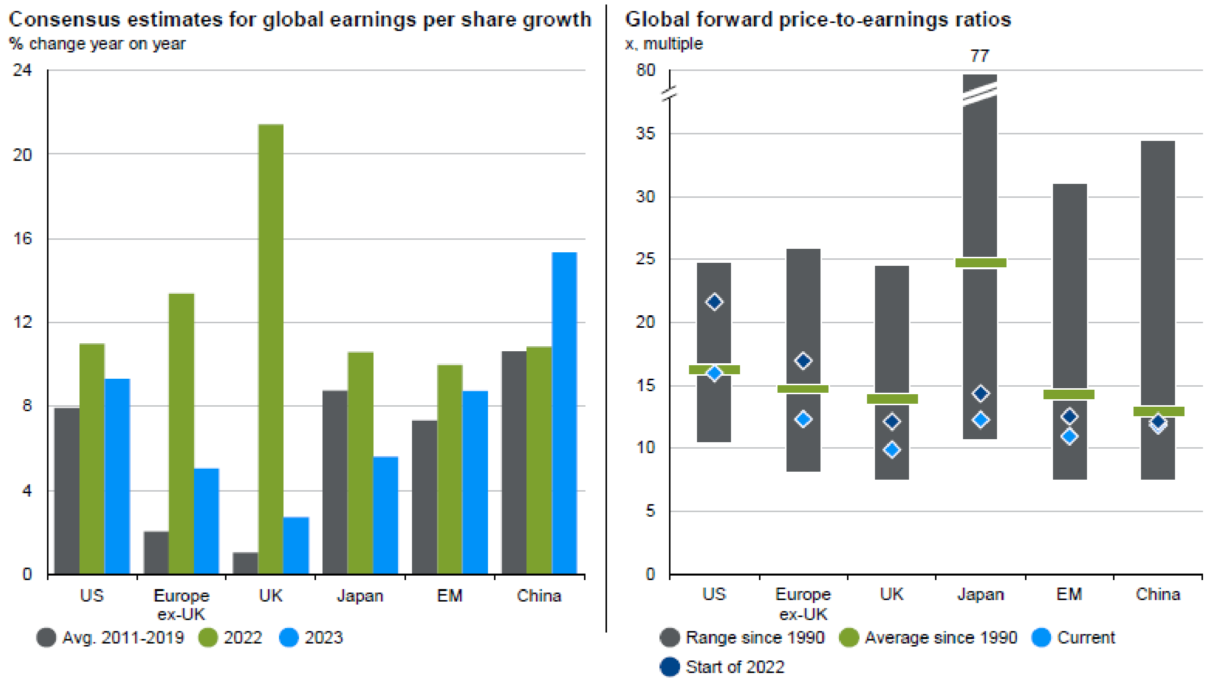
INDEX	YIELD TO MATURITY %	DURATION	YIELD INCREASE %	% TOTAL RETURN, HOLDING PERIOD	
				3 MONTHS	12 MONTHS
All Stock Gilts	2.26	11.2	0.5	-5.0	-3.3
All Stocks Linkers	-1.28	18.0	0.5	-9.3	-10.3
Global IG Corporate	3.96	6.6	0.5	-2.3	+0.7
Global High Yield	7.5	4.0	0.5	-0.1	+5.5

Source: - ICE Indices 12th August 2022

Equity Markets

Chart 12 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 (P/E) 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 12: - LHS - Earnings per Share estimates, RHS - Price/Earnings Ratios, since 1990, China 1996



Source: - JPM Asset Management., June 2022

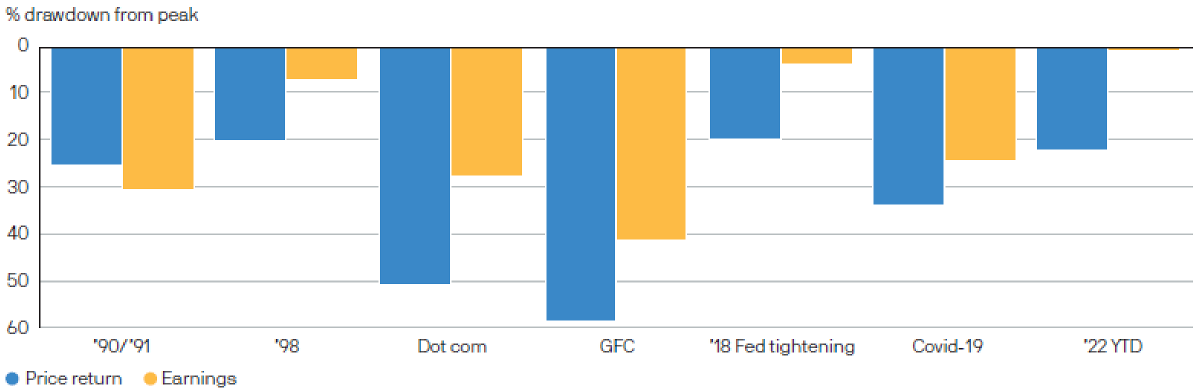
The sharp year-to-date sell-off in equities has been led by declining valuations rather than a shift in earnings expectations. P/E ratios on developed market stocks have slipped from close to 20x 12-month forward earnings at the start of the year, to around 15x currently. Over the same period, earnings growth expectations for 2022 have been upgraded, from 7% to more than 10%, despite the deterioration in the economic outlook.

Looking at sector-level data helps explain some of the resilience in earnings expectations. Surging energy prices have boosted 2022 earnings growth expectations for the developed market energy sector and basic materials companies have also benefited significantly from rising commodity prices. Conversely, earnings forecasts for consumer-facing companies have fallen due to growing fears of a squeeze on disposable incomes. Sector composition has unsurprisingly had a major impact on regional earnings estimates. As can be seen in the green bars on the LHS of chart 12 above the commodity-heavy UK market is a prime example where, despite earnings downgrades for every other sector, overall earnings expectations are higher, thanks to the significant weighting of energy and materials.

But the blue bars for 2023 suggest that earnings growth may not continue into next year especially in Europe and the UK, China on the other hand where earnings have been depressed this year due to covid restrictions is the only region where earnings are expected to be better next year. Overall analysts tend to extrapolate past growth rates which means earnings expectations tend to lag, to try assessing the level of optimism it may be worth looking at Earnings revision ratios – a measure of the number of analyst upgrades versus downgrades for guidance. These ratios have been declining since last summer, implying a larger number of downgrades than upgrades.

Stock prices tend to lead earnings, rather than the other way round. Chart 13 compares historical drawdowns in the market and earnings. The decline in developed market stocks year-to-date now looks broadly in line with the size of the drawdowns experienced during previous non-recessionary economic slowdowns, despite the fact that earnings downgrades are yet to feed through.

Chart 13: - MSCI World earnings and market drawdowns in prior downturns



Source: - JPM Asset Management., June 2022

Charts 12 and 13 above, suggest that just like the bond markets much of the bad news on energy prices, inflation and growth has already been priced into equity markets at these levels. It is earnings that ultimately drive prices and outside of China analysts seem to be forecasting unchanged or declining earnings and the outlook remains uncertain.

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. Despite the sell off this year valuations still appear cheaper outside the US, but this could be a legacy of the FAANG stocks and there may be opportunities in the rest of the market. From a regional perspective the UK and Europe are most exposed to higher energy prices and the situation in Ukraine. If energy and commodity prices stabilise, sector leadership may shift, but I believe it is unlikely to be in favour of interest rate sensitive sectors before we have seen the peak in inflation and interest rates.

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

I have made no changes to the allocation to Income Assets and would continue to fund the 2% over allocation to MAC from Protection Assets. The widening of spreads in the second quarter, 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.

Over the quarter the overall allocations to Infrastructure and Property have been increased closer to neutral from cash. As mentioned, before I would like to see the direct property allocation increase funded using net sales from the in-direct exposure, but 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.

The asset allocation set out in table 8 below, shows the Strategic Asset Allocation Benchmark and my suggested asset allocation weights relative to this benchmark as of the 17th May and the 15th August 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 18TH MAY 2022	ANTHONY FLETCHER 15TH AUGUST 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**	**-2**	**-2**
Conventional Gilts	6	**-1**	**-1**
UK index Linked	6	**0**	**0**
US TIPS	0	**0**	**0**
UK corporate bond	6	**-1**	**-1**
Cash	2	**0**	**0**

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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

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