APPENDIX 2

MJ HUDSON
Allenbridge

First Quarter 2023 Investment Report

PREPARED FOR:

Derbyshire County Council Pension Fund: Pensions and Investment Committee Meeting

JUNE 2023

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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 7th June 2023
Date of paper 18th May 2023

1. Market Background (First quarter 2023)

The rally in equity and bond markets which began in October 2022 continued into the first three months of 2023. Macro-economic data was stronger than expected with Growth, Inflation and Employment in the major economies all outperforming forecasters expectations. The markets chose to focus on the falling trend of US headline inflation, rather than its elevated level and the stubbornness of core inflation, also seemingly failing to realise that if growth and employment data remained better than expected central banks were more likely to continue to increase interest rates. This optimism took a blow in March with the failure of 2 US regional banks and CSFB.

True to their word central banks continued to increase interest rates over the quarter with the US Fed delivering a 0.25% increase in February and March. The BoE and the ECB each increasing rates by 0.5% in February and 0.25% in March. Despite the bank failures all 3 central banks raised rates again at their April and May meetings. Stating that they remained committed to getting inflation down, while in the case of the Fed recognising that credit conditions may have tightened in the domestic economy.

As can be seen in table 1, in Sterling terms over 3 months to the end of March, global equities delivered a return of +4.4%, improving the annual performance to -0.9%. Once again, the range of returns was quite wide with Europe up over 8% but emerging equities only up 0.2%. In terms of theme, growth stocks had a better quarter than value and at the sector level, Tech stocks also outperformed. Over twelve months European equities were +8.7% higher whereas US and emerging equities were down -2.6% and -3.9% respectively.

Bond markets delivered solid positive returns over the quarter with UK index linked gilts delivering the highest returns due to their ultra long interest rate sensitivity. Despite the volatility in the financial sector non-government bonds performed in-line with conventional government bonds. Over twelve months all bond markets delivered huge negative returns, with the highest duration government bond markets delivering the worst returns.

Property markets had another poor quarter with both UK and Global property markets delivering small negative returns adding to the negative annual return. Returns from other real and private market assets like Private Equity and Infrastructure were positive over the quarter and the year.

The US dollar weakened a bit further over the quarter but Sterling was stronger against most currencies as FX markets priced in higher interest rates for longer to tackle inflation. Commodity prices were again mixed, the prices of oil, gas and electricity are now back the level seen at the end of 2021 and industrial commodity prices were fairly stable over the quarter.

The strength of markets in January has been tempered over the year to date by higher interest rates, inflation and better than expected growth. Equities are no longer so over-bought as they were but I also do not believe they are cheap. Even with tighter credit conditions, interest rates may have to rise further to combat inflation, which could lead to further equity market volatility and rising bond yields.

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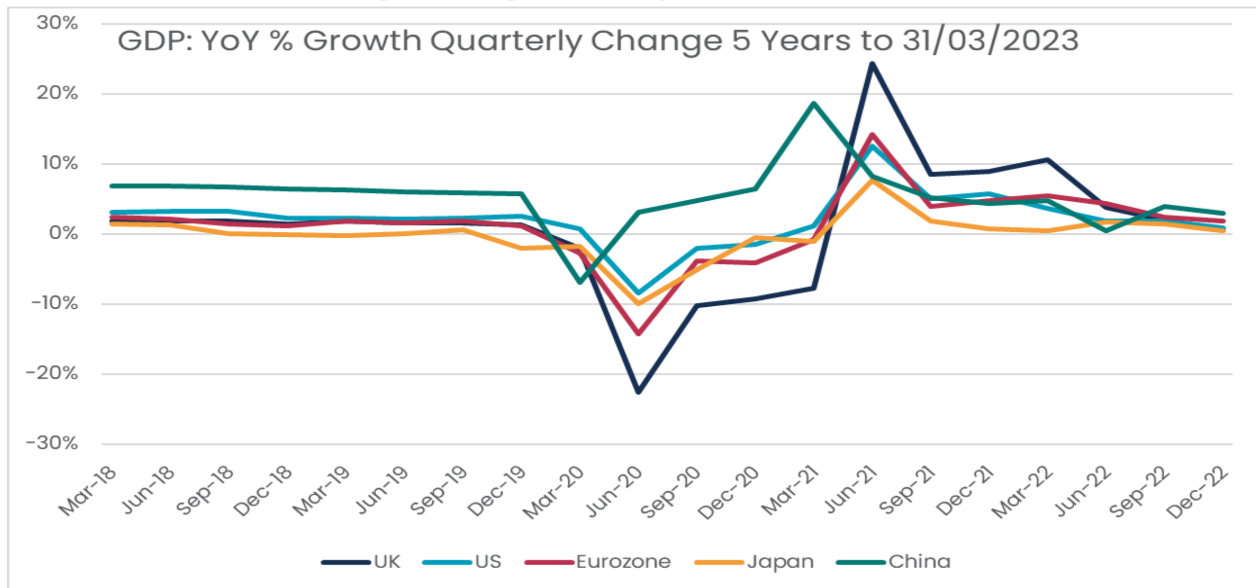
Chart 1: - Annualised rates of quarter on quarter GDP growth.



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 2023 and the 3 and 12 months to the end of March 2023.

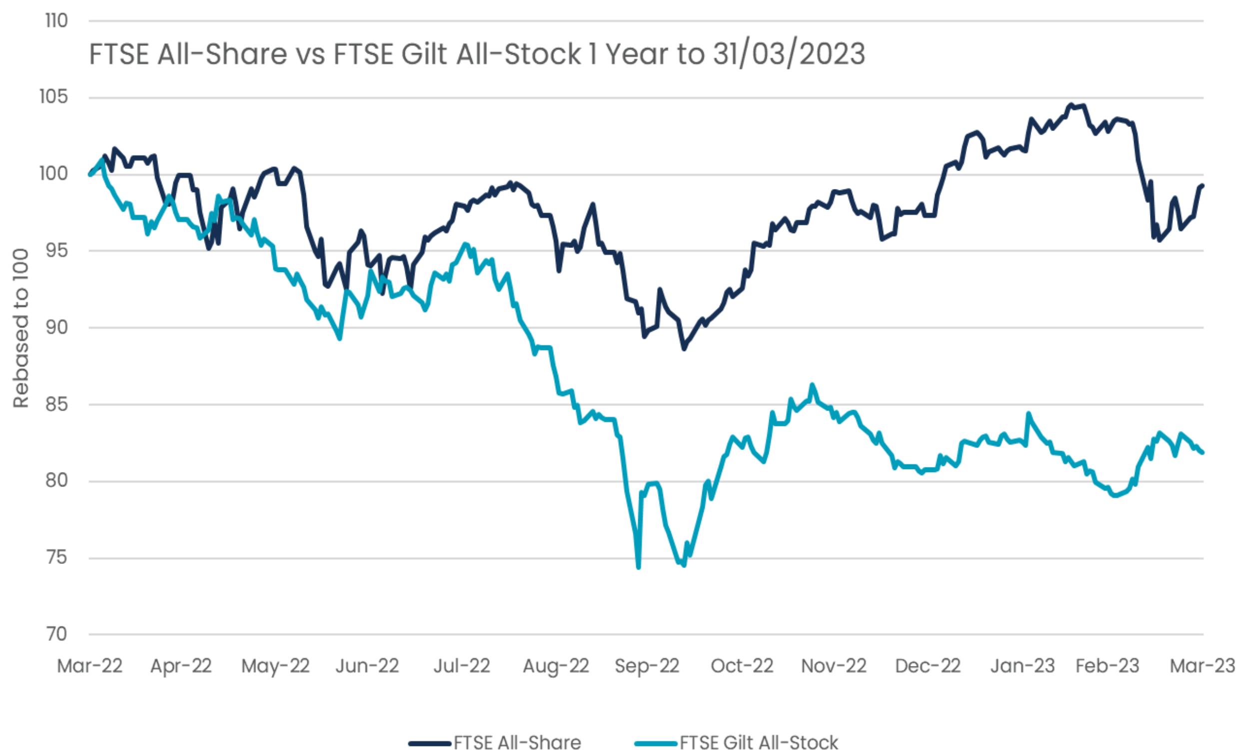
% TOTAL RETURN DIVIDENDS REINVESTED

MARKET RETURNS

		Period end 31st March 2023	
	April 2023	**3 months**	**12 months**
Global equity FTSE All-World	-0.1	+4.4	-0.9
Regional indices			
UK All Share	+3.4	+3.1	+2.9
North America	-0.2	+4.7	-2.6
Europe ex UK	+2.3	+8.6	+8.7
Japan	-1.2	+3.3	+2.0
Emerging	-2.6	+0.2	-3.9
UK Gilts - Conventional All Stocks	-1.8	+2.5	-17.2
UK Gilts - Index Linked All Stocks	-4.0	+4.3	-27.5
UK Corporate bonds*	+0.2	+2.5	-11.4
Overseas Government Bonds**	+0.4	+2.9	-5.5
UK Property quarterly^	-	-1.2	-12.6
Sterling 7 day SONIA	0.3	0.9	2.2

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

Chart 2: - UK bond and equity market returns - 12 months to 31st March 2023



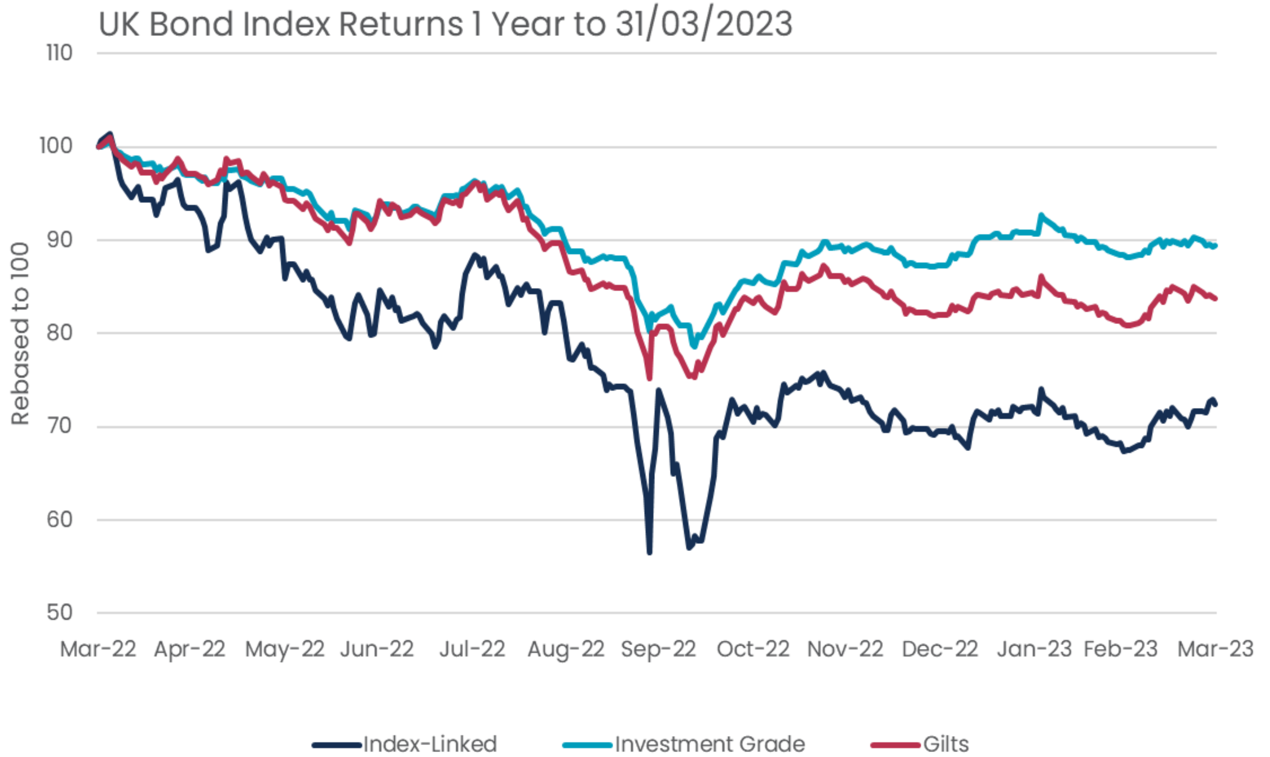
Source: - Bloomberg

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

BOND MARKET % YIELD TO MATURITY	31st December 2022	31st March 2023	Quarterly Change %	31st March 2022	Current 15th May 2023
UK GOVERNMENT BONDS (GILTS)					
10 year	3.67	3.49	**-0.18**	1.61	**3.82**
30 year	3.95	3.84	**-0.11**	1.77	**4.25**
All Stocks ILG	+0.24	+0.13	**-0.11**	-2.38	**+0.60**
OVERSEAS 10 YEAR GOVERNMENT BONDS					
US Treasury	3.83	3.49	**-0.24**	2.33	**3.51**
Germany	2.56	2.31	**-0.24**	0.55	**2.31**
Japan	0.42	0.32	**-0.10**	0.21	**0.41**
NON-GOVERNMENT BOND INDICES					
Global corporates	5.10	4.92	**-0.18**	3.03	**4.92**
Global High yield	8.86	8.50	**-0.36**	6.02	**8.60**
Emerging markets	6.99	7.00	**+0.01**	5.23	**7.07**

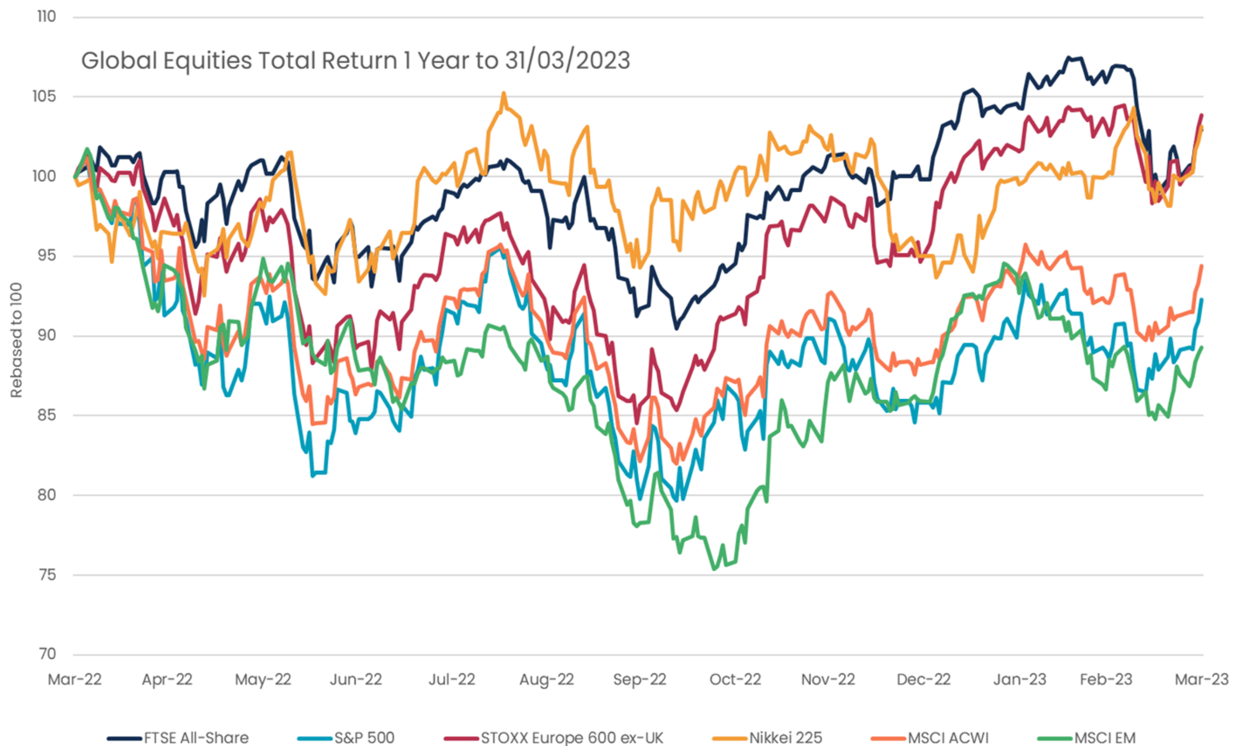
Source: - Trading economics and ICE Indices G0LI, G0BC, HW00, EMGB, 15th May 2023.

Chart 3: - UK Bond index returns, 12 months to 31st March 2023



Source: - Bloomberg

Chart 4: - Global equity market returns in local currency, 12 months to 31st March 2023



Source: - Bloomberg

Recent developments (April and up to 15th May 2023)

Quarter to date has seen another round of interest rate increases from the main central banks as growth, inflation and employment has remained stronger than expected. At their most recent meetings the central banks all increased rates by 0.25% the US Fed to 5.25%, the BoE to 4.5% and the ECB to 3.75%. In their press statements after the increases the Fed did suggest that if tighter credit conditions persist it may impact the outlook for rates, but the BoE and ECB continue to indicate that they are not about to end the tightening of monetary policy.

Tighter credit conditions in the US also claimed another victim with the failure of First Republic Bank. The bank had been struggling since the failure of SVB in March, over the weekend of the 28th April the FDIC seized the bank guaranteeing all depositors and sold it to JP Morgan. JP Morgan is already the USA's largest bank.

Economic data showed that April was a positive month for the global economy with growth remaining remarkably resilient in the face of higher interest rates. US, eurozone, and UK Purchasing Managers Index (PMI) surveys all beat expectations, and China's Q1 GDP print was also stronger than expected.

Falling energy prices helped bring headline inflation down in the major developed economies with the contribution from energy turning negative in the US and the eurozone. In the UK, fuel prices fell while the contribution from broader energy remained positive due to the lags caused by the energy price cap. OPEC announced a cut in production aimed at stabilising oil prices at around $80 a barrel and while this may reduce base effects, the comparison with sky high 2022 prices mean energy should still drag on inflation in the coming months.

This positive economic momentum supported risk assets despite further stress in the banking sector. Developed market equities rose by 1.8% over the month, with value stocks modestly outperforming growth counterparts. Global bonds returned 0.4% with a large part of this driven by investment grade credit which returned 1.2% over the month.

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2. Investment Performance

Table 3 shows the performance of the Derbyshire Pension Fund versus the Fund specific benchmark for the quarter and year to 31st March 2023. Over 12 months, Growth assets underperformed whereas Income and Protection assets outperformed. All the individual active Growth asset managers underperformed their respective benchmarks over 3 months and over 12 months, only the US and Private Equity outperformed.

Over 10 years the Fund has achieved a total return of 8.1% 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	**2.5**	**3.6**	**-1.2**	**0.4**
UK Equity	2.5	3.1	1.9	2.9
Total Overseas Equity	**2.8**	**3.6**	**-3.1**	**-0.5**
North America	4.4	4.6	-1.6	-2.5
Japan	2.9	3.3	-0.5	2.0
Emerging markets	1.0	0.2	-5.1	-4.1
Global Sustainable Equity	3.1	4.2	-3.3	-0.5
Global Private Equity	0.8	4.4	5.1	0.5
Total Protection Assets	**3.1**	**3.0**	**-14.8**	**-17.5**
UK & Overseas Government	1.8	2.0	-12.4	-16.3
UK & Overseas Inflation Linked	5.0	4.3	-20.6	-26.7
Global Corporate bonds	2.4	2.6	-10.8	-9.0
Total Income Assets	**0.7**	**0.7**	**0.2**	**-2.5**
Multi-asset Credit	2.1	2.0	1.0	2.7
Infrastructure	1.0	1.4	7.5	4.3
Property (all sectors)	-1.0	-0.9	-8.6	-13.2
Internal Cash	0.9	0.9	1.7	2.2
Total Fund	**2.1**	**2.7**	**-3.1**	**-3.6**

Total fund value on 31st March 2023 £5,916 million

At the end of March, the Fund was slightly overweight growth assets, within equity the Fund was underweight Global sustainable with an overweight to the UK and a residual position in US Equity. The Fund was also 2% underweight protection assets and 1% overweight income assets relative to the strategic benchmark.

At the end of April the Fund rebalanced it's equity exposures reducing the UK equity exposure by 1.4% and selling out of the residual 1.1% exposure to North American equity. The exposure to Global sustainable equity was increased by 2% with the residual left in cash.

Over the first quarter of 2023, the Fund underperformed with stock selection decisions in growth assets predominantly responsible for the negative contribution. Over 12 months the total return of the Fund was -3.1% but this was better than the -3.6% return of the benchmark, with both asset allocation and stock selection decisions making a positive contribution.

Over 3 years to the end of March, each of the broad asset categories in the Fund has outperformed the benchmark and the total return of the whole Fund, net of fees was +8.0% p.a. compared to the benchmark return of +7.7% p.a. The largest contribution to this outperformance comes from stock selection in all asset classes and asset allocation to protection and income assets, with a small negative contribution coming from the asset allocation to growth assets.

Growth assets – Equity performance

The aggregate performance of growth assets in the first quarter and year as whole was lower than the strategic benchmark. Over three months only the Emerging market equity portfolio delivered an outperformance compared to its benchmark and only North America and global private equity outperformed over twelve months.

Over 10 years growth assets have returned on average 8.6% p.a. compared to 8.3% p.a. for the benchmark.

Protection assets - Fixed Income Performance

The Fund remains underweight its allocation to UK government bonds and has less interest rate sensitivity than the benchmark. As a result, the aggregate return of the government bond portfolio was in line with benchmark over 3 months and significantly outperformed the benchmark over 12 months. Over the quarter and the year, the global corporate bond managers underperformed their benchmark.

Over 10 years protection assets have on average returned +1.7% p.a. compared to the benchmark return of +1.5% p.a.

Income assets – Property, Infrastructure and MAC

Over the quarter, the combined portfolio of income assets has outperformed the benchmark, with all 3 asset classes outperforming their respective indices. Over 12 months a better period for measuring returns both property and Infrastructure outperformed while the MAC portfolio underperformed.

Over 10 years Income assets have on average returned 8.2% p.a. compared to the benchmark return of 3.8% p.a.

3. Economic and Market outlook

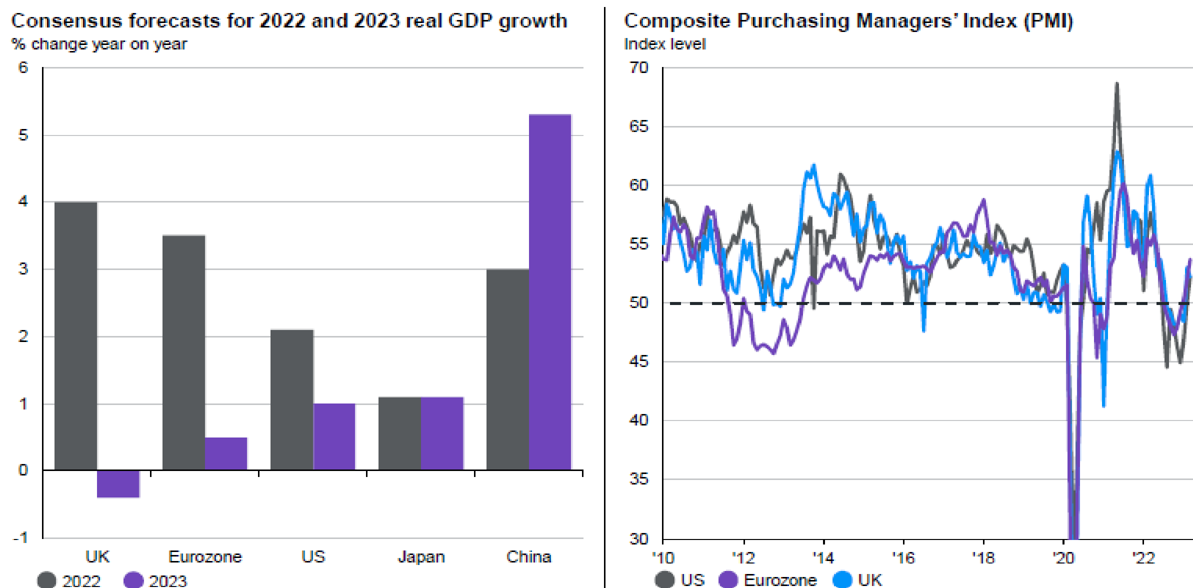
Economic outlook

Market commentators were quite pessimistic on the outlook for growth when I was writing my last report but as I mentioned when we met at the last PIC meeting, anecdotally I had observed rather more activity in the UK than the forecasts would suggest. Equally the actual reported global economic data had not been as weak as expected. Compared to last year growth and inflation are going to be lower and it is possible that the better recent experience could be reversed by the tightening of credit conditions in the US caused by the failure of several regional banks. As can be seen in chart 5 below, generally forecasters are suggesting better growth and even the IMF (23rd May) has revised its global growth forecasts higher increasing their outlook for the UK from -0.3% to +0.4% in 2023. This is still not a great outcome, UK growth should be greater than 2% per year, but the magnitude of the change is worthy of note. In the IMF's previous report UK economic growth was ranked weakest in the G20, that ranking now belongs to Germany which is only expected to achieve 0% growth in 2023.

With growth slightly better than expected and full employment, central banks can feel free to increase interest rates to tackle inflation. The headline rate may be falling but the core rate remains stubbornly high and in some cases continues to rise as the last 12 months of "baked in" price increases start to show up in core goods and services. At the moment my concern about Chinese inflation getting out of hand in the post lockdown recovery seems to be mis-placed.

While the outlook for UK and European economic growth has improved from a low base it could still be characterised as stagnant rather than recessionary. Market volatility has picked up as investors try to figure out how much further central banks need to increase rates especially in the UK and Europe to get inflation back under control, against a backdrop of tighter credit conditions in the US and the brinkmanship over the US Government's debt ceiling.

Chart 5: - Consensus GDP forecasts and PMI's (leading indicators of growth)



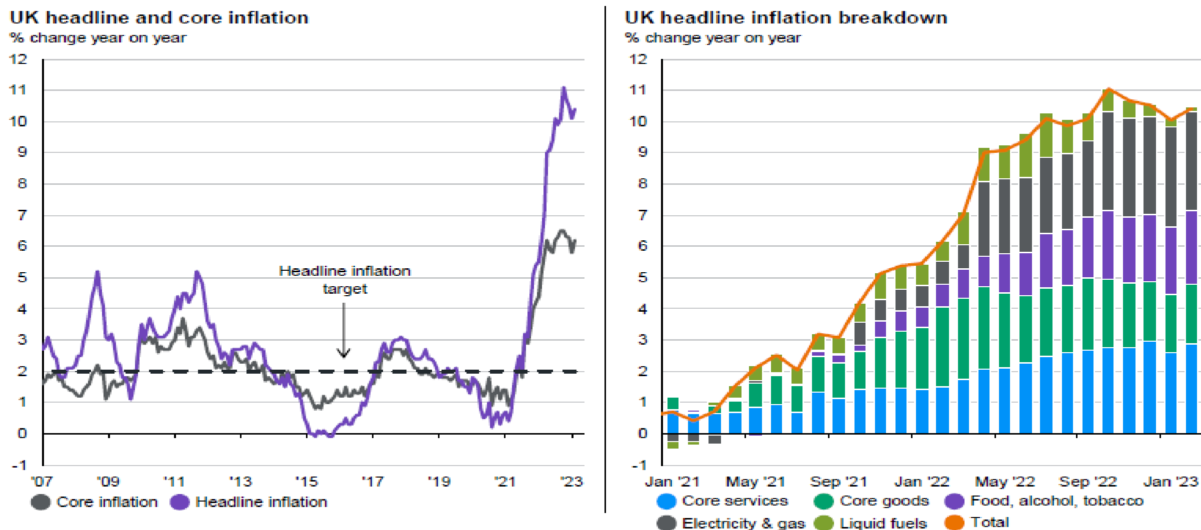
Source: - JPMorgan Asset management April 2023

Inflation

In the US the rate of headline inflation has been trending lower since the summer, in the UK and Europe since October, and in Japan since February, but the core rates of inflation are proving more stubborn. The most significant cause of the inflation has not changed, all the developed world's central banks kept monetary policy too easy for too long into the covid recovery. But the USA's self-sufficiency in energy has meant that the inflation caused by Russia's invasion of Ukraine has fallen faster than it has in the UK, Europe and Japan. The fall in the headline rates has been driven by year over year base effects and the recent sharp falls energy prices, helped by more cautious consumption in Europe and the milder winter. Inflation remains higher in the UK because of the structure of the energy market. Another factor that may keep UK inflation higher for longer is food prices, after a long period of intense competition between the supermarkets, suppliers and the supply chain have been forced to pass on higher prices caused by higher labour and production costs, and supply shortages.

The left hand side of Chart 6 shows, even as UK headline inflation falls, core inflation has remained stubbornly high. Indeed, the April inflation data published on 24th May, reported that headline inflation fell from 10.1% to 8.7%, but the core rate increased from 6.2% to 6.8% the highest rate since 1992. The right hand side shows the components of that make up headline inflation and suggests that even as headline inflation falls due to lower energy prices, core inflation may remain high after the base effects of higher energy prices drop out of the index.

Chart 6: - UK headline and core inflation and the components of headline inflation.

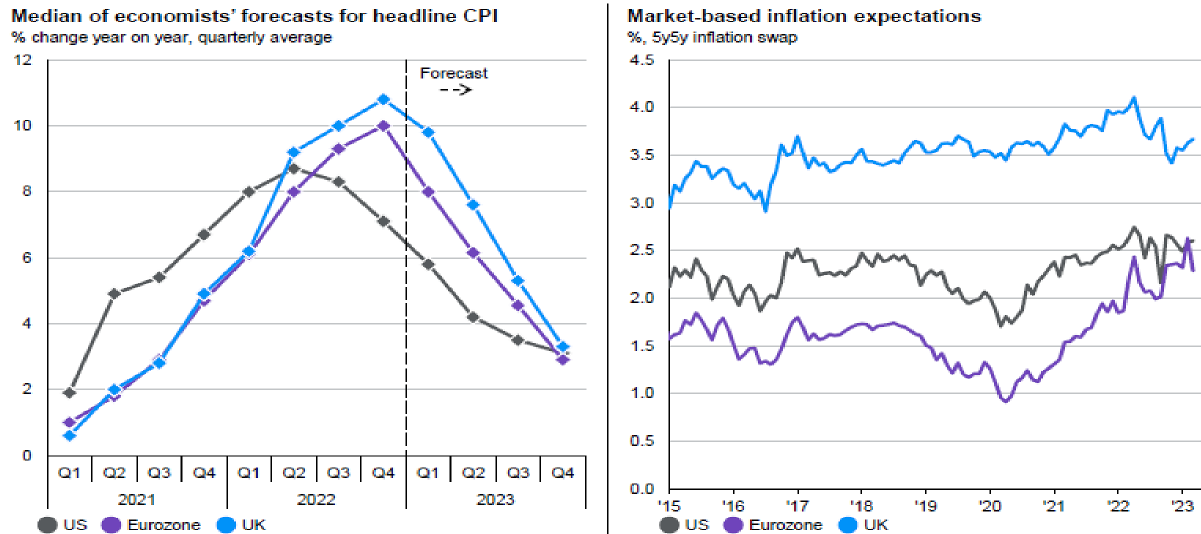


Source: - JPMAM April 2023

I have updated Chart 7 showing that economists expect inflation to fall over the whole of 2023. I believe that while the direction is correct, they are being overly optimistic about the actual level of inflation, because as I have suggested above, core goods and services inflation is not about to decline significantly. As I mentioned last time, they still expect inflation to settle at levels above central bank's target rates. The right hand chart shows that the bond markets also expect over the long term that levels of inflation will be higher than they were before covid. I have not changed my view that

the period of low inflation following the global financial crisis (GFC) is behind us and inflation rates could return to levels we were more familiar with before the GFC and this may require higher levels of interest rates and a more conservative monetary policy approach from central banks.

Chart 7: - Economists' median forecasts of headline CPI, in the US, UK and Europe and market forward looking inflationary expectations.

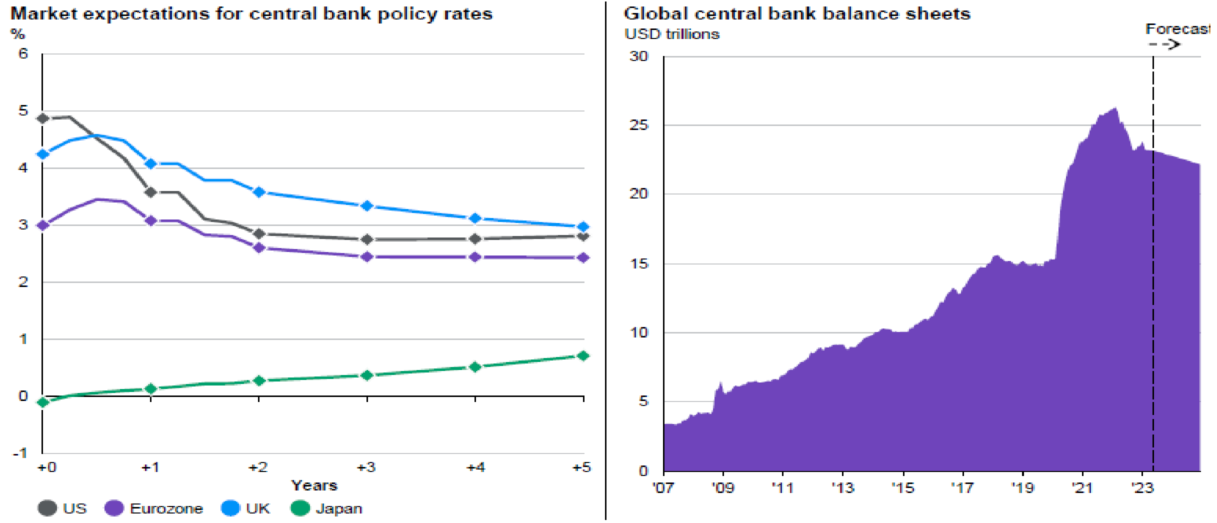


Source: - JPMAM April 2023

Central Banks

The Fed, ECB and the BoE all increased rates by 0.25% at their most recent meetings, but the comments in press conferences afterwards were somewhat different. The Fed was reported to suggest that the tightening of credit conditions after the failure of SVB, First Republic bank and CSFB, may make further tightening less likely, while the ECB (more clearly) and BoE suggested they may have more to do to get inflation under control. As a result, the market has softened its expectations for interest rates hikes going forward, whereas I have not. I still expect rate to rise and to stay higher for longer than the markets expect.

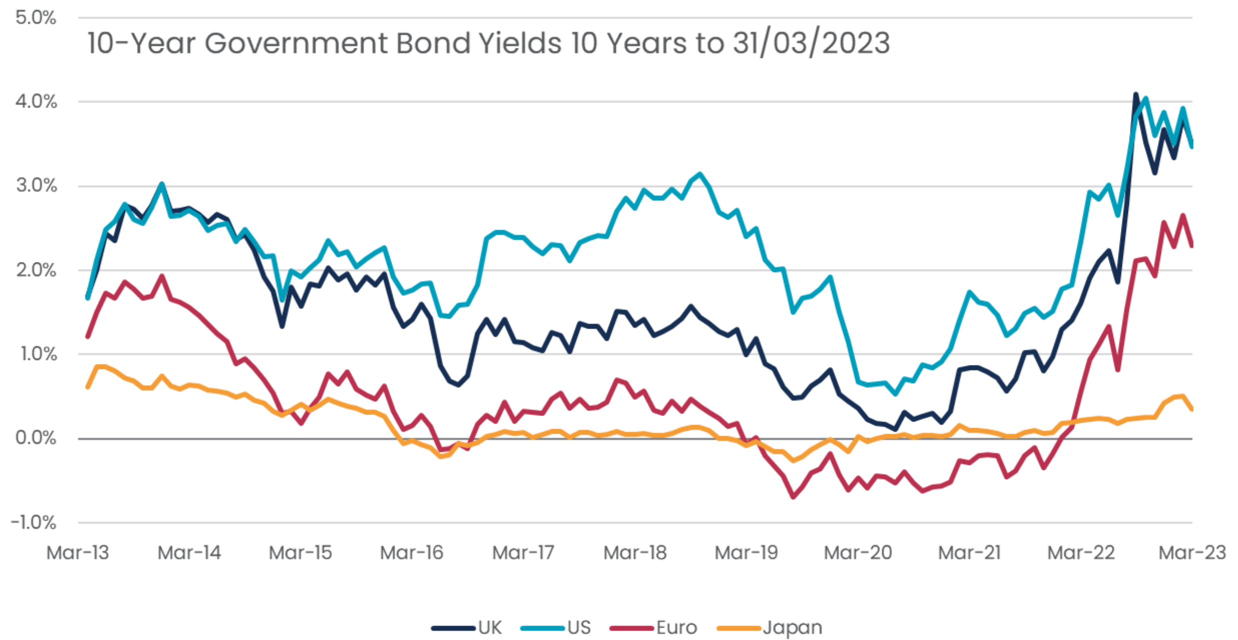
Chart 8: - Market expectations for Central bank policy rates and QT balance sheet reduction.



Source: - JPMAM April 2023

Government bonds

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



Source: - Bloomberg

As can be seen in chart 9, all 10 year government bond yields moved sideways over the first quarter of 2023. This pattern has diverged since the end of the quarter with the UK making new highs, Germany and Japan moving sideways, but with US 10 year yields falling slightly. The slowing of the rate of increase in yields is related to the markets anticipation that we are closer to the end of the rate hiking cycle. The more recent fall in US yields is due in part to the bank failures mentioned above, but also perversely the debate around the US government debt ceiling. In the UK yields have increased on the back of poor demand and supply conditions and higher than expected inflation. The

government is having to borrow much more this year at higher costs and corporate pension funds in particular have less demand as higher yields have reduced their liabilities.

US and German yield curves remain inverted, the UK flat (ish) and Japan positive, each reflecting the relative view of each country's economy and central bank policy. In Japan the BoJ continues to manage the yield curve. In Germany the economy is weak, in the US tighter credit conditions are expected to have big impact, in each case leading to rate cuts, and in the UK inflation and supply dominates sentiment. While I accept that the current shape of curves maybe maintained for the rest of year, as can be seen in table 6 below, I expect that interest rates and government bond yields have further rise in 2023, but they may be falling by June 2024 as the Fed may have stopped increasing interest rates by then.

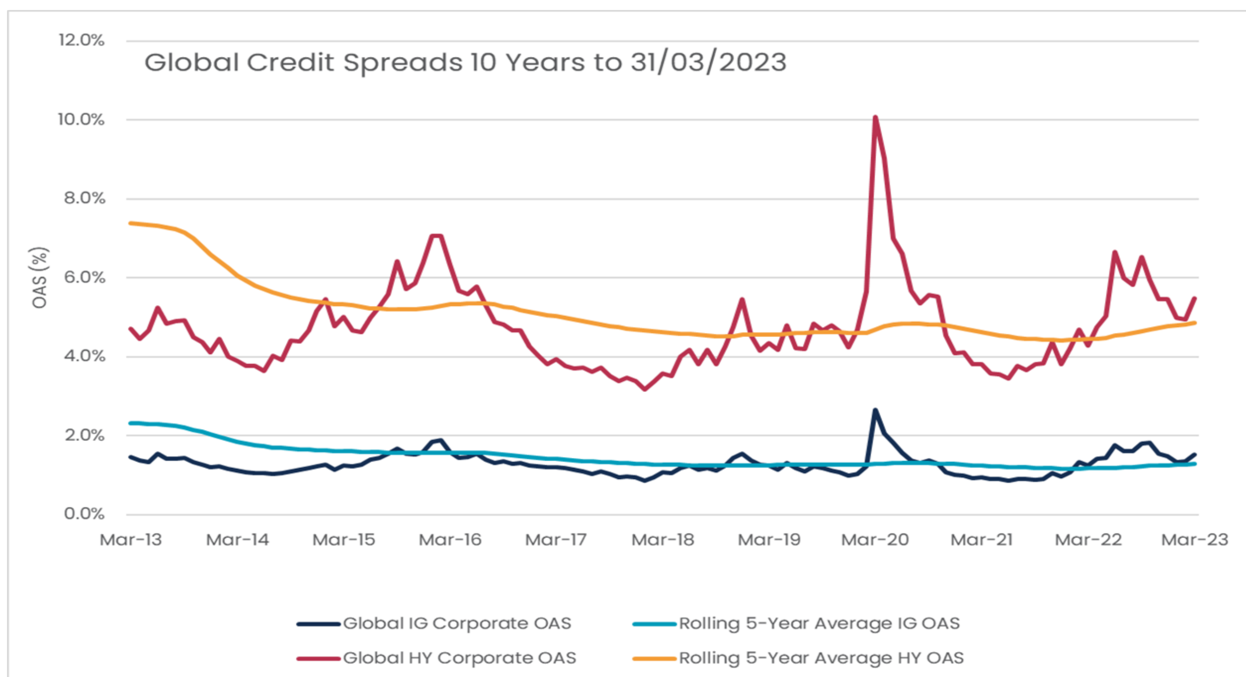
I haven't changed my view on the direction of government bond yields but they are becoming more interesting after years of being highly over valued and may be worthy of consideration in the context of the risks the Fund needs to take. But equally, I accept that relative to other opportunities, government bonds may not yet be cheap enough to merit an increased strategic allocation, but like non-government bonds, they may already be cheap enough to consider tactically increasing exposure.

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 quarter. As can be seen from the chart spreads widened slightly, for 2 reasons, the better relative performance of government bonds and the decision by the Swiss authorities to rank equity holders above bond holders in the bailout of CSFB. This unexpected action briefly ran the risk of undermining the reformed capital structure of the entire banking system since the GFC. Fortunately, the ECB and the BoE stepped in to re-iterate the subordinate position of equity holders to bond holders with respect to Bank Capital issued outside of Switzerland. Despite the volatility, I still believe the total yield of investment grade non-government bonds may be high enough to compensate for their interest rate sensitivity and may be cheap enough to consider increasing exposure. I also still believe that high yield bonds and loans owned as part the Multi-asset Credit allocation can deliver better returns. These assets have much 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 and the monthly carry provides an attractive source of income.

High yield assets are more sensitive to the economy, so the slowdown in economic growth and tighter credit conditions 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 10: - Credit spreads, extra yield over government bonds, last 10 years.



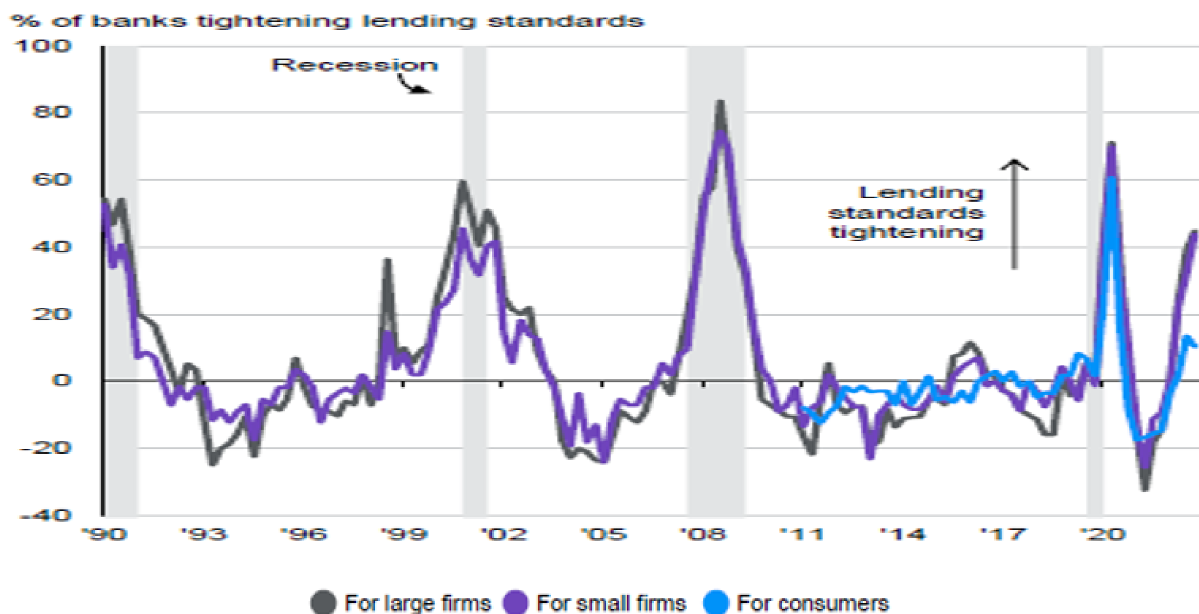
Source: - Bloomberg

Equities

Since my last report equity markets have moved sideways in a fairly wide range on a mix of better growth and worse inflation reports. As I suggested at the time, I believed equities were probably "over-bought" on the idea that the central banks were close to the end of the tightening cycle and therefore vulnerable to a correction if inflation remained higher than expected. The markets now recognise that central banks will have to keep raising interest rates for longer to get inflation back under control.

Added to this change in the macroeconomic outlook, has been the failure of 3 US regional banks, 2 of which were closely associated with the Tech sector and Credit Suisse, the second largest bank in Switzerland. While the failure of these banks can be linked to poor risk management, the rapid withdrawal of deposits from smaller US regional banks risked a contagion to the banking system that the regulators had to rapidly respond to. One of the consequences has been a significant tightening of credit conditions, which could have lasting implications for US, SME's impacting both the value of their equity and corporate bonds.

Chart 11: - US Banks credit conditions

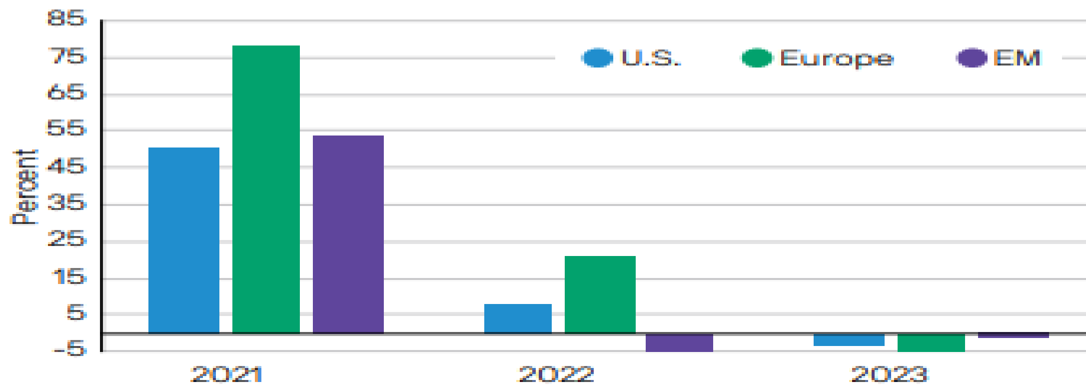


Source: - JPMAM

In terms of stock specifics, the recent earnings season has shown that in general profit margins have been squeezed by higher commodity, production and labour costs. The Tech sector after several years strong growth and hiring is now vigorously in cost cutting mode, after some notable downside surprises on earnings and sales.

In my last report I highlighted a risk to equities was that consensus 12-month forward earnings expectations were too high. As can be seen chart 14, earnings estimates have been revised lower but these probably do not take into consideration the stickiness of recent inflation data or the changes in credit conditions. All this suggests to me that the outlook for developed equity markets is more consolidation and volatility, and that growth stocks could remain under pressure as inflation and interest rates remain higher for longer than previously expected.

Chart 12: - Regional earnings growth estimates.

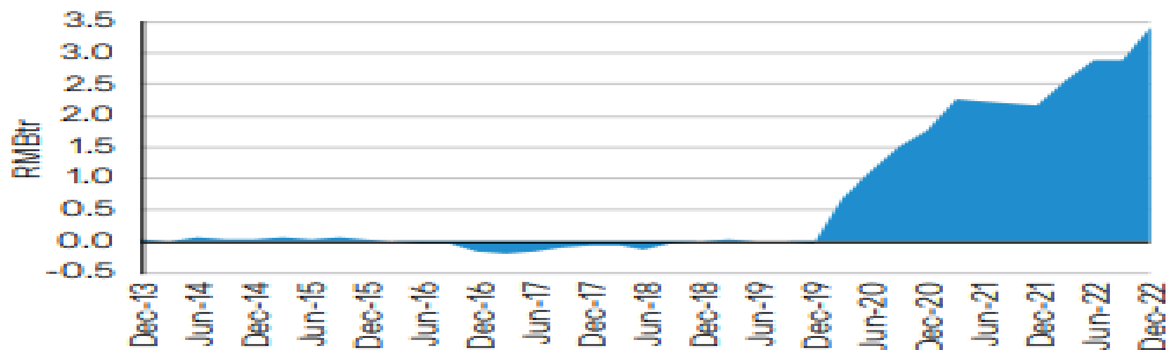


Source: - JPM Asset Management., April 2023

The outlook for Emerging markets and China could be about to change from a price performance point of view even if challenges remain over China's regional political ambitions and their ESG credentials. 2022 was a miserable year for both companies and investors in emerging markets. Profits fell 15% (in contrast to solid gains in most developed countries), and the MSCI Emerging Markets Index lost 15%. The re-opening of the Chinese economy and the removal of all covid restrictions could support an outlook that is changing for the better. The economy is now in full recovery mode and if the re-opening experience of the developed economies is repeated could unleash a consumption boom fuelled by almost USD 500 billion (more than RMB 3 trillion) of surplus savings accumulated during lockdown Chart 13.

The pickup in Chinese activity could also have an impact on its regional hinterland helping growth recover across other emerging markets. Chart 14 shows that valuations remain reasonably cheap, earnings estimates, and profits are forecast to be higher particularly in India, Indonesia and Taiwan. With profits expected to outperform the developed equity markets, investors may be better rewarded for their patience with higher returns from emerging market equities over the next couple of years.

Chart 13: - Estimated Chinese Household excess savings (above historic accumulation rate).



Source: - JPM Asset Management., Haitong Securities, Chinese National Bureau of Statistics December 2022.

GDP

Table 4 shows the consensus forecasts for GDP growth in calendar 2023 and 2024 and my expectations in January and May 2023.

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

% CHANGE YOY								
	2023				2024			
	JANUARY		MAY		JANUARY		MAY	
	Consensus	**AF**	Consensus	**AF**	Consensus	**AF**	Consensus	**AF**
US	0.3	**0.5**	1.1	**0.5**	1.1	**0.6**	0.6	**0.6**
UK	-1.0	**-1.0**	-0.1	**-0.5**	0.6	**0.0**	0.8	**0.0**
Japan	1.2	**1.2**	1.0	**0.8**	1.1	**1.1**	1.1	**1.0**
EU	0.2	**-0.5**	0.7	**0.0**	1.6	**1.0**	1.4	**1.0**
China	4.6	**5.0**	5.8	**6.0**	5.3	**6.0**	4.9	**5.0**
SE Asia	4.2	**5.0**	4.1	**5.0**	4.6	**5.0**	4.6	**5.0**

Source: - Consensus Economics May 2023

The consensus forecasts for GDP growth in 2023 in May have been revised higher as actual growth outcomes have been better than expected. As mentioned in my last report the consumer has remained willing to spend their savings accumulated during the Pandemic. They have also experienced higher, but below the rate of inflation wage growth. However, the most recent data seems to suggest that while the price value of consumption has increased this is not matched by the growth rate in the volume of goods and services consumed. This could be a leading indicator of weaker growth in future. The consensus has rolled it's previously stagnant growth outlook for 2023 into 2024. Outside of China, I remain more negative for growth in the developed world this year and next.

The Chinese economy grew 4.5% in the 12 months to the end March 2023, accelerating from a 2.9% growth rate in the year to the end of December 2022. Not surprisingly after a year of rolling covid related lockdowns, retail sales growth, industrial output and employment all increased, at the strongest rate in the last 2 years. Trade data showed that Chinese exports rebounded strongly over the quarter as trade with developed countries returns to pre-pandemic levels and opportunities with emerging economies increased. Interestingly, the statistics agency announced that a complex global environment and insufficient domestic demand mean the foundation for the country's recovery is "not yet solid." China set a lower GDP target of around 5% for 2023. Last year, the economy only achieved a 2.9% growth rate, missing the government's target of about 5.5%.

In the US, the annual growth rate for the calendar year 2022 was confirmed at +2.1%, down from the covid rebound of 5.6% in 2021. In the first quarter of 2023 the preliminary data showed that the economy grew at an annualised rate of 1.1%, slowing from 2.6% in the previous quarter. The growth rate was lower than expected and reflects an expected weaker business environment with investment

growth slowing and inventories falling in anticipation of slower activity. The weakest area remains housing construction where rising mortgage rates continued to have a direct impact. While the rate of contraction in residential fixed investment has slowed it is the 8th consecutive quarter of negative growth. Private inventory investment also fell as did non-residential fixed investment growth. The positive contributions to overall growth, remain consumer spending which accelerated by 3.7% despite stubbornly high inflation. Public spending increased at a faster rate of 4.7% and net external demand has also contributed positively as exports rose faster than imports.

The UK economy expanded 0.2% year-on-year in the first quarter of 2023, the smallest annual growth rate since 2021, the fourth quarter growth rate of 0.4% was revised higher to 0.6%. Positive contributions to growth came from services which overall increased by 0.7%, with the strongest contribution coming from transportation, storage and communication, followed by the construction sector. Negative contributions to growth came from industrial production and manufacturing. The UK economy expanded 4.1% in 2022, revised up from the preliminary estimate of 4.0%, but much lower than the post covid rebound of 7.6% in 2021. In contrast to the rest of the developed world the UK economy remains 0.6% smaller than it was before the Covid pandemic. The Bank of England and the UK government have revised their expectations for growth in 2023 and now expect the UK could avoid a recession.

The Eurozone's quarterly economic growth was confirmed at a modest 0.1% during the first quarter of 2023, following a revised lower stagnant fourth quarter. The bloc's economy has been significantly impacted by multiple factors, including a notable increase in consumer prices driven by higher energy and food costs. Additionally, the European Central Bank's aggressive tightening of monetary policy, the fastest in over two decades, has added to the economic strain, as well as declining confidence levels among businesses and consumers. Among the Eurozone's largest economies, Germany registered no growth in the first quarter, while the Netherlands experienced a contraction. However, the economies of France, Italy, and Spain did see some expansion. The European Commission revised its growth forecasts for the bloc's economy in May 2023. The EU is expected to grow by 1% in 2023, compared to the previous winter forecast of 0.8%. For 2024, the revised forecast indicates a growth rate of 1.7%, up from the previous projection of 1.6%.

Preliminary estimates suggest the Japanese economy grew by 0.4% in the first quarter 2023 after revised fourth quarter data showed the economy delivered no growth, down from the previous estimate of +0.2%. Private consumption continues to increase as covid related tough border controls were fully lifted. Business investment unexpectedly increased by +0.9%, rebounding strongly from a -0.7% fall in the fourth quarter. Government spending stagnated for the third quarter in a row and net trade contributed negatively reversing the fourth quarters positive contribution as exports fell more than imports. The annual growth rate in 2022 was revised slightly lower to +1.0%, slowing from +2.1% in 2021.

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Consumer Price Inflation

Table 5 shows the consensus forecasts for Consumer Price Inflation in calendar 2023 and 2024 and my expectations in January and May 2023.

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

% CHANGE YOY								
	2023				2024			
	JANUARY		MAY		JANUARY		MAY	
	Consensus	AF	Consensus	AF	Consensus	AF	Consensus	AF
US	3.8	**4.0**	4.2	**5.0**	2.5	**3.0**	2.6	**3.0**
UK	7.2	**7.0**	6.7	**7.0**	3.1	**4.0**	2.8	**4.0**
Japan	1.9	**1.9**	2.6	**3.0**	1.2	**1.9**	1.4	**1.9**
EU	6.4	**6.8**	6.3	**7.0**	2.6	**3.0**	2.9	**3.8**
China	2.3	**3.0**	1.8	**2.2**	2.3	**2.5**	2.4	**3.0**
SE Asia	3.9	**4.2**	2.8	**3.2**	2.8	**3.0**	2.8	**3.2**

Source: - Consensus Economics May 2023

The consensus forecasts for inflation in May 2023 have been revised higher in the US and Japan and lower elsewhere since January. This is probably a more realistic assessment of the inflation outlook as the peak in prices moves from headline and into “stickier” core inflation. The consensus forecast for inflation in 2024 is not significantly different to January and in my opinion remains too optimistic. If these levels of low inflation can be achieved in 2024, without a meaningful recession the central banks will be delighted and may be able to claim they have done a good job of taming inflation.

The headline rate remains high and is slowing most notably in the US, but the core rate is showing how the permanent price increases are being passed into the rest of the economy. In Europe and especially the UK, inflation is proving more stubborn and is declining at a slower rate than the US. While I expect the rate of inflation to fall over the next couple of years, I still expect it to be higher than the consensus in 2023 and 2024. The post covid re-opening of the Chinese domestic economy has not seen the surge in inflation experienced in the developed economies.

In the medium to long term, I believe the period of low inflation is behind us and we should be prepared for the level and range of inflation that was “normal” before the global financial crisis.

The annual inflation rate in the US fell to 4.9% in April 2023, the lowest since April 2021, food prices grew at a slower rate (7.7% vs 8.5% in March) and energy costs fell further (-5.1% vs -6.4%) including gasoline (-12.2%) and fuel oil (-20.2%). Shelter costs which account for over 30% of the total CPI basket, slowed for the first time in two years (8.1% vs 8.2%) and prices for used cars and trucks declined once again (-6.6% vs -11.6%). The slight fall in the rate of Shelter inflation, helped the core inflation rate fall by 0.1% to 5.5%. The more permanent core rate of US inflation is now above the headline rate.

Annual inflation in the UK has remained above 10% for the last seven months, it fell back to 10.1% in March having increased from 10.1% in January to 10.4% in February, CPI has fallen from 11.1% in October 2022. The main upward pressure came from food and non-alcoholic beverages +19.1%, recreation and culture +4.6% and miscellaneous goods and services +6.7%. The cost of housing and utilities has also increased at a solid pace +26.1% and restaurants and hotels by +11.3%. The only meaningful component of inflation whose rate of increase slowed was transport +0.8%. The core inflation rate, which excludes volatile items such as energy and food, was unchanged at 6.2% in March, not far from September's record of 6.5%

The estimated rate of inflation in the Euro Area fell to a thirteen-month low of 7.0% in April slightly higher than the 6.9% for March but well below the peak of 10.6% seen in October 2022. The small increase was due to energy prices which rebounded by +2.4% compared to a decline of -0.9% in March, and the cost of services that increased at a faster pace of 5.2%. However, inflation slowed for food, alcohol, and tobacco, as well as non-energy industrial goods. The core index, which excludes volatile items such as food and energy, eased slightly to 5.6% but remained near the all-time high of 5.7% recorded in March.

The annual inflation rate in Japan increased to 3.5% in April from March's 6-month low of 3.2%, with food prices making the most significant contribution as prices increased +8.4% their highest rate since August 1976. Other costs that increased included transport, clothes, furniture & household utensils, medical care and education. Inflation eased slightly for housing and miscellaneous. Utility charges decreased with the prices of fuel, light, and water falling by -3.8% and electricity -9.3%. Core inflation increased to a 3-month high of 3.4% in April from 3.1% in the previous two months, but below the 4.0%, rate seen in December 2022.

4. The outlook for the securities markets

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 2023.

Table 6: - Interest rate and Bond yield forecasts

%	CURRENT	DECEMBER 2023	JUNE 2024
UNITED STATES			
3month SONIA	5.32	5.5	5.25
10 year bond yield	3.54	4.5	4.25
UNITED KINGDOM			
3month SONIA	4.69	5.0	5.0
10 year bond yield	3.82	4.5	4.25
JAPAN			
3month SONIA	0.07	0.0	0.0
10 year bond yield	0.40	0.50	0.50
GERMANY			
3month SONIA	3.35	4.0	4.0
10 year bond yield	2.30	3.75	3.5

Source: - Trading Economics; 15th May 2023

In May the Fed, BoE and ECB all raised rates by 0.25%, but the Bank of Japan (BoJ) left its monetary policy rates unchanged. The April BoJ meeting was the first chaired by the newly appointed governor Kazuo Ueda, he is considered to be more conservative than his recent predecessors and has decided to carry out a broad based review of forward looking monetary policy. On balance the US Fed and the BoE seemed surprised by the current strength of their respective economies and the stubbornness of inflation especially core rates of inflation. Both said they would continue to increase interest rates, but the market is expecting a pause, especially following the collapse of several US regional banks and the subsequent tightening of credit conditions. The ECB sounded much more hawkish, positively stating that they would not pause the hiking cycle anytime soon. They also announced the end of the reinvestment of proceeds from maturing QE purchased assets, this will further tighten monetary conditions.

As noted last quarter the shape of the government yield curves with 10 year yields lower than 2 year yields and overnight interest rates tells us that the bond markets are expecting a recession, which leads to cuts in interest rates. The US and German government bond yield curves have become more inverted, suggesting that they expect an end the rate cycle sooner despite what they are being told by

the central banks. In contrast the whole UK yield curve beyond 2y has moved higher more or less in parallel suggesting that the market expects further hikes from the BoE. The Japanese yield curve remains steep as the market believes Ueda is likely to allow yields to rise by ending it's yield curve management policy.

We are no doubt closer to the end of the tightening cycle but only due to the passage time not because inflation has fallen enough or because economic growth has slowed enough, indeed growth is stronger than I and many others expected. Market participants should pay close attention to the actions taken by the US and Swiss authorities post the collapse of SVB and First Republic and the final inevitable demise of Credit Suisse because what these actions suggest to me is the "Fed put" may no longer be a policy response to a crisis. As I suggested in my last report, monetary policy changes are being driven by the rate of inflation even if that means recessionary economic growth and the inevitable failure of banks and companies ill-equipped for the end of emergency / zero interest rate monetary policy.

Despite the tightening of credit conditions following the recent bank failures, I still believe there is room for higher bond yields and interest rates, especially if I am correct about the "stickiness" of core inflation in the second half of 2023. The pace of increases may slow, but I do not believe rates will peak until it is clear that inflation is on a path to achieving the central bank target rate, especially as economies remain close to full employment.

UK Government bond yields have continued to move higher with the top of the recent range for 10 year bonds now at 3.85% compared to 3.5% last quarter. I still expect yields to rise as interest rates continue to be increased, however, in 12 months' time slower growth and lower inflation could mean that bond yields start to fall even if there have been no cuts in interest rates. As a result, it would be reasonable to expect low and possibly negative returns from government bonds in the short term. The real yield available from Index Linked Gilts continues to increase making them more attractive as a Protection asset, but this trend may have further to go before these bonds become cheap. UK corporate bonds have become more expensive as spreads compress against government bonds; global corporates however they may remain attractive as long term-investment.

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 in the short term there is still very little income protection for small increases in yield even as the duration of government bonds falls with rising yields. Over the medium term spreads are sufficiently wide that investment grade non-government and high yield bonds may be attractive providing the risk of default does not increase significantly.

Table 7: - Total returns from representative bond indices

INDEX	YIELD TO MATURITY %	DURATION YEARS	YIELD INCREASE %	% TOTAL RETURN, HOLDING PERIOD	
				3 MONTHS	12 MONTHS
All Stock Gilts	3.96	9.6	0.5	-3.8	-0.84
All Stocks Linkers	0.60	13.3	0.5	-6.5	-6.0
Global IG Corporate	4.93	6.1	0.5	-1.8	+1.9
Global High Yield	8.60	3.6	0.5	+0.3	+6.8

Source: - ICE Indices 15th May 2023

Bond Market (Protection Assets) Recommendations

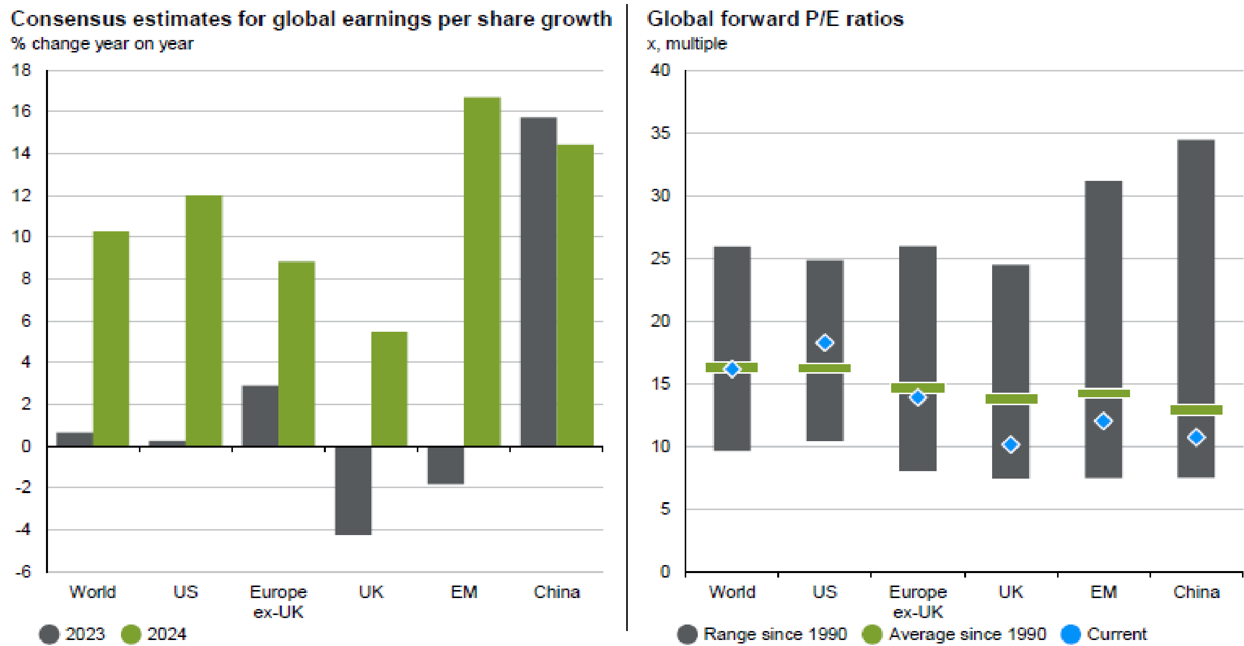
I am not proposing any further changes to the Protection asset allocation. I suggest remaining neutral investment grade corporate bonds and neutral Index Linked Gilts. I also suggest remaining 1% underweight conventional gilts to reflect my negative shorter term outlook for interest rates and bond yields.

The extra yield spread available from corporate bonds has narrowed somewhat but it is currently still wider than it has been for some years and the total yield remains attractive. Falling demand and potential increased supply of Index Linked Gilts has further increased the real yield available, from around +0.33% in my last report to +0.60% currently. As I mentioned last time this means that for the first time in more than 10 years long term investors can receive a small positive risk free rate of real return and thereby genuine protection against inflation.

Equity Markets

Chart 14 below, left hand side, shows the consensus earnings per share growth estimates, for 2023 and 2024. The right hand side shows, the current forward looking estimates of the 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 14: - LHS - Earnings per Share estimates, RHS - Price/Earnings Ratios, since 1990, China 1996



Source: - JPM Asset Management, March 2023

The left-hand side of chart 14 shows the new earnings expectations for 2023 and 2024. Since my last report analysts seem to have woken up to the reality of slower growth, higher interest rates and the price impact of locked in higher inflation, all leading to a squeeze on profit margins. As a result, regional earnings expectations for 2023 have been revised much lower except in China and Europe. The increase in China is probably due to the end of lock-down restrictions and in Europe because of overly pessimistic expectations following the Russian invasion of Ukraine and because Europe's exporters may benefit from the Chinese recovery. The revision to negative earnings growth in the UK and Emerging markets is a recognition that these regions are unlikely to see a repeat of the earnings growth from the energy and commodity sectors experienced post the Russian invasion.

The roughly +2% increase from last quarter to the forecasts for earnings in 2024 reflect the usual positive expectations of this optimistic group of people. As Warren Buffet is reputed to have said "forecasts tell you more about the forecaster than the future" if he did say this, in the case of equity analysts he would seem to have been most prescient.

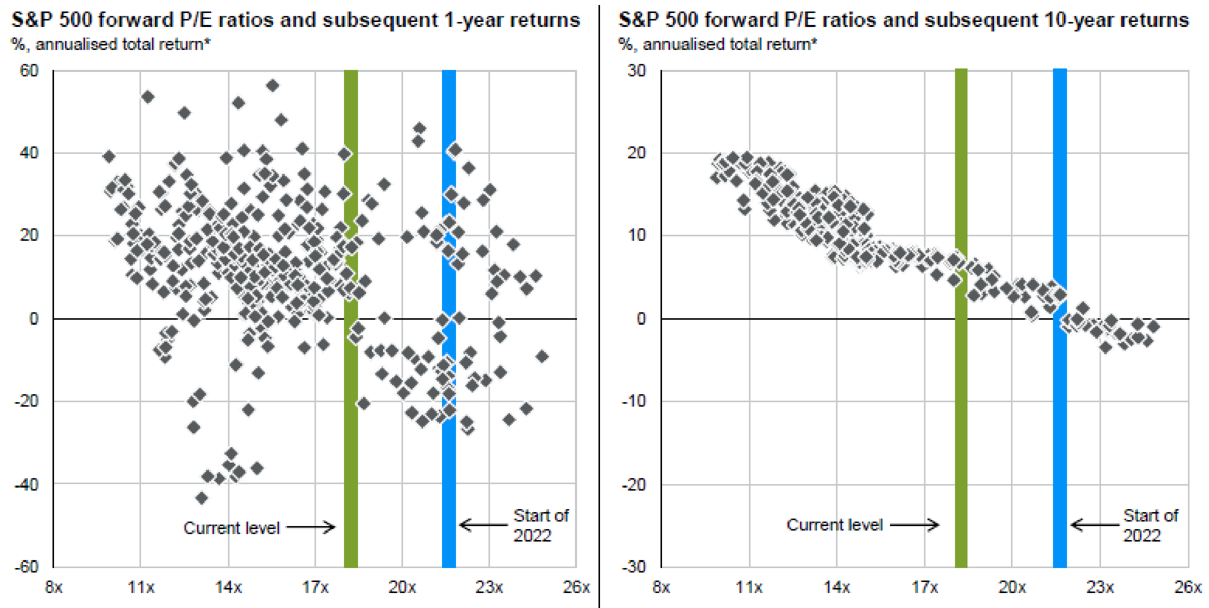
The updated right hand chart shows the regional P/E ratios have become even more expensive in this quarter as the rally in equity markets since October 2022 has broadly continued. As a result, the increase in prices has almost completely offset the "cheapness" of valuations following the sharp sell-off in equities over the 12 months to October 2022. Only UK, Emerging markets and China remain "cheap" relative to their averages.

The P/E ratio chart above suggests that the US is now expensive to its average over the last 30 years. But it remains in the middle of the range of possibilities and as chart 15 below suggests valuations in the US remain attractive to where they were at the start of 2022. As usual these charts suggest there

are regions with reasonable valuations for long-term investors to exploit even after the recent recovery in equity prices.

The updated version of chart 15 below continues to provide some support for this in terms of the level of valuation using the P/E ratio. What the chart suggests is that in the US market, there is no relationship between the forward looking P/E and the subsequent 1 year return of the market. However there does seem to be a relationship in the level of P/E's and the subsequent 10 year returns. At the current 18X P/E ratio the range of outcomes is somewhat wider than it would be at 17X, but it still puts that return at between 4% and 8% p.a. over the next 10 years.

Chart 15: - US equity valuations using forward looking P/E ratios and subsequent annual returns.



Source: - JPM Asset Management., March 2023

The rally in equity markets since October 2022 has pretty much removed the short term "cheapness" of markets but the longer term analysis seems to suggest that some equity markets are reasonable value. Long term valuations appear reasonable and earnings estimates for 2023 may now be more realistic, but I am concerned that the market has rallied significantly since October, partly on the basis of the old idea of the "Fed put", I'm not convinced this can be relied on. Inflation may have peaked but it remains high and central banks have made it clear that interest rates will continue to rise, even if it is at a slower pace and even if it risks a recession. Hence, I remain cautious on equity markets, especially the more interest rate sensitive "growth sectors" which have rallied more aggressively this year. I also believe future volatility may be higher, which suggests investors need to see meaningful "cheapness" in asset prices before committing new capital especially when bonds are looking much better value than they have done in a very long time.

Equity Market (Growth Assets), Recommendations

I have not changed my suggestions for how the growth asset allocation of the Fund should be distributed. I still believe the Fund should consider an overall 1% underweight position in Growth assets with this money being made available to part pay for the overweight in Income assets.

I remain comfortable with a 2% underweight allocation to global sustainable equity because of the strategy's higher interest rate sensitivity and overweight UK equity due to relative valuations of the World and UK equity indices.

Income Assets

Just as last quarter, I have made no changes to the allocation to Income Assets funding the 2% over allocation to MAC 1% each from Growth and Protection Assets. Global credit spreads have moved sideways and have experienced some volatility due to the unexpected action of the Swiss regulator with respect to the AT1 bonds of Credit Suisse, but the overall yield available combined with the low duration and floating rate nature of many of the asset classes suggests to me that MAC remains attractive, relative to longer duration assets in a rising interest rate environment.

As mentioned, before over the long term I would like to see the direct property allocation increase funded using net sales from the in-direct exposure. However, at the moment I believe there may be an opportunity for the Fund to take advantage of distressed selling by other investors to increase its exposure to in-direct property funds at a discount to NAV and thereby increase the overall property exposure to neutral.

Asset Allocation

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 15th February and 15th May 2023. 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, their Pooling partner and 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.

% ASSET CATEGORY	NEW DERBYSHIRE STRATEGIC WEIGHT 1ST JANUARY 2022	ANTHONY FLETCHER 15TH FEBRUARY 2023	ANTHONY FLETCHER 15TH MAY 2023
Growth Assets	**55**	**-1.0**	**-1.0**
UK Equity	**12**	**+1.0**	**+1.0**
Overseas Equity	**43**	**0**	**0**
North America	**0**	**0**	**0**
Japan	5	**0**	**0**
Emerging markets	5	**0**	**0**
Global Sustainable	**29**	**-2**	**-2**
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**	**-1**	**-1**
Conventional Gilts	6	**-1**	**-1**
UK index Linked	6	**0**	**0**
US TIPS	0	**0**	**0**
Investment grade credit	6	**0**	**0**
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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