Appendix 2

MJ HUDSON Allenbridge

Second Quarter 2023 Investment Report

PREPARED FOR:

Derbyshire County Council Pension Fund: Pensions and Investment Committee Meeting

SEPTEMBER 2023

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 6th September 2023
Date of paper 18th August 2023

1. Market Background (Second quarter 2023)

Global macroeconomic data was generally stronger than expected over the quarter, with headline inflation falling in the US, Europe, remaining steady in Japan and finally falling in the UK. Labour markets remained surprisingly robust and GDP growth while weak and below trend, was generally positive. Chinese and European manufacturing data softened over the quarter leading to some concern over the anticipated post-COVID rebound for China.

Despite falling inflation, the US Fed, ECB and the BoE all continued to hike rates and maintain a hawkish posture because of tight labour markets and stubborn core inflation data. The Bank of Japan also changed policy allowing 10 year yields to increase towards 1% from their previous ceiling of 0.5%.

The US banking crisis appears to have been contained, but there are signs of consumer credit card defaults starting to tick up, and it is likely that the effects of the interest rate increases will take time to come through into the real economy. In aggregate consumers still seem to have excess savings which is supporting aggregate demand even as prices continue to rise.

The second quarter was another strong period for global equities with the FTSE World index rising +3.4% over 3 months and +11.7% over 12 months in Sterling terms. Equity markets were led by growth-oriented stocks as investors jumped on board the new innovation of Artificial Intelligence (AI). The best performing companies in the AI induced rally were a narrow set of US companies, now being referred to as the "Magnificent 7". These stocks are Apple, Alphabet, Amazon, Meta, Microsoft, Tesla and Nvidia.

UK equities delivered -0.4% over three months reducing the 12 months return to +7.9%, the UK index has a large weight to undervalued defensive companies that benefited from last year's rotation from Growth to Value. The economy is also seen as a higher recession and inflation risk than other developed markets.

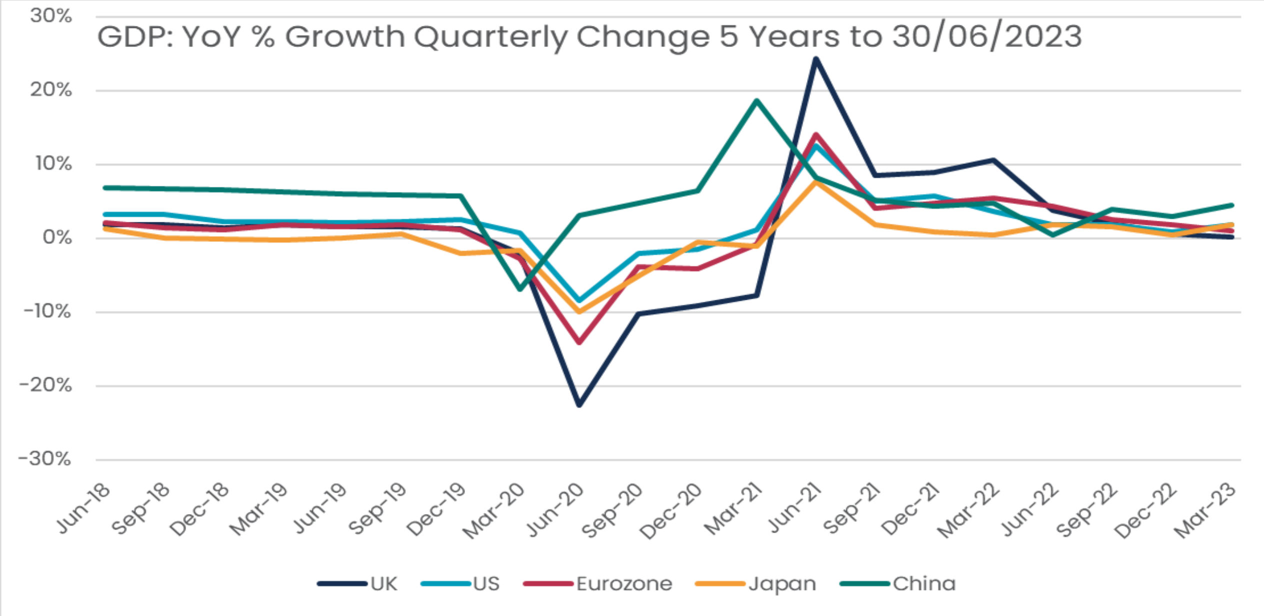
Bond markets had another bad quarter as stronger growth, higher interest rates and stubborn core inflation caused bond yields to rise and prices to fall. Highly interest rate sensitive UK government bond markets delivered the worst returns, at around -6% with global governments and non-government bonds returns at -3%. Over 12 months UK government bond returns were around -16% again roughly twice as bad as other global bond markets.

Property markets had another poor quarter with both UK and Global property markets delivering small returns which did little to offset their negative annual return. Returns from other real and private market assets like Private Equity and Infrastructure were lower and much more mixed over the quarter but remain strong and positive over the year.

The US dollar weakened a bit further over the quarter and again Sterling was stronger against most currencies retracing a lot of its weakness in 2022. Commodity prices were again mixed, the prices of oil, gas and electricity are now back the level seen at the end of 2021 Agricultural and industrial commodity prices were fairly stable over the quarter.

We may be closer to the end of the period of increases but, I believe interest rates and core inflation will remain higher, for longer than equity and bond markets have priced in. Expect more volatility!

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

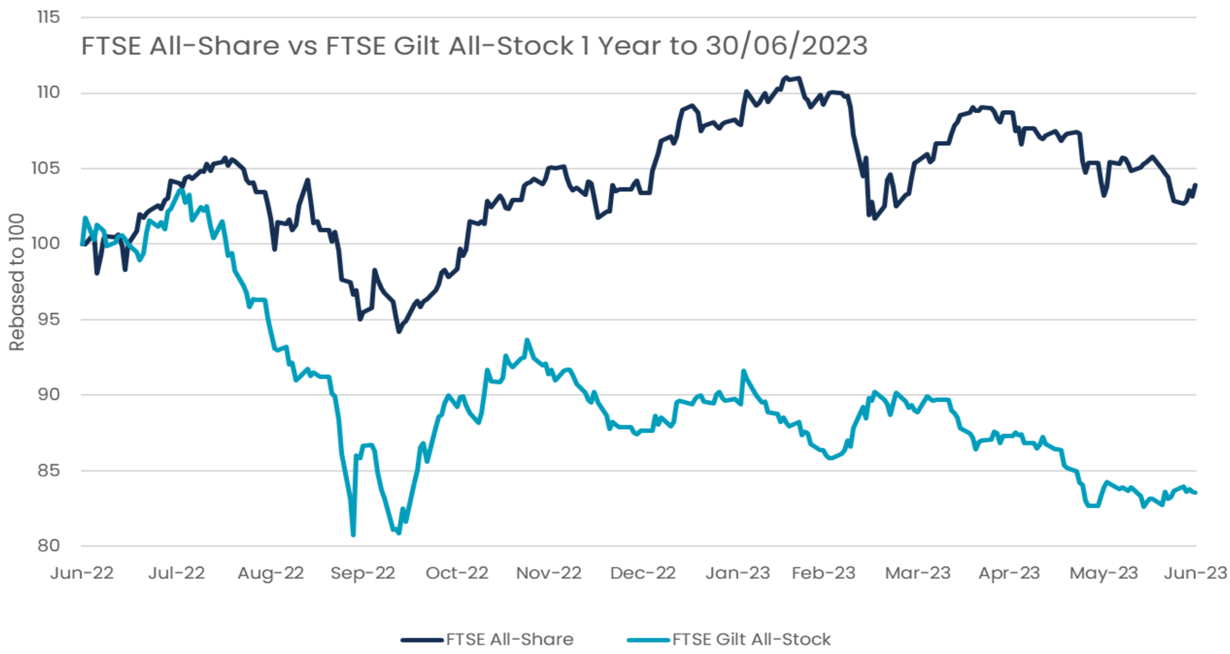
% TOTAL RETURN DIVIDENDS REINVESTED

MARKET RETURNS

		Period end 30th June 2023	
	July 2023	**3 months**	**12 months**
Global equity FTSE All-World	+2.5	+3.4	+11.7
Regional indices			
UK All Share	+3.4	-0.4	+7.9
North America	+2.1	+5.6	+13.7
Europe ex UK	+2.0	+0.6	+19.6
Japan	+2.0	+2.9	+12.6
Emerging	+5.0	-1.9	-3.2
UK Gilts - Conventional All Stocks	+0.8	-6.0	-15.5
UK Gilts - Index Linked All Stocks	-0.5	-6.9	-17.6
UK Corporate bonds*	+2.3	-3.4	-7.1
Overseas Government Bonds**	-0.5	-0.3	-1.8
UK Property quarterly^	-	+0.2	-15.0
Sterling 7 day SONIA	0.3	1.1	3.1

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

Chart 2: - UK bond and equity market returns - 12 months to 30th June 2023



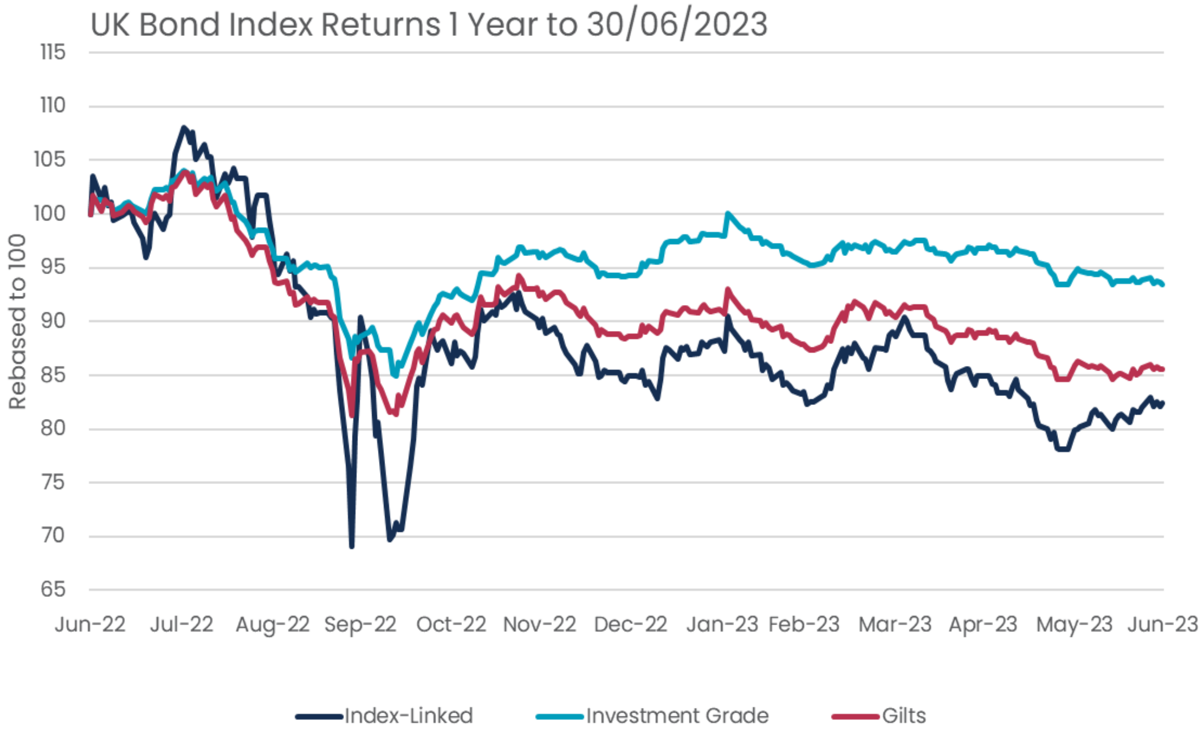
Source: - Bloomberg

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

BOND MARKET % YIELD TO MATURITY	31st March 2023	30th June 2023	Quarterly Change %	30th June 2022	Current 18th August 2023
UK GOVERNMENT BONDS (GILTS)					
10 year	3.49	4.39	**+0.90**	2.08	**4.68**
30 year	3.84	4.42	**+0.58**	2.45	**4.87**
All Stocks ILG	+0.13	+0.98	**+0.85**	-1.14	**+1.23**
OVERSEAS 10 YEAR GOVERNMENT BONDS					
US Treasury	3.49	3.82	**+0.33**	2.90	**4.26**
Germany	2.31	2.39	**+0.08**	1.23	**2.62**
Japan	0.32	0.40	**+0.08**	0.22	**0.63**
NON-GOVERNMENT BOND INDICES					
Global corporates	4.92	5.22	**+0.30**	4.22	**5.40**
Global High yield	8.50	8.52	**+0.02**	9.00	**8.61**
Emerging markets	7.00	7.05	**+0.05**	7.03	**7.31**

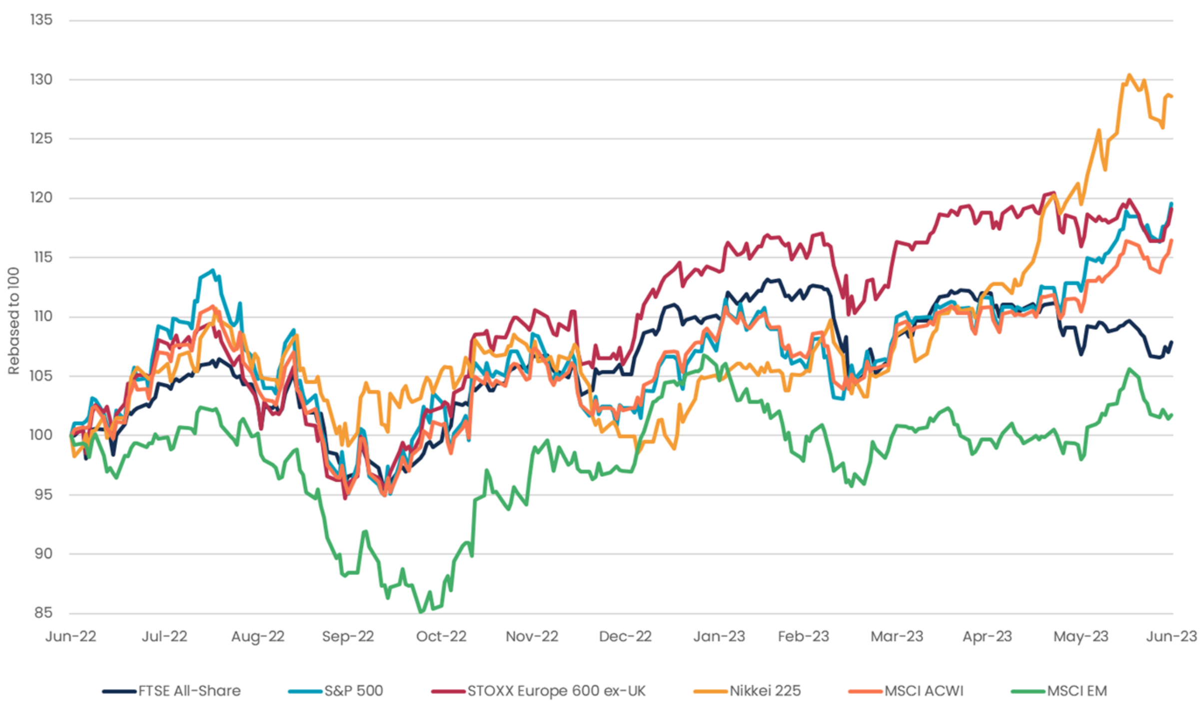
Source: - Trading economics and ICE Indices G0LI, G0BC, HW00, EMGB, 18th August 2023.

Chart 3: - UK Bond index returns, 12 months to 30th June 2023



Source: - Bloomberg

Chart 4: - Global equity market returns in local currency, 12 months to 30th June 2023



Source: - Bloomberg

Recent developments (July and 18th August 2023)

Market sentiment remained positive in July, buoyed by a drop in developed market inflation and resilient GDP data, raising hopes for a soft landing and supporting a broad rally across most asset classes and regions. Global stocks performed well, with the FTSE World Index up 2.5% over the month in Sterling terms. But the narrow nature of this rally is becoming an increasing concern. Within equities, small cap stocks and the Emerging Markets delivered strong returns.

Fixed income markets recorded mixed but positive returns overall, a better than expected fall in the June consumer price index (CPI) supported Gilts, with 10-year yields down a little to 4.3%. However, US Treasuries and European government bonds lost some ground as second-quarter GDP data was relatively strong, UK linker real yields also continued to rise. Commodity prices reversed some of their year-to-date losses, with the broad Bloomberg Commodity Index rising 6.3% over July. The price of oil rallied, and Russia's cancellation of the Black Sea grain export deal contributed to price rises in certain agricultural commodities. However, European natural gas prices continued to fall as storage inventories reached the highest seasonal levels in 10 years.

Quarter to date has seen another round of interest rate increases from the main central banks as growth, inflation and employment have remained stronger than expected. At their most recent meetings the central banks all increased rates by 0.25% the US Fed to 5.5%, the BoE to 5.25% and the ECB to 4.25%. In their press statements, after the increases, all continued to indicate that they are concerned about the tightness of labour markets and the risks this poses to core inflation. In their most recently published minutes, the Fed seemed more hawkish than expected.

Much of July's positive sentiment has been reversed in August and markets have fallen possibly more sharply on lower summer trading volumes. Having said that there has been a number of potentially worse than expected news announcements. The ratings agency, Fitch has downgraded US government debt from AAA to AA+, on increased political uncertainty following the Debt ceiling negotiations and their assessment of the stability of US political institutions after the January 2022 Washington riots. The US treasury also increased the size of its monthly debt auctions. Economic data from China indicated that its economy has not achieved a post covid rebound, with prices falling into deflation and a slowdown in global demand leading to a 14.5% fall in exports and a 12.5% fall in imports. There was also further bad news from their property markets with Evergrande filing for Bankruptcy protection in the US and another large developer Country Garden likely to default on some of it debt.

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2. Investment Performance

Table 3 shows the performance of the Derbyshire Pension Fund versus the Fund specific benchmark for the quarter and year to 30th June 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, except the UK where returns were ahead over 3 months and in line with the benchmark over 12 months. Once again protection assets outperformed in both periods, as did income assets over 12 months, but over 3 months the revaluation of infrastructure assets dragged down returns.

Over 10 years the Fund has achieved a total return of 6.8% per annum, net of fees.

Table 3: - Derbyshire Pension Fund and Benchmark returns

% TOTAL RETURN (NET) 30TH JUNE 2023	3 MONTHS		12 MONTHS	
	Derbyshire Pension Fund	**Benchmark**	**Derbyshire Pension Fund**	**Benchmark**
Total Growth Assets	**1.3**	**2.0**	**8.0**	**10.0**
UK Equity	-0.1	-0.5	7.9	7.9
Total Overseas Equity	**1.5**	**2.6**	**7.6**	**10.2**
North America	-0.5	1.6	8.5	9.4
Japan	1.8	3.0	10.7	12.6
Emerging markets	-2.5	-2.0	-4.6	-3.4
Global Sustainable Equity	2.3	3.3	9.6	12.0
Global Private Equity	3.3	3.4	10.8	13.0
Total Protection Assets	**-4.2**	**-4.6**	**-9.0**	**-11.6**
UK & Overseas Government	-5.4	-5.4	-11.7	-14.5
UK & Overseas Inflation Linked	-6.1	-6.6	-12.4	-17.0
Global Corporate bonds	-1.4	-1.7	-3.3	-3.3
Total Income Assets	**0.7**	**1.4**	**0.7**	**-1.8**
Multi-asset Credit	2.7	2.4	8.2	8.9
Infrastructure	-0.3	1.6	5.3	5.2
Property (all sectors)	0.4	0.4	-10.2	-15.6
Internal Cash	0.5	1.1	2.1	3.1
Total Fund	**0.3**	**0.6**	**3.1**	**2.8**

Total fund value on 30th June 2023 £5,928 million

At the end of June, the Fund was slightly overweight growth assets, within equity the Fund remains underweight Global sustainable with an overweight to the UK, over the quarter the residual exposure to US Equity was sold completely. Due to market movements the Fund became further underweight protection assets at -3%. It remains 1% overweight income assets relative to the strategic benchmark.

Over the second quarter of 2023, the Fund slightly 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 +2.8% 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 have outperformed the benchmark and the total return of the whole Fund, net of fees was +4.8% p.a. compared to the benchmark return of +4.4% 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 second quarter and the year was lower than the strategic benchmark. Over three months only the UK equity portfolio delivered an outperformance compared to its benchmark. Over 12 months the UK equity portfolio performed in line with the benchmark and all other regional portfolios including private equity underperformed.

Over 10 years growth assets have returned on average 8.5% p.a. compared to 8.4% 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 ahead of benchmark over 3 months and significantly outperformed the benchmark over 12 months. Over the quarter, the global corporate bond portfolio outperformed the benchmark and was in line with the benchmark over 12 months.

Over 10 years protection assets have on average returned +1.8% 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 underperformed the benchmark, due to an underperformance from Infrastructure assets. Over 12 months a better period for measuring returns, both property and Infrastructure outperformed while the MAC portfolio slightly underperformed.

Over 10 years Income assets have on average returned 8.2% p.a. compared to the benchmark return of 4.0% p.a.

3. Economic and Market outlook

Economic outlook

Outside of China the developed economies are experiencing more growth than expected. Growth is not very strong but it is not recessionary. Chart 5 below shows upwardly revised growth expectations for 2023 and weakening Composite PMI's. Drilling down into the PMI data it shows manufacturing has suffered through the combination of weaker demand for goods and soaring costs, but service sector activity remains remarkably robust. Strong labour markets and higher wages, pent-up savings and a continued desire to make up for the experiences missed during covid appear to be offsetting some of the drag from higher inflation and interest rates.

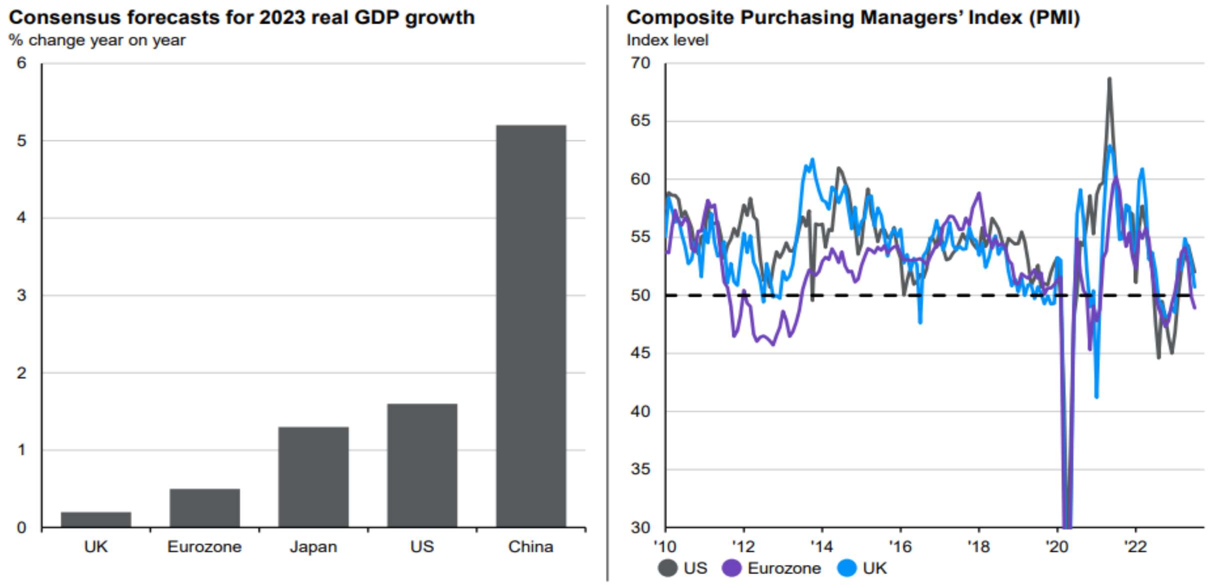
Despite the resilience of growth, as observed here before, markets have failed to realise that these causes of stronger growth are the same indicators the central banks are looking at when determining how much higher they may need to increase rates by and for how long they will remain high. Instead, markets are hopeful that the economy can experience a soft landing, avoid recession and that once headline inflation has fallen back to target, central banks will be quick to cut rates to support growth.

This seems rather optimistic to me, even if headline inflation falls, core inflation remains stubborn and is likely to be high for another year as the lagged effect of higher costs work their way through the economy. Monetary policy remains accommodative even after the recent rapid interest rate increases and fiscal policy is also expansionary. Again, as mentioned here before the era of emergency rates and ZIRP is over and the cost of capital is only returning the kind of levels that were normal prior to covid and the GFC.

The expected post covid Chinese economic recovery seems to be stalling weighed down by a consumer that has chosen to save more and not rush out and release pent-up demand on consumption of retail goods and leisure services as we did in the West. However, the largest impact on the Chinese economy has come from an overbuild and over investment in their property market. We saw the first indication of this with the default of Evergrande in 2021. During the covid lockdown this problem went un-remarked but now it is clear the weakness of property markets has been spreading with County Garden another large developer on the verge of default. In the last few days Evergrande has filed for bankruptcy protection in the US with estimated debts of US$300billion.

This has all the hallmarks of the excess property investment prior to the GFC, but unlike the GFC it is largely confined to China. That is not to say that there will be no contagion, international investors have been willing participants, but I believe it is more of a domestic rather than a global issue. The global impact will come from the overall weakness of the Chinese economy and investment markets as it tries to deal with the problem. The economy is already experiencing price deflation, in addition falling global demand for goods has caused both imports and exports to fall. Unlike the central banks of developed economies, that are still fire-fighting the impacts of higher inflation, growth and tight labour markets. the Chinese authorities have the flexibility to help by cutting interest rates and relaxing fiscal policy.

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



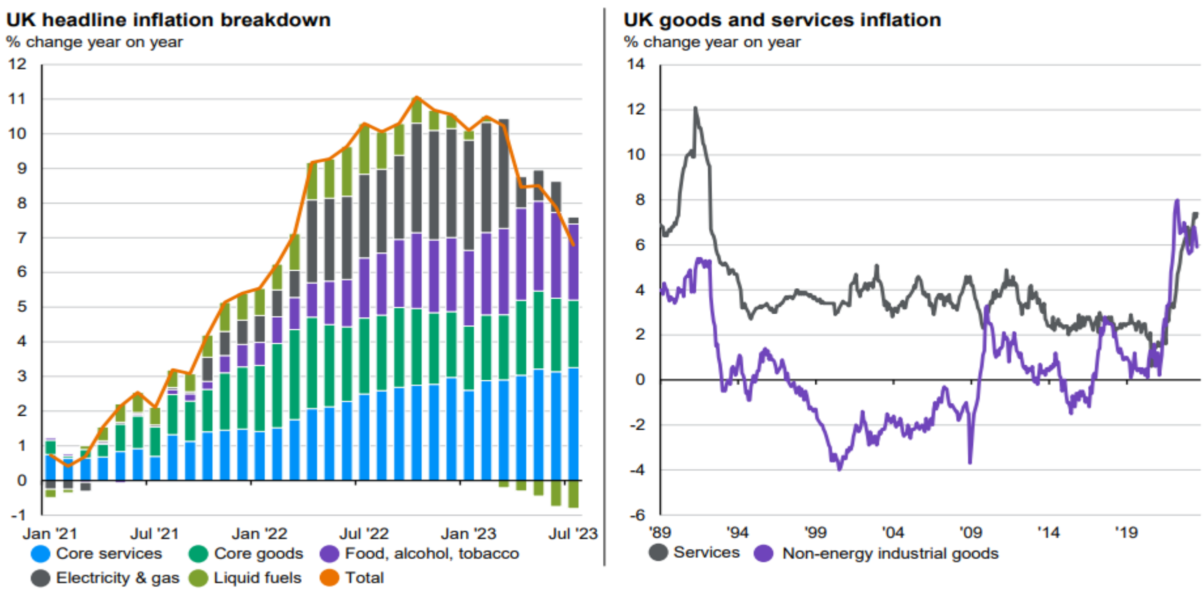
Source: - JPMorgan Asset management July 2023

Inflation

Headline inflation rates continue to fall in the US, Europe and the UK driven by year over year base effects and falls in energy prices. Core inflation on the other hand remains sticky in all regions and broadly for the same reasons, tight labour markets and higher wages.

The left hand side of Chart 6 shows, as UK headline inflation falls, core inflation has remained stubbornly high. While headline inflation fell to 6.8% in July, the lowest since February 2022, the core inflation was unchanged at 6.9%. The right hand side shows that while core goods prices seem to have peaked services inflation may still be trending higher.

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

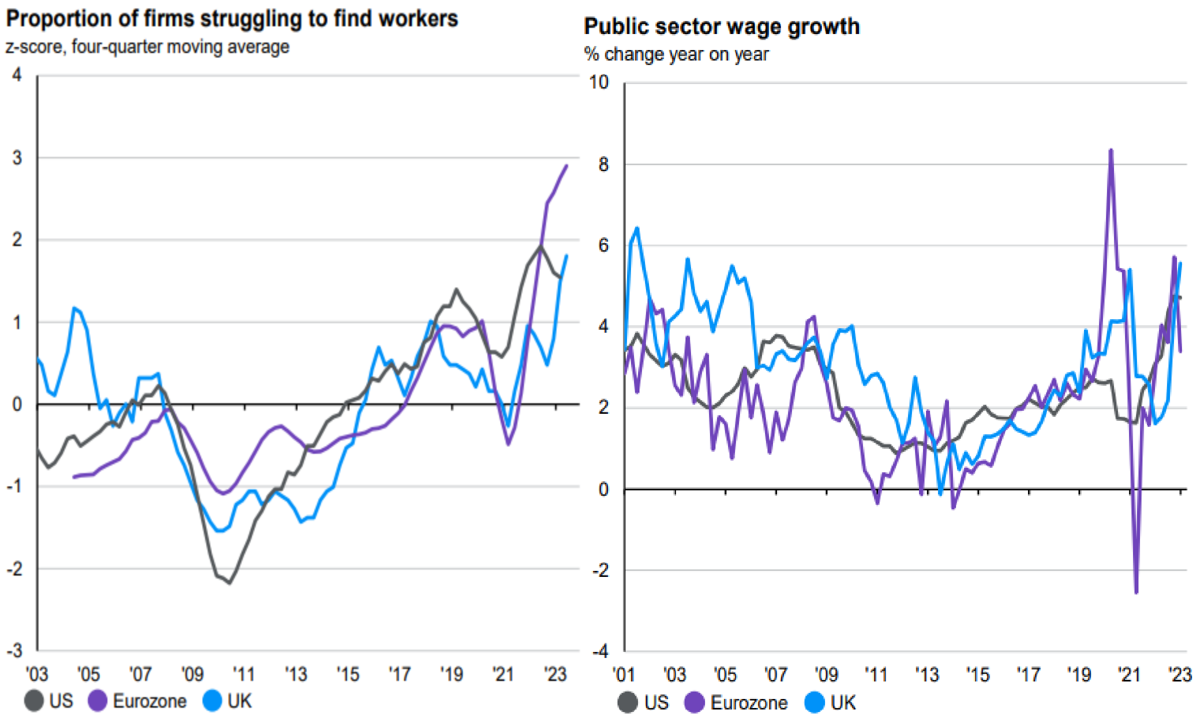


Source: - JPMAM August 2023

Chart 7 below shows how demand for new labour remains high on the left hand side and how public sector wages continue to rise albeit at rates below inflation. The chart shows public sector wages, in the more open public sector they are growing at an even faster rate.

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 for longer levels of interest rates and a more conservative monetary policy approach from central banks.

Chart 7: - Tight labour markets and strong wages growth are keeping pressure on Core CPI.



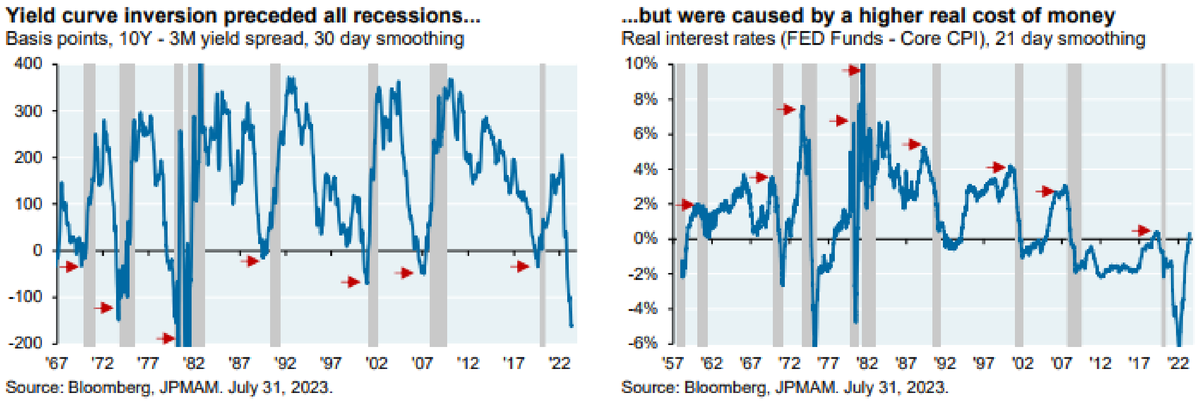
Source: - JPMAM August 2023

Central Banks

In June the Fed decided to pause their rate hiking cycle as headline inflation continued to decline. However, in July they raised rates by 0.25% citing strong growth and tight labour markets as the reason even suggesting that they may have more to do. At each of its June and July meetings, the ECB raised rates by 0.25%, because of high inflation despite a weakening economic outlook. The BoE raised rates by 0.5% in June and 0.25% at its meeting in August for the same reasons. In July the BoJ's newly appointed governor Kazuo Ueda, chose to make his first change in monetary policy. He announced that 10 year government bond yields will be allowed to rise to a ceiling of 1%, in a range defined as 0.5% to 1%, although the official target is still zero. For now, there will be no change to short term rates which remain below zero and the monetary base will be allowed to continue to expand until inflation is sustainably above 2%. It is not clear yet, what these changes to Japanese monetary policy could lead to, but when the overnight rate starts to move into positive territory as well a major source of money to the global credit system could go into reverse as the nearly 20 years Japanese ZIRP comes to an end.

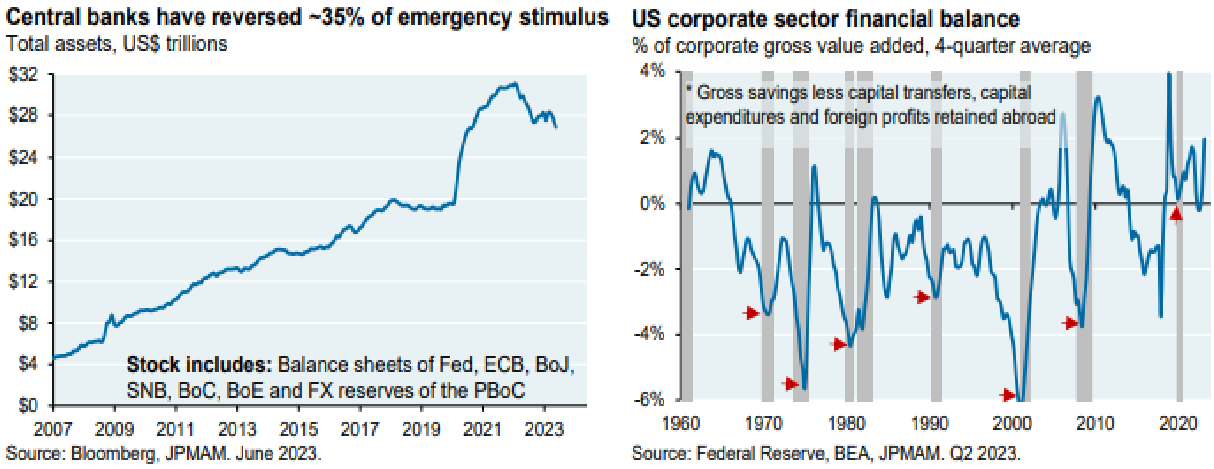
The increases in interest rates, the pressure on costs caused by inflation and signs of slower manufacturing growth suggest developed economies may be closer to recession. Inverted government bond yield curves have in the past been a precursor for recession. Indeed, the US curve is experiencing one of its longest and deepest periods of inversion since the Volker period 40 years ago. But the recessions that followed these inversions were caused by higher real rates, in other words rates are not yet high enough on their own to cause a recession, see Chart 8.

Chart 8: - LHS - US yield curve and RHS - the real cost of money.



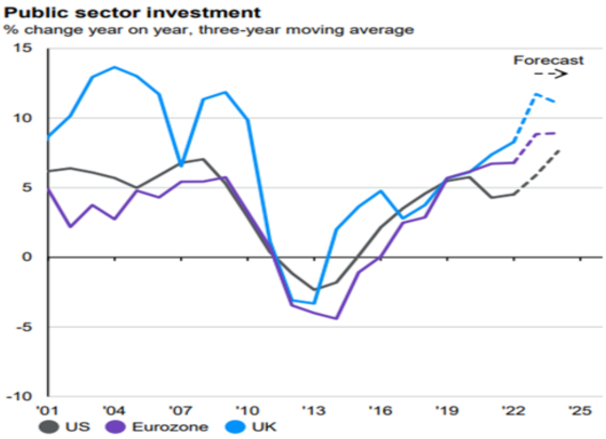
Looking at other evidence, while reduced, the consumer still has some excess savings left over from covid and they are enjoying good returns on cash and equity, central banks have only reversed 35% of the covid emergency stimulus, see LHS, Chart 9, and the US corporate financial balance remains in surplus, a situation that has never preceded a recession, RHS Chart 9.

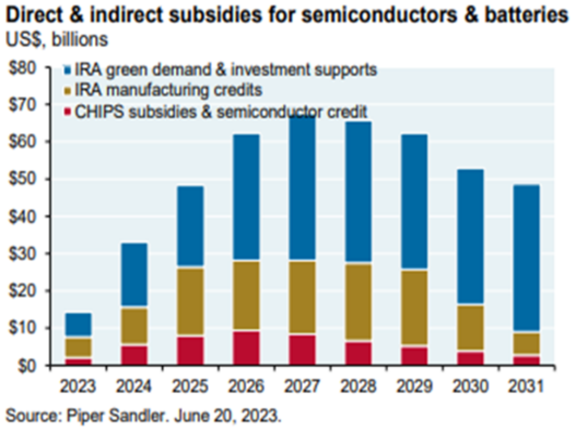
Chart 9: - LHS – Global Central bank balances sheets. RHS – US corporate balance sheets



When you look at fiscal policy, it is increasingly expansionary. Chart 10, the left hand side shows that there are further increases in direct government spending are planned in the US and Europe and to a lesser extent in the UK. Aimed at increasing investment in the green economy, energy transition and resilience in semi-conductor and Lithium battery manufacture. The right hand side shows the magnitude of direct spending as well tax incentives that US Inflation Reduction Act (IRA) is planning, with increases out to 2027 which are supporting growth even as monetary policy is tightening.

Chart 10: - LHS – Public Sector spending. RHS – US IRA spending plans.



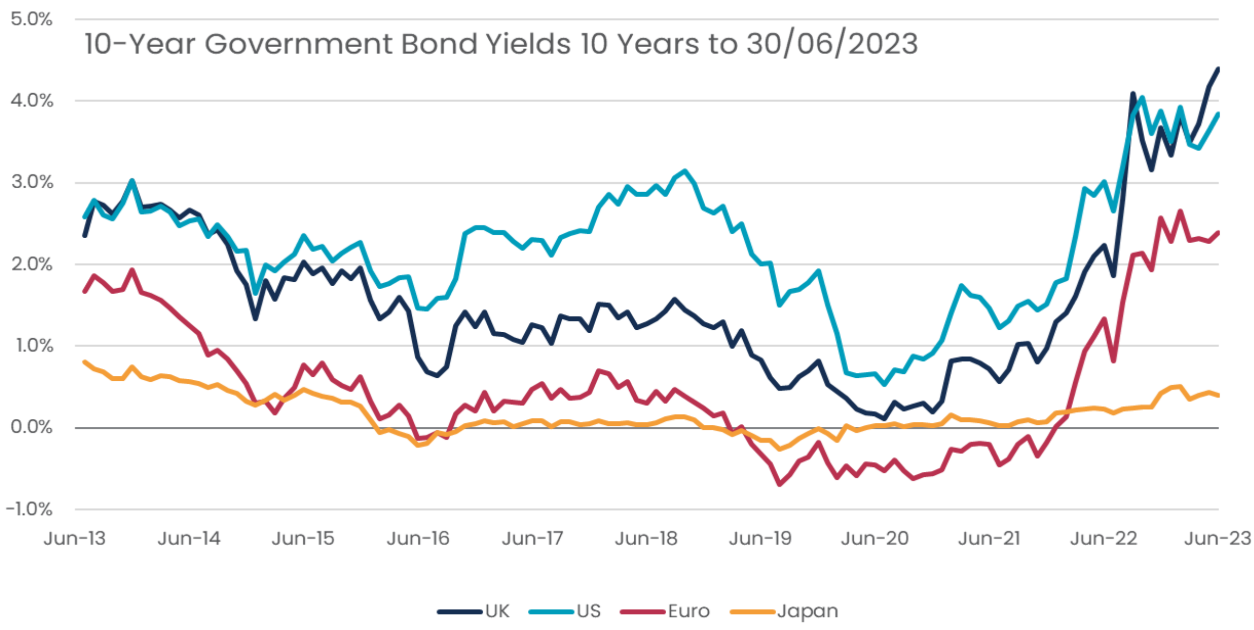


Source: - JPMAM August 2023

As mentioned above this all suggests to me that interest rates may have further to rise but that they will not be falling sharply unless the impact of China property market retrenchment is deeper and unsupported by Chinese government action.

Government bonds

Chart 11: - Government bond yields, last 10 years.



Source: - Bloomberg

Unfortunately Chart 11, above is somewhat out of date, because since the end of the quarter all 10 year government bond yields have moved 0.2% to 0.4% higher. US 10 year yields are 4.25%, UK 4.68%, Germany 2.6% and Japan 0.65%, the universal increase is as discussed above and in last quarter's report, being driven by the realisation that interest rates may have further to rise. The trigger in recent days has been stronger US retail sales and employment data, a more hawkish than realised set of US Fed minutes and the actual increased supply of government bonds combined with the downgrade of US debt by Fitch, and finally the lower trading volumes seasonal effect, of the summer holidays. Possibly the more important effect has been the Bearish flattening of the US yield curve (long dated yields increasing more than short, dated yields).

In my opinion, the bearish flattening is long overdue and could have further to go. It may be indicative that the market has finally realised that governments have more debt to issue, inflation and interest rates may be higher for longer and the realisation that after nearly 20 years the BoJ's is close to ending ZIRP allowing 10 year JGB yield to rise and possibly in the near future raising the overnight rate to positive territory.

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 liabilities that the Derbyshire Pension Fund needs to meet. 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.

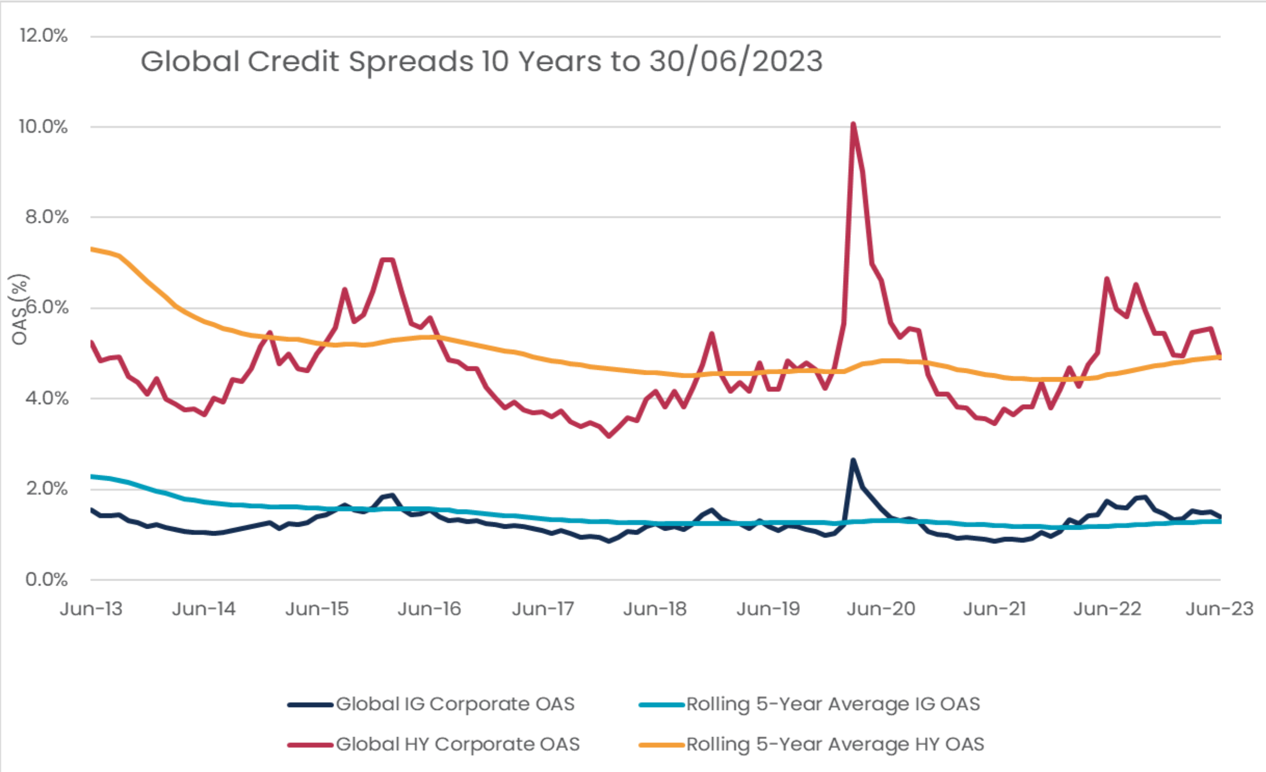
Non-government bonds

Chart 12 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 narrowed over the quarter and given the recent moves in government yields mentioned above, they have narrowed further, while at the same time the total yield has increased.

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 whilst the monthly carry provides an attractive source of income.

High yield assets are more sensitive to the economy, so slower economic growth and tighter credit conditions has increased the risk of default especially for more leveraged parts of the economy. Depending on how widespread the default of Chinese property companies turns out to be there may be a contagion effect impacting other types of property related debt. 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 12: - Credit spreads, extra yield over government bonds, last 10 years.



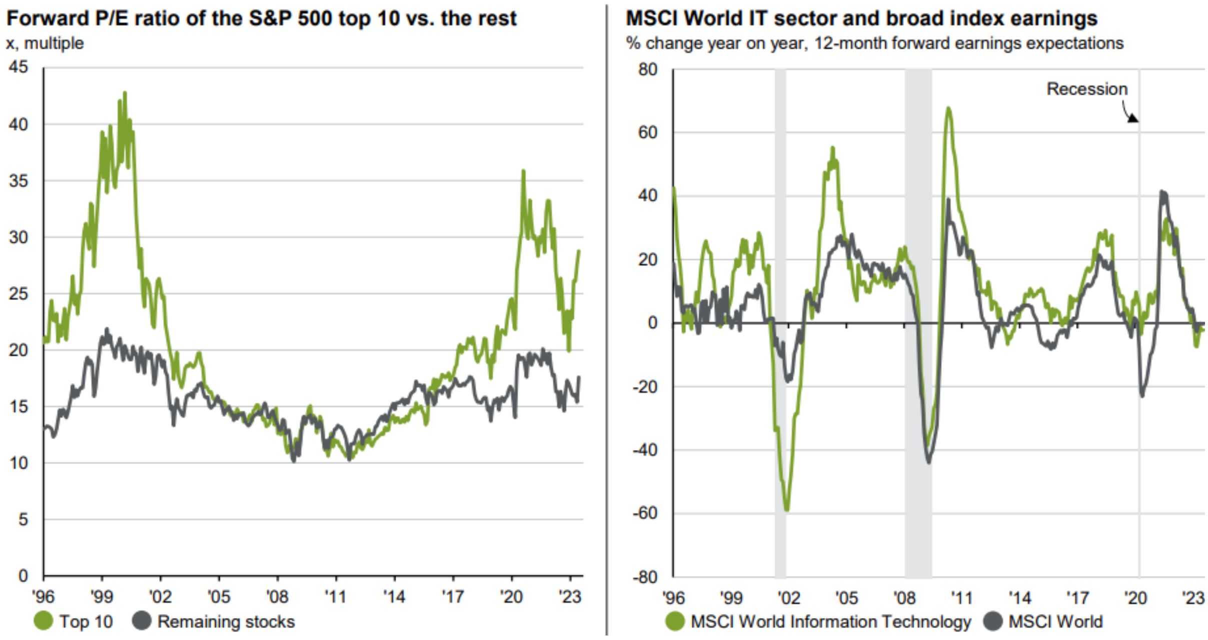
Source: - Bloomberg

Equities

Since my last report most equity markets have moved sideways in a fairly wide range, except the US and global indices which have gone higher, even with the recent fall on concerns about China and its property market. The rally in US and global indices has been driven by the "magnificent 7" or what used to be referred to as the "FAANG". The magnificent 7 stocks are Apple, Alphabet, Amazon, Meta, Microsoft, Tesla and Nvidia. Year to date these 7 companies are responsible for almost 95% of the performance of the US stock markets, and because the US represents 65% of typical market cap weight global equity indices, the vast majority of the performance of those indices. The performance leadership is so narrow and extreme that if you did not hold these stocks in your US equity portfolio, your performance may have been negative year to date.

I have covered this is more detail in section 4 of this report where I have highlighted how narrow this rally has been and how overvalued it leaves the US and global equity indices. Chart 13 below focuses on how expensive these stocks have become on a P/E basis and how there is no extra earnings growth to support it.

Chart 13: - S&P broad market P/E vs top 10 constituents and IT sector earnings compared to the whole index.



Source: - JPMAM August 2023

The message of the global macro-economic factors and maybe the overly generous bail out of Silicon Valley bank seem to have been ignored by investors willing to overly "bet" on the AI revolution. But it has not helped that so many investors now use a specialist passive index based approach to investment in equity. This perpetuates trends as there are no circuit breakers on how big a single stock can be in an index strategy unless the index provider chooses to set one. Recently the US Tech dominated index provider the NASDAQ has chosen to place a ceiling on the % allocation a single stock can have in its indices to prevent distortion and over concentration.

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

My optimism for the outlook for Emerging markets and China now appears misplaced. The re-opening of the Chinese economy and the removal of all covid restrictions has not led to the explosion of consumption that was experienced in the West. With consumers choosing to hold on their savings rather than spend them on increased consumption. The latest problem with China's economy appears to be more the result of over investment in residential real estate than excess industrial capacity.

China's home ownership rate is close to 90%, outstripping the UK and the US and 20% of Chinese households own more than one home. The building boom has led to vacant properties amounting to more than two years of sales, and consumer confidence remains low despite low mortgage rates designed to boost leverage and homebuying. China relies on large amounts of trapped domestic savings to finance itself. Rather than a balance of payments or banking crisis, the housing situation in China is leading to weaker growth and less money for investment in the equity market despite the much cheaper 10-12x valuation. The Chinese central bank recently cut interest rates but this seems to have had the opposite result to what was expected.

GDP

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

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

% CHANGE YOY								
	2023				2024			
	MAY		AUGUST		MAY		AUGUST	
	Consensus	AF	Consensus	AF	Consensus	AF	Consensus	AF
US	1.1	**0.5**	1.6	**2.0**	0.6	**0.6**	0.5	**1.0**
UK	-0.1	**-0.5**	0.1	**0.5**	0.8	**0.0**	0.4	**0.5**
Japan	1.0	**0.8**	1.2	**1.5**	1.1	**1.0**	1.0	**1.0**
EU	0.7	**0.0**	0.7	**1.0**	1.4	**1.0**	1.3	**1.5**
China	5.8	**6.0**	5.5	**5.0**	4.9	**5.0**	4.8	**5.0**
SE Asia	4.1	**5.0**	4.2	**4.0**	4.6	**5.0**	4.6	**5.0**

Source: - Consensus Economics July 2023

The consensus forecasts for GDP growth in 2023 have again been revised higher in August as actual growth outcomes have been better than expected. This may be the last hurrah for consumers who have thus far continued to spend their savings in the face of higher inflation and interest rates. But consumption is being supported by tight labour markets, higher earnings and now by falling energy prices. While the outlook for growth remains anaemic, with estimates in developed markets only a little greater than the rounding error in the calculations. I have decided to revise my estimates for GDP growth to above consensus for this year and next as I believe growth will continue to surprise to the upside. This does however have implications for central bank policy rates, if growth does turn out to be better than expected then interest rates may have to go higher and stay higher for longer than the markets currently expect to combat inflation.

The Chinese economy expanded by 6.3% year-on-year in the second quarter, compared to the 4.5% recorded in the first quarter. The latest figures were distorted by a low base of comparison to last year when Shanghai and other major cities were under strict lockdowns. During the first half of the year the economy grew by 5.5%. China had set a GDP growth target of around 5% for this year, following a 3% expansion in 2022. Beijing remains cautious about launching substantial stimulus measures, due to the large inventory of unsold housing and very high level of local government debt which financed the boom in home building. Economic indicators are mixed with retail sales growing at slower pace, while industrial output growth accelerated. The urban jobless rate remained unchanged at 5.2%, but youth unemployment reached a new high of 21.3%. Exports declined due to high inflation in key markets and geopolitical factors affecting foreign demand.

The advance estimate of US economic growth showed an annualised rate of 2.4% in the second quarter of 2023, higher than the first quarters 2% rate and above market expectations of 1.8%. Non-residential fixed investment accelerated sharply, led by a strong rebound in equipment and intellectual

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property products. Private inventories added to growth after a sharp contraction in the first quarter. While consumer spending on goods slowed sharply, consumption of services remained strong and labour markets remained tight. Public expenditure increased at a softer pace, net trade was also weaker as exports fell faster than imports and residential investment remains negative.

The UK economy expanded 0.4% year-on-year in the second quarter of 2023, following a 0.2% rise in the first three months of the year, preliminary estimates showed. On the production side, the services sector rose 0.5%, manufacturing rebounded 0.8% vs -1.8%, while mining declined again. On the expenditure side, household consumption rose 0.7%, government spending rebounded +2.6% versus -2.2% and gross fixed capital formation increased at faster rate. While exports were down 1.1%, imports declined at a faster rate down 6%.

The Eurozone economy grew by 0.3% in the second quarter of 2023 after a flat first quarter, the preliminary estimate showed. The recovery in demand was bolstered by a moderation in inflationary pressures. However, higher interest rates and falling confidence indicators continued to weigh on the European economy. Among the largest economies in the bloc, France and Spain sustained their positive growth rates, whereas Germany's economy continues to stagnate, and Italy unexpectedly experienced a contraction. On a yearly basis, the Eurozone grew by 0.6 percent, the weakest pace of expansion since the 2020-21 covid induced recession.

The Japanese economy grew by 2.7% on an annualised basis during the first quarter of 2023, compared with the preliminary figure of a 1.6% rise. An acceleration in private consumption following the removal of all pandemic measures was the main positive contribution to growth. Although business activity rebounded strongly and government spending continued to rise. Net exports, remain a drag on growth amid persistent uncertainty from global trade due to higher inflation and interest rates.

Consumer Price Inflation

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

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

% CHANGE YOY								
	2023				2024			
	MAY		AUGUST		MAY		AUGUST	
	Consensus	AF	Consensus	AF	Consensus	AF	Consensus	AF
US	4.2	**5.0**	4.1	**3.5**	2.6	**3.0**	2.6	**2.6**
UK	6.7	**7.0**	7.4	**7.0**	2.8	**4.0**	3.2	**3.5**
Japan	2.6	**3.0**	2.9	**2.5**	1.4	**1.9**	1.7	**1.5**
EU	6.3	**7.0**	6.3	**6.0**	2.9	**3.8**	2.9	**3.0**
China	1.8	**2.2**	1.0	**1.0**	2.4	**3.0**	2.1	**2.1**
SE Asia	2.8	**3.2**	3.6	**3.6**	2.8	**3.2**	2.8	**2.8**

Source: - Consensus Economics July 2023

The consensus forecasts for inflation in August have been revised higher in all developed economies for both 2023 and 2024 other than in the US. US inflation is more subdued than other economies because of its self-sufficiency in oil and particularly gas. The tax and regulatory element of these prices in the US is also much lower than in the UK, Europe and Japan. While I expect inflation in 2024 could be lower than it will be in 2023, I believe it may be higher that consensus expectations, because as mentioned above, growth although anaemic may be stronger than expected. Tight labour markets and the willingness of consumers to spend especially on services may also be another factor that could keep core inflation higher for longer than expected. I also mentioned in my last report that we are returning to a period where cash has a real cost. At the moment that cost is still negative in real terms because of high inflation, but I expect it to be higher than we have experienced over the last 15 years and that should also have an impact on core inflation over the next year or so.

The Chinese economy has not experienced the explosion of service price inflation that the developed economies saw after the covid re-opening. In June headline consumer prices fell for the fifth month in a row mainly due to a fall in transportation and non-food prices. As a result, annual headline inflation is zero, but the core rate is +0.4%.

The annual headline inflation rate in the US slowed to +3% in June, the lowest since March 2021, falling from +4% in May. The primary driver of the fall was the high base effect from last year when a surge in energy and food prices pushed the headline inflation rate to +9.1%. Year over year energy costs fell -16.7%, with the price of fuel oil falling -36.6%, gasoline -26.5% and -18.6% for utility gas service, while Electricity prices increased this was only by +5.4%. Food prices also increased at a slower rate, as did the prices of core items such as shelter, new vehicles, apparel, and transportation services. The cost of medical services was down -0.8% and prices of used cars and trucks declined by

-5.2%. The core inflation rate remains well above the headline rate but it also dropped to +4.8%, the lowest increase since October 2021.

Consumer price inflation in the United Kingdom dropped to +7.9% in June and to +6.8% in July, the lowest level since March 2022, mainly due to a slump in fuel prices. Additionally, the core rate, which excludes volatile items such as energy and food, eased to +6.9% in June and July from May's 31-year high of +7.1%. Transportation costs declined -1.8%, driven by a -22.7% fall in the cost of fuels and lubricants. The annual rate of price increases from food and non-alcoholic beverages, furniture and household goods and restaurants and hotels also slowed.

The advance estimate of inflation in the Euro Area slowed for a third consecutive month to +5.3% in July 2023 from +5.5% in June. This is the lowest rate of increase since January 2022 and was mainly due to a further drop -6.1% in energy prices and a slowdown in the increased cost of food, alcohol and tobacco and non-energy industrial goods. Services inflation continued to increase by +5.6% up from +5.4% in June. As a result, core inflation rate which excludes prices for energy, food, alcohol & tobacco was unchanged at +5.5% and is now higher than the headline rate for the first time since 2021.

The annual inflation rate in Japan edged up to +3.3% in June 2023 from +3.2% in May. Cost increases were broad based with food, housing, transport, furniture & household utensils, medical care, culture & recreation, education and miscellaneous all higher. In contrast, the prices of fuel, light, and water decreased for the fifth month in a row, mainly due to falling electricity prices. Core inflation also ticked higher to +3.3% in June from +3.2% in May.

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 August 2023.

Table 6: - Interest rate and Bond yield forecasts

%	CURRENT	DECEMBER 2023	JUNE 2024
UNITED STATES			
3month SONIA	5.63	5.75	5.75
10 year bond yield	4.25	4.75	4.50
UNITED KINGDOM			
3month SONIA	5.55	5.50	5.50
10 year bond yield	4.66	5.00	4.75
JAPAN			
3month SONIA	0.07	0.0	0.0
10 year bond yield	0.63	0.75	1.00
GERMANY			
3month SONIA	3.67	4.0	4.25
10 year bond yield	2.62	4.0	3.75

Source: - Trading Economics; 18th August 2023

The central banks have increased rates by 4% to 5% in a very short period of time and I believe that we are no doubt closer to the end of the tightening cycle but as suggested above real rates may not have risen enough to cause a recession. Headline inflation is falling largely because of base effects as last year's rapid increase in food and energy costs have not been repeated. The pressure on inflation has moved from headline to core and this could persist for at least another year before it too falls out of the calculations. While I believe we may be close to peak of rates, I do not share the markets optimism that they are going to fall quickly and significantly thereafter. As I have said before the period of low inflation and ultra-low emergency interest rates is behind us. Which suggests to me that interest rates will be higher for longer than expected to ensure inflation returns closer to central bank policy levels and that even when this has happened short term interest rates will only come down slowly and will settle at levels similar to those before the GFC, 15 years ago. This has implications for the shape of the yield curve, the ultimate level of bond yields and the valuation of all asset markets as the potentially higher cost of capital is priced in.

UK Government bond yields continued to move higher, peaking 4.65% in early July, just ahead of the Fed's meeting, since then they have fallen to 4.36% on optimism that US short term interest rates may finally have finally peaked. As suggested above I do not completely agree with this view and I wouldn't be surprised to see further rate hikes from the Fed over the rest of this year and I expect them to stay high for longer than the market. I am even more confident that the BoE and the ECB will continue to increase rates. Hence, I see further market volatility and the chance of yet another period of negative return from bonds. If I am right about the longer period of high rates the yield curve especially in the US could flatten with longer dated bonds increasing relative to shorter dated bonds.

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; but the all in yield and spread of global corporates is still above the 5 year average.

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	4.87	8.9	0.5	-3.2	+0.4
All Stocks Linkers	1.23	12.9	0.5	-6.1	-5.2
Global IG Corporate	5.40	5.9	0.5	-1.6	+2.4
Global High Yield	8.61	3.5	0.5	+0.4	+6.8

Source: - ICE Indices 18th August 2023

Bond Market (Protection Assets) Recommendations

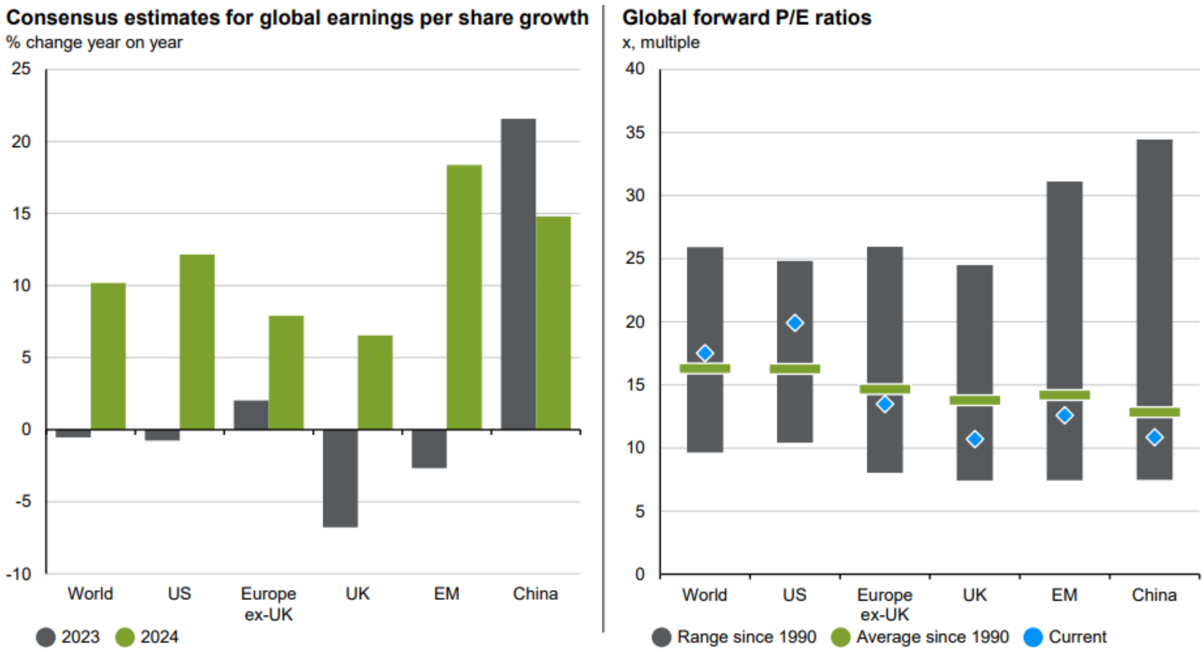
I suggest that the Fund sticks with its current allocation to Protection assets. Remaining neutral investment grade corporate bonds. The extra yield spread available from corporate bonds has been both wider and narrower since my last report, but it is currently still wider than it has been for some years and the total yield remains attractive.

I am somewhat torn between the allocation to Fixed Interest Gilts (FIG) and Index Linked Gilts (ILG). I haven't changed my suggestion to be underweight FIG and neutral ILG, but I could just as easily be underweight ILG and Neutral FIG as I still believe linkers are expensive in the short term and I am more pessimistic about the longer term fall in demand and potential increased supply of Index Linked Gilts. Having said that they are much cheaper than they were at the beginning of last year, with the real yield increasing from around -2%, 18 months ago to +1.07% currently.

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



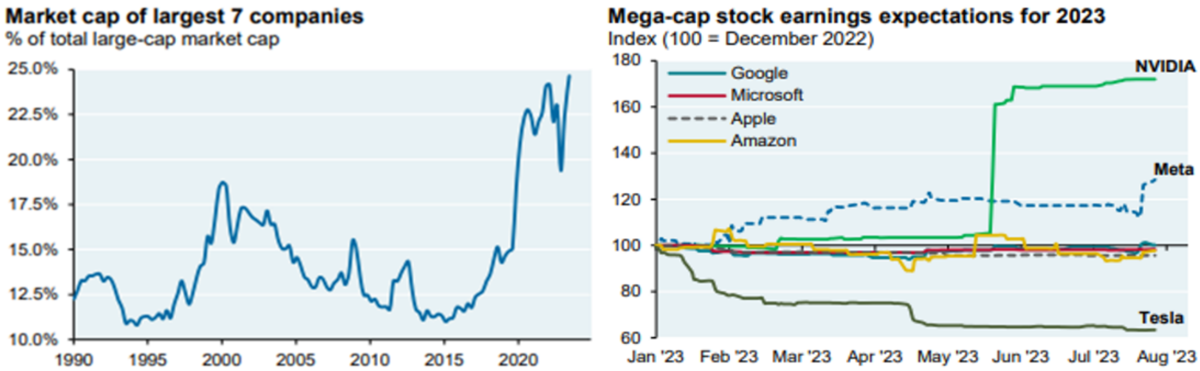
Source: - JPM Asset Management, July 2023

The left-hand side of chart 14 shows the new earnings expectations for 2023 and 2024. Since March analysts have moved their earnings expectations lower, to negative for the world in aggregate and the US and more negative in the UK for 2023, despite the stronger macroeconomic performance experienced year to date. In contrast they have revised up their earnings expectations for China despite its sluggish post lockdown recovery. Interestingly they have left 2024 more or less unchanged.

The updated right hand chart shows the world and US P/E ratios in particular have become even more expensive in this quarter with the aggregate world P/E ratio moving above average. This P/E expansion is largely confined to the US, making the US market look very expensive relative to history. This is even more of a concern when further analysis shows that the P/E expansion is confined to the very narrow set of "Tech stocks" now being referred to as the "Magnificent 7" namely Apple, Alphabet, Amazon, Microsoft, Meta, Nvidia and Tesla. The left-hand side of Chart 15 below shows that these 7 largest stocks in the S&P 500 represent nearly 25% of the market cap. They are also responsible for more than 50% of the market's gain year to date. This is despite the right-hand chart showing that Nvidia and Meta are the only companies expected to increase their earnings in 2023, with the others flatlining or in the case of Tesla falling by 30%.

Because the US makes up 65% of the typical global equity index, much of this year's global equity performance and P/E expansion can be explained by these same US Mega-cap companies.

Chart 15: - S&P 500 – LHS Market cap of the Magnificent 7; RHS - Their earnings expectations for 2023.



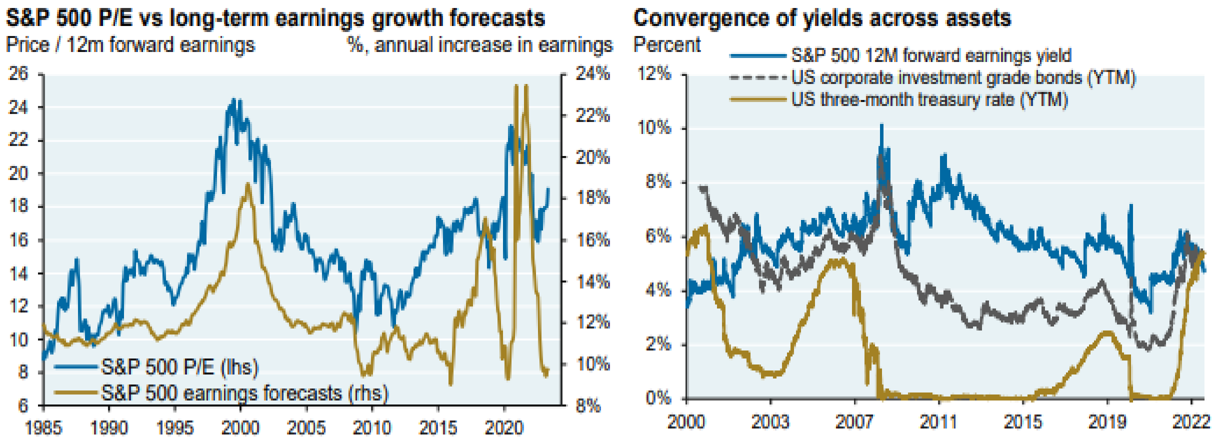
Source: - JPM Asset Management. August 2023

The market cap concentration of these companies is the highest since the 1970's and the market leadership even narrower than it was in the Tech Bubble of 2000. Market performance when measured by the "growth" factor is in the 97th percentile, the only time this was higher was during the Tech bubble of 2000.

A number of factors could be responsible for this, more conservative positioning last year, due the war in Ukraine and the unexpected rate hikes from the central banks; stronger than expected growth and falling headline inflation this year; over optimism about the prospective earnings potential of AI. I also see the influence of index / passive investing, where these funds are forced to buy these companies just because of their weight in the index. Which means that active investors who would have made the reasonable observation that these companies are already expensive and their earnings growth did not look good, will have underperformed because they would have been underweight.

In the past when these events happen, they are usually followed by a couple of years of poorer performance of market cap weighted indices and relative better performance of active managers and equal weight indices. I believe equity markets and the US in particular could also struggle over the next couple of years because so much good news is already in the price and as the LHS side of chart 16 below shows earnings expectations are low and as the RHS shows cash and bonds are now attractive alternative sources of yield.

Chart 16: - S&P 500 – LHS forward looking P/E ratios and earnings forecasts; RHS US Asset class yields.



Source: - JPM Asset Management. August 2023

Inflation may have peaked but it is likely to remain higher than expected and I believe central banks are likely to keep rates higher for longer than expected. As I have suggested above, I expect the cost of capital to rise and as the RHS of chart 16 above shows there are now safer places for investors to get reasonable risk adjusted returns without having to invest in equities. Hence, I remain cautious on equity markets, especially the more interest rate sensitive "growth sectors" which have rallied much 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

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, but the overall yield has increased, when combined with the low duration and floating rate nature of many of the asset classes it suggests to me that MAC still remains attractive, relative to longer duration, more interest rate sensitive assets.

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 May and 18th August 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 MAY 2023	ANTHONY FLETCHER 18TH AUGUST 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**

Anthony Fletcher

Independent External Adviser to the Derbyshire Pension Fund

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