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Third Quarter 2023 Investment Report

PREPARED FOR:

Derbyshire County Council Pension Fund: Pensions and Investment Committee Meeting

DECEMBER 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 6th December 2023
Date of paper 17th November 2023

1. Market Background (Third quarter 2023)

GDP growth while weak and below trend, was again positive, growth continues to be supported by consumers who have continued to spend their savings, but consumption is also being supported by tight labour markets, higher earnings, falling energy prices and falling headline inflation which in recent reports show that wages are now increasing in real terms. While the outlook for growth remains anaemic, with outcomes in the UK and Europe oscillating around zero Japan and the USA seem to be growing relatively strongly. Growth in China especially in the domestic economy remains weak weighed down by excess property investment.

Once again and despite a falling trend in headline inflation, the US Fed, ECB and the BoE all increased rates in the third quarter. Base rates now stand at 5.5% in the US, 5.25% in the UK and 4.5% in Europe. These central banks also reiterated their commitment to hike rates and maintain a hawkish posture in light of tight labour markets and stubborn core inflation data. The Bank of Japan also firmed up its policy on yield curve control, stating that it would not prevent 10 year JGB yields rising towards 1%.

The third quarter saw a reversal in the first half performance of global equities with the MSCI world index falling -3.4% in local currency terms. Not surprisingly after the strong performance of the Magnificent 7 global growth equity was down -5.1%, whereas value only fell -2.5%. Japanese equities outperformed delivering +2.5% in local currency largely due to the weakness of the Japanese yen. UK equities returned +1.8% due to their energy tilt, benefitting from the rising oil prices caused by Russia and Saudi Arabia's extension of voluntary output cuts.

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 again delivered negative returns, but the increase in long bond yields in the rest of the world especially the US meant these markets delivered larger negative returns.

Non-government bonds outperformed governments over the quarter as spreads remained stable and the benefit of the higher yields supported returns. Real Assets had another difficult quarter with the short term impact of funding discount rates adjusting to higher levels of yield, not being offset by higher revenues which will take time to feed through.

The US dollar strengthened over the quarter on the realisation that US rates are likely to be higher for longer and Sterling, although weaker against the US dollar, was stronger against most other currencies.

Commodity prices were again mixed, with the prices of oil and gas higher on supply cuts by Russia and Saudi Arabia. Gold was lower as fiat currency yields have become more attractive, Copper was also weaker due to weakness in the Chinese housing sector, but other industrial metals prices were higher.

Since the end of the quarter central banks have paused rate hikes, hence we may be closer to the end of the interest rate tightening cycle but, I believe interest rates and core inflation will remain higher for longer than equity and bond markets have priced in. Expect more volatility!

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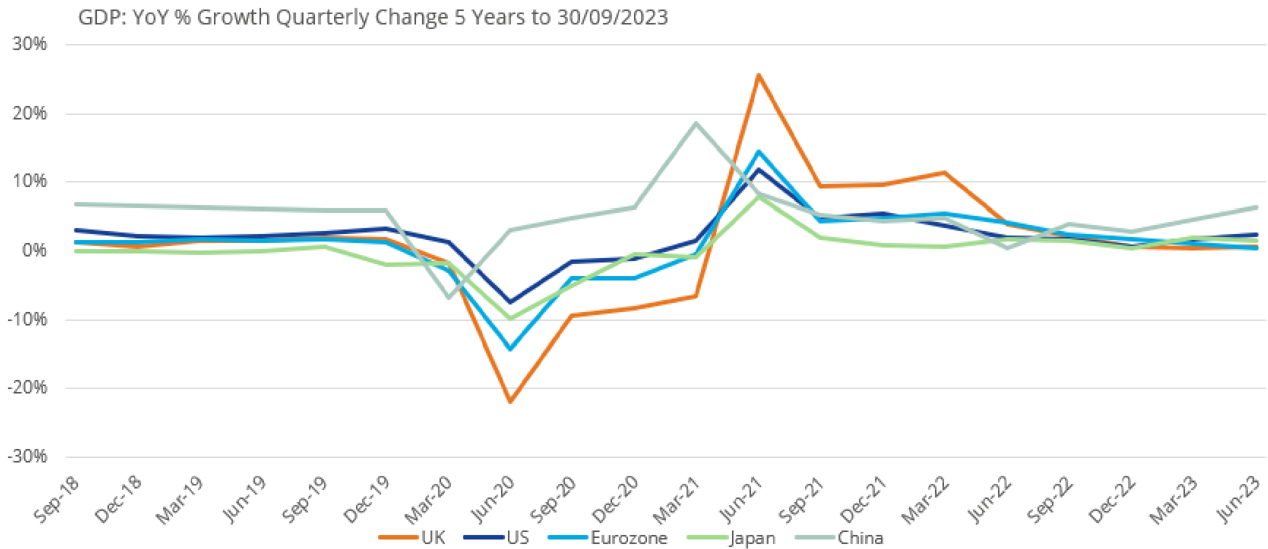
Chart 1: - Annualised rates of quarter on quarter GDP growth.



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 October 2023 and the 3 and 12 months to the end of September 2023.

% TOTAL RETURN DIVIDENDS REINVESTED

MARKET RETURNS

		Period end 30th September 2023	
	October 2023	**3 months**	**12 months**
Global equity FTSE All-World	-2.4	+0.9	+10.9
Regional indices			
UK All Share	-4.1	+1.8	+13.6
North America	-1.8	+1.0	+11.0
Europe ex UK	-3.0	-1.6	+19.3
Japan	-3.9	+2.1	+12.1
Emerging	-3.2	+2.6	+1.6
UK Gilts - Conventional All Stocks	-0.4	-0.6	-2.5
UK Gilts - Index Linked All Stocks	-1.3	-4.7	-12.8
UK Corporate bonds*	-0.2	+2.0	+8.4
Overseas Government Bonds**	-0.8	-2.6	-0.7
UK Property quarterly^	-	+0.2	-12.2
Sterling 7 day SONIA	0.4	1.3	4.1

^ 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 September 2023

Source: - Bloomberg

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

BOND MARKET % YIELD TO MATURITY	30th June 2023	30th September 2023	Quarterly Change %	30th September 2022	Current 17th November 2023
UK GOVERNMENT BONDS (GILTS)					
10 year	4.39	4.44	**+0.05**	4.09	**4.09**
30 year	4.42	4.90	**+0.38**	3.83	**4.53**
All Stocks ILG	+0.98	+1.0	**+0.02**	+0.23	**+0.83**
OVERSEAS 10 YEAR GOVERNMENT BONDS					
US Treasury	3.82	4.57	**+0.75**	3.80	**4.44**
Germany	2.39	2.84	**+0.45**	2.11	**2.58**
Japan	0.40	0.77	**+0.37**	0.25	**0.74**
NON-GOVERNMENT BOND INDICES					
Global corporates	5.22	5.58	**+0.26**	5.25	**5.37**
Global High yield	8.52	8.74	**+0.18**	9.78	**8.60**
Emerging markets	7.05	7.59	**+0.54**	7.81	**7.49**

Source: - Trading economics and ICE Indices G0LI, G0BC, HW00, EMGB, 17th November 2023.

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

Source: - Bloomberg

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

Source: - Bloomberg

Recent developments (October and to 17th November 2023)

Bond and equity prices fell simultaneously in October as bond yields rose sharply and heightened geopolitical uncertainty weighed on market sentiment. Commodities were the notable outperformer, as energy prices rallied and investors fled to gold as a safe haven. The sell off in the bond market continued in October, with global bonds returning -1.2% over the month. US and UK 10-year government bond yields hit the top of their recent range at 5% and 4.7% respectively along with German and Japanese yields that also made new highs. Market performance was driven by a combination of buoyant economic data making 'higher for longer' rates look increasingly likely, and concerns around the sustainability of government finances. The move to higher yields was seen throughout the global government bond and credit markets, where widening spreads dented monthly returns for both investment grade and high yield bonds.

Global equity prices fell as the prospect of 'higher for longer' rates hurt equity multiples and the Israel-Hamas conflict dampened risk appetite. Developed market equities fell -2.9% on the month, while emerging market stocks fell -3.9%. Growth stocks proved relatively resilient versus their value counterparts, returning -2.4% over the month in comparison to -3.4% for value stocks.

Commodity prices reversed some of their year-to-date losses, with the broad Bloomberg Commodity Index rising 0.3% over October. The tragic events that unfolded in the Middle East led to a flight to safety in gold. Oil prices also rallied amid concerns that an escalation into a wider regional conflict could disrupt oil supply, although the price of Brent Crude remained below its September peak. Meanwhile, European gas prices rose due to fears over global supply chain disruptions, exacerbated by the sabotage of a gas pipeline in the Baltic Sea.

Month to date performance in November shows just how data dependent the bond and equity markets have become. With prices higher in both markets after the central banks decided for the second time not to raise rates at their respective policy setting meetings. After the extremely strong economic reports in October, November's were also somewhat softer, with labour markets beginning to show signs of weakness and headline inflation resuming its downward trajectory even though the core rate remains stubbornly high.

2. Investment Performance

The contract for performance evaluation that the Fund had with PEL came to an end on the 30th June. Since then, the Officers have been working hard with the new provider Northern Trust, but sadly at the time of writing my report, the work required to produce an independent valuation had not been completed. The data presented in Table 3 below shows the Officer's reasonable estimate of performance and the value of the Derbyshire Pension Fund versus the Fund specific benchmark for the quarter and a total fund return for the year to 30th September 2023.

It is expected that Northern Trust will be able to provide an independent valuation for the committee to consider by the time of the meeting on the 6th March 2024. Based on the data below the Fund appears to have underperformed the strategic benchmark over the quarter and the year. The continued underperformance of our Growth assets managers is most likely to be responsible for the relative performance. But due to the lack of independent data only high level observations can be made.

Table 3: - Derbyshire Pension Fund and Benchmark returns

% TOTAL RETURN (NET) 30TH SEPTEMBER 2023	3 MONTHS		12 MONTHS	
	Derbyshire Pension Fund	**Benchmark**	**Derbyshire Pension Fund**	**Benchmark**
Total Growth Assets	**0.3**	**0.5**	**-**	**-**
UK Equity	1.6	1.9	-	-
Japan	1.1	3.1	-	-
Emerging markets	0.3	2.6	-	-
Global Sustainable Equity	-0.6	+0.7	-	-
Global Private Equity	3.7	0.9	-	-
Total Protection Assets	**-0.2**	**-0.3**	**-**	**-**
UK & Overseas Government	-1.2	-0.6	-	-
UK & Overseas Inflation Linked	-4.8	-4.7	-	-
Global Corporate bonds	0.7	0.2	-	-
Total Income Assets	**0.1**	**0.3**	**-**	**-**
Multi-asset Credit	1.7	2.2	-	-
Infrastructure	-0.9	+1.8	-	-
Property (all sectors)	-0.2	0.2	-	-
Internal Cash	0.7	1.3	-	-
Total Fund	**0.2**	**0.8**	**4.6**	**5.6**

Total fund value on 30th September 2023 £5,937 million

Growth assets – Equity performance

The aggregate performance of growth assets in the third quarter and the year was lower than the strategic benchmark, mainly due to the underperformance of the Sustainable equity portfolio. Over three months, only Private equity delivered a positive contribution to overall performance, continuing the trend seen over the last year.

Protection assets - Fixed Income Performance

Over the quarter, the global corporate bond portfolio outperformed the benchmark and delivered a positive return. The government bond portfolio continued to deliver negative returns due to their higher interest rate sensitivity.

Income assets – Property, Infrastructure and MAC

Over the quarter, the combined portfolio of income assets delivered a small positive return but all asset classes underperformed their respective benchmark. The most significant negative contribution came from the infrastructure assets. Over the longer term, a better period for measuring returns, both property and Infrastructure may well have outperformed.

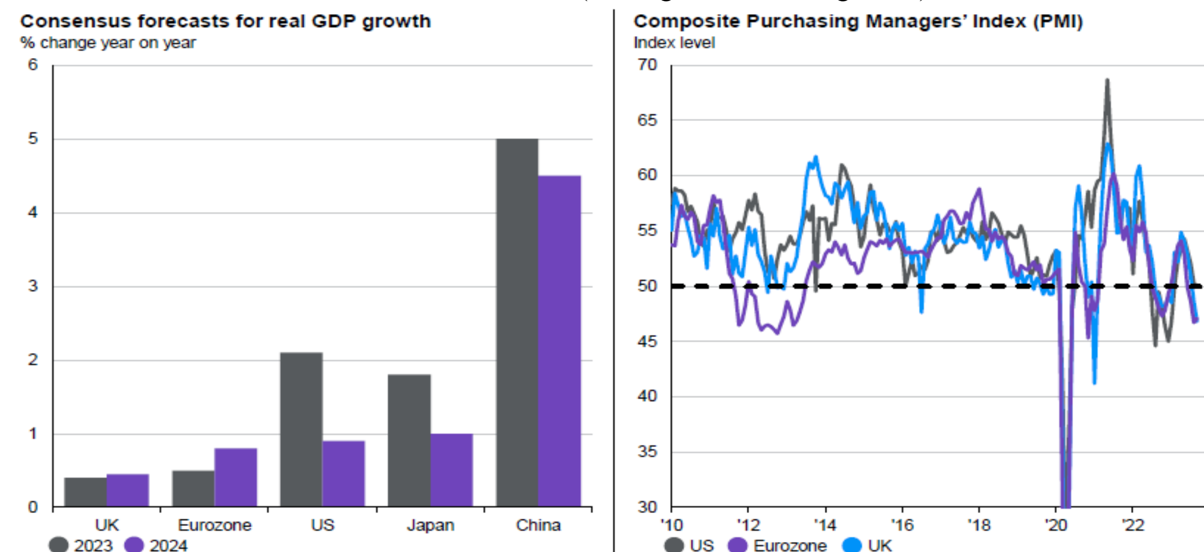
3. Economic and Market outlook

Economic outlook

As I mentioned in my last report outside of China the global economy is experiencing slightly more growth in 2023 than expected, growth remains weak, but it is not recessionary. Chart 5 below shows revised growth expectations for 2023 and 2024 in the left hand graph and composite PMI's on the right hand graph. The much anticipated weakness of growth in 2023 has been transferred to 2024, except in Europe and the UK which have again been revised slightly higher. While I do not have much conviction in my forecast, I believe that growth may be higher than these consensus forecasts suggest. For the following reasons: Fiscal spending in all the developed economies is still increasing, higher interest rates mean savers have more money and while employment data may be softening higher earnings are recurring unless one becomes unemployed. If inflation continues to fall, cost pressures for businesses will stabilise and higher wages and interest income, become real increases in spending power. Once again, the composite leading indicators are not an especially helpful guide to future activity as they are mixed with services negative but manufacturing positive. If the composite PMI is forecasting anything it is that they are likely turn higher from here unless we enter a deep manufacturing led recession.

The resilience of growth does mean that interest rates may rise further to combat inflation and they will in my opinion remain higher for longer than the markets expect in the developed economies. Chinese economic growth on the other hand may continue to disappoint as the domestic economy deals with the overhang left from over-investment in the property market. It is estimated that there is currently over two years of excess inventory of new homes in China. As mentioned in my last report 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 as it tries to deal with the problem. The economy is experiencing deflation, however 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)



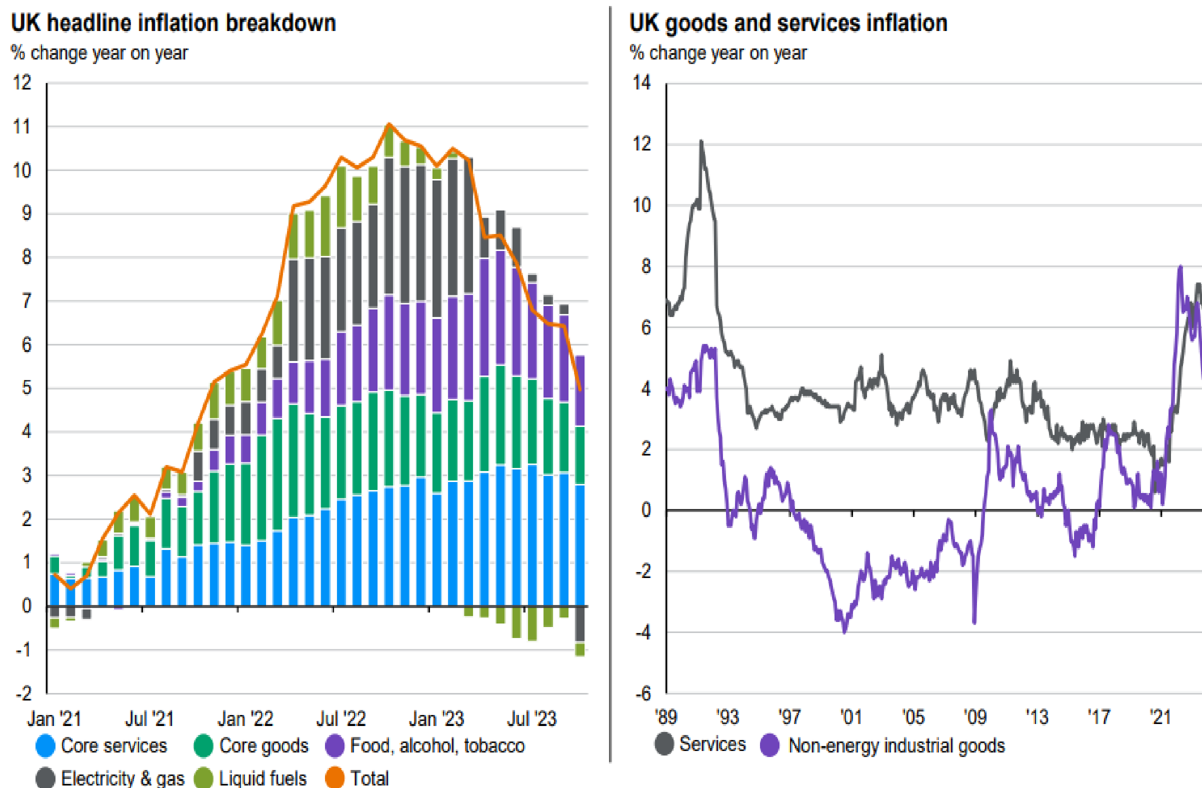
Source: - JPMorgan Asset management October 2023

Inflation

The good news on inflation is the headline rates continue to fall in the US, Europe and the UK driven by year over year base effects and falls in energy prices and in the UK the Electricity and Gas price cap. 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 graph on Chart 6 shows in the orange line, UK headline inflation and in the coloured bars its components. As can be seen in the October report, the Ofgem Energy price cap reduction that came into force in in October had a negative impact as did oil/petrol prices, despite the unrest in the middle east. The right hand graph shows core goods and services, while goods prices continue to fall as the global supply chain disruption following covid fades, services inflation remains stubbornly high.

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

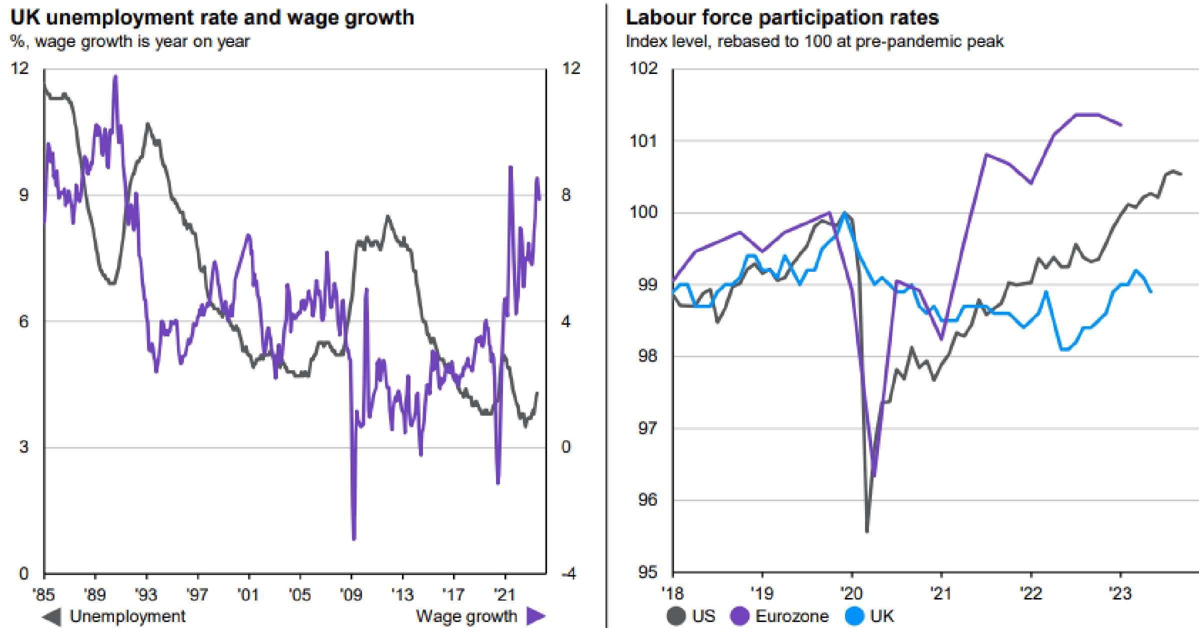


Source: - JPMAM 16th November 2023

Chart 7 below shows how wage growth in the UK is now above headline inflation despite a softening in the employment numbers, the right hand graph shows how Labour participation rates have not shown a meaningful recovery beyond pre-covid levels. This suggests that it will take another year for core inflation to fall provided wage growth stabilises at the current level or more people are encouraged to join the workforce.

I have not changed my view that the period of low inflation and interest rates following the global financial crisis (GFC) is behind us. I expect inflation rates could return to levels we were more familiar with before the GFC and this will also result in a return to higher 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 November 2023

Central Banks

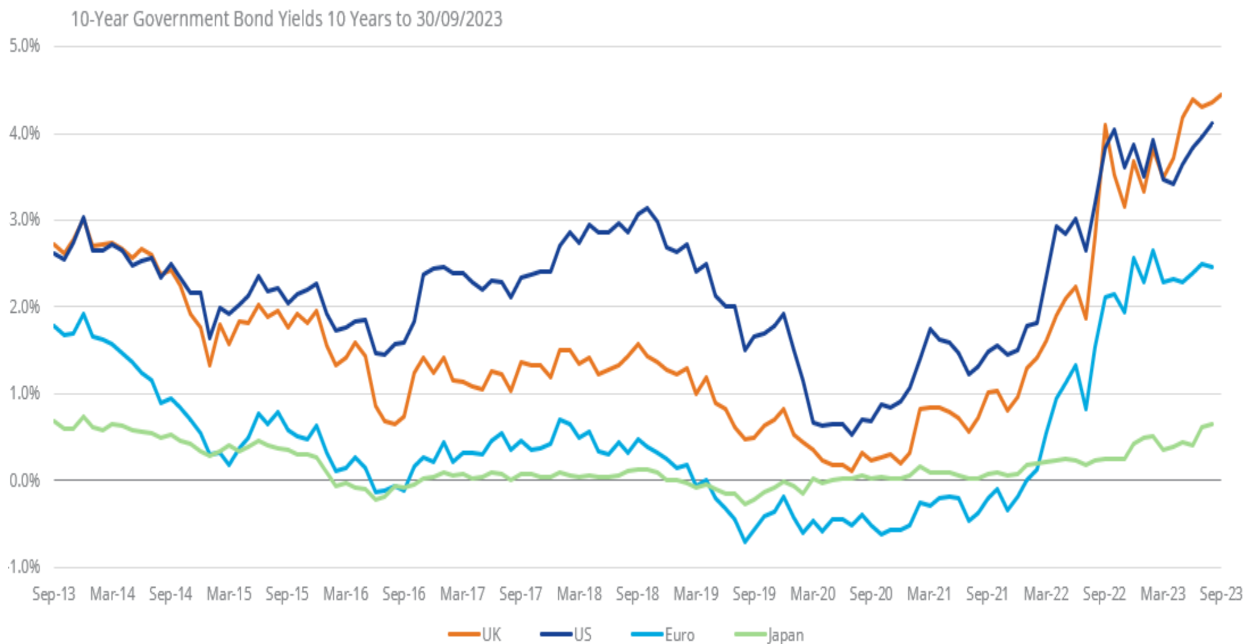
The continued moderation is the rate of inflation has encouraged the Fed to keep interest rates at 5.5% since July. They have maintained their hawkish stance and have stated that they remain willing to increase rates if needed. The ECB raised rates by 0.25%, in September to 4.5%, but made no change at its October meeting. The BoE raised rates by 0.25% in August to 5.25% and like the Fed has left them unchanged. At its October meeting the BoJ announced that 10 year government bond yields will be allowed to rise to an upper bound of 1%, rather than a ceiling and that it would not defend this level through monetary policy. In other words, 10 year JGB yields will be allowed to find a clearing level defined by the market rather than the BoJ. This is another step on the way to the end of ZIRP in Japan and brings forward the decision to increase official overnight rates from -0.1% to zero or even a positive level. When this happens, I believe it could mark a turning point in the flow of cash out of Japan and over time have a globally significant impact on the cost of money.

As explored in my last report I do not believe the central banks have sufficiently tightened monetary policy to cause a deep recession, but the risks of recession and stagnant growth have increased. Provided we do not get any surprises on the trend of inflation we may not see any further interest rate increases. However, I do not believe we will see any rate cuts for at least twelve months in other words until the core rate of inflation moderates.

The Peoples Bank of China, (PBoC), cut rates from 3.8% in March to 3.45% in August but left rates unchanged at its October meeting. Earlier in the month it had significantly eased policy through a medium term lending facility aimed at supporting banks exposed to the domestic property market. The PBoC also made it clear that it was ready to provide support to tackle “unexpected challenges and changes”.

Government bonds

Chart 8: - Government bond yields, last 10 years.



Source: - Bloomberg

Chart 8 above shows the 10 year government bond yields for the major developed markets for the last 10 years to the end of September. In October yields increased to a peak of 5% in the US, 4.7% in the UK, 2.9% in Germany and 0.95% in Japan on stronger than expected economic data and fears of a widening of the crisis in the Middle East following the upsurge in the Israel / Hamas conflict. Since then, yields have fallen back to the levels show above as central banks decided not to raise rates for a second time, raising optimism that the tightening cycle may be over. While growth has continued to upward surprise, Jobs data has been slightly weaker and the trend of falling headline inflation has been maintained, even if the rate of core inflation has remained sticky.

As suggested in my last report the bearish flattening of the yield curve has continued even if the pace has slowed recently. I believe yields may have entered a sideways range roughly between 4% and 5% for the US and the UK, with the yield dependent on economic data and market sentiment around central bank policy. I have not changed my mind about the impact of supply, the end of yield curve control in Japan, or that interest rates will be higher for longer than expected. For me the main driver of falling rates and bond yields will be lower and more stable rates of core inflation and that is still about 6 to 12 months away. If the consensus forecast for growth in 2024 turns out to be wrong and economies fall into recession, this could pull forward rate cuts and deliver strong returns from government bonds. But I would attach a low probability to this outcome and even if rate cuts were brought forward, they would probably be quite small.

Government bond yields have become 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 still be at the low

end of expected returns, but it should also be remembered that unlike equity the income is almost guaranteed.

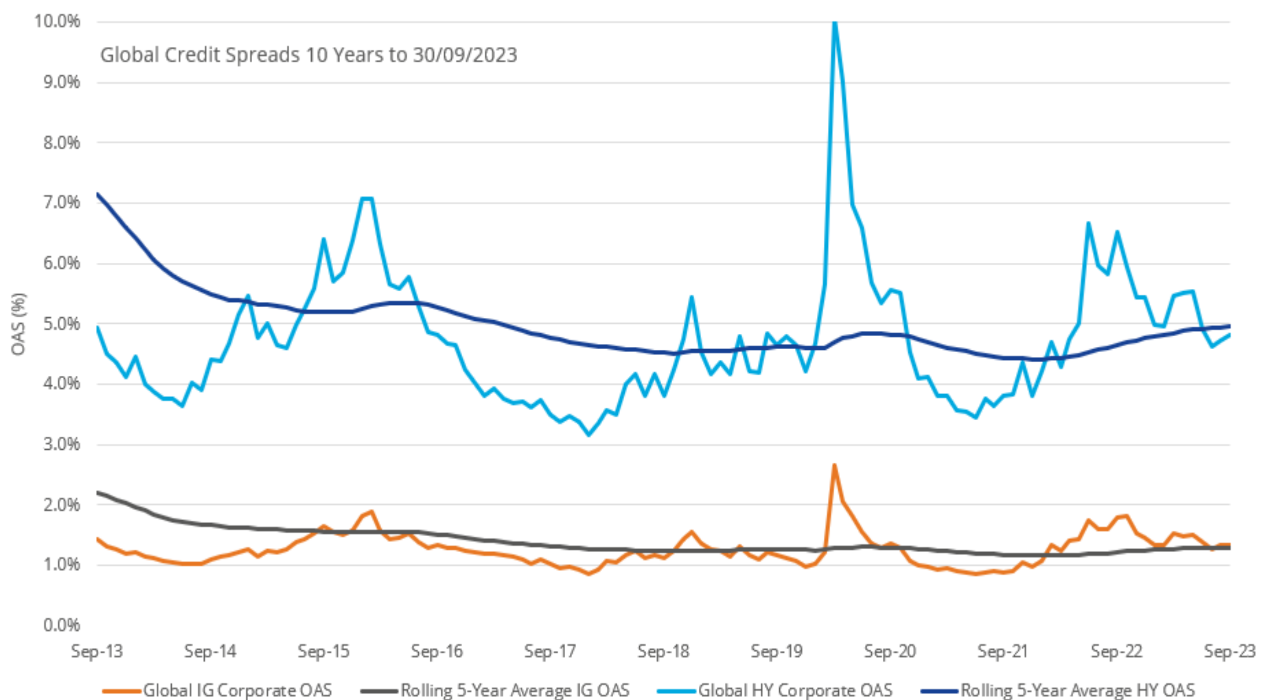
Non-government bonds

Chart 9 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 but given the recent moves in government yields mentioned above, they have widened even though the total yield has fallen slightly.

I still believe the total yield of investment grade non-government bonds is high enough to compensate for their interest rate sensitivity and are probably cheap enough to maintain the Fund's exposure. I also believe that high yield bonds and loans owned as part the Multi-asset Credit allocation can deliver good returns. But if we are close to the end of the interest cycle in the short term higher duration government bonds could outperform in the short term. Non-government bonds have much lower interest rate sensitivity (duration), but much higher yields, and those assets which have floating rather than fixed coupons, can continue to benefit from higher short term interest rates and 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 have increased the risk of default especially for more leveraged parts of the economy. If the consensus growth forecasts turn out to be wrong and economies experience a recession then in the short term this asset class could underperform as the risk of higher defaults is priced in by the market. However, over the medium term I still expect Multi-asset Credit funds, with their mix of low duration bonds and floating rate loans, to provide good returns, as the key to success with this asset class, is picking managers with the skill to avoid defaults.

Chart 9: - Credit spreads, extra yield over government bonds, last 10 years.



Source: - Bloomberg

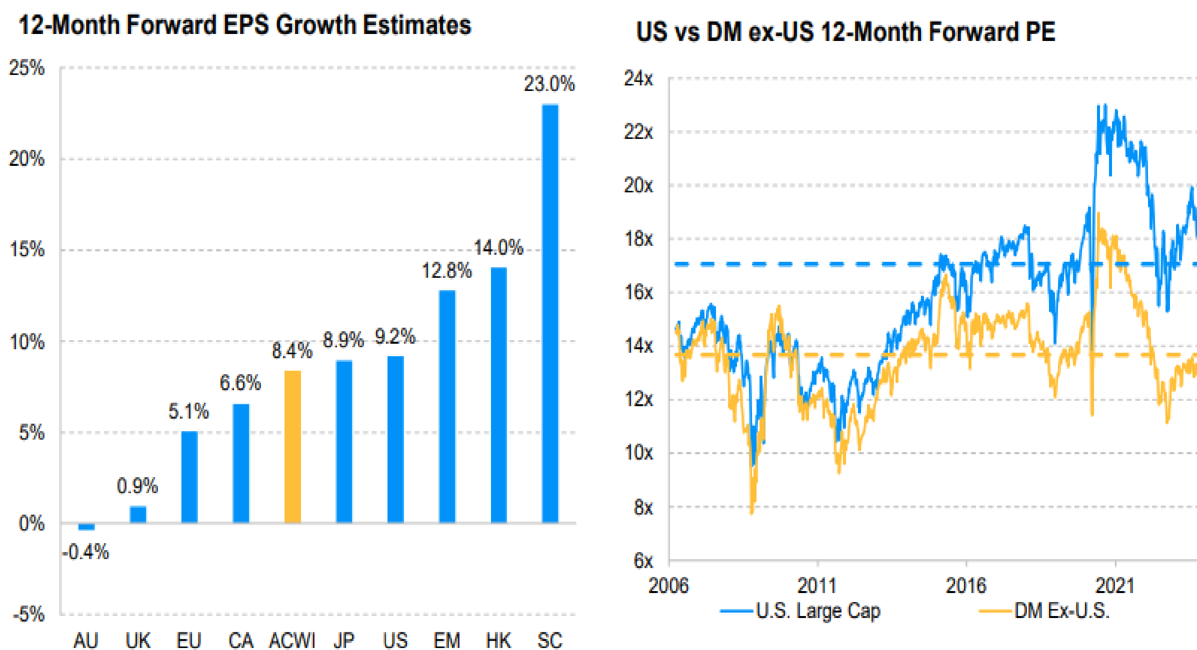
Equities

Over the quarter most equity markets moved sideways in a fairly wide range, but in October they sold off sharply as the prospect of 'higher for longer' rates hurt equity multiples and the Israel-Hamas conflict dampened risk appetite. In November markets have recovered their composure with better performance as economic data was slightly weaker and the central banks did not raise rates as feared in October. Like the bond markets, equity markets have become more sensitive to data releases and fears of central bank activity.

In my last report I wrote about the extreme valuation of the Magnificent 7 and the narrowness of the market leadership performance since March. This is still present as can be seen in the right hand graph of chart 10 below. Where the forward P/E for the US large cap sector is still elevated and well above its long run average as shown by the dashed line. However, the rest of the developed world looks only just in line with its long run average. The left hand graph shows selected country and regional 12 month forward earnings per share estimates. The earnings estimates look reasonable but given the interest rate and economic outlook not hugely attractive, especially when compared to valuations and the fact that over 65% of the global equity (ACWI) earnings will be expected to come from the US. Earnings forecast for emerging equity (EM) looks better than for global equity but even here a lot of hope is pinned on Chinese company earnings (SC) which make up around 30% of the emerging index and again P/E valuations do not look especially cheap.

I believe equity markets could struggle to deliver the strong returns we have become used to from here especially as there is greater competition for capital and bond and cash yields offer a lower risk source of returns. I have covered the outlook for equity markets in more detail in section 4 of this report.

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



Source: - JPMAM November 2023

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GDP

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

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

% CHANGE YOY								
	2023				2024			
	AUGUST		NOVEMBER		AUGUST		NOVEMBER	
	Consensus	**AF**	Consensus	**AF**	Consensus	**AF**	Consensus	**AF**
US	1.6	**2.0**	2.2	**2.2**	0.5	**1.0**	0.9	**1.0**
UK	0.1	**0.5**	0.4	**0.5**	0.4	**0.5**	0.3	**0.5**
Japan	1.2	**1.5**	1.9	**2.0**	1.0	**1.0**	0.9	**1.0**
EU	0.7	**1.0**	0.5	**0.5**	1.3	**1.5**	1.0	**1.0**
China	5.5	**5.0**	5.0	**4.5**	4.8	**5.0**	4.4	**4.0**
SE Asia	4.2	**4.0**	4.0	**4.3**	4.6	**5.0**	4.5	**4.5**

Source: - Consensus Economics October 2023

The consensus forecasts for GDP growth in 2023 have again been revised higher in October as actual growth outcomes have been better than expected. This growth continues to be supported by consumers who have continued to spend their savings, but consumption is also being supported by tight labour markets, higher earnings and now by falling energy prices and falling headline inflation which in recent reports show that wages are now increasing in real terms. While the outlook for growth remains anaemic, with outcomes in the UK and Europe oscillating around zero Japan and the USA seem to be growing relatively strongly. I have decided to stick with my above consensus estimates for GDP growth for this year and next as I believe growth may 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 while nearer to their peak in this cycle may stay higher for longer than the markets currently expect.

The Chinese economy expanded by an annual rate 4.9% in Q3 2023, beating market forecasts of 4.4% and offering hope that it will meet the official annual target of around 5% this year. The property market has become a major drag on the economy and it is likely to take several years to work through the excess inventory. This has required sustained stimulus from government to offset the impact, not helped by a period of weak growth in international trade. The 4.9% growth rate was lower than the 6.3% achieved in Q2, which was supported by a bounce back from strict lockdown measures in 2022.

The advance estimate showed that the US economy grew at an annualised 4.9% in the third quarter of 2023, the highest rate since the fourth quarter of 2021 and well above the 2.1% expansion in Q2. The expansion in growth was broad based. Consumer spending rose 4%, led by consumption of housing and utilities, health care, financial services and insurance, food services and accommodation and nondurable goods, recreational goods and vehicles. Exports soared +6.2%, rebounding from a -9.3% fall in Q2 and imports also increased +5.7% compared to -7.6%. Private inventories added 1.3% to

growth, the first gain in three quarters. Residential investment increased for the first time in nearly two years and government spending also increased at a faster rate. Growth fell in non-residential investment for the first time in two years, mainly due to a fall in equipment purchases. The annual growth rate was 2.9%.

The United Kingdom's second quarter economic growth was confirmed at +0.2%, following an upwardly revised expansion of +0.3% in the first quarter of 2023. Household consumption rose by 0.5% driven by spending on housing, water, electricity, gas, transport, and recreation and culture. Fixed investment increased by 0.8% mainly due to an increase in business investment, and government consumption expenditure rose by 2.5%, mainly reflecting higher spending on public administration and defence, and to a lesser extent, on health. On the other hand, net trade contributed negatively to GDP as exports dropped by -0.9% and imports rebounded by +2.2%.

Preliminary estimates showed that growth in the Euro Area fell by -0.1% in the third quarter of 2023, the result was worse than an upwardly revised +0.2% increase in the second quarter. This was the first quarter of negative growth since 2020. Among the bloc's biggest economies, GDP shrank in Germany -0.1%, stalled in Italy and rose modestly in France +0.1% and Spain +0.3%. Year-on-year, the economy advanced a meagre +0.1%. The ECB expects the Euro Area economy to grow +0.7% in 2023, as tighter financial conditions and higher prices slow domestic demand, the ECB noted that foreign demand remains subdued and the industrial sector continues to contract, especially in Germany. The ECB have forecast that GDP growth is expected to pick up to +1% in 2024 and +1.5% in 2025.

The Japanese economy expanded by 1.2% in Q2 of 2023, compared with a downwardly revised 0.8% increase in Q1. Capital spending and private consumption were both weaker in the second quarter and government spending was unchanged. Positive contributions came from net trade as exports rebounded and imports fell for the third quarter in a row. The economy grew by 1.6% in the last year.

Consumer Price Inflation

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

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

% CHANGE YOY								
	2023				2024			
	AUGUST		NOVEMBER		AUGUST		NOVEMBER	
	Consensus	AF	Consensus	AF	Consensus	AF	Consensus	AF
US	4.1	**3.5**	4.1	**3.5**	2.6	**2.6**	2.6	**3.0**
UK	7.4	**7.0**	7.4	**7.0**	3.2	**3.5**	3.1	**4.0**
Japan	2.9	**2.5**	3.2	**2.5**	1.7	**1.5**	2.2	**2.5**
EU	6.3	**6.0**	6.1	**6.0**	2.9	**3.0**	3.0	**3.0**
China	1.0	**1.0**	0.6	**0.6**	2.1	**2.1**	1.7	**1.5**
SE Asia	3.6	**3.6**	3.6	**3.6**	2.8	**2.8**	2.9	**2.5**

Source: - Consensus Economics October 2023

The consensus forecasts for inflation in November have not changed materially in all developed economies for both 2023 and 2024, however Chinese inflation has been marked down presumably reflecting the impact of the deflationary consequences of the domestic Property market. I expect inflation in 2024 to be lower than it will be in 2023, but I am happy to stick with my above consensus expectations, because as mentioned above, growth although anaemic may be stronger than expected. Tight labour markets, rising real incomes 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. Falling headline inflation now means that cash has a real cost and it 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.

China's consumer prices remained unchanged in September 2023 from a year earlier, following a 0.1% rise in the previous month. The latest data indicated persistent deflationary pressures in the world's second-largest economy, raising concerns about the sustainability of the economic recovery due to sluggish demand. Food prices dropped, driven by a steep decline in pork prices, but non-food inflation accelerated slightly driven by price increases in clothing, housing, health and education. The annual core inflation rate, which excludes food and energy prices, remained unchanged at +0.8%.

The US inflation rate remained steady at 3.7% in September 2023, as a softer decline in energy prices offset slowing inflationary pressures in other categories. The decline in the growth rate of headline inflation components was fairly broad based but insufficient the change the rate as energy costs were more or less unchanged. Core CPI, which excludes volatile food and energy prices, slowed to 4.1%, marking its lowest reading since September 2021.

The inflation rate in the United Kingdom remained stable at 6.7% in September 2023, holding at August's 18-month low. Lower price increases in food and non-alcoholic beverages, furniture and

household goods, were offset by a smaller decline in energy costs on the back of a monthly rise in motor fuel costs. The core inflation rate, which excludes volatile items such as energy and food, dropped to 6.1%, reaching its lowest level since January 2023.

Preliminary estimates showed the inflation rate in the Euro Area declined to 2.9% year-on-year in October 2023, reaching its lowest level since July 2021. October's data was helped by a sharp fall in energy costs and the rates of inflation also eased for food, alcohol, tobacco and non-energy industrial goods, however services inflation remained relatively stable. The core rate, which filters out volatile food and energy prices, also declined to 4.2% in October, marking its lowest point since July 2022.

The annual inflation rate in Japan fell to 3.0% in September 2023 from 3.2% in August, the lowest reading since September 2022. Price increases eased for furniture & household utensils, clothes, and culture & recreation. Energy costs fell with the prices of fuel, light, and water charges falling due to lower electricity and gas prices. By contrast, food prices, housing and transport costs increased. Core inflation rate dropped to a 13-month low of 2.8%.

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 November 2023.

Table 6: - Interest rate and Bond yield forecasts

%	CURRENT	MARCH 2024	SEPTEMBER 2024
UNITED STATES			
3month SONIA	5.64	5.75	5.75
10 year bond yield	4.44	4.75	4.50
UNITED KINGDOM			
3month SONIA	5.38	5.50	5.50
10 year bond yield	4.09	5.00	4.75
JAPAN			
3month SONIA	0.07	0.25	0.25
10 year bond yield	0.73	1.00	1.25
GERMANY			
3month SONIA	3.94	4.25	4.25
10 year bond yield	2.58	3.5	3.25

Source: - Trading Economics; 17th November 2023

The central banks have paused, deciding not to increase rates at the last 2 meetings in the case of the US Fed and at the most recent meetings of the ECB and the BoE. However, all 3 have emphasised that at the moment this is just a pause while they await further data on the impact of rate increases on the economy, inflation, jobs and wages. Headline inflation continues to decline, but as I have mentioned before core inflation and not yet started to fall. In the US economic growth has turned out to be stronger than expected, while in Europe and the UK it oscillates around zero and jobs and wage growth also remains mixed. There are some signs of a weakening labour market in the "high frequency" data but despite this, there is still robust wage growth. With workers now managing to achieve increases which, because of lower headline inflation are positive in real terms, which at the margin has improved their spending power.

As can be seen from the table above I believe there is a reasonable chance that we could see 1 further rate increase in this cycle. But unlike the markets which are still clinging to the idea of this being followed almost immediately by significant rate cuts, I see rates stable at the highs for some time before possibly starting a slow decline in 2025. As I have mentioned before the era of ZIRP is behind us and even the BoJ have started to respond by allowing 10 year JGB yields to rise.

While long dated (beyond 15 year) UK gilt and linkers yields continue to trend higher, between 5 and 10 years they have moved sideways in a range between 4.25% and 4.75% since my last report and shorter dated yields have started to fall, following the recent central bank rate decisions.

More importantly for the global direction of bond yields the trend in US increases on all points of the yield curve “seems” to have come to an end with the second pause by the Fed. I believe this could herald the beginning of a period of consolidation in government bond markets and a more mixed period of returns with yields moving up and down in a sideways range, driven by economic data and announcements from the central banks.

As mentioned above the yield of long dated UK Gilts continues to trend higher and the real yield available from Index Linked Gilts also continues to increase making them more attractive as a Protection asset, but as mentioned before for various reasons this trend may have further to go before these bonds become cheap. Non-government bonds continue to outperform government bonds due to the lower interest rate sensitivity, some degree of spread compression and as mentioned before the “all in yield” for corporates remains attractive.

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	4.28	9.2	0.5	-3.5	-0.3
All Stocks Linkers	0.83	14.4	0.5	-7.0	-6.4
Global IG Corporate	5.37	5.8	0.5	-1.5	+2.5
Global High Yield	8.60	3.4	0.5	-0.6	+6.9

Source: - ICE Indices 17th November 2023

Bond Market (Protection Assets) Recommendations

I suggest that the Fund sticks with its current allocation to Protection assets and remains neutral investment grade corporate bonds. The extra yield spread available from corporate bonds has

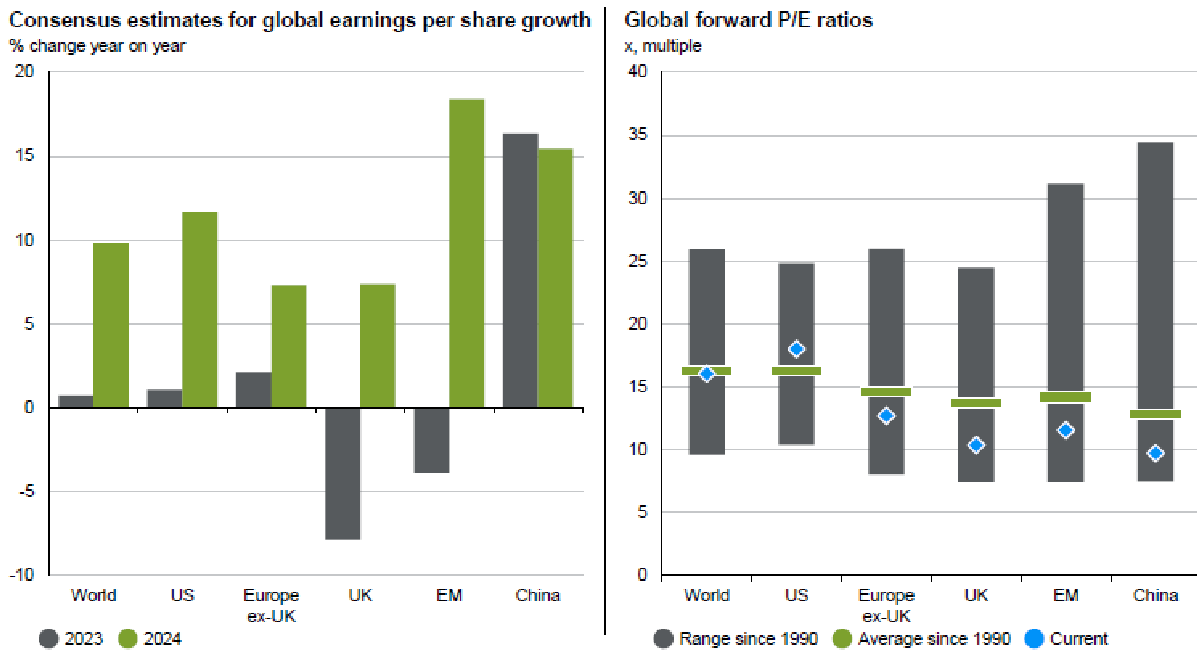
narrowed slightly since my last report, but it remains wider than it has been for some years and the total yield remains attractive.

Given that I believe the outlook for returns from Government bonds is mixed it may be worth increasing the duration of the Fund's allocation to fixed interest gilts from underweight to neutral. However, as I have mentioned before Gilts and Index Linked Gilts in particular remain expensive and I am more pessimistic about the longer-term fall in demand and potential increased supply. Since my last report the real yield of 20 year Linkers has been volatile but it has increased by 0.25% to around +1.3%, from around -2%, 18 months ago.

Equity Markets

On chart 11 below, the left hand graph, shows the consensus earnings per share growth estimates, for 2023 and 2024. The right hand graph 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 11: - LHS - Earnings per Share estimates, RHS - Price/Earnings Ratios, since 1990, China 1996



Source: - JPM Asset Management, October 2023

The left-hand graph of chart 11 shows the new earnings expectations for 2023 and 2024. Since July analysts have moved their earnings expectations slightly higher for the world in aggregate and the US and more negative for the UK and Emerging markets in 2023, despite the better than expected macroeconomic performance experienced year to date. China's expected earnings have been revised down significantly reflecting its sluggish post lockdown recovery and the ongoing problems in the

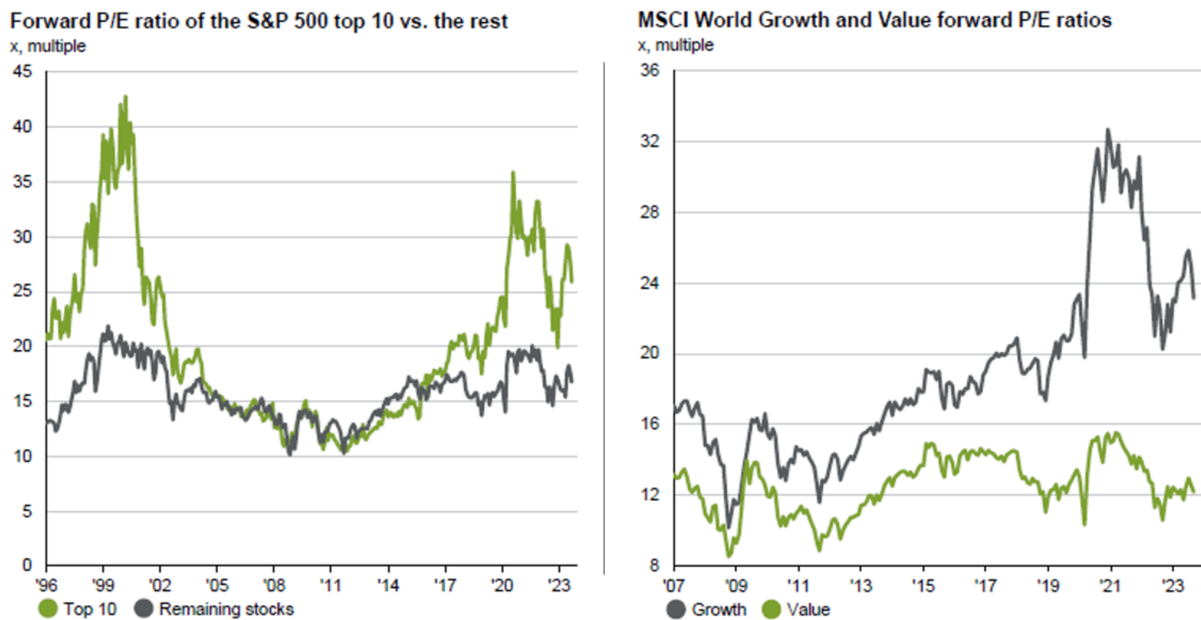
domestic property market. Other than the UK, which have been revised slightly higher and China which have been revised down, other regional earnings estimates for 2024 have been left more or less unchanged.

The updated right-hand graph shows the valuation of regional equity markets using P/E ratios, all of which appear to have fallen since July. This is because in local terms equity markets are lower but also earnings outcomes have been broadly better. These two factors have slightly reduced the overvaluation of the US market in particular and as a result the World index. It remains the case that other regional market valuations appear relatively (even more than last quarter) attractive.

In my last report I wrote about the extreme overvaluation of the "magnificent 7" and how the performance of these "growth" stocks had dominated the performance of the US and global market indices in the first half of 2023. As can be seen in the left-hand graph of chart 12 below the valuation of the top 10 stocks in the S&P 500, which contains all these stocks, has fallen somewhat. Equally the right-hand graph of chart 12 shows the valuation of the "growth" stocks in the MSCI World index, which also contains these companies, has also fallen. However, in each case these companies' valuations have distorted the performance of the US and global indices, suggesting a further correction compared to the rest of the global equity market is required.

This can be achieved either by their prices falling or the rest of the market catching up. Given the more broad-based demand for capital in other areas of the economy, the opportunities provided by fixed income markets and the likelihood that interest rates remain higher for longer, the business plans of these growth companies may come under closer scrutiny and any disappointment with delivery is in my opinion the more likely to lead to a correction of the imbalance.

Chart 12: - S&P 500 – LHS P/E valuation of the top 10 versus the rest of the market; RHS – P/E valuation of "growth" and "value" stocks in the MSCI World indies.



Source: - JPM Asset Management. October 2023

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 remains attractive. 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 increasingly funded using net sales from the indirect 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 indirect 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 18th August and 17th November 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.

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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 18TH AUGUST 2023	ANTHONY FLETCHER 17TH NOVEMBER 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