Appendix 2

MJ HUDSON Allenbridge

First Quarter 2024 Investment Report

PREPARED FOR:

Derbyshire County Council Pension Fund: Pensions and Investment Committee Meeting

JUNE 2024

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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 5th June 2024
Date of paper 17th May 2024

1. Market Background (First quarter 2024)

In broad terms the key central bank indicator, headline inflation, moved sideways in the first quarter of 2024 thereby undoing all the optimism of the fourth quarter on the possibility of early cuts in central bank interest rates. The US Fed, ECB and the Bank of England (BoE) left rates unchanged over the whole period. Growth in the US also surprised to the upside just as growth in the UK and Europe disappointed. The UK was confirmed as being in technical recession in the second half of 2023, although preliminary data suggests that the UK returned to growth in the first quarter of 2024.

Growth and inflation in China showed continued weakness in the first quarter despite the measures introduced to support a recovery in the property market. While domestic demand remains subdued, exports continue to recover with "western" governments now beginning to worry about the supply of Electric Vehicles and putting in place new tariffs on imports.

The ongoing war in Gaza had little direct impact on asset prices but it has underpinned commodity prices and increased the cost of transportation.

Falling government bond prices were the main asset casualty of the quarter as rates were not cut as had been expected. Non-government bonds delivered positive returns as spreads narrowed, shorter duration high yield bonds produced the best returns. Equity markets prices were generally higher on the benign outlook for inflation, better growth and higher earnings.

In local currency terms global equities returned more than 9%, with growth stocks again outperforming, value stocks. Japanese equity enjoyed the best returns, up over 20% in local currency and 11.6% in sterling terms, as the Bank of Japan (BoJ) ended its negative interest rate policy. Outside of the US and Japan other equity markets produced much smaller positive returns.

Energy prices generally increased in the first quarter, with crude oil prices increasing +13.6% reversing the 2023 calendar year decline of -10.3%. Natural gas prices were down more than -30% after sharp falls last year, driven lower by abundant supply, high inventories and another mild winter.

A further increase in the Middle East tensions helped Gold to new highs, despite the strength of the US dollar. The US dollar was stronger against its major trading partners including the UK pound, euro, Chinese yuan and especially against the Japanese yen.

I would not be surprised to see continued market volatility over the rest of the year with equity and bond prices just as likely to rise as to fall. Inflation remains the key central bank indicator and it now looks to me that central banks may not cut rates until the summer and that sticky core inflation and less favourable base effects will mean fewer cuts over the rest of the year. As we get into the third quarter central banks will also want to avoid accusations of political interference in the US and UK elections, so they may leave further rate changes until their mid-November meetings.

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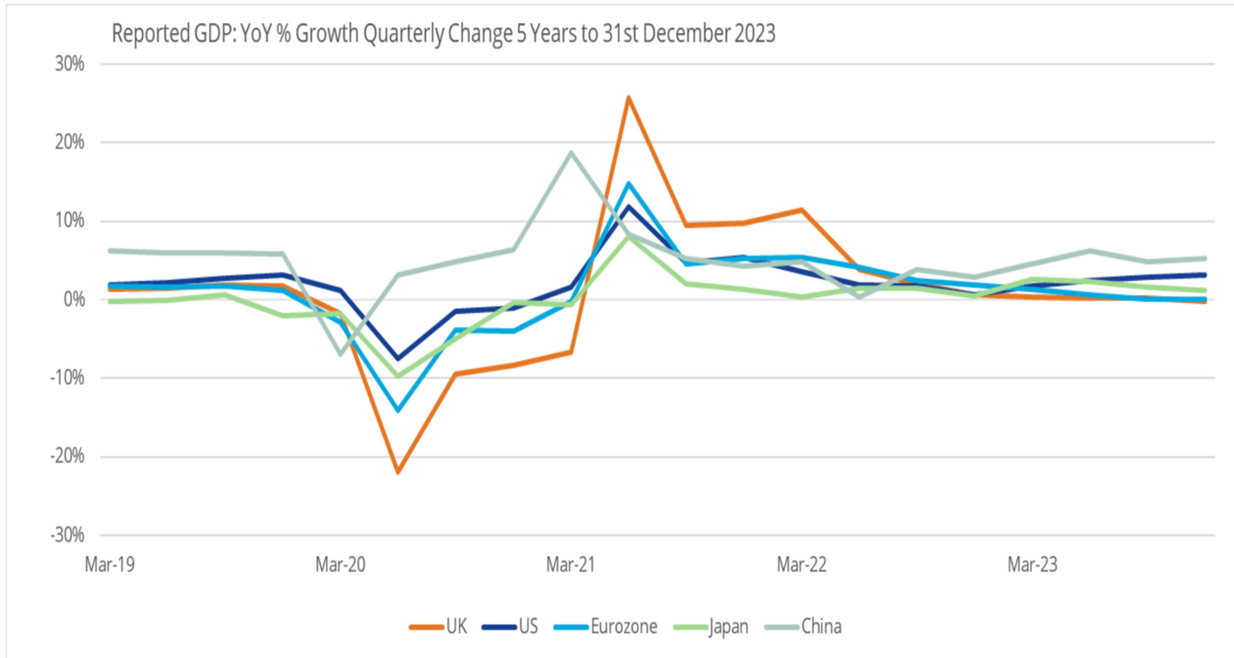
Chart 1: - Annualised rates of quarter on quarter GDP growth.



Source: - Bloomberg

Table 1, below shows the total investment return in pound Sterling for the major asset classes, using FTSE indices except where noted; for the month of April 2024 and the 3 and 12 months to the end of March 2024.

% TOTAL RETURN DIVIDENDS REINVESTED

	MARKET RETURNS		
		Period end 31st March 2024	
	April 2024	**3 months**	**12 months**
Global equity - FTSE – All World	-2.3	+9.3	+21.3
FTSE Regional indices			
UK All Share	+2.5	+3.6	+8.4
Japan	-3.9	+11.6	+22.3
Emerging	+2.4	+3.3	+5.8
UK Gilts - Conventional All Stocks	-3.2	-1.9	-0.5
UK Gilts - Index Linked All Stocks	-5.0	-2.5	-5.6
UK Corporate bonds*	-2.1	+0.2	+7.2
Overseas Government Bonds**	-1.7	-0.4	+1.8
UK Property quarterly^	-	-1.1	-2.7
Sterling 7 day SONIA	0.5	1.4	5.1

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

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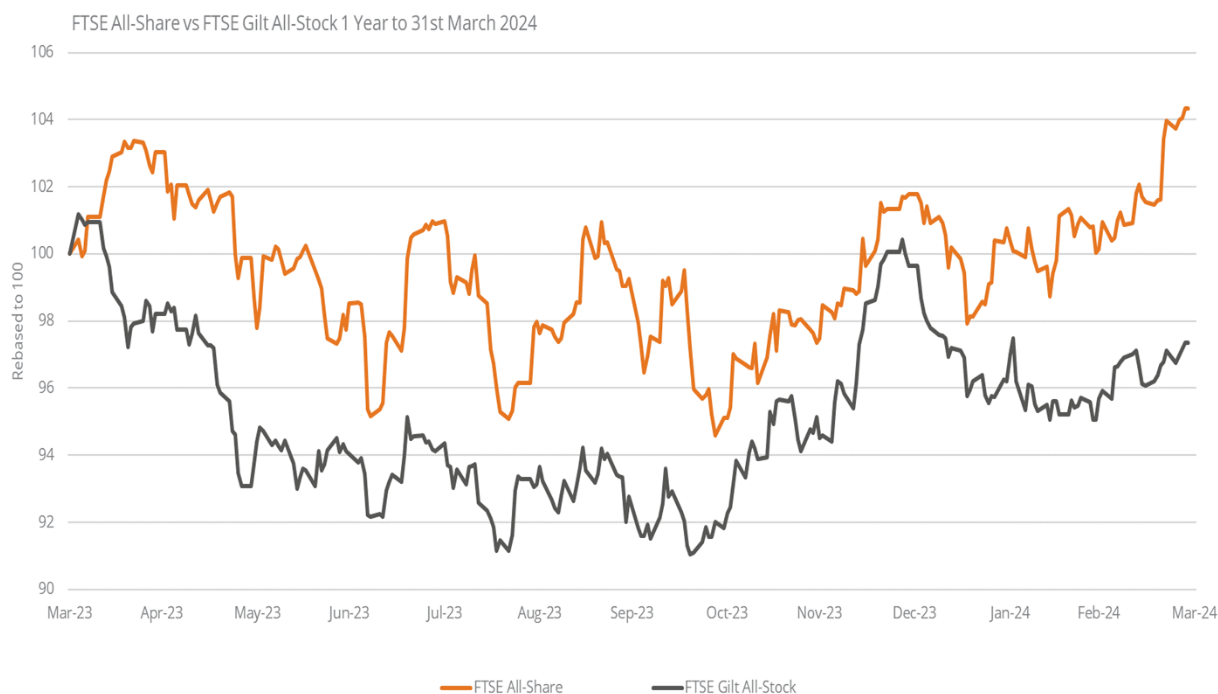
Chart 2: - UK bond and equity market returns - 12 months to 31st March 2024



Source: - Bloomberg

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

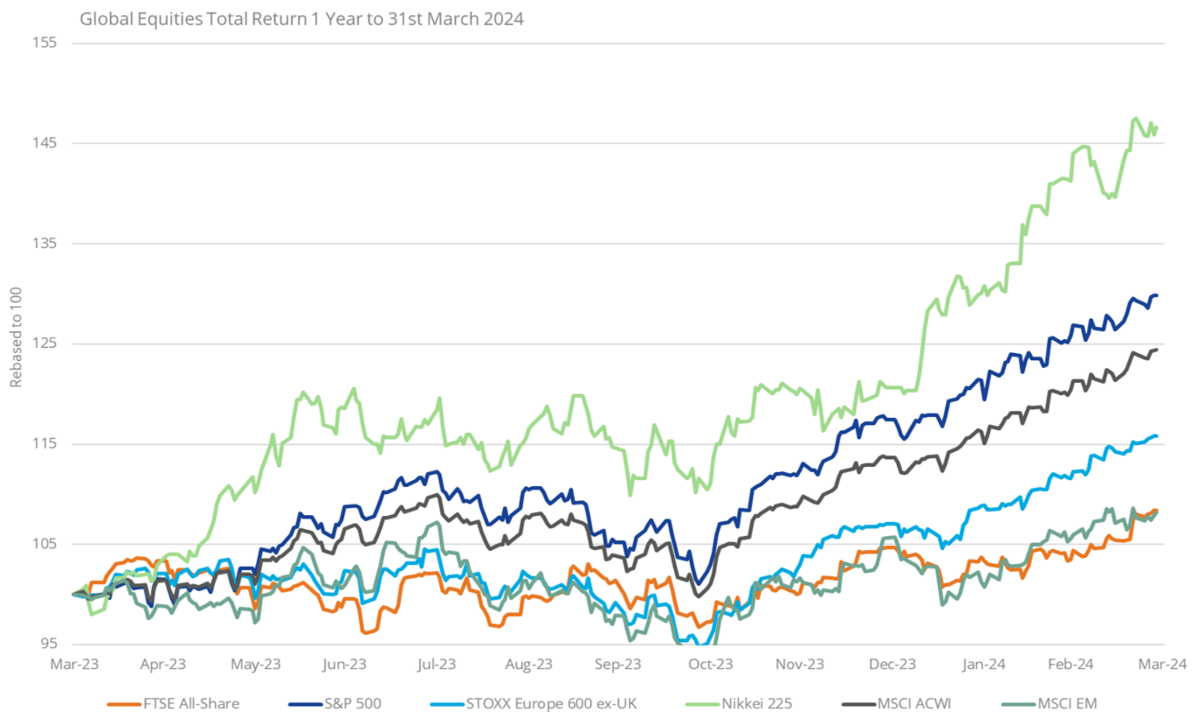
BOND MARKET % YIELD TO MATURITY	31st December 2023	31st March 2024	Quarterly Change %	31st March 2023	Current 17th May 2024
UK GOVERNMENT BONDS (GILTS)					
10 year	3.54	3.94	**+0.40**	3.49	**4.13**
30 year	4.14	4.43	**+0.29**	3.84	**4.66**
All Stocks ILG	0.51	0.65	**+0.14**	0.13	**0.75**
OVERSEAS 10 YEAR GOVERNMENT BONDS					
US Treasury	3.86	4.21	**+0.35**	3.38	**4.42**
Germany	2.03	2.29	**+0.26**	2.31	**2.52**
Japan	0.62	0.74	**+0.12**	0.22	**0.95**
NON-GOVERNMENT BOND INDICES					
Global corporates	4.66	4.85	**+0.19**	4.92	**4.99**
Global High yield	7.41	7.41	**0.00**	8.50	**7.45**
Emerging markets	6.54	6.56	**+0.02**	7.00	**6.63**

Source: - Trading economics and ICE Indices G0LI, G0BC, HW00, EMGB, 17th May 2024.

Chart 3: - UK Bond index returns, 12 months to 31st March 2024

Source: - Bloomberg

Chart 4: - Global equity market returns in local currency, 12 months to 31st March 2024



Source: - Bloomberg

Recent developments (April to 16th May 2024)

April saw a fall in the prices of both equity and bond markets. A combination of higher than expected US inflation and a GDP report that showed resilient private demand, fuelled market fears that central banks will not ease monetary policy as quickly as previously hoped. Higher commodity exposure indices and increased investor interest in low valued Chinese equities and helped emerging market and ironically UK indices deliver positive returns over the month.

A resilient economic environment and the danger of escalation in the Middle East boosted commodity prices. The Bloomberg Commodities Index increased 2.7% in April, ending the month as the top performing major asset class. A combination of rising energy prices, and lower interest rate sensitivity also supported the value segment of the equity market, which outperformed the growth segment on a relative basis. In a difficult month for equity, Europe and the UK outperformed the US. Stronger economic indicators and falling inflation helped to offset the headwinds of higher for longer interest rates and geopolitical risks.

Japanese equities gave up some of the gains that they had made over the last five months. Widening interest rate differentials between Japan and other developed market countries put downward pressure on the yen and increased investor concerns about the risk of imported inflation, weakening domestic demand and increased the risk of a BoJ interest rate increase.

In May reported inflation data has tended to be on the weaker side and commodity prices a bit lower, which has encouraged markets to become more optimistic for a rate cut especially in Europe, even speculating that the ECB and the BoE could act before the US Fed.

2. Investment Performance

The data presented in Table 3 below shows performance of the Derbyshire Pension Fund versus the Fund specific benchmark for the quarter and the year to 31st March 2024, as calculated by Northern Trust.

Based on the data below the Fund has slightly underperformed the strategic benchmark over the quarter and one year. The relative performance of Growth assets was primarily responsible for a negative contribution to overall Fund performance, but private market assets will have also contributed partly due to the lagged nature of their valuations. The combined total return of Protection assets produced a positive contribution to overall performance.

Table 3: - Derbyshire Pension Fund and Benchmark returns

% TOTAL RETURN (NET) 31ST MARCH 2024	3 MONTHS		12 MONTHS	
	Derbyshire Pension Fund	**Benchmark**	**Derbyshire Pension Fund**	**Benchmark**
Total Growth Assets	**6.9**	**7.4**	**14.1**	**16.3**
UK Equity	3.2	3.6	8.6	8.4
Japan	10.5	11.6	17.9	22.3
Emerging markets	2.6	3.3	1.9	5.8
Global Sustainable Equity	9.5	9.3	18.8	20.9
Global Private Equity	2.0	5.0	11.8	12.1
Total Protection Assets	**-0.5**	**-1.1**	**1.7**	**0.4**
UK & Overseas Government	-1.4	-1.6	+0.2	-0.1
UK & Overseas Inflation Linked	-1.3	-1.8	-4.7	-5.0
Global Corporate bonds	+0.9	+0.2	+8.5	+6.3
Total Income Assets	**0.0**	**0.8**	**4.6**	**4.4**
Multi-asset Credit	2.0	2.1	11.4	10.7
Infrastructure	-1.8	+1.8	+2.4	+7.1
Property (all sectors)	+0.7	-1.1	+1.3	-2.4
Internal Cash	0.0	0.0	0.5	1.1
Total Fund	**3.8**	**4.1**	**9.3**	**10.0**

Total fund value on 31st March 2024 £6,495 million

At the end of the financial year, I thought it would be worth looking at the Fund's return over longer periods of time net of fees and expenses. Over three years the Fund has delivered a total return of

4.44% per annum (p.a.), in line with strategic benchmark return of 4.45% p.a. Over 5 and 10 years and since inception the Fund has outperformed the strategic benchmark. Since the start of performance calculation in April 1987, the Fund has returned 8.11% p.a. outperforming the benchmark return by 0.31% on average each year.

Over these longer time horizons, it is also possible to see the benefits of asset class diversification, and the strategic and tactical asset allocation decisions taken. While growth assets have delivered high levels of return in most periods, it is the allocation to Private equity which has delivered the highest absolute and relative returns. Long term absolute returns from income assets are also above benchmark, helped by the direct property portfolio, and aggregate returns from the early adoption of Infrastructure and Multi-asset credit funds. As would be expected the protection assets portfolio has delivered the lowest returns, but the tactical positioning has added value in all periods.

Growth assets – Equity performance

The aggregate performance of growth assets in the first quarter and the year was lower than the strategic benchmark. Over three months all regional equity portfolios underperformed their benchmarks except Global sustainable equity which slightly outperformed. Over the year all the Fund's equity managers underperformed their respective benchmarks, except the UK.

Protection assets - Fixed Income Performance

The sell off in Government bonds over the quarter resulted in negative returns, whereas the continued narrowing of credit spreads enabled global corporate bonds to outperform and deliver a positive return. The Fund's defensive positioning in government bonds and neutral allocation to corporates enabled Protection assets to outperform the benchmark over the year.

Income assets – Property, Infrastructure and MAC

Over the quarter, the combined portfolio of income assets delivered a zero return and underperformed the benchmark. Over the year Income assets outperformed due to positive contributions from MAC and Property. Infrastructure returns were lower than the benchmark but as noted before this is mainly due to the lagged valuation of some of the assets in this allocation. Despite the underperformance of Infrastructure, the aggregate return of the Income asset component was positive and ahead of benchmark over twelve months.

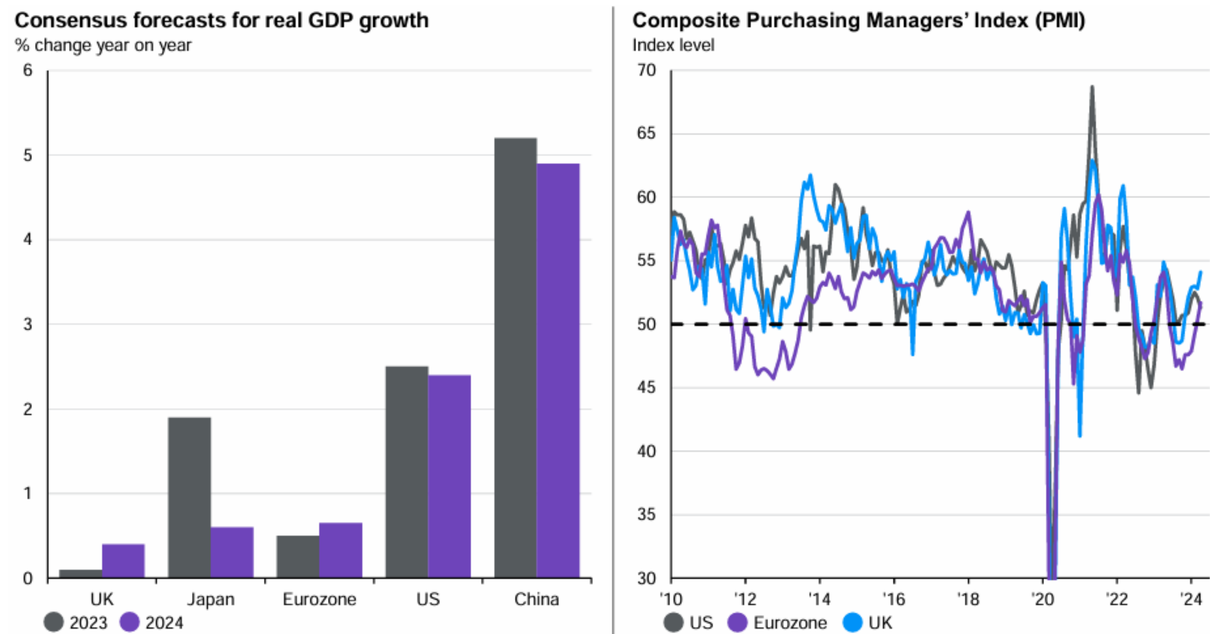
3. Economic and Market outlook

Economic outlook

As can be seen in Chart 5 below the most recent set of consensus GDP forecasts for 2024 have been revised up. As noted, before most of the drivers of economic activity remain positive. 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. As headline inflation continues to fall, cost pressures for businesses are stabilising and higher wages and interest income, are resulting in real increases in spending power. As forecast in my last reports composite PMI in all the major developed economic regions are now in positive / expansionary territory.

As suggested in previous reports the resilience of growth and sticky inflation, especially in the US has made it more difficult for the Fed, and to date they have been unable to justify a cut interest rates even though they have indicated they would like to. Some commentators have even suggested the Fed may have to increase rates. I still expect the next decision by the Fed will be to cut rates, probably before September to avoid being accused of political bias as the Presidential election campaign properly gets underway. The new question is, will the ECB and the BoE take the decision to cut before the Fed? It is increasingly possible that they could, as inflation could be within acceptable target ranges over the summer. The reason they may not is labour markets remain tight and core services inflation remains high. Also, just as in the US it is possible that headline inflation could tick up as nearly all the benefit of base effects from the previous year falls away, the BoE has suggested as much in its recent inflation report.

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



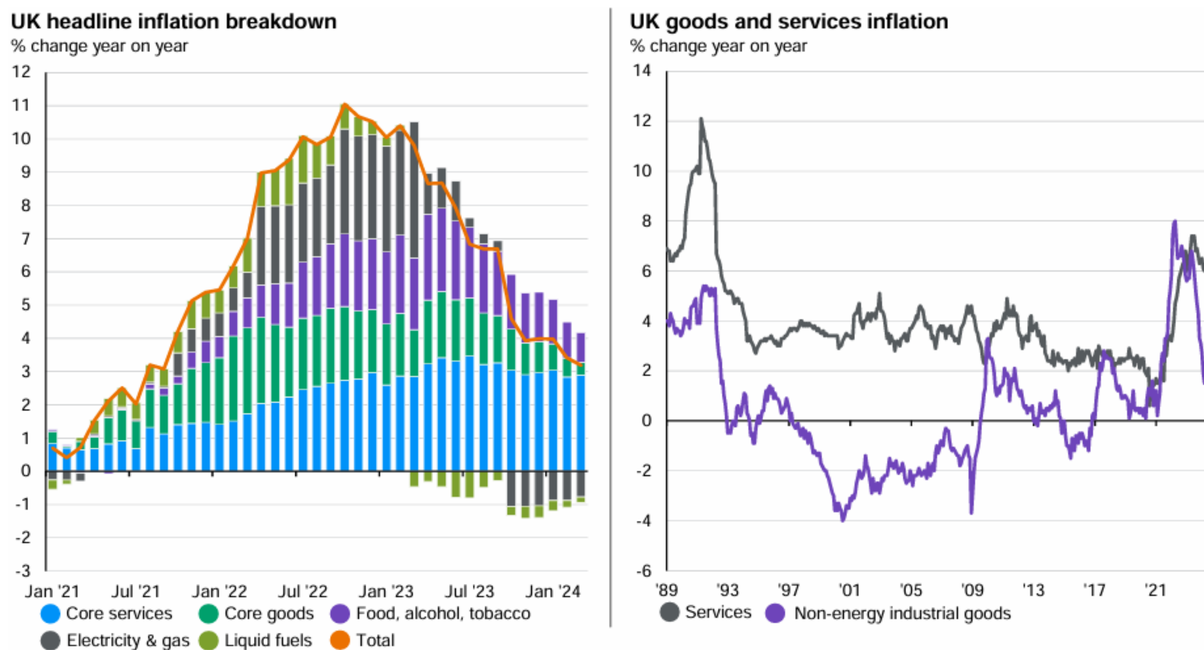
Source: - JPMorgan Asset management May 2024

Inflation

Inflation remains the key economic variable and the news on headline rates is good even though in recent months it has gone sideways in the US, UK and Europe after significant falls in the last twelve months. Core inflation is also falling but remains sticky, especially for services, in all regions and broadly for the same reasons, tight labour markets and higher wages, as the pale blue bars in the left hand graph of chart 6 below shows for the UK.

The left hand graph on Chart 6 shows in the orange line, that UK headline inflation has stated falling again and April's report is widely expected to be sharply lower due to the latest energy price cap reduction. The right hand graph shows core goods and services, while goods prices continue to fall, services inflation remains stubbornly high.

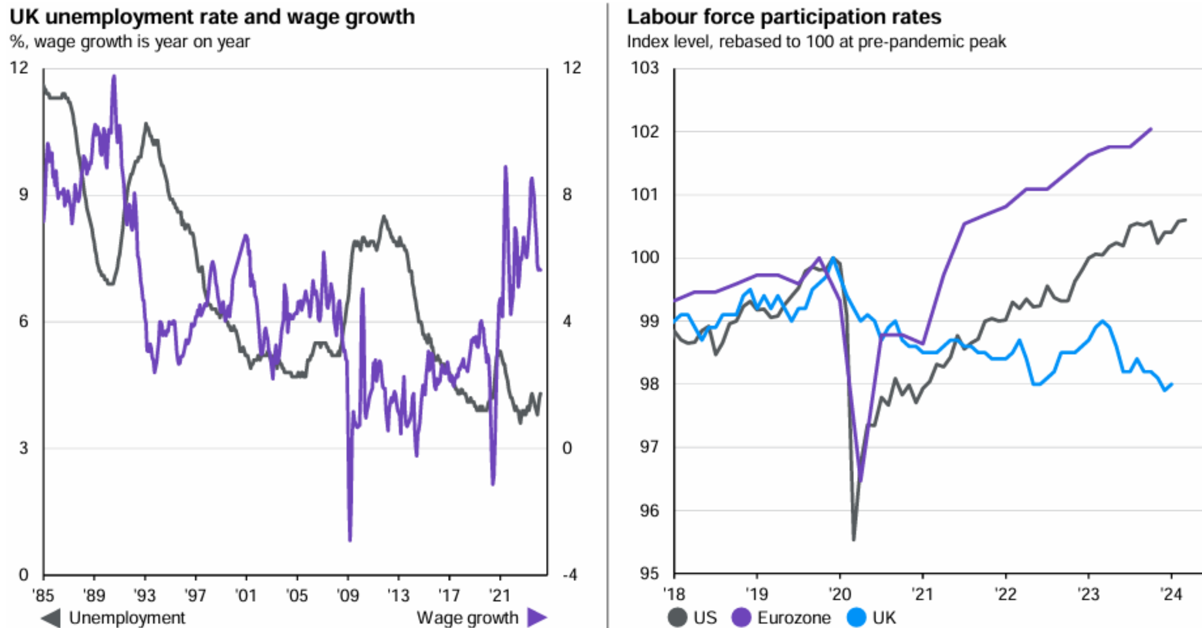
Chart 6: **-** UK headline and core inflation and the components of headline inflation.



Source: - JPMorgan Asset management May 2024

As can be seen in the purple line of the left hand graph on Chart 7 below, In the first quarter of 2024 wage growth in the UK has softened from over 8% but it remains high at around 6%, and unemployment the black line ticked up to 4.3% but remains close to a 30 year low. As mentioned before this labour market tightness is underpinning the stubbornly high rate of core services inflation. But for the first time in many years this means employed people are seeing real increases in income, and this should support increased consumption and maybe stronger overall growth in the economy. The right hand graph on Chart 7 shows Labour participation rates and it suggests that in the UK even fewer people in the working age population, ie those aged between 16 and 64, are active in the labour market. If these "inactive" people were to return to the workforce it could further ease the pressure on inflation.

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



Source: - JPMAM May 2024

Central Banks

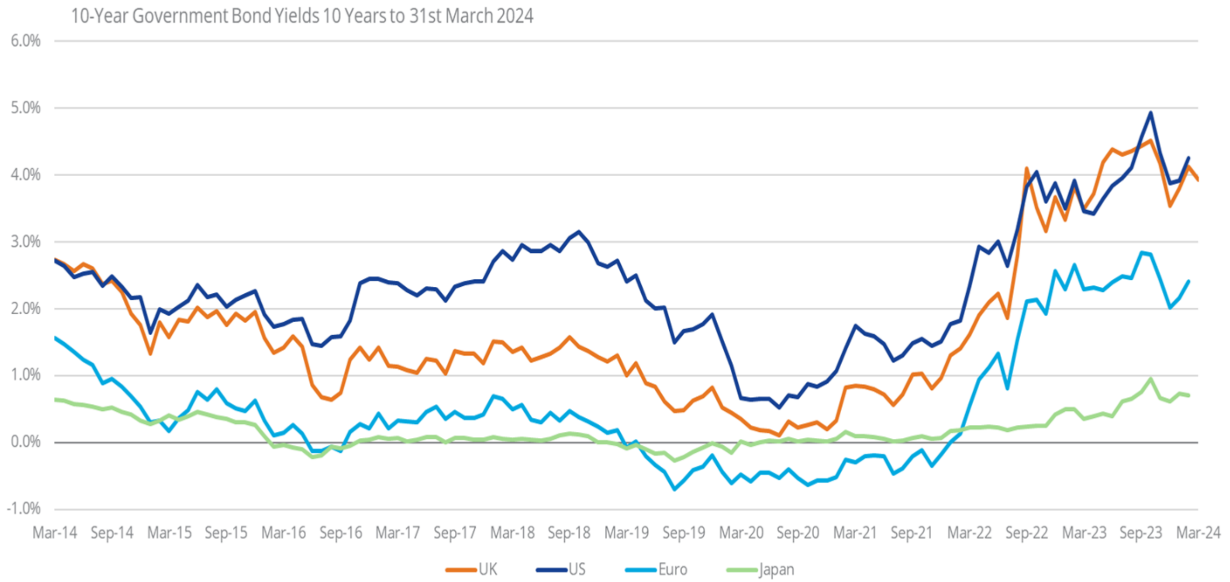
In my last report I suggested there was no urgent need for central banks to cut interest rates and indeed, this has proved to be the case, growth is OK, monetary and fiscal conditions are easy and employment strong. Inflation remains the key driver for decision making. The US has seen headline inflation tick up slightly even as core inflation continues to fall. In the UK and Europe headline inflation has continued to fall, but these regions are about to enter the same period of less positive base effects that has kept US inflation higher than expected. I said I expected rates to fall but not by much and the markets seem to have also discovered this may be the outcome. As mentioned, before I believe central banks will continue to take the opportunity to sell assets accumulated during QE and even the Bank of Japan is now actively considering increasing the bank rate and slowing the pace of bond purchases as it responds to higher growth and inflation.

The upcoming US Congressional and Presidential elections present a challenge for the Fed, in the past they have tried to not change rates during the campaign "proper" for fear of being accused of political interference. With Mr Trump as a candidate this is a given! Hence the Fed has the dilemma of when it should cut. The ECB and the BoE have both signalled that they are much closer to cutting rates but while it is not unheard of, it is still a rare event for them not to co-ordinate monetary policy decisions with the Fed.

The People's Bank of China (PBoC) maintained their easy policy stance established earlier in the year, as it responds to the domestic property slump. New measures announced to support the weak housing sector include, PBoC funding of State Oened Enterprises to buy finished, unsold housing for conversion into public housing. They also announced further deregulation of finance for the sector including lowering the deposit required to buy your first home and removing the floor on the rates charged by banks for mortgages.

Government bonds

Chart 8: - Government bond yields, last 10 years

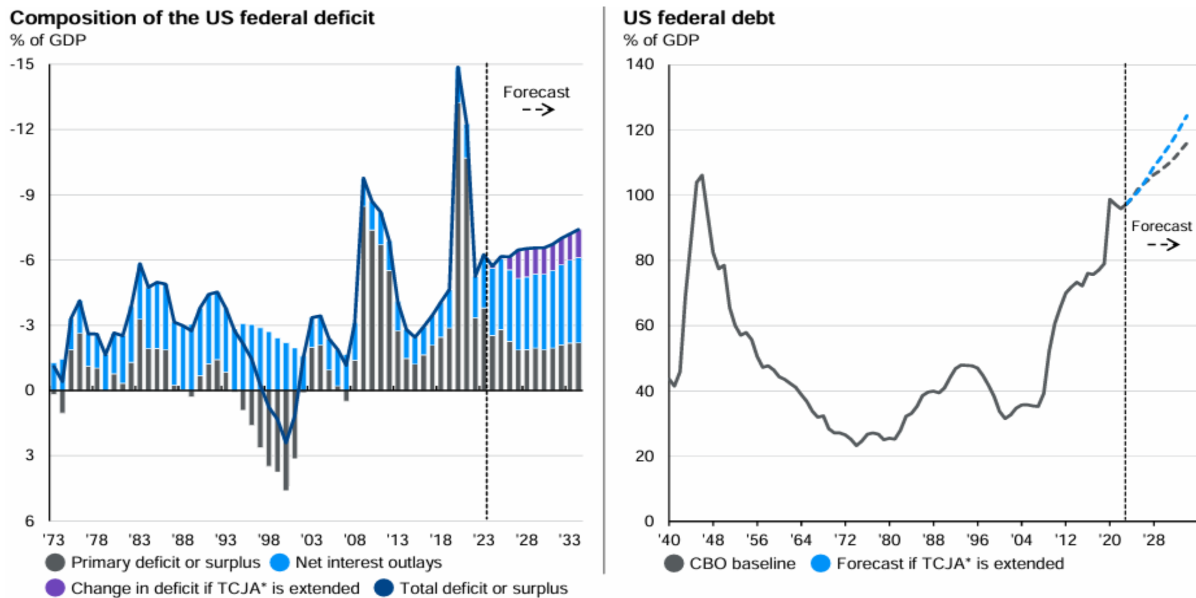


Source: - Bloomberg

As Chart 8 above shows 10 year government bond yields for the major developed markets all increased during the first quarter as optimism around the pace and size of rate cuts evaporated due to higher than expected growth and inflation.

Government bonds remain highly sensitive to inflation data, but the sideways range, I suggested for 10 year bonds does seem to have become established. It is also noticeable that yield curves are continuing to steepen, especially for inflation linked government bonds. Markets are talking more frequently about high budget deficits, the huge stock of outstanding government debt, the increased cost of financing the debt and the apparent lack of any government plans to reduce the debt burden.

Chart 9: - US Federal deficit and total Federal debt as a % of GDP.



Source: - JPMAM May 2024

Chart 9 above shows forecast for the US Federal deficit and debt as a % of GDP, based on current levels of expenditure and the cost of financing it in the pale blue bars. The picture is similar in the UK and Europe and is multiples higher in Japan. Without more growth or a commitment from governments to reduce spending, government bond markets could face a buyers strike or bouts of volatility, especially if new administrations do not present credible plans that address these issues.

The yield of government bonds if held to maturity has become more interesting after years of being extremely low 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. Government bonds also provide some protection against falling equity market values.

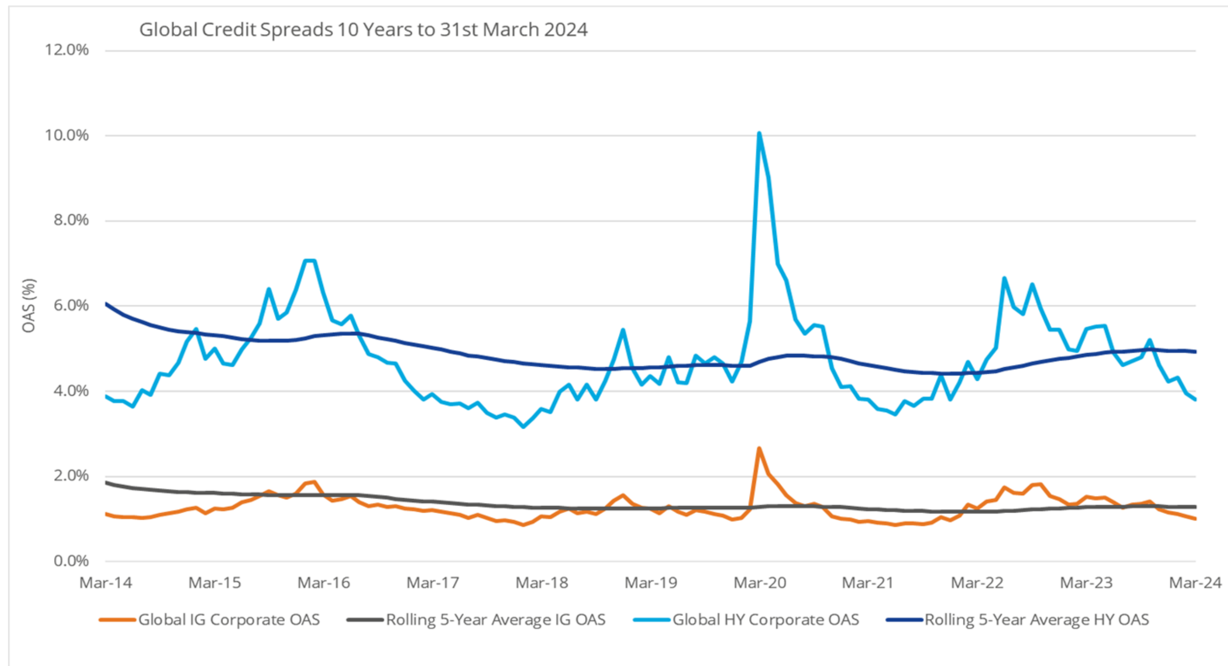
Non-government bonds

Chart 10 below, shows the excess yield spread for both investment grade non-government and high yield bonds to the end of the quarter. As can be seen from the chart spreads narrowed over the quarter and even as government yields have risen year to date, spreads have fallen further, outperforming duration equivalent government bonds in both directions.

This has in the short term at least made non-government bond look more expensive on a relative value basis, indeed as the chart below shows both investment grade and high yield bond spreads are below the five year moving average. However, over the medium term they could still be attractive compared to a few years ago as they have lower duration and a higher total yield than government bonds.

I still expect Multi-asset Credit funds, with their mix of low duration bonds and floating rate loans, to provide good income based returns, provided our managers continue to avoid defaults.

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



Source: - Bloomberg

Equities

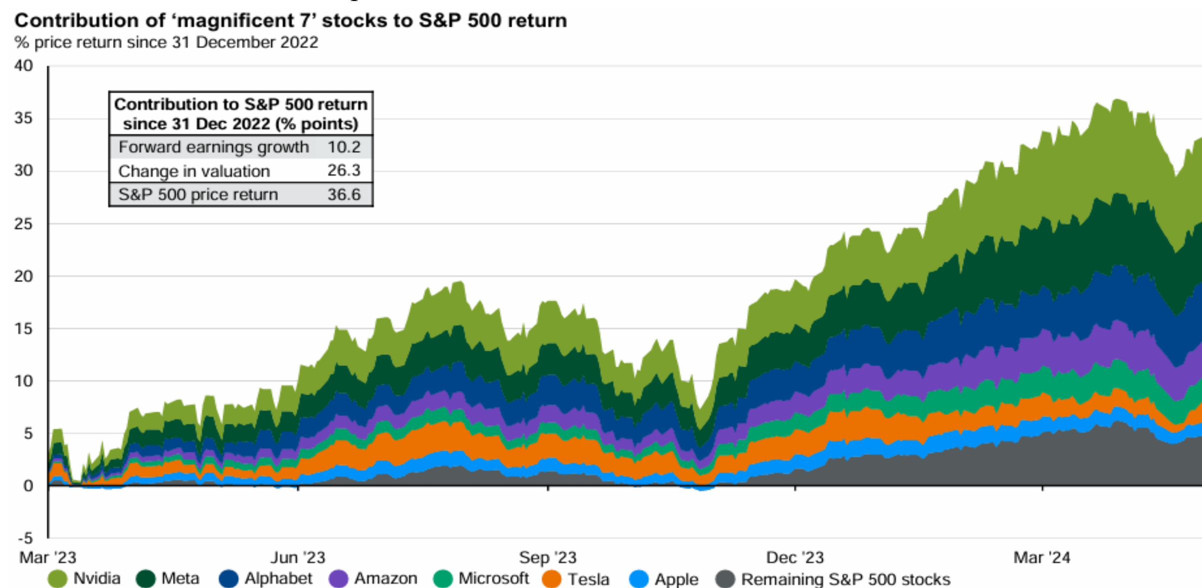
Equity markets rallied strongly over the quarter led by global and Japanese indices despite the less optimistic outlook for rate cuts. At the end of March Japanese, US and Global indices again recorded new all time highs. These markets did however suffer a brief correction in April as US GDP and inflation data surprised to the upside and re-introduced the idea of a rate hike or an extended period of no cuts in rates.

In the first quarter, markets like the UK, Europe and China continued to struggle, but in April falling inflation data and dovish comments from the ECB and BoE, increased the markets expectations for a rate cut in the UK and Europe, possibly before the US Fed. Despite this short term relative performance, the UK and European indices are still more than 30% cheaper than the US, as can be seen in chart 13 of this report. Chart 14 also flags up that small-cap equity has not participated in the rally for some time and is also relatively cheap. If the cycle of increased interest rates has come to an end, small-cap equity has in the past been a beneficiary outperforming larger cap equity. The weakness of Chinese property market continues to weigh on performance, domestic investors who dominate activity neither have the cash or the leverage they used to have and international investors have become more cautious about investing in China.

Despite my caution on the continued narrowness of the markets rally and the extreme valuation of some companies, equity markets remain strong as the macro-economic outlook seems benign. But as recent price performance has shown markets remain vulnerable to negative surprises at both the macro level and at the individual company level. Companies that disappoint are seeing sharp negative moves in their share prices. The US first quarter company earnings reports are due any day now, it will be interesting to see what happens.

Chart 11 below, shows the contribution of the Magnificent Seven to the price performance of the S&P 500 index since the beginning of 2023. While the index price change has been 36.6%, 26.3% of this came from change in valuation and only 10.2% from actual earnings, and the other 493 stocks in the index contributed less than 5% of the total return.

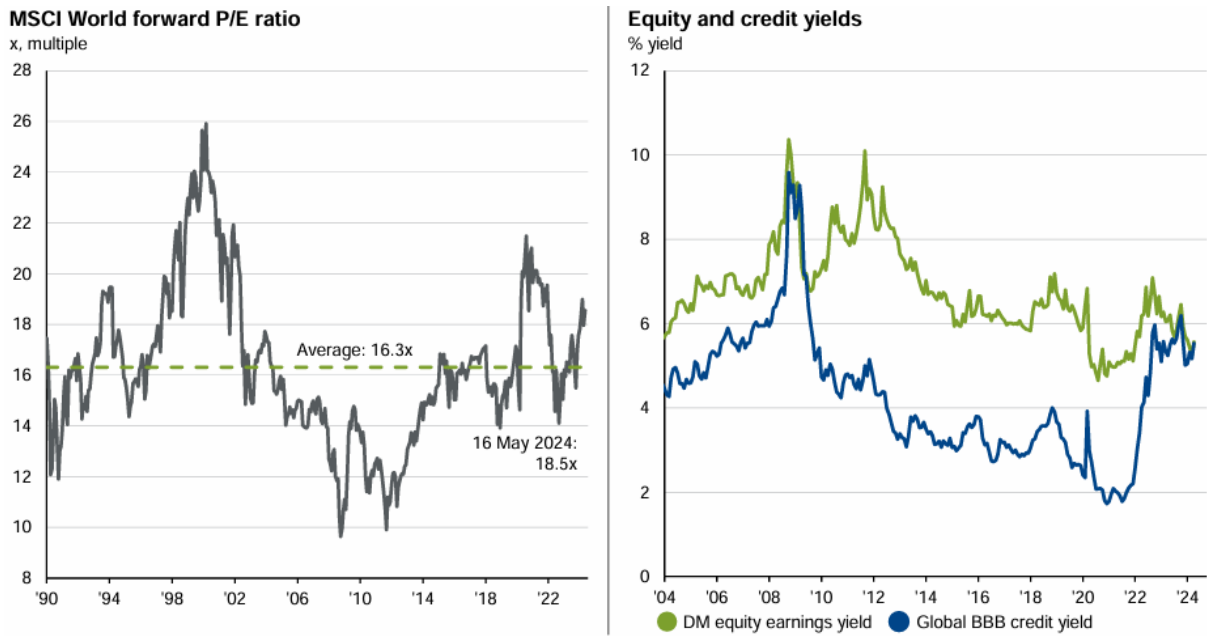
Chart 11: - Contributions to performance of the S&P 500.



Source: - JPMAM 30th April 2024

Chart 12 below, the left hand graph shows the forward P/E ratio of the MSCI World index, is currently at 18.5x compared to the average since 1990 of 16.3x. Later, in section 4 of this report on charts 13 and 14, it can be seen, that there may be pockets of value elsewhere, but the P/E ratios shown on chart 12 suggest to me that global equity is expensive and this is largely due to the magnificent seven. The right hand graph on chart 12, points to the competition for capital I have mentioned before in my reports. Investment grade corporate bonds with a BBB credit rating are not the safest fixed income assets to invest in but they do have lower volatility and interest rate sensitivity than equity and fixed coupons rather than variable dividends as a source of income.

Chart 12: - World equity valuations.



Source: - JPMAM 16th May 2024

Based on the above analysis in the short to medium term I believe US and global equity markets are overvalued and vulnerable to disappointment from a macro-economic and company specific point of view, therefore I am comfortable for the Fund to remain underweight growth assets.

GDP

Table 4 shows the consensus forecasts for GDP growth in calendar 2024 and 2025 in April and my expectations in January and May 2024.

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

% CHANGE YOY								
	2024				2025			
	JANUARY		MAY 2024		JANUARY		MAY 2024	
	Consensus	**AF**	Consensus	**AF**	Consensus	**AF**	Consensus	**AF**
US	1.4	**2.0**	2.3	**2.5**	1.7	**2.0**	1.7	**2.0**
UK	0.2	**0.3**	0.3	**0.5**	1.0	**1.2**	1.2	**1.4**
Japan	0.8	**1.0**	0.6	**1.0**	1.0	**1.2**	1.2	**1.4**
EU	0.9	**1.1**	0.8	**1.0**	1.7	**2.0**	1.6	**1.8**
China	4.6	**5.0**	4.7	**5.0**	4.3	**5.0**	4.4	**5.0**
SE Asia	4.5	**4.7**	4.4	**4.6**	4.6	**4.8**	4.6	**4.8**

Source: - Consensus Economics April 2024

Consensus estimates for US and UK growth in 2024 have been revised slightly higher and slightly lower in 2025, the estimates for Europe are slightly lower in both years and in Japan lower in 2024, higher in 2025. Interestingly, given the weakness of China property sector, growth estimates are slightly higher. I am again comfortable to suggest growth will be higher than consensus pretty much globally as it seems to me that economies are not being slowed further by the level of interest rates and with inflation much more under control central banks can respond with lower interest rates if needed.

The Chinese economy grew by 5.3% yoy in the first quarter of 2024, after growing at a slightly lower rate of 5.2% in the fourth quarter of 2023. The recovery in growth was supported by continued stimulatory measures from Beijing and spending related to the Lunar New Year festival. In the first quarter, fixed investment grew by 4.5%, the highest level for more than a year and the statistics agency said the economy had made a good start, delivering a strong foundation for achieving the GDP growth target of around 5% this year. March data showed that industrial output and retail sales rose less than estimated, underscoring the need for continued policy easing measures. Unemployment remains a concern with an overall jobless rate of 5.2% in March, and a youth unemployment rate of over 21%.

The advance estimate showed that the US economy grew at an annualised rate of 1.6% in the first quarter, compared to the 3.4% annualised rate achieved in the fourth quarter of 2023. Slower consumer spending was the main reason, while services spending increased it was not enough to offset the decline in goods consumption. Non-residential investment in buildings slowed but this was partly offset by higher spending on equipment and intellectual property products. Government spending was also lower. In terms of trade, exports slowed sharply and imports soared. Private

inventory investment also slowed, while residential investment jumped by more than 10%, suggesting that the housing market is climatising to the higher level of interest rates.

The UK economy recovered from its technical recession in the fourth quarter of 2024. Preliminary estimates of GDP show the economy expanded 0.2% year-on-year in the first three months of 2024, recovering from a revised -0.2% decline in the fourth quarter of 2023. The recovery was driven by a rebound into positive territory in the growth rate of services consumption and industrial production, both of which declined in the fourth quarter. Not surprisingly given the wetter than usual winter, construction activity remains in recession. On the expenditure side, public spending increased but household consumption, business investment and trade were all lower.

Preliminary estimates showed that the Euro Area economy grew by +0.3% in the first three months of 2024, recovering from a -0.1% contraction in each of the previous two quarters. Growth in Europe's largest economies, most notably Germany rebounded into positive territory after weak growth in the second half of 2023. Growth in France and Italy also expanded at a faster pace. The Spanish economy along with many of the smaller European countries saw continued strong growth. The European Commission now forecasts 0.8% growth for 2024, driven by a steady rise in consumer spending and improved trade, although investment growth appears to be softening.

The Japanese economy grew by 1.9% in the year to the end of 2023, almost double the 1% growth rate seen in 2022. The continued expansion was broad based driven by increases in public and private, residential, and non-residential investment, and net trade. Helped by the weaker Japanese yen, exports increased, but imports were also lower. Notwithstanding the overall stronger growth for the year, the economy did fall into a technical recession in the second half of 2023 with negative growth rates of -0.2% in each of the third and fourth quarters. In terms of US$ value, the depreciation of the yen has moved the economy into 4th place and Germany into 3rd place globally.

Consumer Price Inflation

Table 5 shows the consensus forecasts for Consumer Price Inflation in calendar 2024 and 2025 in April and my expectations in January and May 2024.

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

% CHANGE YOY								
	2024				2025			
	JANUARY		MAY		JANUARY		MAY	
	Consensus	AF	Consensus	AF	Consensus	AF	Consensus	AF
US	2.6	**3.0**	2.9	**3.1**	2.3	**2.5**	2.2	**2.5**
UK	2.7	**3.0**	2.5	**2.3**	2.2	**2.0**	2.2	**2.0**
Japan	2.2	**2.4**	2.4	**2.2**	1.5	**1.3**	1.8	**1.6**
EU	2.7	**2.9**	2.6	**2.4**	2.2	**2.0**	2.1	**1.9**
China	1.2	**0.8**	0.8	**0.6**	1.7	**1.5**	1.6	**1.4**
SE Asia	2.8	**2.6**	2.6	**2.4**	2.6	**2.4**	2.6	**2.4**

Source: - Consensus Economics April 2024

Outside of the US where consensus forecasts for inflation in 2024 have increased between January and May, the consensus estimates for inflation rates in 2024 and 2025 have fallen slightly in all economies. As mentioned last time, I expect inflation in 2024 to be lower than it was in 2023, but I am happy to stick with my above consensus expectations, in 2024 and probably in 2025 because I remain confident that, growth although anaemic may be stronger than expected. Tight labour markets, rising real incomes and the willingness of consumers to spend increasingly on services may also be another factor that could keep core inflation higher for longer than expected.

China's annual inflation rate rose to +0.3% in April 2024, the third monthly report in positive territory after six months of deflation between July 2023 and January 2024. Non-food inflation increased the most with prices for clothing, housing, health, and education all higher. Transport costs also increased reversing recent declines and some local governments increased utility prices. Food prices continued to fall, marking the 10th consecutive month of decrease. Core consumer prices, which exclude food and energy prices, increased by +0.7% yoy in April, up from +0.4% in January. The Chinese Producer prices index remains at -2.5%, the nineteenth month of deflation.

US headline inflation has been in a range of 3.1% to 3.5% since October last year with the last 2 data points at the top of this range driven by higher energy and transportation costs. In April the rate fell slightly to 3.4% after increasing by 3.5% in March. The rate of food and shelter inflation slowed and the prices of new and used cars fell at a higher rate. Core inflation also slowed to a pace of 3.6% the lowest level since April 2021.

Headline inflation in the UK fell to 3.2% year-on-year in March 2024 down from 3.4% February. The rate for April is widely expected to fall sharply maybe even as low as to 2% because of adjustments to the Energy price cap and base effects from 12 months ago. The level in March was the

lowest rate since September 2021. The main contributions came from lower food price inflation, and slightly lower price increases for restaurants and hotels, recreation and culture, the cost of housing also continued to decline. Transportation prices slightly increased, ending the recent trend of falling prices especially of motor fuels. The annual core inflation rate, which excludes volatile items such as energy and food, dropped to 4.2%, the lowest rate since December 2021.

The annual inflation rate in the Euro Area was confirmed at 2.4% in April 2024, the same as in March, and holding at levels not seen in nearly three years. A year ago, the inflation rate was 7%. The rate of increase for services and non-energy industrial goods slowed slightly and the prices for energy continued to decline. Prices of food, alcohol and tobacco rose slightly more. The core rate which excludes energy, food, alcohol & tobacco, fell for a 9th straight month to 2.7%, the lowest level since February 2022. In its Spring 2024 Economic Forecast, the European Commission said it expects inflation to fall to 2.1% in 2025.

The annual inflation rate in Japan fell to 2.7% in March 2024 from February's 3-month peak of 2.8%. The slower pace of price increases was broad based, transport, clothes, furniture & household utensils, healthcare, communication, and culture & recreation, all saw smaller price increases. Inflation was stable for food, housing, education, and miscellaneous. The pace of falling Energy prices slowed and the government confirmed that energy price subsidies will fully end in May. The core inflation rate fell to 2.6%.

4. The outlook for the securities markets

Bond Markets

In table 6, below I have set out my expectations for 3 month SONIA interest rates and benchmark 10 year government bond yields, over the next 6 and 12 months. They are not meant to be accurate point forecasts, more an indication of the possible direction of yields from May 2024.

Table 6: - Interest rate and Government bond yield forecasts

% Yield to maturity	Current	September 2024	March 2025
United States			
3month SONIA	5.58	5.25	4.50
10 year bond yield	4.42	4.30	4.25
United Kingdom			
3month SONIA	5.30	5.00	4.50
10 year bond yield	4.13	4.10	4.00
Japan			
3month SONIA	0.28	0.50	0.50
10 year bond yield	0.95	1.00	1.25
Germany			
3month SONIA	3.81	3.75	3.25
10 year bond yield	2.52	2.40	2.30

Source: - Trading Economics; 17th May 2024

In my last report I said it was looking increasingly likely that central banks may begin cutting interest rates in the Summer of 2024. I remain confident that over the 6 and 12 month forecast time horizon central banks will have started cutting rates. While there appears to be some caution in the US because, growth has been stronger than expected and inflation, while substantially lower than a year ago, remains higher than expected. The ECB and the BoE seem to be more optimistic about being able to cut rates soon as inflation seems to be falling faster than expected and growth remains lacklustre.

Year to date the US interest and bond markets have been forced to revise their rate cutting expectations and some participants have started worrying about another US rate hike. As a result, government bond yields have risen and returns have been negative. From here onwards the bond markets will also begin to focus on the US and UK election cycles and the impact these may have on borrowing and budget deficits.

As suggested in my last report I expect government bonds to trade in a range around their current levels. Unless there is a full blown recession, energy prices are unlikely to fall much further, and full employment and higher costs is keeping pressure on core inflation. I am also concerned about the

high levels of government debt and the cost of financing it, as this should lead to higher long term rates and further steepening of yield curves.

Year to date Gilts have been volatile and currently yields are higher than they were at the time of my last report. Real yields are also higher and yield curves are much steeper than 12 months ago. Because I believe these two trends remain in place, I would not suggest increasing exposure to protection assets at this time.

Once again, all the recent volatility was mainly expressed in government bond yields with non-government bonds outperforming government bonds, leaving spreads narrower than they were at the time of my last report. As noted before non-government bonds have lower interest rate sensitivity, but as chart 10 above shows investment grade and especially high yield spreads have narrowed significantly and are below the 5 year average. This makes them less attractive in the short term, but the "all in yield" for corporates remains attractive and as table 7 below suggests, high yield bonds remain attractive in a rising yield environment provided the default rate doesn't increase significantly.

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.

Table 7: - Total returns from representative bond indices

Bond Index	Yield to maturity %	Duration years	Yield increase %	Holding period, total return %	
				3 Months	12 Months
All Stock Gilts	4.3	9.2	0.5	-3.5	-0.3
All Stocks Linkers	0.8	12.4	0.5	-6.0	-5.4
Global IG Corporate	5.0	5.9	0.5	-1.7	+2.1
Global High Yield	7.5	3.2	0.5	+0.3	+5.9

Source: - ICE Indices 17th May 2024

Bond Market (Protection Assets) Recommendations

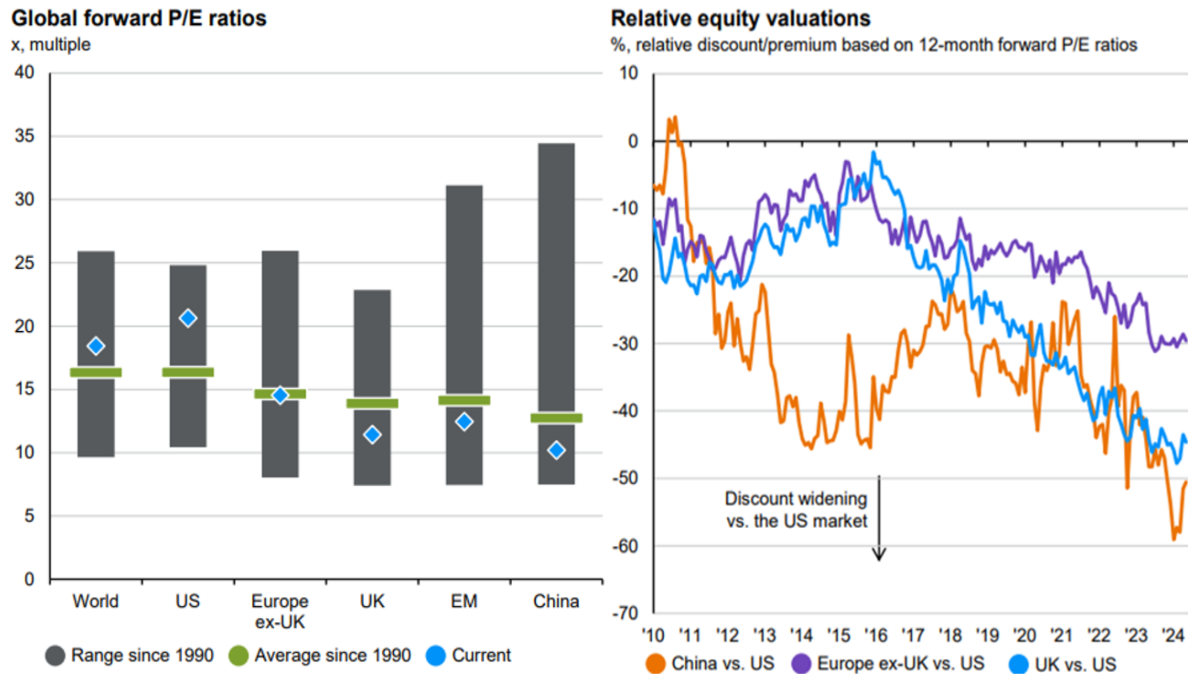
I suggest that the Fund sticks with its current allocation to Protection assets and remains neutral investment grade corporate bonds. The extra yield spread available from corporate bonds has narrowed since my last report, but in the bigger picture, yields overall are higher than they have been for some years. I believe the outlook for returns from government bonds remains mixed, in the short term I would not be surprised to see yields higher or lower on the back of economic news. As a result, it may be worth keeping the duration of the Fund's allocation to fixed interest Gilts benchmark neutral. However, as I have mentioned before Gilts and Index Linked Gilts remain over-valued and I remain pessimistic about the longer-term demand and potential increased supply.

Equity Markets

In my last report I expressed concern about the high valuations of equity markets. This hasn't gone away, but despite the less optimistic outlook on the path of US interest rates and inflation. Equity markets have continued to deliver reasonably strong returns and it is noticeable that performance has broadened out to include regions and sectors that had been left behind by the AI driven performance of the Magnificent Seven.

Chart 13 shows valuations based on P/E ratios of regional equity indices, the left-hand graph suggests that the US remains the most expensive, relative to last 30 years, but this quarter the increased valuation of the global index has been driven by the better performance of the rest of the world. The right-hand chart shows that the rest of the world may have turned the corner as relative valuations and performance have improved from a very low base.

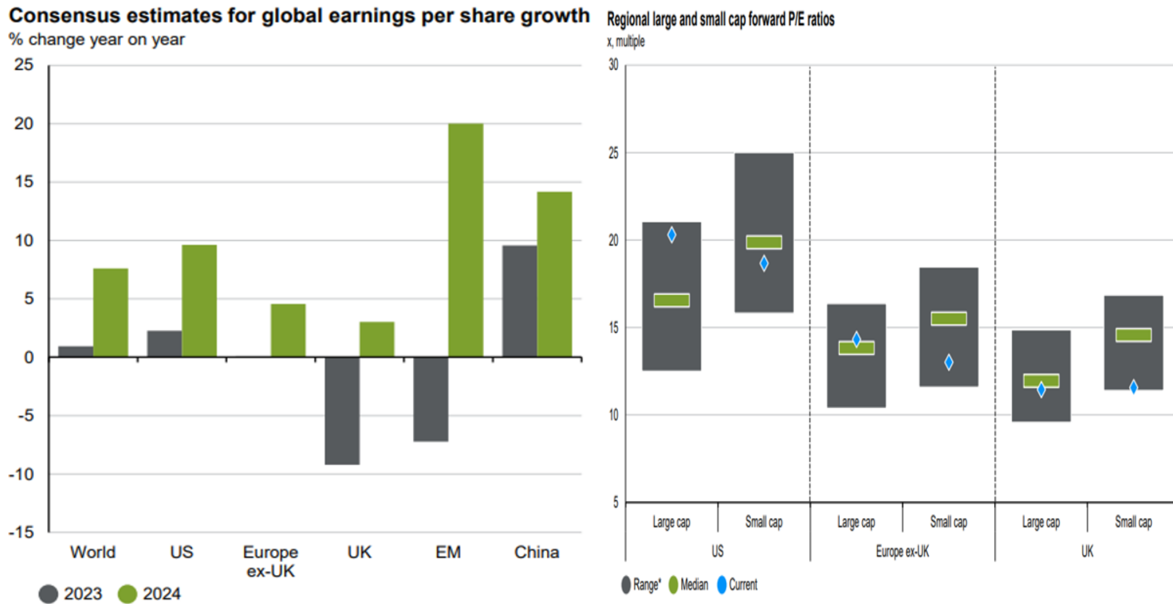
Chart 13: - Regional equity indices; Valuations based on Price/Earnings Ratios, since 1990, China 1996



Source: - JPM Asset Management, 3rd May 2024

The left-hand graph of chart 14 shows earnings growth expectations for 2023 and 2024 and the right-hand graph the valuations of large cap and small cap companies by region using P/E ratios. As discussed before, markets will need to see these earnings estimates realised if markets are going to remain buoyant. The right-hand chart suggests that as usual the averages don't tell the whole story. As can be seen in chart 13, outside of the US, equity appears better value and as chart 14 suggests small-cap equity may be cheaper than large cap. If as I have suggested above in the bond market outlook, interest rates do start to fall, small cap equity should as it has been in the past a major beneficiary and therefore could start to outperform other parts of the equity market.

Chart 14: - LHS Earning per share growth rates, RHS Large cap versus Small cap equity valuations.



Source: - JPM Asset Management, 3rd May 2024

Equity Market (Growth Assets), Recommendations

From the 1st of April 2024, the Fund has started a phased transition to a lower equity market allocation reducing growth assets from 55% to 50% over the next 2 years. This will be achieved by reducing the allocation to UK equity and folding the stand alone allocations to Japanese and Emerging market, equity into Global sustainable equities and increasing the exposure to Private equity. In light of these strategic changes, I am not making any suggestions for new tactical changes to how the growth asset allocation of the Fund is currently distributed.

The changes to the Fund's strategic growth and income allocations are consistent with my previous suggestions to have a greater tactical weight to income assets.

While noting my comments above about global equity long term performance I remain comfortable in the short term, with a 2% underweight allocation to global sustainable equity because of the strategy's higher interest rate sensitivity. I am also happy to remain overweight to UK equity due to the extreme relative valuation discount for the UK relative to the US (and by proxy) the World index as noted in the right hand graph of chart 13 above. I also recognise that the strategic changes being adopted outweigh my tactical suggestions and will lead to an increased strategic exposure to Sustainable global equity and lower exposure to UK equity.

Income Assets

The new Strategic asset allocation increases the weight to income assets from 25% to 27.5% in the next year and to 30% the year after. While these strategic changes are consistent with my previously suggested tactical 27% allocation, this quarter I am suggesting the Fund remains overweight the MAC allocation by +1%, because of the continued strong performance of high yielding assets. The strategic changes have already increased the allocation to MAC by 0.5%, infrastructure by 1.5% and property

by 0.5% this year. It will also take some time to increase the infrastructure and property allocations. I still believe MAC remains attractive, relative to longer duration, more interest rate sensitive assets, just not as attractive in the short term as it was.

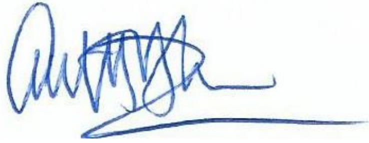
Asset Allocation

The asset allocation set out in table 8 below, shows the new Strategic Asset Allocation Benchmark that came into effect on the 1st April 2024 and my suggested weights relative to the new benchmark. 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 comes into effect on the 1st April 2024.

% Asset Category	**Derbyshire Strategic Weight 1st April 2024**	**Anthony Fletcher variance**	
		16th February 2024	**17th May 2024**
Growth Assets	**52.5**	**-1.0**	**-1.0**
UK Equity	**10**	**+1.0**	**+1.0**
Overseas Equity	**42.5**	**-2**	**-2**
Japan	2.5	**0**	**0**
Emerging markets	2.5	**0**	**0**
Global Sustainable	31.5	**-2**	**-2**
Global Private Equity	6	**0**	**0**
Income Assets	**27.5**	**+1**	**+1**
Property	9.5	**0**	**0**
Infrastructure	11.5	**0**	**0**
Multi-asset Credit	6.5	**+1**	**+1**
Protection Assets	**18**	**0**	**0**
Conventional Gilts	6	**0**	**0**
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