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Second Quarter 2020 Investment Report

PREPARED FOR:

Derbyshire County Council Pension Fund: Pensions and Investment Committee Meeting

SEPTEMBER 2020

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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.

Meeting date 2nd September 2020
Date of paper 21st August 2020

1. Market Background (Second quarter 2020)

Overall, the Covid 19 outbreak and the enormous central bank and government support packages put in place to counter the effects of lock downs, continued to be the dominant global theme driving markets, and they are likely to continue to do so until a vaccine is developed, or the number of new cases significantly decreases.

Europe and Asia started to re-open as their outbreaks have been brought under control, while the United States saw a resurgence in cases, with some States starting to reverse their re-openings. In the second quarter the regional infection hotspots were the United States, Russia, and Brazil. In the US and Brazil, the outbreak was made worse by the political response to what should have been treated as a universal public health emergency. In both counties the response has undermined the presidential leadership. This is bad news for President Trump who is looking to be re-elected later this year, he is now trailing in the polls to the Democrat candidate Joe Biden.

Risk assets, mainly equities and high yield bonds had a strong quarter with prices rising sharply as can be seen in table 1 and 2 below. Within the regional indices, there was a marked dispersion in sector performance. Those indices with a high weight to technology stocks produced the strongest returns whereas Indices like the FTSE 100 with a high weight to energy, commodity and financial stocks performed less well.

All bond markets produced solid returns with the highest duration and unusually the most economically sensitive sectors producing the highest returns, as central bank started buying not just government but also corporate bonds.

Most economies are probably in recession at the end of the second quarter of 2020, the depth and length of the recession is highly uncertain, due to the progression of the virus, the time taken to come out of lockdown, the risk of a second wave of lockdowns as infections increase and because of the potential for people, companies and governments to change their longer term behaviour.

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Table 1, below shows the total investment return in pound Sterling for the major asset classes, using FTSE indices except where noted; for the month of July 2020 and the 3 and 12 months to the end of June 2020.

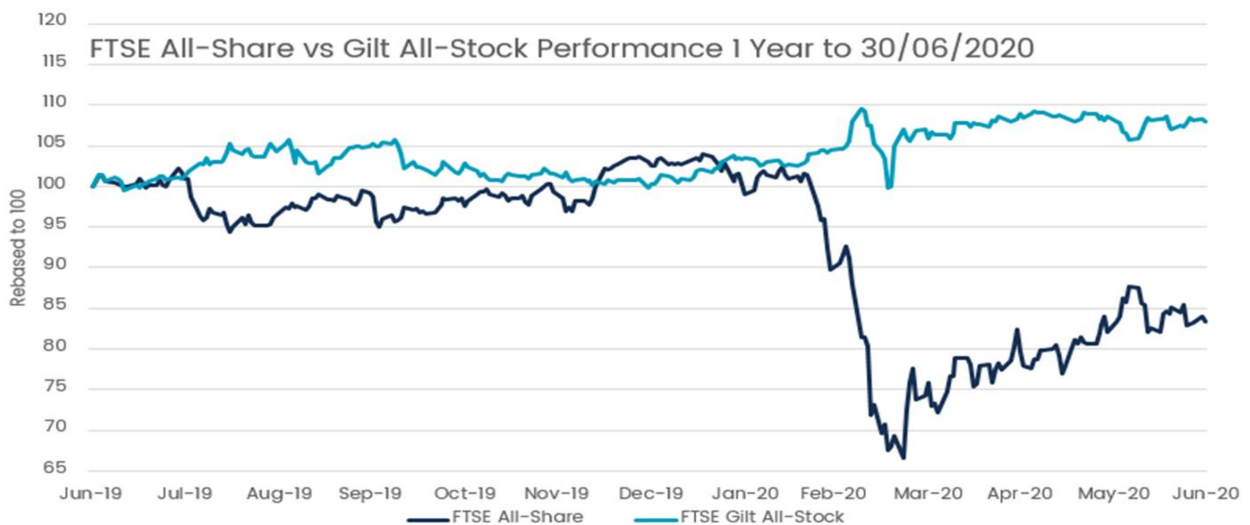
% TOTAL RETURN DIVIDENDS REINVESTED

MARKET RETURNS

		Period end 30th June 2020	
	July 2020	**3 months**	**12 months**
Global equity ACWI^	-1.3	19.7	6.5
Regional indices			
UK All Share	-3.6	10.2	-13.0
North America	-0.4	21.9	10.9
Europe ex UK	-1.5	18.8	0.6
Japan	-7.7	12.2	6.8
Pacific Basin	1.5	19.8	2.8
Emerging Equity Markets	2.7	18.9	-0.4
UK Gilts - Conventional All Stocks	0.4	2.5	11.2
UK Gilts - Index Linked All Stocks	0.7	10.3	10.6
UK Corporate bonds*	1.9	9.0	6.5
Overseas Bonds**	0.9	0.9	5.3
UK Property quarterly^	-	-2.2	-2.7
Sterling 7 day LIBOR	0.01	0.02	0.5

^ MSCI indices * iBoxx £ Corporate Bond; **Citigroup WGBI ex UK hedged

Chart 1: - UK bond and equity market returns - 12 months to 30th June 2020



Source: - Bloomberg

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

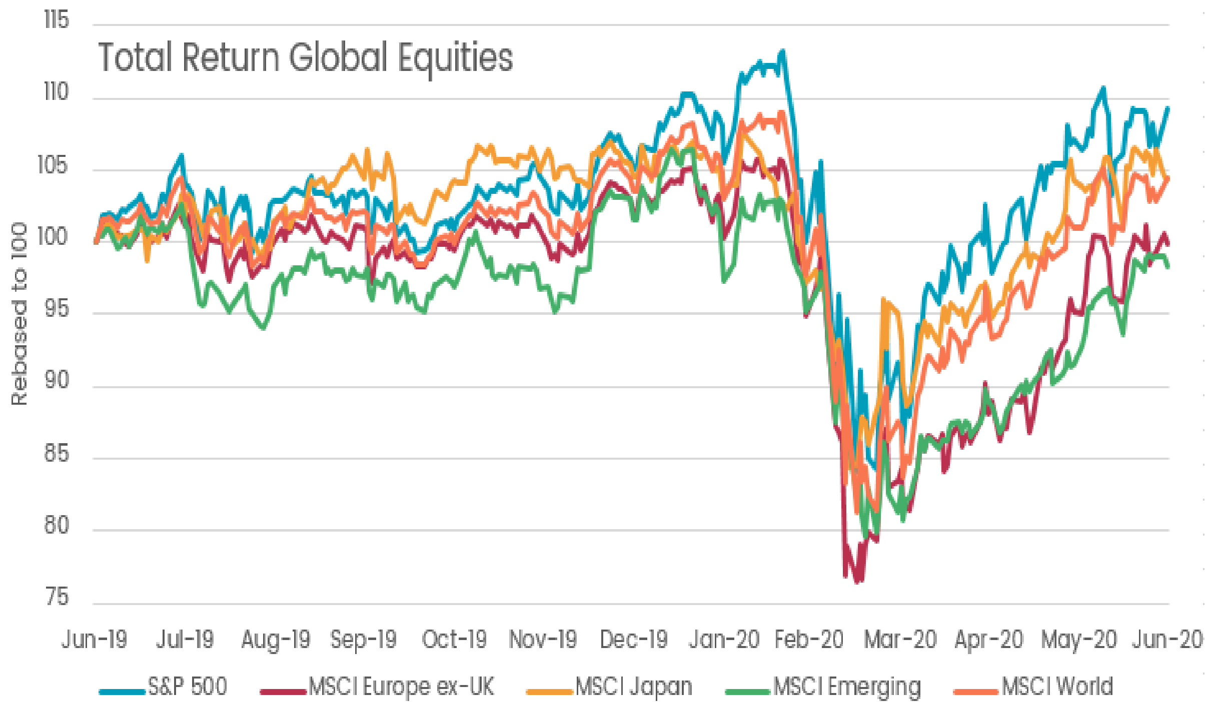
BOND MARKET % YIELD TO MATURITY	31st March 2020	30th June 2020	Quarterly Change %	31st June 2019	Current 7th August 2020
UK GOVERNMENT BONDS (GILTS)					
10 year	0.35	0.17	**-0.18**	0.83	0.11
30 year	0.82	0.64	**-0.18**	1.47	0.65
Over 15y Index linked	-1.91	-2.36	**-0.45**	-1.88	-2.33
OVERSEAS 10 YEAR GOVERNMENT BONDS					
US Treasury	0.67	0.66	**-0.01**	2.01	0.57
Germany	-0.46	-0.46	**0.00**	-0.33	-0.53
Japan	-0.01	0.02	**0.03**	-0.16	0.01
NON-GOVERNMENT BOND INDICES					
UK corporates	2.96	1.95	**-1.01**	2.39	1.74
Global High yield	9.39	6.61	**-2.78**	5.59	5.47
Emerging markets	6.16	4.38	**-1.78**	4.36	3.91

Source: - Bloomberg, G8LI, UC00, HW00, EMGB, ICE indices 7th August 2020.

Chart 2: - UK Bond index returns, 12 months to 30th June 2020.

Source: - Bloomberg

Chart 3: - Overseas equity markets returns in Sterling terms, 12 months to 30th June 2020.



Source: - Bloomberg

Recent developments (July and August 2020)

In July and August global equity market have continued to rally in local currency terms, but because of the weakness of the US dollar equity returns look much more mixed from a UK point of view as shown in table 1 above. The dispersion of sector and regional returns noted in the first half of 2020, remains in place as Covid remains the main driver of performance. The UK markets were further hindered by the strength of Sterling, which dents the earnings of most of the major companies in the FTSE indices.

The recovery from the first wave of Covid and the experience of a second wave of infections is most advanced in China and the Asia-pacific region. As economic activity has increased it has not been accompanied by a significant increase in infections save for a small number of isolated outbreaks which have been dealt with quickly and efficiently by the local authorities. The situation in Europe and the UK is much more mixed and is leading to more uncertainty especially in the UK where the government seems to stumble from one mis-step to another. The pace of economic activity in the USA seems to be slowing as the focus of infections moves away for the North-East to the South, Central and West coast states, which arguably both went into lockdown and then re-opened too early. Hence the rapid increase in infections and hospitalisations as activity increased.

Central bank policy makers have largely stepped back from making further monetary policy provisions, but fiscal policy makers in Europe have stepped up with new measures. In the UK the Chancellor announced a modified but also extended support for employment, reduced VAT for food and hospitality and sprinkled a bit of "helicopter money" in the form of "eat out to help out" in August. Much more significantly in Europe, the European Union agreed a Euro 750 billion Covid

recovery fund. This fund will be backed by bonds issued by the European Commission, this is a significant step on the path to fiscal integration and will benefit the southern European, smaller and newer member states the most. Sadly, the situation the USA is not as clear due to the further politicisation of the issue by President Trump. The employment support package, which had significantly boosted the income of the lowest paid workers in the US, expired at the end of July and as of 17th August a new package of measures has not been agreed. Officially 10.2% of the workforce is unemployed, but when the "absentee" workforce is added to the data the number is closer to 20%. Therefore, failure to approve even a reduced value support package could lead to a significant impact on the prospects for employment and future personal earnings and consumption.

July and August has also seen an increased temperature in the political situation in the USA. Joe Biden the Democrat Candidate for President has appointed the highly regarded Kamala Harris as his running mate. President Trump has been trying to do anything to help his chances of re-election, including a ban on postal votes, asking friendly state governors to close polling stations in some swing constituencies, in order to make it more difficult to vote. He has even suggested a delayed election date due to Covid, or what he prefers to call the "china virus". He has also turned up the pressure on China by closing embassies, sanctioning members of the Hong Kong administration and ordering Chinese companies operating in the USA to cease business operations, in order to try and recapture his lost popularity in poll ratings.

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2. Investment Performance

Table 3 shows the performance of the Derbyshire Pension Fund versus the fund specific benchmark for the 3 months and year to the end of June 2020. The Fund's value sharply rebounded in the second quarter reversing most of the negative performance seen in the first quarter on 2020. At the end of June 2020, relative performance was slightly behind the benchmark over 3 and 12 months, but it should be remembered that the value of some of the Fund's Private market and Property assets may be subject to "material uncertainty" at both the March and June valuation points. Measured against longer time horizons, more appropriate for Pension Fund performance, the Fund continues to deliver positive returns and has outperformed the strategic benchmark on rolling 3,5,10 years and since inception on a net of fees basis.

Over 10 years the Fund has achieved a total return of 8.5% per annum.

Table 3: - Derbyshire Pension Fund and Benchmark returns

% TOTAL RETURN (NET) 30TH JUNE 2020	3 MONTHS		12 MONTHS	
	Derbyshire Pension Fund	**Benchmark**	**Derbyshire Pension Fund**	**Benchmark**
Total Growth Assets	**16.3**	**16.0**	**-2.0**	**-1.3**
UK Equity	10.5	10.2	-12.5	-13.0
Total Overseas Equity	**20.6**	**19.2**	**3.4**	**5.4**
North America	23.2	21.9	10.5	10.9
Europe	18.7	18.8	0.6	0.6
Japan	18.8	12.2	5.3	6.8
Pacific Basin	19.3	19.8	-2.0	2.8
Emerging markets	19.7	18.9	-5.6	-0.4
Global Sustainable Equity	17.8	19.7	0.0	5.7
Global Private Equity	0.2	10.3	-3.3	-12.0
Total Protection Assets	**6.1**	**7.1**	**7.7**	**9.0**
UK Gilts	1.6	2.5	7.9	11.2
UK & Overseas Inflation Linked	6.6	10.3	9.4	10.6
Global Corporate bonds	9.8	8.5	-	-
Total Income Assets	**1.8**	**1.0**	**2.6**	**-0.2**
Multi-asset Credit	6.2	6.5	-1.4	-0.3
Infrastructure	0.9	0.6	9.1	2.8
Property (all sectors)	-0.5	-2.2	0.6	-2.7
Internal Cash	0.0	0.0	0.2	0.4
Total Fund	**9.9**	**10.5**	**0.8**	**1.1**

Total fund value at 30th June 2020 £5,168 million

After a shocking performance in March, most equity markets have rebounded strongly in April, May and June, but the monthly pace of price moves slowed over the quarter. The country indices which were Technology sector heavy like the US and South-east Asia had the strongest returns and those with high weights to Cyclical, Energy and Financial sector stocks like the UK and Europe have lagged.

Over 3 months, Growth assets strongly outperformed the rest of the Fund, over 12 months the benefits of a diversified portfolio can clearly been seen given the mixed performance of growth, protection and income generating asset classes.

Growth assets – Equity performance

Over the quarter most of the regional portfolios outperformed their indices, but over the 12 months the performance is much more mixed and in aggregate growth assets underperformed their respective benchmarks. The negative performance of the UK over 12 month dominates this contribution but it should be noted that all regional equity portfolios underperformed their benchmark with the exception of Private Equity and the passively managed European equity portfolio.

North American equity performance was 1.3% ahead of the 22% market performance in the quarter, this has gone someway to repairing the poor relative 12 month, 3 and 5 year performance numbers. North American equity has delivered the highest annualised returns over 10 years at 17.1% p.a. and the highest outperformance of the benchmark index at +1.5% p.a.

The UK and continental European equity portfolios are passively managed by LGIM and UBS. The 3 and 12 month returns are in line with the benchmark.

The other equity assets are invested in Japan, the Pacific Basin and Emerging Markets equities, via a number of pooled funds selected by the in-house team, there were no significant changes in allocation. All 3 regional portfolios continue to deliver mixed performance over shorter periods but over the long term have in aggregate delivered reasonable returns and they have been an overall diversifier of risk, especially Japan.

Private equity continues to deliver strong positive absolute and relative returns that are significantly ahead of the benchmark over the more meaningful 3, 5 and 10 year periods, after US equity this is the second strongest performing equity allocation, but with the largest outperformance of the benchmark.

In April the in-house team began allocating cash to sustainable equity, at the end of the quarter the allocation was 1.7% compared to an index neutral allocation of 3%.

Protection assets - Fixed Income Performance

Over the quarter the bond portfolio delivered a return of 6.1% compared to the benchmark of 7.1%, despite the strong rebound in Index Linked Gilts and Global corporate bonds. This is because the Fund is slightly underweight relative to the strategic allocation and the Fund's assets have lower

aggregate duration (interest rate sensitivity) than the benchmark. The underperformance over 12 months can be attributed to the same reasons.

Income assets – Property, Infrastructure and MAC

Over the year, the combined portfolio of income assets has outperformed, the benchmark. Infrastructure and total property delivered another positive and above benchmark return. MAC experienced a strong rebound in the second quarter but remains behind benchmark over 1 year, but over 3 years returns are positive and slightly better than benchmark.

The total allocation to all property produced positive returns that were ahead of the benchmark over 3 months and well ahead of benchmark over 12 months. Over the longer-term direct property investments have helped the allocation outperform the benchmark whereas indirect property returns have been more mixed.

Infrastructure allocations continue to produce positive absolute returns well ahead of the benchmark, over 10 years returns have been the highest in the Fund at 14.8% p.a. This will not always be the case but it does demonstrate the value of diversification.

The Multi-Asset Credit (MAC) allocation a combination of private debt, high yield and emerging market debt had a strong quarter delivering a return of 6.2% with all sectors achieving positive returns. The 3y returns have recovered somewhat at 2.4% p.a. compared to 3.6% for the LIBOR based benchmark.

3. Economic and Market outlook

Economic outlook

It goes without saying that the Covid 19 Pandemic and the actions being taken by governments and central banks have the power to dominate all other drivers of economic activity in 2020 and into 2021. Until the virus is contained the global central banks are likely to continue their policy of "Financial Repression" meaning that interest rates and government bond yields will be held at extremely low levels in the hope that this will be enough to support economies and financial markets as they recover.

2020 will record the lowest level of global economic growth in the modern era. The almost total shut down of activity in the second quarter by all the developed and many of the developing economies cannot be offset by the recovery that began in China and south-east Asia. As I mentioned in my last report, it is the path of progress of the virus, the rate of recovery in the actual data and how the stimulatory measures are removed, that will drive the markets over the next 12 to 18 months. The longer the restrictions on activity remain in place the longer it will take to recover and the more likely that the economy will see permanent "scarring". While the development of a vaccine looks promising, it will be some time before it becomes clear which combination of the 29 vaccines that are being worked on, enables the infection to be contained.

The charts below are an attempt to assess how activity is increasing and the impact this is having on the level of infections in the USA and Europe. Chart 4 shows the USA, the left hand chart shows the level of infections and hospitalisations as they started to come out of lockdown in May. These are total cases for the whole of the USA, the first peak was driven by infections in New York and New Jersey, the second peak is driven by Florida, Arizona, Texas and California, where Covid arrived later, so this is not an indication of a second wave effect. It just reflects the later arrival of the first wave if infections in those states, in part probably because they locked down too early. The right hand charts are potentially more worrying from an economic point of view, especially as the employment support programme finished at the end of July. Small businesses and the consumer (like the UK) are the backbone of the US economy, both of these have flattened off and may be declining, having failed to return to their levels before Covid. Clearly the re-imposition of lockdown measures in some states and the fear and uncertainty created by the level of infections is slowing the pace of economic recovery.

Chart 4: - LHS. Total USA Covid cases. RHS. Small business and consumer activity

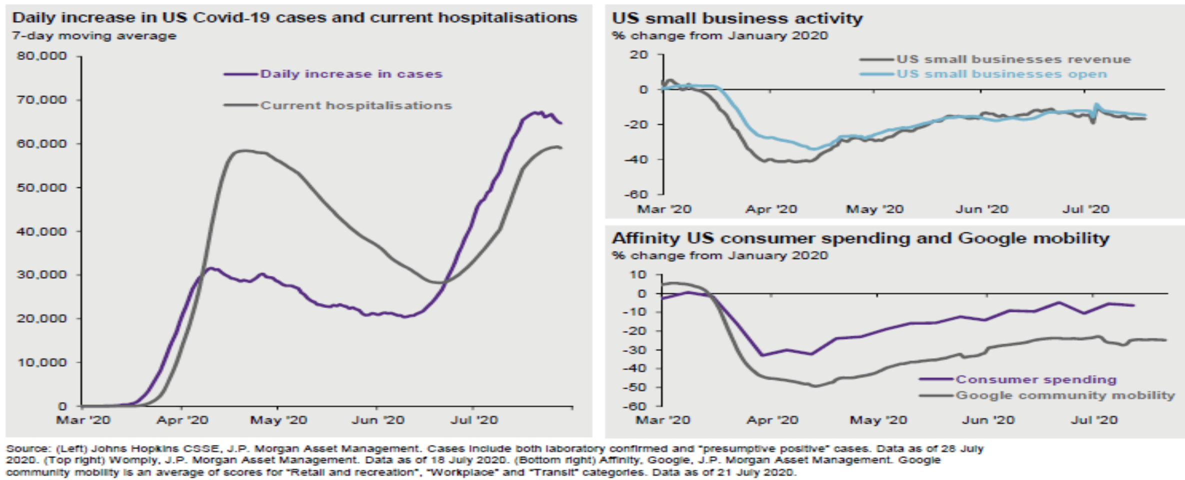


Chart 4: - LHS. Transportation activity. RHS. Reported cases of Covid in UK and Europe.

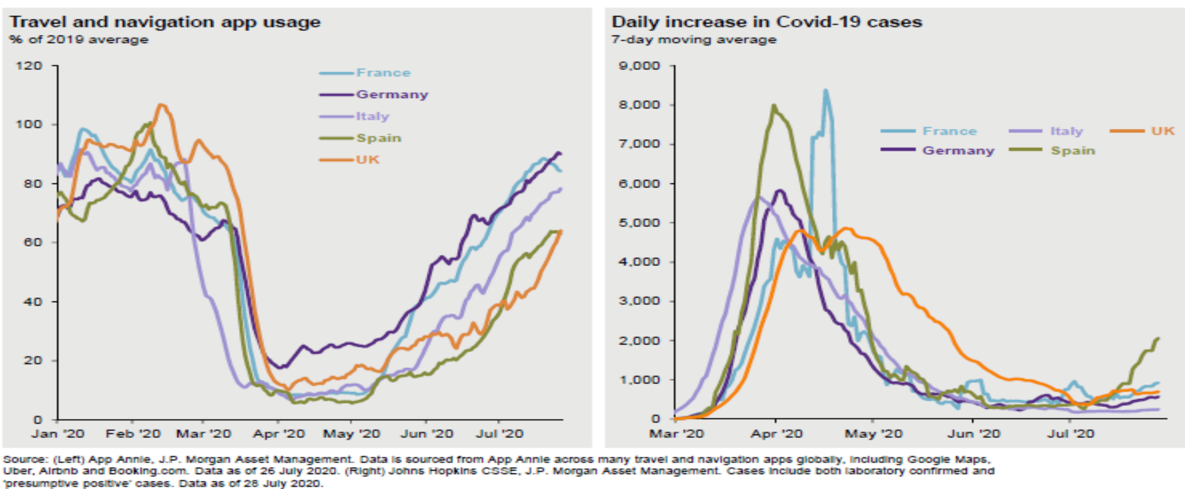


Chart 5 is an attempt to show the picture in Europe but here we only have transportation activity data to go on. The left hand chart appears to show that in much of Europe and the UK motor vehicle journeys have returned to near normal, but anecdotally I would suggest that journeys by public transport have not. The right hand chart shows the level of Covid infections, which outside of Spain seems to have remained broadly flat. Spain can probably be explained by the holiday season, Spain remains the place of choice for many people in Northern Europe to take their summer holiday, in the UK we tend to fly there, most of the rest of Europe drives there. Unlike the USA, most of Europe has kept its employment support schemes in place for longer which should help. In the UK the chancellors "Eat out to Help out" and VAT measures and the introduction of the widespread wearing of "masks" has encouraged people to feel more confident. Again anecdotally this does seem to be helping as some people are going out for the first time since March, but all the places to eat in holiday destinations are full of "staycationers" and for local pubs and restaurants, all it has done is shift eating out from Thursday, Friday and Saturday to Monday, Tuesday and Wednesday.

The observation I am trying to make using this data is that I believe economies have stopped shrinking and while weaker, the recovery has probably begun. The risk is the pace of the recovery could easily slow and take much longer to be achieved even if long term human behaviour has not been permanently changed by the pandemic. Also, the risk of localised lockdowns to contain

outbreaks of infection and the uncertainty this creates for businesses and the consumer, is a further reason to be cautious on near term economic growth.

On a more optimistic note, we know a lot more about Covid now and treatments to mitigate its effect are becoming increasingly available therefore I believe peak infection rates, hospitalisations and deaths could be substantially lower in each future wave of infection.

In the long term Covid and the mitigating actions put in place to tackle the virus are likely to be temporary but that does not mean that the virus may not have an impact on some of the long term issues that are already influencing the future development of the global economy.

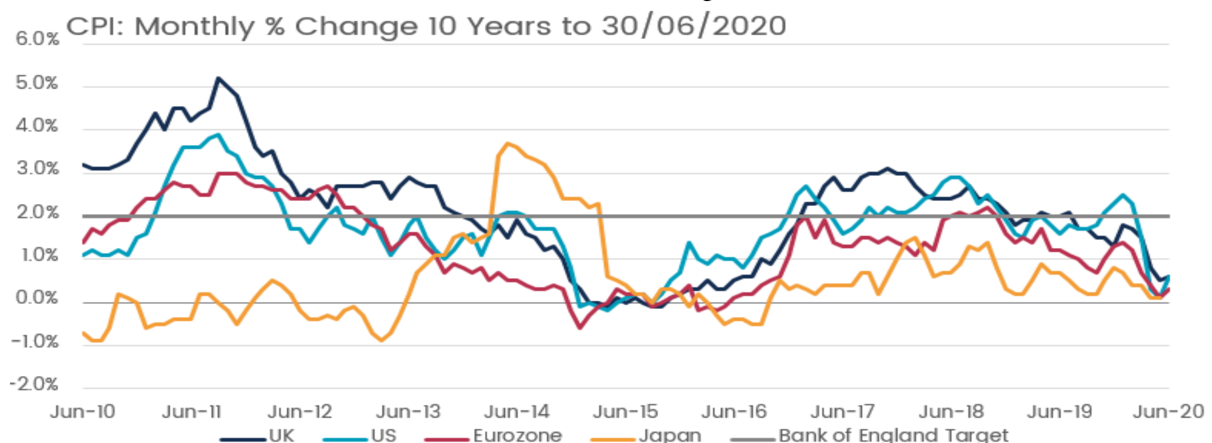
Thus far China and the south-east Asian economies appear largely unaffected by Covid compared to those of Europe and the USA where domestic consumption and leisure activities dominate the mix of economic activity. Technology and communications services which have been major beneficiaries of the pandemic and are at the core of future economic development. Aggregate demographics still favour emerging markets and expect the "fulcrum" of global economic power will continue to shift East towards Asia.

The Developed world will increasingly be weighed down by debt and demographics, with lower aggregate levels of return. In general, Emerging markets should do better because of the development of their own domestic markets, creating consumption for themselves rather than for the developed countries, as a result trade in goods could become more regional. The trend away from traditional retail to increased ecommerce will continue.

Inflation

While the most recent inflation prints for the developed economies have been higher as can be seen in chart 6 below, the medium term trend for inflation is broadly lower and well below the central bank's target rate of 2% p.a. In aggregate I expect it to remain low for a very long time, but there could be localised, short term hotspots resulting from extra costs caused by the implementation of Covid protection measures.

Chart 6: - Inflation – Annual rate versus Central Bank Target



Source: - Bloomberg

Central Banks

The Central banks have been pretty quiet since they announced their unprecedented levels of support for markets in March. The support measures put in place have stabilised the financial system, underpinned a huge rally in the value of global equity and both Investment grade and Sub-investment grade debt.

In the US the Fed made it clear in their recent meetings that the Fed Funds rate is unlikely to be changed until 2022. They also said they were unlikely to use negative policy rates as a tool but they would consider yield curve management. This means that they could attempt to fix long term bond yields, for instance the yield on 10 year US Treasury bonds at a certain level. Since the beginning of March, the US Fed has been the main buyer of debt issued by the US Government.

The Bank of England have raised the issue of negative rates further up the Agenda and have asked Banks and Building Societies to prepare for the possibility. I still believe that the lessons learned from the experience of the ECB and the Bank of Japan and the negative impact these policies have had on the profitability of the banking system will discourage their use in both the UK and the USA.

Politics

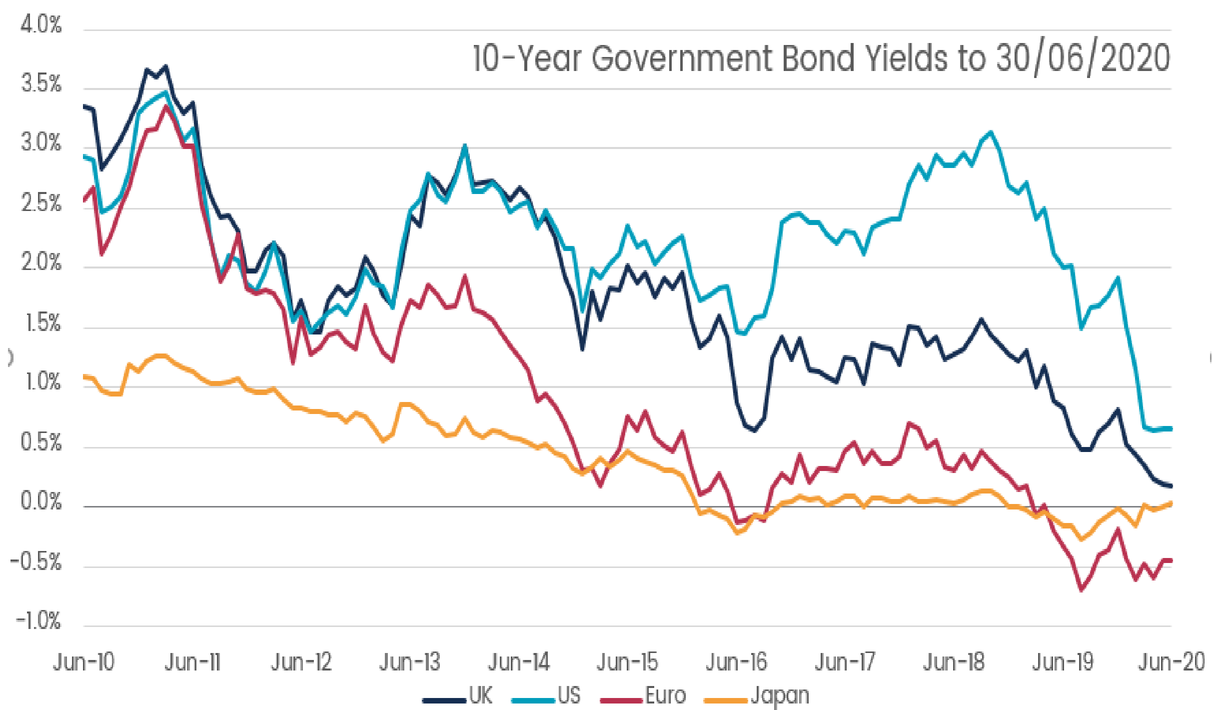
As mentioned above the US Presidential Election campaign is beginning to warm up, Mr Trump had to cancel the Republican Party convention in Florida due to the Pandemic. This will now be a virtual conference; it seems the Democrats had decided some time ago that theirs to be an on-line event. So far Mr Biden has not had to properly campaign and has just left Mr Trump to damage his chances of re-election, judging by the polls this is proving to be the right strategy at the moment. Should Mr Biden win and have a Democrat majority in Congress, the new administration is likely to adopt a less belligerent style in its negotiations with China, increase spending on Healthcare and do an about-face on Climate change policies. Equally because most of President Trump's "legislation" has been by Executive Order, most of it has not actually been passed into law by Congress, so much of it will simply disappear if he leaves office. If Mr Trump wins, then it will be more of the same as he is unlikely to win a majority in Congress. He is likely to continue to pack the supreme court with Conservative judges and is also expected to try and fill the Fed with people who are more compliant to pressure from the White House on the direction of monetary policy.

The European Union has agreed a Euro 750 billion Covid Recovery fund, Euro 390 billion will be in the form of Grants with the balance in loans. In terms of money it represents a net transfer from the richer Northern European countries of between 1 and 2% of GDP, to the poorer and smaller Southern European and new member countries, where the impact will be between 2% and 3% for Italy and Spain and 9% for Greece and 12% for Croatia. Most significantly, the recovery fund will be backed with common bond issuance by the European Commission. This is a significant step toward potential fiscal integration and further strengthens the European Union.

Government bonds

As can be seen in table 2 above and chart 7 below, Government bond yields have broadly tracked sideways close to their all-time lows since their dramatic falls in March and April. Unless the UK and US adopt a negative interest rate policy, I believe that government bond yields have reached the lower boundary and cannot fall much further on a sustainable basis. If the Fed adopts a policy of yield curve management, this will be achieved by targeted buying of certain maturities, thereby pegging the level of bond yields close to their current low levels. During the time that this policy is in place it would provide greater certainty for borrowing costs and allow government bonds to provide protection in the event of future equity market volatility, but it would also lead to extremely low cash like returns and could result in a sharp rise in yields once the policy comes to an end. Given the extremely high interest rate sensitivity of Government bonds this could lead to significant negative returns. Either way I maintain my view that over the longer term government bond yields will rise.

Chart 7: - Government bond yields, last 10 years.



Source: - Bloomberg

Non-government bonds

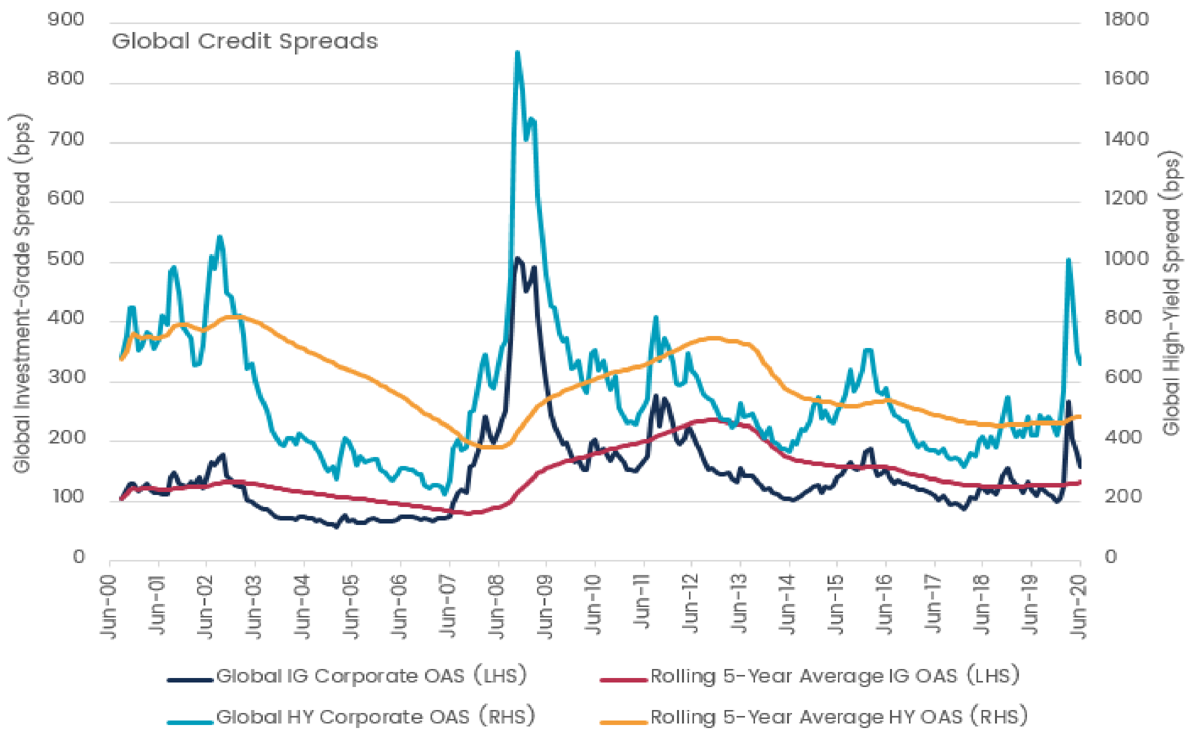
As can be seen in Chart 8 below, the excess yield spread for both investment grade non-government and high yield bonds narrowed sharply in the second quarter, as a result of the policy measures put in place by central banks, including offering to buy significant amounts of mostly investment grade corporate debt.

I still believe there is an opportunity to be exploited in sub-investment grade debt that can probably best be delivered by a Multi-Asset Credit manager. If my comments above, about a period of extended central bank financial repression are correct then both investment grade and sub-investment

grade bonds will deliver better returns than government bonds provided they have a lower default experience.

Spreads have narrowed significantly since the end of the second quarter, so the future return achieved from this asset class is likely to much more driven by the yield or income rather than the capital gain of further spread narrowing.

Chart 8: - Credit spreads, extra yield over government bonds, last 10 years.

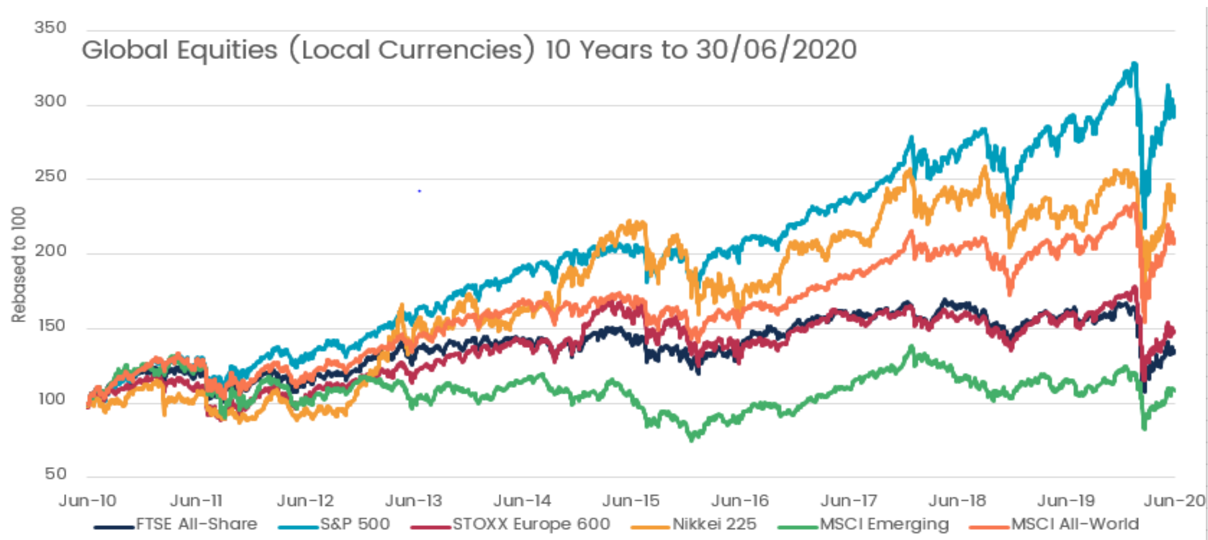


Source: - Bloomberg

Equities

As can be seen in Chart 9 below and in table 1 above equity market returns have been strongly positive in the second quarter. They are all still negative since the beginning of the calendar year but all equity market indices except the UK are positive over 12 months. In local currency and Sterling terms equity market index returns have been more mixed in July and August. Technology stocks continue to drive index returns, hence indices with higher weights to technology like emerging Asia and the USA have delivered the best returns.

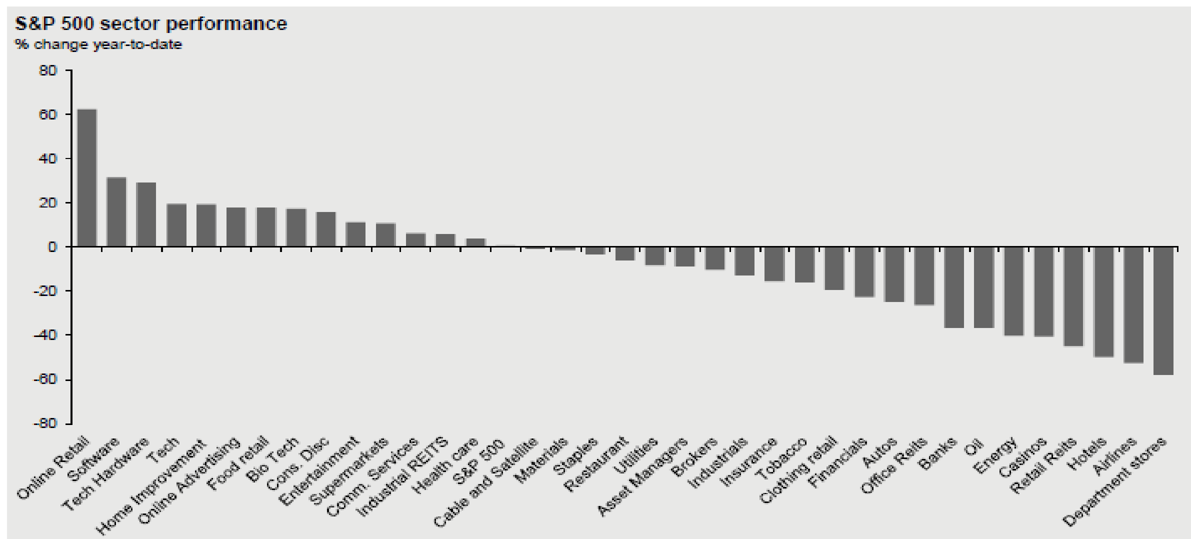
Chart 9: - Global equity indices, last 10 years.



Source: - Bloomberg

The recovery in markets remains highly differentiated by sector as can be seen in chart 10 below. This chart is for the US S&P 500, but it is a similar story for all other equity indices. This trend may continue for a while but over the longer term as activity returns, those equity market sectors and indices hardest hit like the UK should start to see improved performance.

Chart 10: - S&P 500 sector returns calendar year to date.



Source: Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management. Data as of 21 July 2020.

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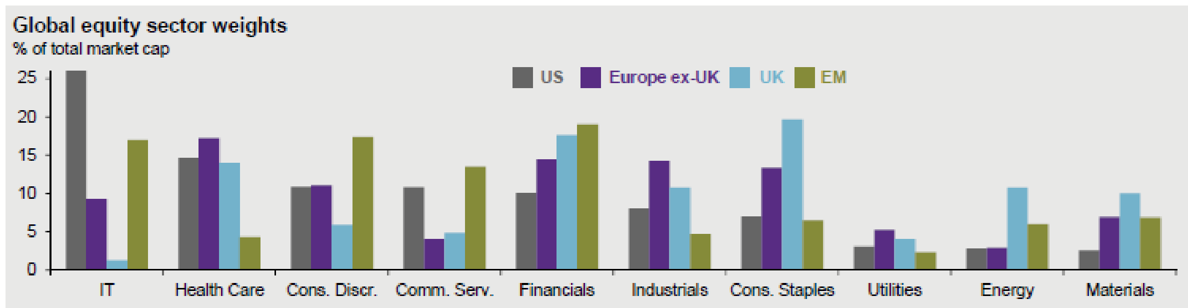
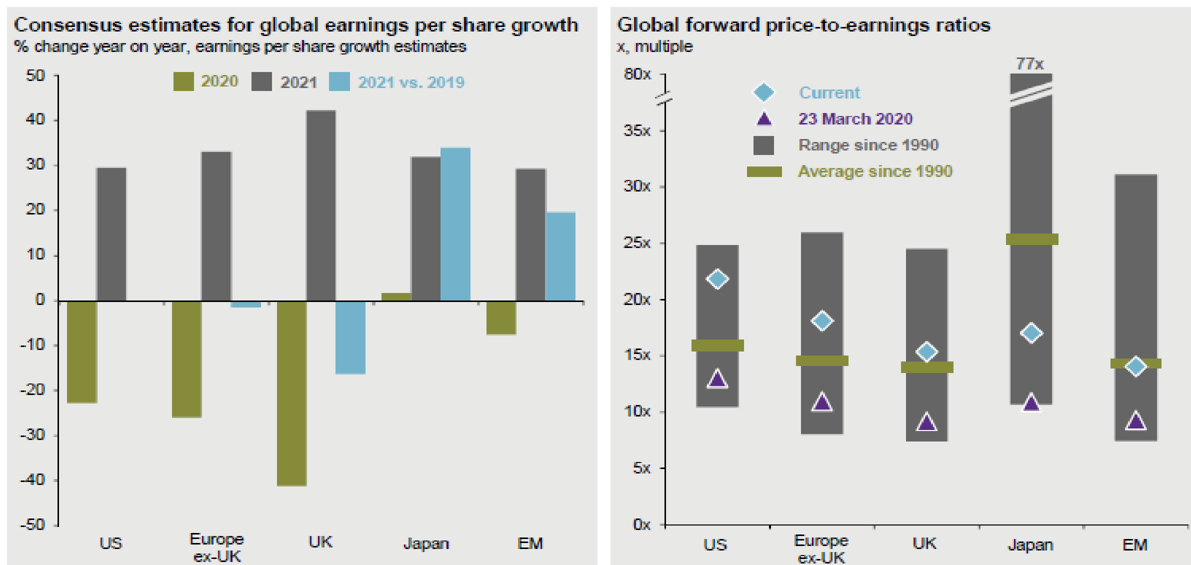
Chart 11: - Global equity sector weights.



Taking a look at the range of returns shown in chart 10 and the global sector weights in chart 11, it is clear to see the winners so far, but as the recovery broadens most of the other sectors should catch up over time.

Chart 12: - Left Hand Chart; Consensus earnings per share; Right Hand Chart; P/E ratios.



Source: JP Morgan Asset Management 30th June 2020

In chart 12 above I have shown consensus estimates for earnings per share (EPS) in 2020 and 2021 compared to actual EPS in 2019 and the resulting price earnings ratios at the 30th June compared to their history since 1990. As can be seen only in Japan and Emerging markets is EPS expected to be higher than 2019, elsewhere EPS is expected to be lower in 2021 than it was in 2019. This has elevated the P/E ratios to above average especially in the US, which leaves the markets vulnerable. either to fear of an increase in interest rates or lower earnings. While higher rates looks extremely unlikely, lower EPS is highly likely given the uncertainty being caused by an increase in the level of Covid infections as economies come out of lockdown.

For these reasons I would not recommend being overweight any part of the equity market, but I would suggest that the allocation is maintain as close to neutral as possible.

GDP

Table 4 shows the consensus forecasts for GDP growth in calendar 2020 and 2021 and my expectations in May and August 2020.

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

% CHANGE YOY	2020				2021			
	MAY		AUGUST		MAY		AUGUST	
	Consensus	AF	Consensus	AF	Consensus	AF	Consensus	AF
US	-5.4	**-6.0**	-5.2	**-6.0**	4.3	**5.0**	4.0	**4.0**
UK	-7.9	**-9.0**	-9.9	**-10.0**	6.1	**6.5**	6.4	**6.4**
Japan	-5.5	**-6.0**	-5.3	**-6.0**	2.4	**3.0**	2.5	**2.5**
EU 28	-7.2	**-8.0**	-7.8	**-8.0**	5.6	**6.0**	5.3	**5.3**
China			2.1	**2.5**			7.8	**8.0**
SE Asia			-3.6	**-3.2**			5.7	**6.0**

Source: - Consensus Economics August 2020

Since the last PFC in June economies have been gradually coming out of lockdown, starting in the far east and through Europe and into the USA. At the same time the level of economic activity has increased and with it the number of infections. The increase in infections has caused local lock downs or restrictions on activity and/or movement to be re-imposed. The high frequency data that was surprising to the upside has been softened somewhat in response to the uncertainty created by the re-imposition of restrictions.

As can be seen in the table above consensus forecasts for GDP have not materially changed from May. I have maintained my more pessimistic view for developed economies in 2020 and I am now less optimistic for 2021, but I remain optimistic for China and South East Asia. I continue to believe that the numbers are not useful but the direction of growth expectations are reasonable. I also believe that it will take longer for these economies to return to the level of activity seen before the start of the pandemic.

In terms of actual data, first quarter GDP in China was revised to -10% quarter on quarter marking the 1st quarter of negative growth in the modern era. In the second quarter growth rebounded by 11.5% as both domestic and external demand improved following the removal of most Covid 19 restrictions.

In the US, fourth quarter 2019 growth was revised higher to 2.4% annualised. The estimate of first quarter growth was revised to -5%, but the advance figure for the second quarter was truly shocking - 32.9% the worst ever recorded. The US Fed expects the economy to shrink by 6.5% in 2020.

In the UK, the growth rate in the first quarter was -2.2% and the advance estimate of second quarter 2020 growth was -20.4%. Like the US this was the worst ever reported decline in GDP, but both outcomes were better than expectations.

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The Japanese economy shrank by 7.8% in the second quarter of 2020, it was the third quarter of negative growth, this means the economy is 10.3% smaller than it was 12 months ago.

In the Euro-area second quarter growth was -12.1% after a slightly revised fall of 3.6% in the first quarter. The rest of the European economy joins Germany and France that were already in recession.

Consumer Price Inflation

Table 5 shows the consensus forecasts for Consumer Price Inflation in calendar 2020 and 2021 and my expectations in May and August 2020.

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

% CHANGE YOY	2020				2021			
	MAY		AUGUST		MAY		AUGUST	
	Consensus	AF	Consensus	AF	Consensus	AF	Consensus	AF
US	0.7	**0.7**	0.8	**0.7**	1.8	**1.6**	1.7	**1.6**
UK	1.0	**1.0**	0.7	**0.6**	1.4	**1.2**	1.4	**1.2**
Japan	-0.4	**-0.4**	-0.1	**-0.2**	0.1	**0.0**	0.2	**0.0**
EU 28	0.5	**0.5**	0.6	**0.5**	1.2	**1.0**	1.2	**1.0**
China			2.7	**2.5**			2.0	**2.0**
SE Asia			1.0	**0.9**			2.1	**2.0**

Source: - Consensus Economics August 2020

The consensus forecasts for inflation in calendar 2020 and 2021 have not been materially changed. Despite the recovery in the oil price demand remains subdued. Anecdotal evidence would suggest some service prices have been marked higher due to Covid induced capacity constraints but these are being more than offset elsewhere. I continue to expect inflation to be lower than the consensus forecasts for some time to come.

The annual rate of US headline inflation picked up to 1% in July after recording a 4.5 year low of 0.1% in May, food and medical service prices were higher but energy prices were lower. Ex food and energy, core inflation also increased from an annual rate of 1.4% in April to 1.6% in July.

In July the UK headline inflation rate (CPIH) which includes housing costs was higher than the 0.8% reported in June at 1.1%, but this is down from 1.5% in March. Core inflation which excludes food, energy, alcohol and tobacco in the UK, was also lower at 1.4% p.a.

The July "flash" report of inflation in the Euro Area remains 0.4% p.a. but the core rate continues to steadily pick up and now stands at 1.2%.

The Japanese inflation rate was only 0.1% p.a. in June and the core rate that excludes fresh food was 0% p.a.

4. The outlook for the securities markets

As the shock and awe of the initial impact of unprecedented interventions from central banks and governments has subsided equity and credit markets have slowed their rate of advance. We now have the reality of navigating a path out of lock down and to containment of the virus through a vaccine or through learning to live with it.

The quick response of the central banks and their promises to underwrite the financial markets has bought governments time to work out what to do next. Going forward the outlook for the securities markets is now dominated by the respective national government response. The failure of the US government to extend the employment support programme is a concern as it will further slow the rate of the consumers recovery and risks dramatically increasing unemployment. The response in the UK and the deal on the recovery fund in the EU leaves these regions in a much better place. Equally the recovery of economic activity in China and South East Asia, the first regions to be impacted by the virus, gives some reason for optimism. But for the developed markets the short term outlook remains highly uncertain and the pace of economic activity looks likely to be lower.

The challenge for a pension fund is to look through the short term and focus on the medium to long term. The history of past crises is that after a sharp sell-off and recovery markets grind higher over an extended period of time. The easy money from the market recovery has been made now the chances are that we could have a set-back especially if either activity levels disappoint or infection rates get out of hand. However, over the medium to long term I expect equity and credit markets to deliver stronger returns than cash or government bonds.

Covid has turbo-charged many of the disruptive themes that have been acting on markets and economies for a while, even as we return to more normal levels of economic activity things may have changed and human behaviour and attitude to personal risk may be different. The Fund’s allocation and the managers used may need to be adjusted to take advantage of the potential new landscape for investment. It is also possible that the regulatory framework for companies may change just as it did after the GFC. I believe it will be seen as unreasonable for companies not to be more resilient to market or financial shocks in future, especially if they have sought government support in this crisis. This could mean that the overall return on equity may be lower and practices like distributing high dividends, using debt to retire shareholder capital and taking on higher levels of leverage; could attract a higher degree of regulatory scrutiny as well as carrying a higher risk premium for investors.

Bond Markets

In table 6, below I have set out my expectations for 3 month LIBOR interest rates and benchmark 10 year government bond yields, over the next 3 and 12 months. They are not meant to be accurate point forecasts, more an indication of the possible direction of yields from August 2020.

Table 6: - Interest rate and Bond yield forecasts

%	CURRENT	MARCH 2021	SEPTEMBER 2021
UNITED STATES			
3month LIBOR	0.26	0.25	0.25
10 year bond yield	0.71	0.75	0.75
UNITED KINGDOM			
3month LIBOR	0.07	0.10	0.10
10 year bond yield	0.25	0.5	0.5
JAPAN			
3month LIBOR	-0.05	-0.10	-0.10
10 year bond yield	0.05	0.10	0.10
GERMANY			
3month EURIBOR	-0.50	-0.50	-0.50
10 year bond yield	-0.45	-0.25	-0.25

Source: - Bloomberg, Trading Economics; 14th August 2020

As can be seen in table 2 above government bond yields have continued to fall, making new "All Time Lows" as markets have responded to the Covid 19 pandemic. While 3 and 5 year government bonds in the UK have joined Germany and Japan in printing negative yields since mid-June, US government nominal yields remain above zero across the whole yield curve. There continues to be a lot of discussion about negative central bank policy rates, but I believe the Bank of England and the US Fed, will choose to adopt yield curve management instead, in order to prevent disruption in the wider banking and money markets. The main message I want to give from my forecasts in table 6 is that I expect government bond yields to remain around their current levels for some time. I do not expect central bank policy rates to change for the next 12 to 18 months. Over the long term I expect government bond yields to rise and there is the risk that yield curves could steepen if inflation becomes more of a concern, but for now central banks will do all they can to keep government yields at or close to their current levels.

With a background of very low central bank policy rates and low refinancing costs, the extra yield spread for non-government bond and high yield bonds in particular is very attractive, but spreads have narrowed significantly already. With most of the global economy in recession it is highly likely that the level of defaults in credit markets will increase, especially in those sectors of the economy that are more at risk from the pace of recovery. Active management, dynamic asset allocation and security selections skills will now, more than ever will be the key to success for investment in this asset class.

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Bond Market (Protection Assets) Recommendations

The total allocation to Protection assets in the strategic benchmark is 18%. I continue to suggest that this is reduced to 16% and this 2% given to the MAC allocation in the Income asset portion of the Fund. I would take this 2% from conventional gilts and within the allocation to Protection assets I would take a further 1% from conventional gilts and allocate this money to Global corporate bonds, increasing this allocation to 1% overweight.

I believe this underweight recognises the value of owning protection assets against the risk of another sell off in growth assets, but it also reflects my view that government bonds will not provide as much protection as they have done in the past at these extremely low levels of yield.

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 do not take into consideration any narrowing or widening of spread over the holding period but does indicate the level of losses that can be experienced in long duration assets for only a small change in yield.

Table 7: - Total returns from representative bond indices

INDEX	YIELD TO MATURITY %	DURATION	YIELD INCREASE %	% TOTAL RETURN, HOLDING PERIOD	
				3 MONTH	12 MONTHS
All Stock Gilts	0.41	13.4	0.5	-6.6	-6.3
All Stock Linkers	-2.36	15.4	0.5	-7.7	-7.5
Global IG Corporate	1.62	7.3	0.5	-3.2	-2.0
Global High Yield	5.58	3.8	0.5	-0.5	+3.7

Source: - ICE Indices 14th August 2020

In terms of the allocation to index linked gilts I would prefer to remain 2% underweight UK linkers with a 2% allocation to US TIPS. The real yield on TIPS has fallen over the quarter and but index linked gilt yields have fallen further so there is still a yield pick-up for holding TIPS and this market is not subject to the potential change of inflation indexation. UK Linkers remain overvalued relative to UK gilts and UK inflationary expectations. The consultation on the change to CPIH from RPI indexation closes in August. At the moment the Linker market has only priced in about 50% of the change in the market valuation. While asset managers continue to lobby for no change or compensation, Corporate Pension Fund trustees with RPI liabilities appear much more relaxed about the change. Broadly speaking there is an increasing consensus that the Chancellor will endorse the change in the Autumn Budget statement without compensation to bond holders.

Equity Markets

Table 8 below, shows the dividend yield for 2020 and the earnings growth and price / earnings ratio estimates, for 2020 and 2021 provided by Citi Research.

Table 8: - Dividend yield, Earnings growth and Price/Earnings Ratios

COUNTRY	DIVIDEND YIELD %	EARNINGS GROWTH		PRICE/EARNINGS RATIO	
FORECAST PERIOD	2020	2020	2021	2020	2021
United Kingdom	3.9	-34.8	32.3	18.2	13.8
United States	1.8	-18.5	26.9	25.2	19.9
Europe ex UK	2.8	-28.8	34.2	21.3	16.0
Japan	2.4	-11.5	28.2	19.7	15.4

Source: - Citi Research, Global Equity Strategist, July 2020

The data set out in the table of earnings growth, P/E ratios and dividends above is a better reflection than the data presented last quarter but once again I am sceptical about the optimism expressed for 2021. In aggregate the direction of the change is probably the only useful bit of information. Covid has split companies into 3 broad categories, those which have been able to carry on as normal, those which could re-open with some changes and those that can't yet fully re-open. Clearly the swing factor for earnings growth will come from those that "could" with those that "can't" unlikely to make a difference for some time. As the number of infections increases as activity starts to recover it will impact the "could" category most, thereby extending the period of below expected earnings and higher costs.

As I mentioned last time dividends are being passed or cut, to enable companies to better weather the loss of earnings during lockdown and re-opening. In the medium to long term I believe one of the changes we will see in markets is lower distributions to shareholders via the dividend and higher "cash" on company balance sheets. Having said that the dividend yield from equity, while not guaranteed like coupons on bonds, is likely to remain higher, maintaining the attractiveness of growth assets

Equity Market (Growth Assets), Recommendations

The equity markets have run out of steam since the end of the second quarter after 3 positive months, global and UK equity returns in July were negative as can be seen in table 1 above. The increase in the value of Sterling is partly responsible, regional returns were more mixed than seen in the preceding quarter. The dispersion between growth and technology stocks in particular and the rest of

the market has continued and is now extreme levels. In my last report I suggested a neutral allocation to all equity regions, I continue to believe this probably the best strategy for now.

Thus far the recovery of equity markets has been driven by the unprecedented monetary and fiscal stimulus measures and better than expected high frequency data. The risk for markets from here is the number of Covid infections is increasing as the level of activity in the economy goes up. This is leading to new restrictions on activity and a slowing of the pace of coming out of lockdown, which further weakens and extends the earnings recovery.

I still believe that over the next 12 to 18 months the Fund could be presented with the opportunity to adjust the regional allocations and maybe even go overweight Growth assets. But at the moment with the level of uncertainty maintaining a neutral or even slightly underweight position relative to the strategic benchmark may be the most prudent action.

Income Assets

As suggested above the low return from protection assets and the increased likelihood that they fail to provide as much protection as they did in the past suggests an overweight to Income assets.

I continue to favour a 2% overweight allocation and suggest that this money be used to increase the MAC allocation. My reason for this is the main opportunity in MAC comes from global high yield bonds, emerging debt, loans and the dynamic allocation between these sectors of the bond market. As can be seen in table 2 and chart 8 above spreads have narrowed significantly, but central banks remain determined to support the markets through bond purchases, an extended period of low policy rates and government bond yields. As always with this type of asset avoiding the risk of default is the key to success, but even at the current lower level of spread, sub-investment grade assets appear attractive despite the increased risk of default.

I believe Property should remain neutral overall, but over the next couple of years, I believe the uncertainty over the future use of buildings created by Covid has increased the potential volatility of the returns from this asset class. Certain types of building may need to be re-purposed, at a minimum property could see a medium term downward re-rating and the income generated by rents could have an impact beyond the short term. As a long term investor, the Fund can afford to "look through" the volatility and in low yield environment, property probably remains an attractive income asset class.

I would suggest holding the cash allocation neutral at 2%. At the end of July, the Fund was holding 6.6% in cash, however more than 3% of this figure is already promised for future investments. Given the current level of uncertainty a higher cash balance remains a good strategy for the Fund.

The asset allocation set out in table 9 below, shows the new Strategic benchmark allocations for the Derbyshire Pension Fund and my suggested relative weights as of 18th May and 17th August 2020. My suggested asset allocation weights are relative to the classification of assets and strategic benchmark ranges. 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 in reallocating between asset classes and the time needed by the In-house Team and their investment managers to find correctly priced assets for inclusion in the Fund.

Table 9: - Recommended asset allocation against the new Strategic Benchmark that came into effect on the 1st January 2019.

% ASSET CATEGORY	DERBYSHIRE STRATEGIC WEIGHT 1ST JANUARY 2019	ANTHONY FLETCHER 18TH MAY 2020	DERBYSHIRE STRATEGIC WEIGHT 1ST JANUARY 2019	ANTHONY FLETCHER 17TH AUGUST 2020
Growth Assets	**57**	**0**	**57**	**0**
UK Equity	**16**	**0**	**16**	**0**
Overseas Equity	**41**	**0**	**41**	**0**
North America	12	**0**	12	**0**
Europe ex UK	8	**0**	8	**0**
Japan	5	**0**	5	**0**
Pacific ex Japan	4	**0**	4	**0**
Emerging markets	5	**0**	5	**0**
Global Sustainable	3	**0**	3	**0**
Private Equity	4	**0**	4	**0**
Income Assets	**23**	+2	**23**	+2
Property	9	**0**	9	**0**
Infrastructure	8	**0**	8	**0**
Multi-asset Credit	6	+2	6	+2
Protection Assets	**18**	**-2**	**18**	**-2**
Conventional Gilts	6	**-3**	6	**-3**
UK index Linked	6	**-2**	6	**-2**
US TIPS	0	+2	0	+2
UK corporate bond	6	+1	6	+1
Cash	**2**	**0**	**2**	**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
- Citi Research,
- FTSE, Citigroup, IPD, Barclay's Global and ICE Indices
- Kames, Blackrock, M&G and JP Morgan, Asset Management
- Bank of England, UK Debt Management Office, UK OBR, UK Treasury, ONS
- US Bureau of Labour Statistics, US Commerce Dept. Executive office of the President of the United States.
- Bank of Japan, Japan MITI
- ECB, Eurostat
- Bloomberg, Markit, Trading Economics, DataStream and S&P
- Financial Times, Daily Telegraph, Wall Street Journal, New York Times, Washington Post

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