Appendix 1

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First Quarter 2018 Investment Report

PREPARED FOR:

Derbyshire County Council Pension Fund: Pensions and Investment Committee Meeting

JUNE 2018

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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.

Since the contents of this report have been dictated by the Pension and Investment Committee it does not contain performance data for longer periods in accordance with the requirements of the FCA Rules.

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 13th June 2018
Date of paper 21st May 2018

1. Market Background

The global economy entered 2018 on a strong note, with economic fundamentals supporting equity market valuations. However, this picture began to change during the first quarter of 2018, with the return of significant volatility to the markets. Volatility, which had been abnormally subdued for two years, spiked in February. This was marked by an 81% increase in the VIX index, the biggest move since the third quarter of 2011. The return of volatility is not necessarily a cause for concern. Instead, it may indicate that markets are returning to normality, after years of central bank intervention that has depressed volatility and dispersion. This could ultimately be beneficial for a number of investment strategies, and will be particularly welcome for active stock pickers.

Global equity markets had a volatile quarter, due to concerns regarding the pace of monetary tightening and the threat of a trade war between the US, China and Europe. Many equity markets had their first negative quarterly return in two years.

In March, the US Federal Reserve increased the Fed Funds rate by 25 basis points, to a range of 1.5%-1.75%, with two further increases expected this year, the next potentially in June. Corporate earnings remained robust, with US earnings growing at the fastest rate since 2011, in part due to President Trump's tax reform.

Brexit continued to act as a drag in the UK, but there was some progress on a transition deal. At the same time, inflation started to decline and the Bank of England revised its predictions for growth in 2018 higher in February and then lower in May. UK equities continued to be relative underperformers, hampered by political uncertainty over Brexit and further sterling strength.

Higher volatility and rising interest rates hit fixed income markets, with losses across most segments. Corporate bond spreads, which had been narrowing in recent quarters, widened on a combination of excess supply and increased uncertainty.

The dollar weakened further, following comments from the US Treasury Secretary and escalating trade tensions with China. Increased uncertainty led to an appreciation of the Japanese yen, and sterling strengthened in anticipation of a rate rise by the Bank of England in May.

Activity in the UK property market, and particularly in the residential sector, was more subdued in the first quarter of the year. This was in part due to low real wage growth and concerns over the ability of households to service debt in an environment of increasing interest rates.

The first quarter of 2018 has seen substantial turbulence, and suggests that 2018 as a whole will not be as smooth sailing as 2017.

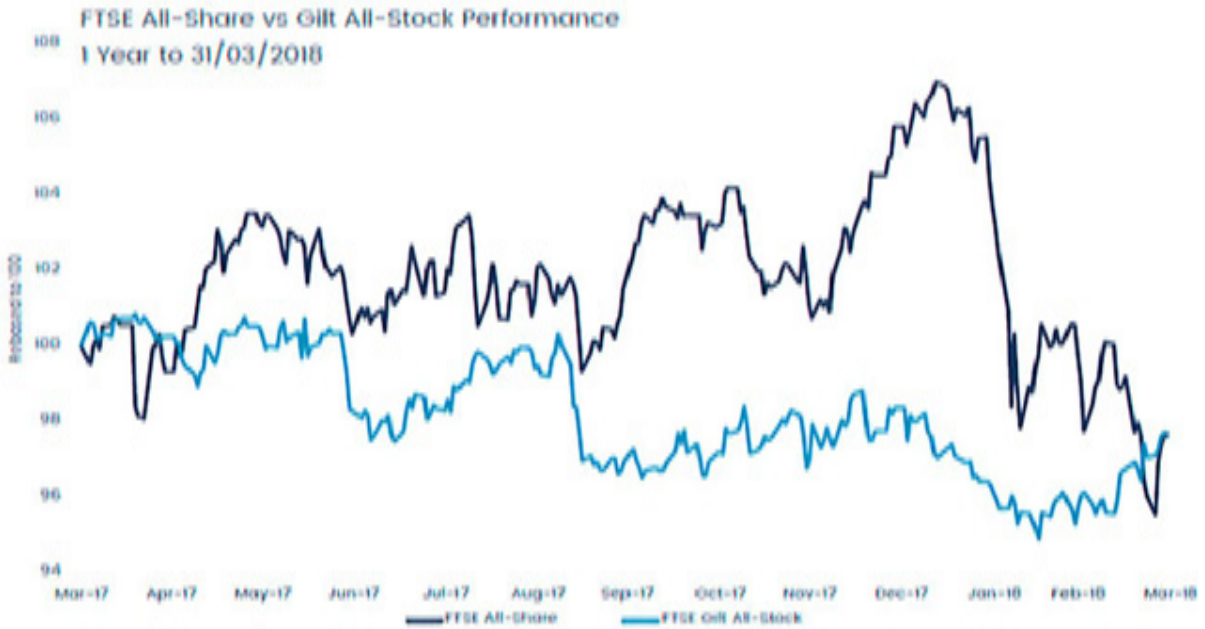
Table 1, below shows the total investment return in pound Sterling for the major asset classes, using FTSE indices except where noted; for the month of April 2018, 3 and 12 months to the end of March 2018.

% TOTAL RETURN DIVIDENDS REINVESTED

	MARKET RETURNS		
		Period end 31st March 2018	
	April 2018	3 months	12 months
FTSE All-Share	6.4	-6.9	1.3
FTSE World ex UK	2.7	-4.2	3.1
North America	2.4	-4.5	1.3
Europe ex UK	4.6	-4.4	4.3
Japan	2.6	-2.6	7.5
Pacific Basin	2.9	-4.5	6.0
Emerging Equity Markets	1.0	-2.2	8.8
UK Gilts - Conventional All Stocks	-1.0	0.3	0.5
UK Gilts - Index Linked All Stocks	-2.6	0.1	0.5
UK Corporate bonds*	0.0	-1.4	1.4
Overseas Bonds**	-0.5	0.3	1.6
Property IPD quarterly	0.6	2.9	10.9
Cash 7 day LIBID		0.09	0.21

* Merrill Lynch £ Corporate Bond; **Citigroup WGBI ex UK hedged

Chart 1: - UK bond and Equity markets since 31st March 2017



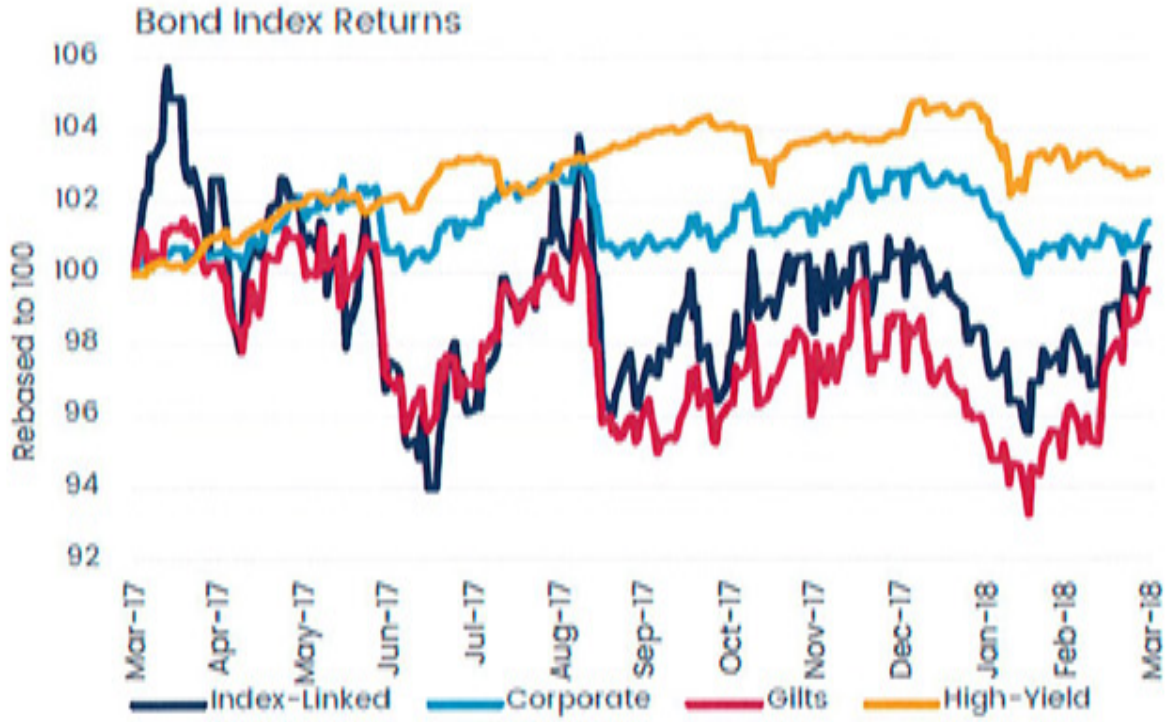
Source: - Bloomberg

Table 2: - Change in Bond Market yields over the quarter

BOND MARKET % YIELD TO MATURITY	31ST DECEMBER 2017	31ST MARCH 2018	CHANGE	31ST MARCH 2017	CURRENT 18TH MAY 2018
UK GOVERNMENT BONDS (GILTS)					
10 year	1.19	1.35	+0.16	1.14	1.50
30 year	1.76	1.71	-0.05	1.72	1.90
10 Index linked	-1.85	-1.73	+0.12	-1.99	-1.58
30 Index linked	-1.61	-1.63	-0.02	-1.67	-1.43
OVERSEAS GOVERNMENT BONDS					
10 US Treasury	2.41	2.74	**+0.33**	2.39	3.06
10 Germany	0.43	0.49	**+0.06**	0.33	0.58
10 Japan	0.05	0.04	**-0.01**	0.07	0.06
NON-GOVERNMENT BONDS					
UK corporates	2.35	2.64	**+0.29**	2.39	2.73
Global High yield	5.25	5.68	**+0.43**	5.57	5.85
Emerging markets	4.07	4.48	**+0.41**	4.54	4.93

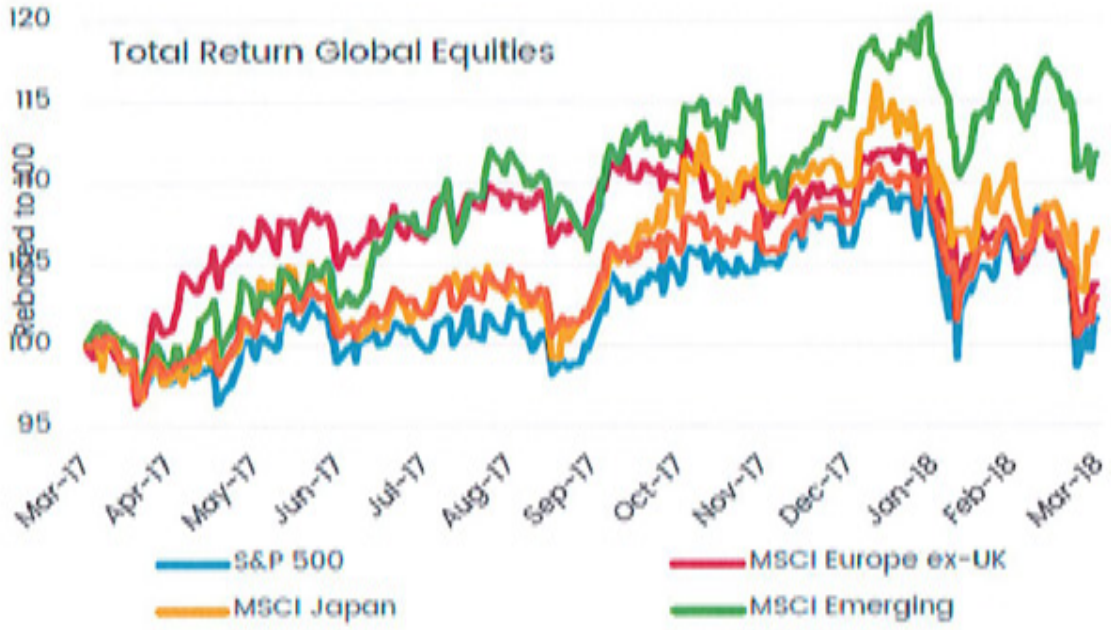
Source: - BoE DMO; Bloomberg and Merrill Lynch. indices 18th May 2018.

Chart 2: - Bond index returns in Sterling terms, since 31st March 2017.



Source: - Bloomberg

Chart 3: - Total return of overseas equity markets in Sterling terms, last 12 months.



Source: - Bloomberg

Recent developments.

Volatility, which returned with a vengeance in the first quarter, persisted through much of April. Geopolitical headlines continued to play a significant role in unsettling investors, particularly the prospect of a "trade war" between the US, China and Europe over Steel and Aluminium, alongside an escalation of tensions between the US and Russia over the situation in Syria. Coupled with uncertainty over the role of Iran in the international community, oil prices rose 7% over the month.

Investors had to balance the potential downside of these events with an earnings season that, particularly in the US, has exceeded expectations. In the end, the stronger earnings momentum was enough to push developed market equities higher over the month and into May. As of the 18th May most equity market indices are about 2 to 3% higher in sterling terms than when they started the year.

The perception that inflationary risks are starting to build, put pressure on global bond prices and this pushed the US 10-year Treasury yield over 3% for the first time in over four years. In aggregate global bond yields are rising again and returns are broadly negative. At close of business on the 18th May, the All stocks gilts index had fallen 1.5% and the All stocks index linked gilt index had fallen 3.7% year to date.

With the publication of the May Inflation Report, Mr Carney had to take back most the Bank of England's (BofE) hawkishness on interest rates proposed in February. Just a few weeks ago, the market had been expecting a 25 basis point increase in the Bank Rate at this meeting. But a string of disappointing data in recent weeks changed that. Although the labour market still looks incredibly strong, real wage growth remains low, 1Q18 GDP was weak growing just 0.1% over the quarter. Data on consumer lending, retail spending and the housing market have also been soft. As a result BoE's assessment of growth for 2018 has been reduced from 1.8% to 1.4%, the expected inflation rate was also marked down from 2.4% to 2.2%.

2. Investment Performance

Table 3, shows the performance of the Derbyshire Pension Fund versus the fund specific benchmark for the 3 and 12 month periods to the end of March 2018. The performance data has been provided by Portfolio Evaluation Limited (PEL) using their own data for the period since the end of March 2017 and a combination of PEL and WM data over longer periods. The analysis shows that the Fund slightly underperformed its benchmark over 3 months, but outperformed over 12 months, 3,5,10 years and since inception on a net of fees basis. The PEL attribution data suggests that both Asset Allocation and Stock Selection made small negative contributions to overall returns in the first quarter of 2018.

Table 3: - Derbyshire Pension Fund and Benchmark returns

% TOTAL RETURN (NET) 31ST MARCH 2018	3 MONTHS		12 MONTHS	
	Derbyshire Pension Fund	**Benchmark**	**Derbyshire Pension Fund**	**Benchmark**
UK Equity	-6.6	-6.9	2.0	1.2
Overseas Equity	-4.1	-4.0	5.3	4.3
North America	-3.8	-4.5	0.4	1.3
Europe	-4.6	-4.6	3.9	3.9
Japan	-3.6	-2.6	12.8	7.5
Pacific Basin	-5.4	-4.4	6.4	6.0
Emerging markets	-3.0	-2.2	7.8	8.8
UK Gilts	-0.2	0.3	0.3	0.5
UK and Overseas Inflation Linke	-0.5	-0.1	1.8	0.5
UK Corporate bonds	-1.2	-1.4	2.6	1.7
Multi-asset Credit	1.0	0.9	5.4	3.4
Alternatives (all sectors)	-2.2	-2.6	4.7	2.4
Property (all sectors)	2.0	1.8	10.4	9.7
Cash	0.1	0.1	0.3	0.2
Total Fund	**-3.4**	**-3.1**	**3.8**	**3.2**

Total fund value at 31st March 2018 £4,624 million

The Fund produced its first negative total return in almost 2 years as Markets in general sold off, delivering a return of -3.4% versus -3.1% for the strategic benchmark, while UK equities outperformed the market, they produced the largest negative return. Total overseas equities were down slightly more than the benchmark. Investment grade Government bond and credit returns were also negative but much less than equity. Other diversifiers such as Multi-asset credit and property produced positive returns and while returns from alternatives were negative, these returns were less negative than equity. Over 12 months all returns were positive and the Fund outperformed its

benchmark by 0.6% with a total net return of 3.8% versus 3.2%. Overseas equities outperformed the UK, in particular Japan and diversifiers such as Property and multi-asset credit made positive contributions. The total fund return net of fees over the last 10 years has been 7.9% per annum (pa), compared to the strategic benchmark return of 7.4%.

Equity performance

Over the quarter, UK equity market exposure was reduced from 26% of total assets under management to 24%. Performance over the quarter was negative but slightly better than benchmark, over 12 months returns were 2%, outperforming the benchmark by 0.8%. The 3, 5 and 10 year results are consistently ahead of benchmark. Over 10 years UK equity performance is 7.5%pa versus the market return of 6.5%

Like the UK overseas equity returns were negative over the quarter but less so than the UK. Overseas equity continues to make a very strong positive contribution to the total return of the Fund, outperforming UK equities over all periods, in absolute and relative terms.

North American equity, actively managed in a segregated portfolio, by Wellington, outperformed in 1Q18 but still lags the benchmark over 12 months, as a result the 3 year numbers are now flat to benchmark, but the portfolio has significantly outperformed over longer time horizons and outperformed the UK over 3, 5 and 10 years. North American equities have returned 14.7% pa versus the benchmark index of 12.6%, over 10 years.

The continental European equity portfolio is passively managed by UBS. The 3 and 12 month returns are in-line with the benchmark as are the 3 year returns. The 5 year returns continue to reflect a period of poor results from active management and remain 0.5% behind benchmark. Despite a period of poor active returns, 3 to 5 years ago the European fund has delivered 6.1% pa compared to the market return of 6.2% over 10 years.

The other equity assets are invested in Japan, the Pacific Basin and Emerging Markets equities, via pooled funds selected by the in-house team. In 1Q18, allocations to Japan and Pacific ex Japan outperformed the UK but were slightly worse than benchmark. Over longer periods both these allocations were well ahead of benchmark, with the strong relative performance from Japan, persisting over 12 months. Over the last 10 years; Japan has returned 10.3%pa vs 7.9%; Pacific ex Japan 10.4%pa vs 9.3%; and Emerging Markets equity 6.8%pa vs 7.2%.

Fixed Income Performance

With the increase in volatility and the broad based weakness of equity markets the UK government bond market (Gilts) performed as expected and managed to achieve a small positive return. Long dated gilts in particular had the best returns. Because the Fund is underweight duration by owning shorter maturity gilts and because allocation to Gilts and Index Linked Gilts is also underweight, the Fund's gilt portfolio underperformed the market. While the allocation has changed over the years the Bond portfolio has produced a return slightly behind the market return of 7%pa over 10 years.

The Fund's allocation to Non-government bonds like corporates also produced a negative return but the fund outperformed its benchmark slightly. Corporate yields rose and the spread over gilts also widened as the market tried to absorb the large supply of new bonds issued over the first quarter. The volatility of equity markets caused high yield bond spreads to widen, also producing larger negative returns than gilts. The allocation to Multi-Asset Credit produced positive returns and the fund outperformed its benchmark.

Over the year, with the exception of the conventional gilts, all the active decisions taken relative to the benchmark added value, exposure to outperforming US TIPS helped inflation linked bond portfolio outperform the benchmark. As did the allocations to Investment Grade and Multi-asset credit. The performance of the bonds in the first quarter shows their importance as diversifiers of return. Over the medium and longer term, returns from bonds have been lower than from equity and alternatives and the overall contribution negative relative to benchmark.

Alternatives

The performance of the in-house team's portfolio of Alternative investments was negative but slightly outperformed the benchmark over the quarter, like bonds showing their importance as diversifiers of return. Over longer term periods Alternatives continue to enjoy excellent absolute and relative returns despite the underweight allocation. At the end of the quarter the allocation stood at 5.4% with cash committed but as yet un-invested by the selected managers. The 5 year track record of the Alternatives portfolio is 11.9%pa versus 4.6% for the benchmark.

Property

Over the quarter and the year the total allocation to all property produced good positive returns with the allocation to direct property outperformed and indirect property funds slightly underperformed. Over the longer term direct property investments have helped the allocation outperform the benchmark whereas indirect property returns have been more mixed. Total return from the sector remains strong and positive on an absolute and relative basis. Over 10 years the Property portfolio has delivered 6.1% pa versus the benchmark return of 5.8%

Asset Allocation

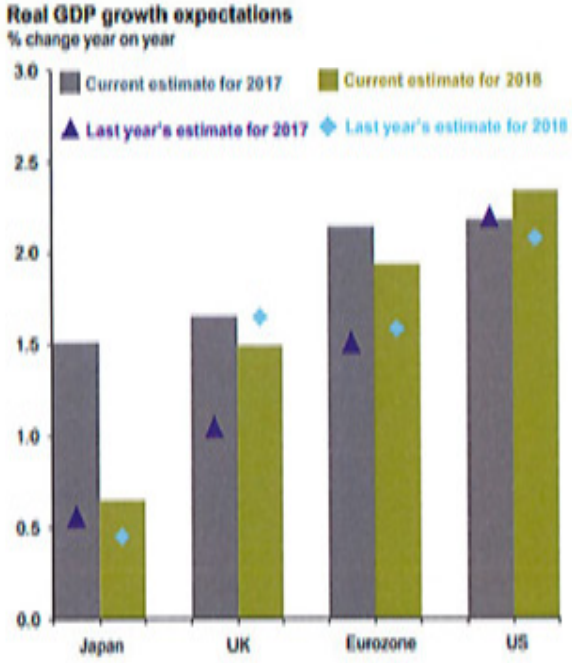
At the asset allocation level the DPF's in-house team has made some excellent decisions. In general over the medium to long term, being overweight "growth" assets like equities at the expense of "income" assets like bonds, has been a good decision. Within equity, being overweight higher growth regions like Asia Pacific and Emerging Markets has in absolute terms increased Fund performance. Within bonds the Fund could have benefitted from a higher allocation to non-government sectors but this would have increased risk. On balance in terms of total return it is has probably been better, to use the money generated by being underweight bonds in general to invest it in being overweight equity. The Fund has also been successful with its allocations to Property and Alternatives and it also identified good managers that have outperformed their benchmarks, the contribution to overall Fund return would have been even more significant if the Alternatives managers had invested all the DPF's committed cash.

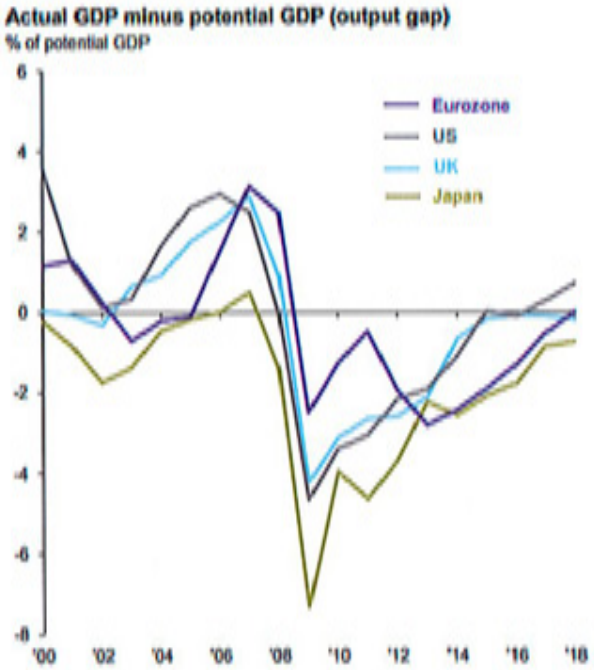
3. Economic and Market outlook

Economic background

The strong synchronised global expansion began to show some signs of slowing down in the first quarter of 2018, and inflation accelerated in most regions, although on the whole economic data was positive. The UK remained the outlier: growth remained slow, and inflation started to fall, to 2.5% for March from its peak of 3% in January. Monetary policy was further tightened in the US, with the US Fed raising rates by 0.25% to a range of 1.5 to 1.75%. Elsewhere rates were unchanged but the Bank of England in its February inflation report had sounded more hawkish on the future direction of rates. Global growth in Q1 was steady, albeit slower than in Q4 2017. In the US, UK and Eurozone, declines in manufacturing and purchasing managers' indices indicated potentially slower (although still positive) growth to come. As Chart 4a shows the current consensus estimates for growth in 2018, compared to last year's remain positive, except in the UK.

Chart 4a: - Real GDP expectations 2017 and 2018; **Chart 4b**: - Output Gaps

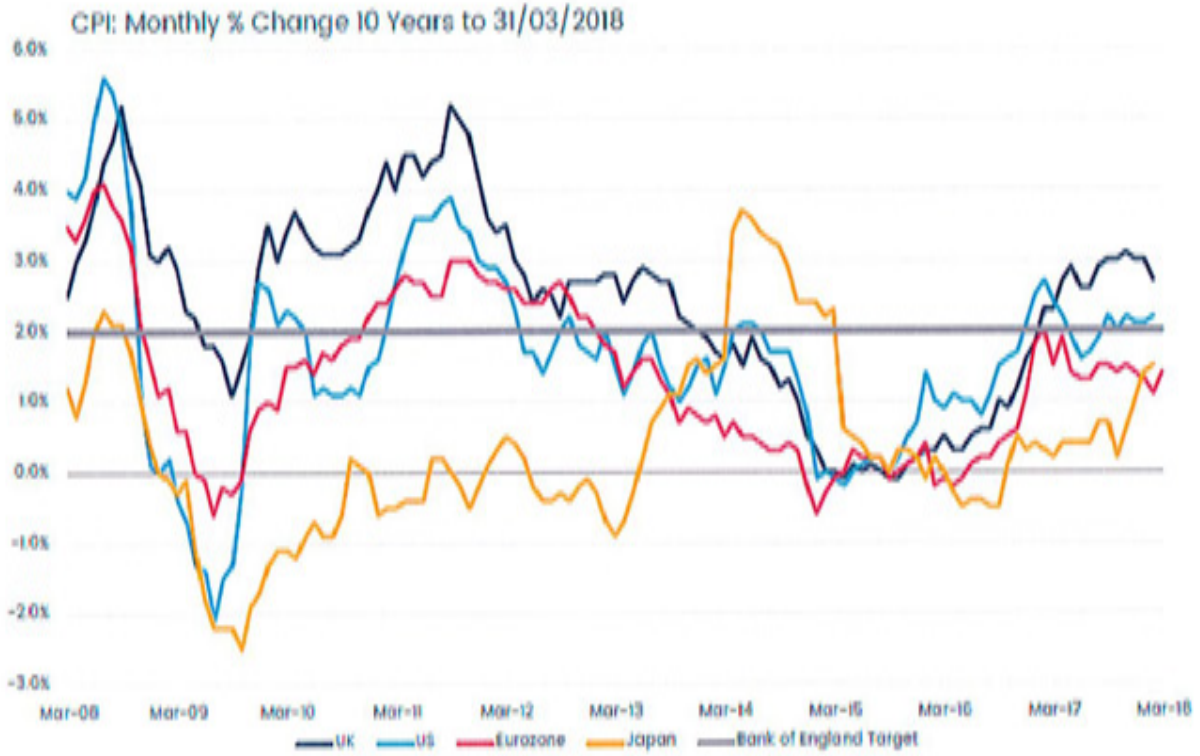




Source: - JPM Asset Management

In terms of Inflation see chart 5, US inflation has ticked up causing some concern that the US Fed may become more activist. However the recent uptick in oil prices may dampen expectations as the increase has taken back about half the value of the income tax cut. As predicted by the Bank of England, UK inflation has started to fall, as the weakness of sterling washes through the data. Outside of the US strong activity has not yet translated into higher inflation, because the other economies have yet to exceed their respective "output gaps" (chart 4b above).

Chart 5: - Inflation remains at or below the central bank target rate of 2%.



Source: - Bloomberg

Central Banks

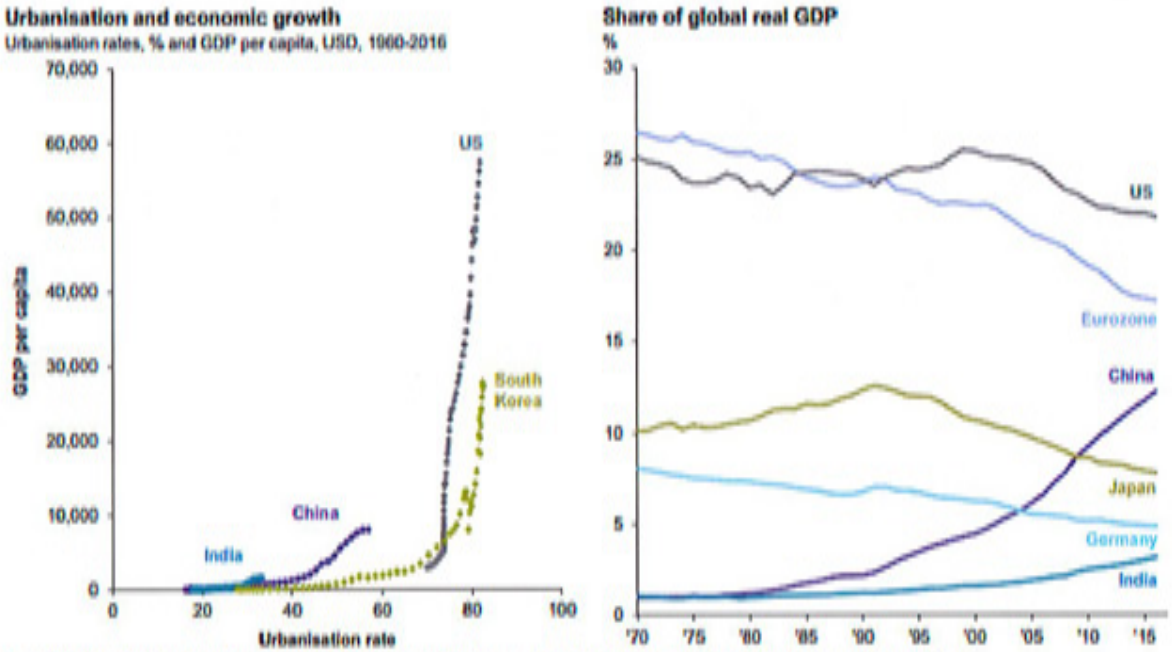
The US Fed raised rates in March to the 1.5 – 1.75% range and is expected to increase them again in June, after that 2 further rate increases have been price into the market by the end of the year. They have also chosen to maintain their QT programme. The Bank of England sounded Hawkish on inflation in February, but Dovish at the May Inflation Report meeting, as growth was weaker than expected and the past weakness of Sterling is falling out of the inflation data, which they have been predicting for the last year. The ECB confirmed that it expected to end QE in September and announced there would be no rate hikes until after programme is over. It is worth remembering that overnight rates are still negative at around -0.3% in Europe. The Bank of Japan left its key short-term interest rate unchanged at -0.1 percent at its April 2018 meeting, as expected. Policymakers also kept its 10-year government bond yield target around zero percent but dropped their target date for reaching 2 percent inflation. The end of the growth expansion in Japan is unlikely to lead to any change of policy this year.

Emerging economies

Chinese growth surprised on the upside with 6.8% in the first quarter whereas India slightly disappointed, but the long term drivers of secular expansion remain in place. The left hand graph on chart 6, shows that as the urbanisation rate increases it is accompanied by higher incomes and this drives domestic consumption. The irony over the discussions on trade tariffs, is China is already moving from expanding its export led growth to domestic growth, so the US may be pushing on an open door. For the emerging economies as a whole the demographics are also more favourable and

their debt burdens lower which means they can probably continue to sustain higher growth rates. As emerging economies switch to domestic demand they are becoming less internationally dependent and increasingly able to finance activity from their own domestic savings and growth. The right hand graph on chart 6 also shows how the share of global real GDP has changed over time, China already outstrips the contribution from developed markets like the UK, Germany and Japan.

Chart 6: - Emerging market structural economic dynamics and share of global GDP.



Source: (Left) IMF, J.P. Morgan Asset Management. Urbanisation rate refers to the proportion of the total population living within an urban area defined by national statistical offices. (Right) Thomson Reuters Datastream, World Bank, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - UK.* Data as of 31 March 2018.

Politics

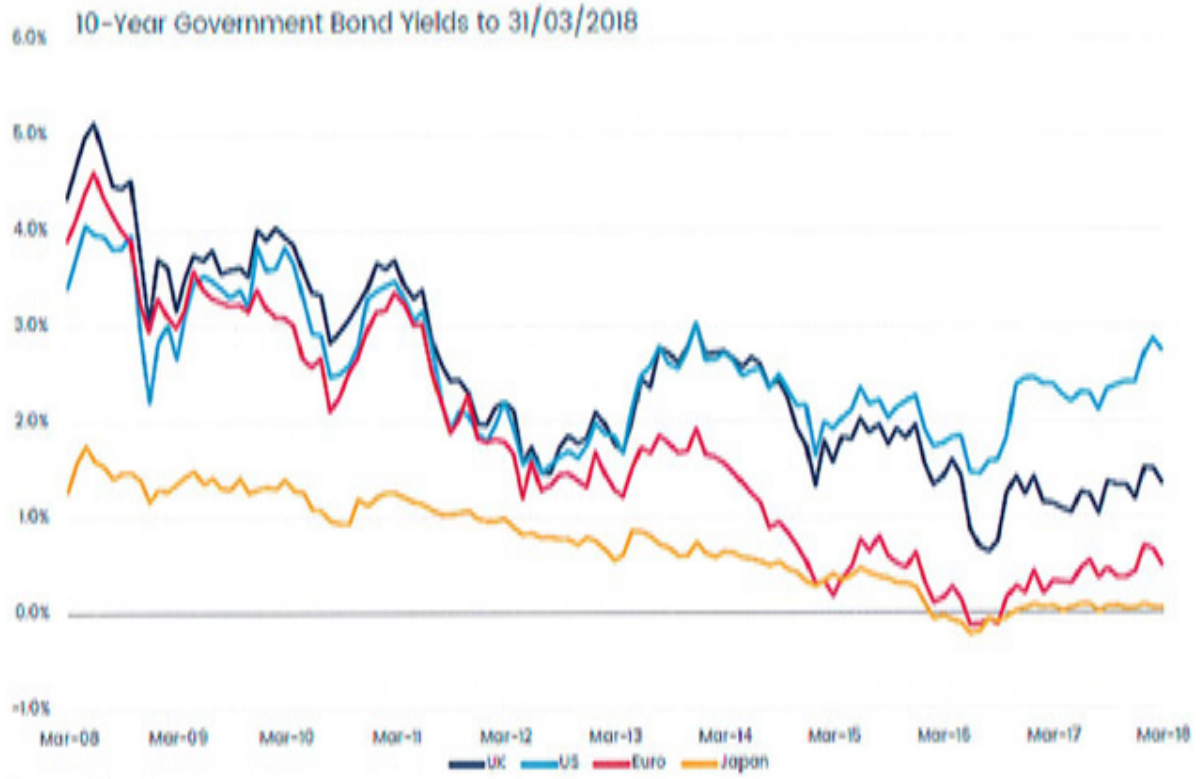
After the concerns of a year ago it seems politics just happens and the markets get on with life. In no particular order of importance. Mrs Merkel finally formed a grand coalition with the Social Democrats. Italy failed to have a clear election result and after 2 months of negotiations, the 2 largest parties, the populist "5 Star movement" and the far-right wing "League" (formerly Northern League, whose stated policy was the separation of Italy into North and South), have formed a coalition. However their plans for government have been rejected by the President because of the choice of Economic Minster and his openly "anti-Euro" stand point. The outcome may lead to a new general election because the President's point is that leaving the Euro was not put clearly to the electorate. In Russia the Kleptocracy was confirmed by the Election of Mr Putin. Mr Trump is taking credit for bringing North Korea to the negotiating table and winning ground on trade negotiations with China. In Venezuela Mr Madura has been re-elected as President again as the economy spirals out of control.

In the UK, the Brexit negotiations rumble on becoming more complex by the day, especially surrounding the negotiations on trade and the border with the Republic of Eire. In the meantime companies that have close links with Europe, are implementing their contingency plans. This is especially true of service companies like banks and insurance companies who currently have no certainty over access to the European market post Brexit.

Government bonds

The Government bond market produced negative returns in 1Q18 and yields have continued to move higher into the second quarter, on higher US inflation and fear of a more activist US Fed. Ten year government bond yields are, at the time of writing 15 to 30bps higher, on top of the yield increase we saw in the first quarter (see table 2) and unlike in 1Q18 where 30 year yields were slightly lower they have risen by more. Shorter dated US bonds in particular have seen their yields increase the most as the prospect of further Fed tightening has been priced in. This is not true outside of the US (and Japan) where the yield curves remain relatively steep. Where central bank policy rates have less impact (5 years and longer) I continue to expect that global bond yields led by the US, are likely to trend higher, which may lead to further quarters of very low positive or even negative returns from Government bonds. I continue to believe it is sensible to remain underweight and short of duration in government bond markets.

Chart 7: - Government bond yields, last 10 years



Source: - Bloomberg

Non-government bonds

The non-government market showed its vulnerability to periods of excess supply in 1Q18 especially, in a generally rising yield environment. As a result yields rose faster and created larger negative returns in both investment grade and high yield credit markets. In the second quarter with the supply glut out of the way credit markets have in general performed better.

Chart 8: - Investment grade credit spreads, extra yield over government bonds.

Source: - Bloomberg

As you can see in Chart 8, above the extra yield spread over government bonds for investment grade credit (non-government) bonds widened in 1Q18 but has since stabilised. While this may not be an argument for increasing exposure just yet, it is not a case for reducing exposure. The overall yield is still higher and the interest rate risk lower, so non-government bonds could resume their outperformance of government bonds whichever the direction of the market.

I continue to expect that government bonds in general will achieve a low single digit and even a negative total return over the next 12 months and it is entirely likely that we could see further quarters of negative returns. As I am not expecting a generalised credit event or a sharp increase in default rates, I expect non-government bonds in general to outperform government bonds over the year ahead. See Table 7, below for an estimate of the impact of rising bond yields on Government and non-government bond markets.

Equities

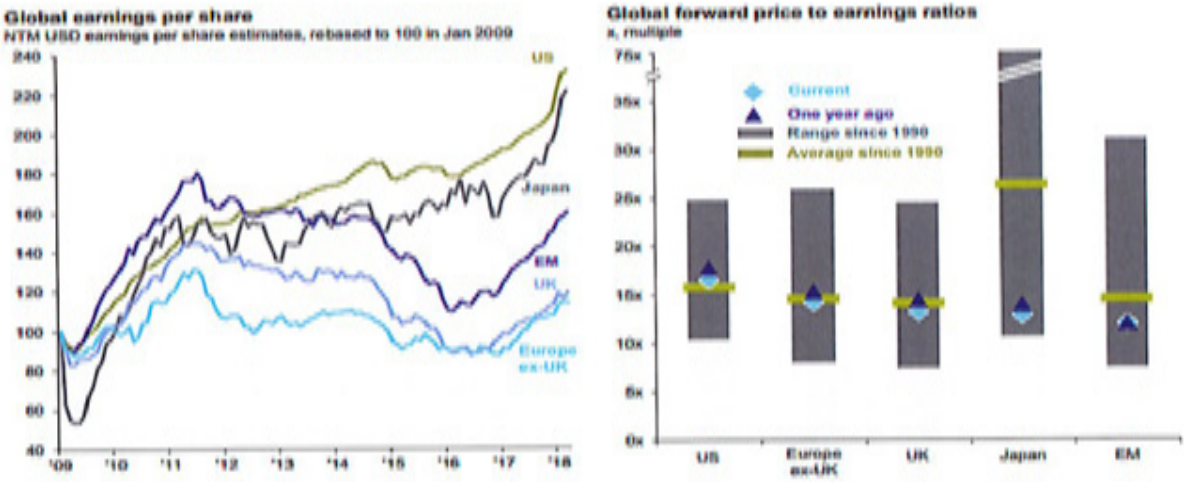
Chart 9, below shows the performance of representative equity market indices in local currency terms over the last 10 years. The US market represented by the S&P 500 index has had the strongest returns since the GFC and Europe (STOXX Europe 600) and emerging markets the poorest.

Chart 9: - Global Equity returns, last 10 years.

Source: - Bloomberg

Chart 10, below shows on the left hand side (LHS) shows estimated Earnings per Share (EPS) for the next 12 months this would support the idea of further positive price developments but I am increasingly concerned that there is a lot of good news already priced in at these levels, having said that both graphs support the idea that outside the US equity prices may have some way to go.

Chart 10: - LHS - Global Earnings per Share estimates, in US dollars since January 2009; RHS – Global forward P/E's.



Source: - MSCI, DataStream, JP Morgan Asset Management, March 2018

The poor performance of Europe over the last year reflects the strength of the Euro but also the residual effects of the more uncertain political situation. But, Europe remains a beneficiary of a stronger global economy and as can be seen in the charts above valuations are not especially stretched, this combined with the policy of the ECB should help certain European equities perform well on an absolute and relative basis.

As mentioned above and in my last report the fundamentals (chart 6) for most emerging economies remain positive, growth is stronger and their valuations (charts 10) remain attractive. As they develop, the positive demographics and the rise of the "middle classes" means they are becoming more domestically orientated, hence policy decisions taken in the US may not have such a negative impact on emerging countries as they did in the past.

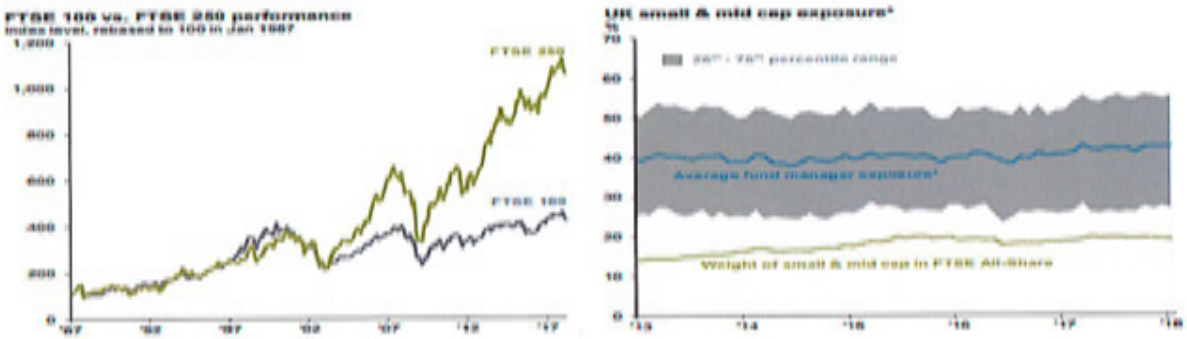
UK equity

Since the US dollar started to strengthen in April combined with higher Oil prices, the UK market has been one of the best performing markets recovering its out size losses in the 1st quarter. However I suspect the performance is quite narrow and has been enjoyed by only a few sectors and individual stocks. The current strength may provide the tactical opportunity to reduce UK exposure and increase allocations elsewhere.

Recent research would suggest that from a sources of global growth point of view, the asset allocation to UK equity in the overall Fund could be moved lower to reflect the UK's contribution to global growth. Having said that, the UK is the Home Market, the pensions are paid to UK residents, the UK has very high standards in terms of governance, accounting and the rule of law. The UK stock market indices have a high weight of international earnings, so for this reason the UK equity market can be seen as a proxy for global equity, thus justifying a higher weight in a portfolio. In terms of how to be positioned between domestic versus overseas earnings, I continue to believe the performance of the UK domestic economy looks more uncertain. UK growth continues to slow relative to the rest of the world and even the Bank of England's forecasts for 2018 and beyond support a further underperformance of the UK economy.

I therefore reiterate my suggestion that a switch from domestic sources of growth to international sources may be prudent, either by further reducing the UK strategic allocation or by a shift in emphasis towards overseas earners in the FTSE100, relative to the FTSE 250 (LHS Chart 11). There is also a technical argument for considering such a switch, see the RHS graph on Chart 11, investors in small and mid-cap UK equity have held more than a double weight to this sector relative to its weight in the FTSE All-share, so that should this sector fall out of favour, the outflow could cause significant underperformance.

Chart 11: - FTSE 100 relative to FTSE 250 index, LHS, performance and RHS relative weight of investor exposure



Source: FTSE Indices, DataStream, JPMorgan Asset Management March 2018.

GDP Forecasts

Table 4, shows the consensus forecasts for GDP growth in calendar 2018 and 2019 and my expectations in January and May 2018.

Table 4: - GDP forecasts - Consensus versus Advisor expectations

% CHANGE YOY								
	2018				2019			
	JANUARY 2018		MAY 2018		JANUARY 2018		MAY 2018	
	Consensus	**AF**	Consensus	**AF**	Consensus	**AF**	Consensus	**AF**
US	2.3	**2.5**	2.8	**3.0**	2.6	**3.0**	2.6	**3.0**
UK	1.7	**1.7**	1.4	**1.4**	1.5	**1.5**	1.5	**1.5**
Japan	1.8	**1.9**	1.3	**1.5**	1.1	**1.5**	1.1	**1.5**
EU 28	2.3	**2.4**	2.2	**2.4**	1.9	**2.2**	1.9	**2.2**

Source: - Consensus Economics May 2018

Consensus estimates for 2018 have been marked higher in the USA and down elsewhere and the consensus for 2019 is lower for all countries, in line with the Bank of England, the consensus for the UK has been revised down. I continue to believe that the period of synchronised growth that the global economy is experiencing may continue into 2019 and result in growth being generally higher than consensus. In the UK I believe the consensus is probably about right, the recent increase in Oil prices will dampen growth but real earnings have improved slightly as the past weakness of Sterling falls out of the inflation index, however, the impact of the continued uncertainty generated by Brexit makes UK growth very difficult to forecast.

The US economy expanded an annualised 2.3% in the first quarter of 2018, below 2.9% in the previous period but beating market expectations of 2%, it is the lowest growth rate in a year. The increase in real GDP reflected positive contributions from non-residential fixed investment, personal

consumption expenditures (PCE), exports, private inventory investment, federal government spending, and state and local government spending.

In the first three months of 2018, the UK economy expanded by 0.1%, in line with the preliminary estimate and well below 0.4 percent in the fourth quarter. It is the lowest growth rate since a 0.1 percent contraction in Q4 2012, household spending rose the least in over three years and business investment shrank the most in over 2 years. Year-on-year, the economy rose 1.2 percent, below 1.4 percent in Q4 but matching the preliminary estimate.

The Japanese economy contracted 0.2% in the three months to March of 2018, after a downwardly revised 0.1% growth in the previous period. This is the first contraction since the fourth quarter 2015, private investment fell and households' consumption stagnated. On an annualised basis, GDP shrank 0.6%, compared to a downwardly revised 0.6% expansion in the preceding quarter. The figure came in worse than market expectations the contraction ended the longest run of positive growth in 28 years!

The Eurozone's gross domestic product grew by 0.4% in the first three months to March 2018, unrevised from the preliminary estimate and below 0.7% achieved in the fourth quarter. Among the bloc's largest economies, GDP growth slowed in Germany and France, and was unchanged in Italy and Spain. Compared with the same quarter of the previous year, the Eurozone economy expanded 2.5%, slightly below the 2.8% growth rate seen in the previous period.

Consumer Price Inflation

Table 5, shows the consensus forecasts for Consumer Price Inflation in calendar 2018 and 2019 and my expectations in January and May 2018.

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

% CHANGE YOY								
	2018				2019			
	JANUARY 2018		MAY 2018		JANUARY 2018		MAY 2018	
	Consensus	AF	Consensus	AF	Consensus	AF	Consensus	AF
US	2.1	**2.3**	2.5	**2.7**	2.2	**2.5**	2.2	**2.5**
UK	2.7	**3.0**	2.5	**2.5**	2.2	**2.5**	2.2	**2.5**
Japan	0.5	**0.7**	1.0	**1.2**	1.1	**1.2**	1.1	**1.2**
EU 28	1.7	**2.0**	1.7	**2.0**	1.7	**2.0**	1.7	**2.0**

Source: - Consensus Economics May 2018

With the exception of the UK, inflation trended upwards across the quarter, as increasing price pressures began to be felt. In the US, higher inflation figures caused some market turbulence, as fears arose that the Fed would raise rates more quickly than planned. This increase was in part due to the effects of the US tax cuts acting as a stimulus. In the UK, inflation began to decline in February, as the effects of the post-Brexit sterling depreciation dropped out of the system. While inflation

remained above the Bank of England's 2% target, it dropped to its lowest level in more than a year in March 2018. I still expect that inflation will come in above expectations but I do not believe that this will be a surprise to any of the major central banks, therefore I do not see any unexpected changes in policy.

The inflation outlook remains fairly benign while the trend in US inflation is higher, the US Fed is responding with measured increases in rates and a further reduction in QE. The Bank of England has been proved correct that inflation would fall as the impact of currency depreciation fell out of the system, although they have blown "hot and cold" on the inflationary outlook in recent inflation reports. I therefore believe Central banks remain comfortable with the level of inflation and are unlikely to respond unexpectedly. It is also a recognition that the developed economies, other than the US and the UK, have some way to go before growth will put pressure on inflation.

Having said that I believe the secular outlook for inflation globally has changed after a long period of low inflation driven by weak economic activity in the developed economies and the deflationary influence on global goods prices from emerging economies. As we move through the growth cycle it would be reasonable to experience a period of higher inflation arising from stronger developed country growth and a switch from exports to domestic consumption in developing countries. The prospect of policy error with tariffs and protectionism on global trade also increases the risk of higher inflation.

4. The outlook for the securities markets

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 likely direction of yields from May 2018.

Yields have continued to move higher in the second quarter on higher US inflation and fear of a more activist US Fed, 10 year government bond yields are 15 to 30bps higher than they were at the end of March and unlike in 1Q18 where 30 year yields were slightly lower their yields have risen by more. I continue to expect that global bond yields led by the US, are likely to trend higher in 2018.

The US Fed raised rates in March 2018 to a range of 1.5 to 1.75%, the market now expects at least 2 and maybe 3 more 0.25% increases in 2018, with next 0.25% increased expected in June. As a result US bond yields could rise to around 3.25% by the end of the year. The markets had expected the Bank of England to raise rates in May, but weaker 1Q18 growth and falling inflation has caused the Bank to revise down its forecasts and as I said last quarter, I do not anticipate any further changes in official rates in the UK at all this year. After the more hawkish rhetoric of the Governor at the February Inflation Report, he was more conciliatory at the May press conference. It remains unlikely that rates will be increased in Europe or Japan in 2018, although the ECB is expected to cease QE in September. It will be very interesting to see how the political situation in Italy plays out for Eurozone bond yields!

While the Central banks outside of the US, are not yet raising interest rates they are reducing the level of QE, and the US has begun Quantitative Tightening (QT). As a result a new buyer for government bonds needs to be found. Japanese and German (the benchmark for Europe) government bond yields are still negative out to 5 years in Germany and 7 years in Japan, as mentioned before these rates have and will continue to become less negative as these economies build on their economic recoveries.

Table 6: - Interest rate and Bond yield forecasts

%	CURRENT	SEPTEMBER 2018	JUNE 2019
UNITED STATES			
3month LIBOR	2.32	2.50	3.25
10 year bond yield	3.06	3.25	3.50
UNITED KINGDOM			
3month LIBOR	0.61	0.60	0.75
10 year bond yield	1.50	1.80	2.00
JAPAN			
3month LIBOR	-0.02	0.00	0.00
10 year bond yield	0.04	0.10	0.10
GERMANY			
3month EURIBOR	-0.33	-0.25	0.00
10 year bond yield	0.58	1.00	1.25

Source: - Bloomberg, Trading Economics; 18th May 2018

Bond Market Recommendations

As mentioned above I expect global bond yields to continue to rise, led by the US and the market expects that the Fed is likely to raise rates 2 or 3 times this year and through QT, they will no longer be recycling coupons and principle repaid on their holdings of government bonds purchased during the QE programme. Therefore it remains appropriate to focus on US government yields as the main driver of higher global government bond yields. Balanced against this the ECB and the Bank of Japan are keeping overnight interest rates negative, the ECB continues to buy bonds for QE and in Japan 10 year government bond yields are pegged at 0.1% as part of their QE programme. The resulting capital flow into the US Government bond markets higher yields may actually be keeping global government bond yields artificially low.

The surprise for me in the first quarter was that non-government bond yields rose faster than government yields. This was caused by the glut of new issuance in the corporate market and the lower quality standards in the high yield market. Now that the new supply has been absorbed by

investors, since the end of the quarter non-government bond yields have risen by less, except in emerging markets were yields have matched the move higher seen in the US.

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 widening of spread over the holding period. If the yield spread on investment grade corporates and global high yield widened by 0.3% and 2% respectively then all 3 indices would have a similar negative return to gilts over 12 months.

Table 7: - Total returns from representative bond indices

INDEX	YIELD TO MATURITY %	DURATION	YIELD INCREASE %	% TOTAL RETURN, HOLDING PERIOD	
				3 MONTH	12 MONTH
All Stock Gilts	1.78	10.6	0.5	-4.9	-3.5
UK Corporate Bonds	2.73	8.3	0.5	-3.4	-1.4
Global High Yield	5.85	4.1	0.5	-0.5	+3.8

Source: - BofA Merrill Lynch Indices 18th May 2018

In table 7 above I have shown how investing in non-government bond sectors could protect the DPF from the scale of negative returns that investment in gilts could result in. As mentioned before spreads are lower than they have been since the GFC, but the investment grade market is arguably better quality that it was before the GFC. Once the ECB QE programme has truly ended there has to be a risk that spreads could widen and as we saw in 1Q18 the market can be sensitive to new issue supply exceeding demand. It should also be remembered that gilts provide a hedge for the DPF's potential liabilities and as we have seen in 1Q18 bonds can reduce the negative impact that falling equity prices can have on the overall portfolio. If higher equity volatility is here to stay then any further reduction in gilts may not be desirable at this stage. I also know that the DPF is underweight duration, this combined with an underweight to bonds in general has and will continue to reduce the negative impact of higher gilt yields relative to the strategic benchmark allocation.

I continue to believe that the DPF's bond allocation should have diversified sources of bond market risk and return and that this can be achieved through allocations to Investment grade and sub-investment grade credit and to emerging market debt funds. This can also be achieved by an allocation to Multi-asset Credit Funds and Private Debt funds, but the accumulation of a position in private debt is subject to the opportunities being available and requires a lot of due diligence and careful research. I continue to suggest increasing the allocation to Multi-asset Credit from 2% to neutral at 4% as soon as is reasonably possible. Strategically I maintain my view that the fund should have a higher weight to corporate bonds, while I accept that tactically the current level of spread may

not be attractive I maintain the view that the overall level of yield relative gilts argues for a neutral exposure.

UK Index Linked gilts remain some of the most expensive bond assets in the world in absolute terms and when compared to inflation linked government bonds elsewhere. However, demand remains high from corporate pension schemes and Insurance companies looking for safe long term Inflation linked returns. The in-house team has maintained their position in US TIPS and this has added value both on an absolute and relative return basis. Overall I believe it is appropriate to be underweight this asset class and to continue to hold the position in US TIPS instead of UK Index Linked gilts.

Equity Markets

Table 8 below, shows the dividend yield, earnings growth and price / earnings ratio forecasts, for 2018 and 2019 provided by Citi Research.

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

COUNTRY	DIVIDEND YIELD	EARNINGS GROWTH		PRICE/EARNINGS RATIO	
FORECAST PERIOD	2017	2018	2019	2018	2019
United Kingdom	4.3	8.1	6.2	13.3	12.6
United States	1.8	19.4	10.6	17.2	15.5
Europe ex UK	3.3	10.8	9.5	14.4	13.2
Japan	2.1	6.6	6.9	13.5	12.6

Source: - Citi Research, Global Equity Strategist, 4th April 2018

Earnings growth for 2018 has been revised higher in all regions, reflecting analysts' more optimistic outlook and in the US, the impact of the corporate tax cuts, except Japan, which have been revised 0.4% lower. However the boost to the US appears short lived as estimates have been revised lower for 2019, the UK has also been marked lower, but Europe and Japan have been revised higher. The downward revision of the US and the UK probably reflects their position in the economic cycle and the anticipation of a late cycle slowing caused by higher rates or inflation or a combination of both, whereas Europe and Japan's expansion is considered less mature. The estimates for 2018 are consistent with a continuation of the global synchronised expansion in growth and with my expectation of slightly stronger than consensus GDP growth. However they appear rather poorer than I would have expected for 2019.

The recent volatility and price correction in all equity markets, has bought 12 month market returns down to around 3%, but average returns are still above 8%pa for the last 10 years. This high level of

average long term returns is unlikely to be sustained into the future and forecasters are expecting average equity market returns to be around 4% for developed markets, but maybe as high as 7% for developing markets. The other factor supporting equity markets has been the uncharacteristically low volatility over the last 5 years, this is another market feature that is unlikely to persist. Lower aggregate returns and higher uncertainty are both strong arguments for active rather than passive investment, it is also an argument for diversification. In terms of the macro-economic factors investor should focus their asset allocation on markets where the secular as well as the cyclical factors still have upside potential and secondly on active asset managers with a proven ability to add value in all market conditions. I still believe equity markets can go higher, but the total return over the next 12 months is likely to be lower and more volatile than the 8% average we have become accustomed to.

Equity Market Recommendations

After the market volatility seen in 1Q18 the markets appear to have returned to business as usual, with a strong rally in prices since the end of the quarter. However the mix of drivers may have subtly changed, the markets are now expectant of higher earnings so the upside goes unrewarded and the downside punished. Higher interest rates and bank deregulation should present opportunities for the financial sector, it also has negative implications for higher yielding (yield proxies) equity. The recent scandal over privacy and the imposition of GDPR in Europe has implications for all, but in particular those companies in the Tech sector that relied on the flow of nil cost personal data to help drive their business model. The geo-political and trade tensions created by Mr Trump and his administration's style do not help. Currency moves, the strength of the Euro and the Pound versus the dollar has held back returns, with the return of relative US dollar strength the UK market has already rallied and Europe could also see better performance. Meanwhile the developing markets continue to trend gently higher in the background, but not without headline surprises like Argentina, or unexpected weakness in India and strength in China. All this should remind us of the importance of diversification.

In summary, I have not changed my position since the last report and PIC meeting. I continue to suggest a 2% overweight to equity funded from bonds mainly because while I do not expect a continuation of the strong equity returns we have seen in the last couple of years, I believe equities will outperform bonds. The strategic weight to UK equities should be underweight; despite the valuation a neutral position in the US would appear for now to remain appropriate; I recommend a neutral exposure to Europe ex UK, because investment policy is passive rather than active; but I recommend a +1% overweight to Japan and Asia-Pacific and a +2% overweight to Emerging Markets.

An underweight in the UK equity market has to be measured because it is the home market and the beneficiaries live in the UK. But I remain concerned about the low level of real earnings growth, the level of consumer debt and the squeeze this is continuing to put on the UK domestic economy. This combined with poor pace of progress on Brexit could increase negative sentiment for UK assets and lead to a generalised weaker relative performance. On the other hand, as can be seen since the end of the quarter renewed Sterling weakness has a strong impact on the market because of the high overseas earnings content. In conclusion, with the uncertainty around Brexit likely to increase as we go through the year and the continued poorer macro-economic news, I believe a lower allocation is prudent.

Despite the recent sell off, the US equity market remains overvalued, even if higher earnings growth is taken into consideration. Recent macro-economic data and the bond market have raised concerns of a more activist US Fed. For now, despite Mr Trump's rhetorical style and approach to geo-politics and trade negotiations the market remains sanguine. I suggest staying with a neutral position.

If the DPF had an active manager for European equity I would like to be overweight because I think the risks are well known and can be avoided by good country and stock selection, overall I believe the economy will again surprise with stronger growth in 2018 and if the Euro can stabilise, its strength over the last year will be less of a drag on the market. However as the assets are managed passively I believe it is appropriate to remain neutral.

The Japanese equity market weathered the volatile first quarter well and has recovered strongly in the quarter to May, despite the recent slowdown in the economy. On a fundamental value basis the market is fair value, but cheap relative to the rest of the world and relative to its own longer term history. The heightened political risk surrounding Mr Abe seems to have subsided and his reforms remain on track. One of which could have strong implications for the distribution of cash being held on company balance sheets, which are the highest in the world. The domestic and regional economic fundamentals underpinning the Japanese equity market have not changed. I therefore continue to recommend an overweight position of 1%.

Based on research on the contribution to global growth, the DPF is more underweight developing equity markets than it is to any other source of growth. The economies represented in the Pacific ex Japan and Emerging market equity indices are growing on average, roughly twice as fast as developed economies and have positive domestic macro fundamentals. The secular trends are intact and cycle is less mature, in addition relative to developed markets the valuation appears reasonable. I believe that a 1% overweight to both sectors can be justified for the long term and maybe some more consideration should be given to a significantly higher weight to the countries in the Emerging Equity index.

Property, Alternatives and Cash

The Strategic benchmark is well diversified and contains an allocation to Property and Alternatives. These areas of investment tend to be less liquid (more difficult to buy and sell) and require high levels of due diligence to ensure only the best opportunities are acquired. The manager selection process is resource intensive, can be slow and once the manager is selected, deployment of committed cash can take a long time. Despite this, the assets purchased have many desirable attributes for pension funds whose long term liabilities have call for a balanced portfolio of long term assets whose performance is dependent on diverse sources of risk and return to more traditional tradable asset classes such as bonds and equities. For instance alternatives can provide a cheaper way to access long term inflation linked cash flows than through index linked gilts. Asset Allocation is increasing but remains below benchmark. It is also more appropriate to judge the performance of these asset classes on a longer term time horizon.

The Property market has again delivered strong diversified returns for the Fund and the direct property manager has outperformed. While all the focus has been on the weakness of currency and the strength of traded equity markets, property values have steadily improved without exhibiting short

term volatility. Which again emphasises the need to be more long term in the approach to investment in property to avoid bouts of short term volatility. I continue to recommend that a neutral overall weight to property be maintained and express a preference for being 1% overweight direct, against being 1% underweight indirect property. The in-house team continues to add to its property investments by using the approach of buying well researched, quality properties at the right price and minimising "voids" is likely to continue to be successful in future.

Alternatives; the Strategic weight of Infrastructure has been increased from 3 to 5% and the in house team has added to selected fund managers over the year. As the allocation is still underweight I am therefore happy to be neutral both Infrastructure and Private Equity. Should the demand / supply imbalance improve I would like to see the allocation increased to overweight but it is more important to get the right opportunities than it is to fill the allocation with potentially expensive low yielding assets.

Finally cash, because the Fund is cash flow positive there is no requirement to carry a large cash balance. The current balance appears to still be quite high but it has declined over the year as committed funds have been taken up. Much of the cash held is committed to fund managers that have yet to "draw down" their allocations for investments, further drawdowns will see the excess cash balance fall. Where there is excess cash above the committed balances the recent sell off may provide the opportunity to re-allocate to some cash to the market, especially as it would now appear that the Bank of England is unlikely to raise rates this year.

The asset allocation set out in table 9 below, shows the Derbyshire Pension Fund's Strategic benchmark allocations and my recommended relative weights as of 14th February and the 27th May 2018. My suggested asset allocation weights 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 to be taken by the investment managers to find correctly priced assets for inclusion in the Fund.

Table 9: - Recommended asset allocation against the new strategic benchmark set on 1st April 2017

% ASSET CATEGORY	DERBYSHIRE STRATEGIC WEIGHT 1ST APRIL 2017	ANTHONY FLETCHER 14TH FEBRUARY 2018	ANTHONY FLETCHER 21ST MAY 2018
Total Equity	**58**	**+2**	**+2**
UK Equity	**25**	**-2**	**-2**
Overseas Equity	**33**	**+4**	**+4**
North America	12	**0**	**0**
Europe ex UK	9	**0**	**0**
Japan	5	**+1**	**+1**
Pacific ex Japan	4	**+1**	**+1**
Emerging markets	3	**+2**	**+2**
Total Bonds	**22**	**-2**	**-2**
Conventional Gilts	5.5	**-1.5**	**-1.5**
UK index Linked	6.5	**-2.5**	**-2.5**
US TIPS	0	**+1**	**+1**
Non-government	6	**0**	**0**
Multi-asset Credit	4	**+1**	**+1**
Total Alternatives	**18**	**0**	**0**
Infrastructure	5	**0**	**0**
Private Equity	4	**0**	**0**
Direct Property	5	**+1**	**+1**
Indirect Property	4	**-1**	**-1**
Cash	**2**	**0**	**0**

Contact:

Anthony Fletcher
Senior Adviser

DD: +44 20 7079 1000
anthony.fletcher@mjhudson.com

Appendix

References

Source material was provided by, including but not limited to, the following suppliers:-

- Derbyshire Pension Fund, PEL and WM performance services
- GFC Economics, Citi Research,
- FTSE, Citigroup, IPD, Barclay's Global and Interbank Indices
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- 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.
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8 Old Jewry, London EC2R 8DN, United Kingdom | +44 20 7079 1000 | london@mjhudson.com| mjhudson-allenbridge.com

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