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01 March 2022

The end of the peace dividend

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Lenin is claimed to have said: "There are decades when nothing happens; and there are weeks when decades happen." Like most famous quotations, this has probably been distorted a little by the sands of time, but it seems extremely apt given what has happened over the last few weeks.

In the global inflation-linked team at Sanlam, we are trying to break down what the tragedy in Ukraine might mean. To us, a few key takeaways seem quite obvious:

1. **The long period of security and stability that the West enjoyed following the end of the Cold War is over.** The developed world, and particularly countries in Western Europe, are going to need to ramp up defence spending significantly – and quickly. The folly of austerity (and the West's inability to keep up in other key areas of 'engagement' on the international stage, such as cyber warfare) has been laid bare. Ramping up spending on defence when the West also needs to de-carbonise is going to put huge pressure on government and household finances.

2. **The West looks weak with few good options.** Biden does not want a war, and neither do most Americans. The Americans aren't coming. Germany is highly dependent on imported Russian energy, and some European nations are refusing to completely expel Russia from Swift, the global payments system, which is one of the few useful non-military levers that the West has at its disposal (at the moment, some Russian banks are excluded from Swift). This might not matter much anyway as Putin has stockpiled significant foreign currency reserves (around $650bn) to see him through the crisis. Asking Germany to get really tough on Russia is unfortunately a little bit like asking a junkie to sanction his or her dealer. President Macron has tried to pursue the diplomatic route, but that seems to be dead now, and he faces a very difficult election campaign at home. In the UK, 'Partygate' has shown PM Johnson to be either an inveterate liar, a simpleton or some combination of the two. At any rate, he is not someone who is respected or feared by Putin. Outside of the EU the UK can no longer play its 'honest broker' role between the US and the rest of Europe. Sir John Major once said that Britain had become a second-rate power post its exit from Europe – now even that statement looks a little generous. The UK's attempts to clean up all the dirtymoney in 'Londongrad' have been woeful – perhaps not surprising when Russian oligarchs are major donors to the Johnson government. Mr Putin knows he can operate with impunity and he isn't overly worried about the hardships that ordinary Russian people might have to endure as a result of sanctions – which the US have deployed for years on Russia with little or no impact.

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3. **The cost of living crisis is, unfortunately, going to get a lot worse.** Energy prices are soaring already and food prices will rise – Ukraine and Russia are huge exporters of grain, accounting for almost a third of total global exports. Ukraine has often been labelled the 'bread basket' of Europe in history books – not that we seem to learn much from history nowadays.

4. **Inflation forecasts, at least in the short term, are moving to levels that even we (as structural bulls on inflation) would not have predicted.** In the US, some strategists are talking about inflation at 10% - the market was braced for an eight handle this year but that has moved by a full two points for a number of market participants. These are inflation levels that will be very, very alien to anyone who was not alive in the 1970s or early 1980s.

5. **Central banks may just have to live with inflation, at least for the time being.** Inflation is uncomfortably high, but trying to tame it now with aggressive rate rises looks like a sure-fire route to recession, given the pressure that consumers are under. The question is, will consumers assume – like markets did – that inflation is still 'transitory' or do they do the rational thing and push for pay rises to try and protect their living standards? At the BoE, Governor Bailey would like wage restraint but that looks like a very tough ask at the moment. Central bank credibility in the West is not in a great place, rather like its foreign policy.

What to do?

We've often said that inflation-linked bonds are a form of disaster insurance for portfolios. As we highlighted in a recent article, if you do need duration, you should be taking this in the inflation-linked space as the current levels of inflation that we are seeing are hugely corrosive for nominal bonds and the yield protection that one could normally fall back on in the nominal world simply isn't there. To us, a US nominal 10y yield of less than 2% in a world where inflation could easily hit 8% or 9% doesn't make a great deal of sense. It does perhaps tell you however that the longer-term growth outlook is not that great and developments last week have only made that picture a lot worse. In a stagflation environment, we'd expect global inflation-linked bonds to outperform nominals, but bear in mind these are long duration assets and thus sensitive to changing rate and inflation expectations. The flipside to this of course is that if the Fed loses its nerve and adopts a softer stance on rates, rate-sensitive assets will rally – good news if you are global bond investor with some duration in your portfolio or indeed an investor in any other long duration asset (like growth stocks, for example). The irony here is at the start of 2022 no-one wanted to touch duration with a barge pole.

We'll provide another update soon, but as long-term advocates of what you could call a 'safety first' asset class, and as investors who view the world with that mindset, we ended last week with a sense of sadness and some bewilderment. Our thoughts and prayers are with the people of Ukraine.

The Sanlam Global Inflation-Linked Team
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Contact us

Bruce Simpson
Head of Distribution and Marketing

+44 (0) 20 3316 4064
Bruce.Simpson@Sanlam.co.uk

Liz Adnitt
Head of UK Wholesale Distribution

+44 (0) 20 3116 4071
Liz.Adnitt@Sanlam.co.uk

Andy Groves
Sales Manager

+44 07917580592
Andrew.Groves@Sanlam.co.uk

Tom Whitfield
Sales Manager

+44 (0) 20 3116 4016
Tom.Whitfield@Sanlam.co.uk

Sanlam Investments

Monument Place
24 Monument Street
London
EC3R 8AJ