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The invasion of Ukraine will change the world

Guy Monson

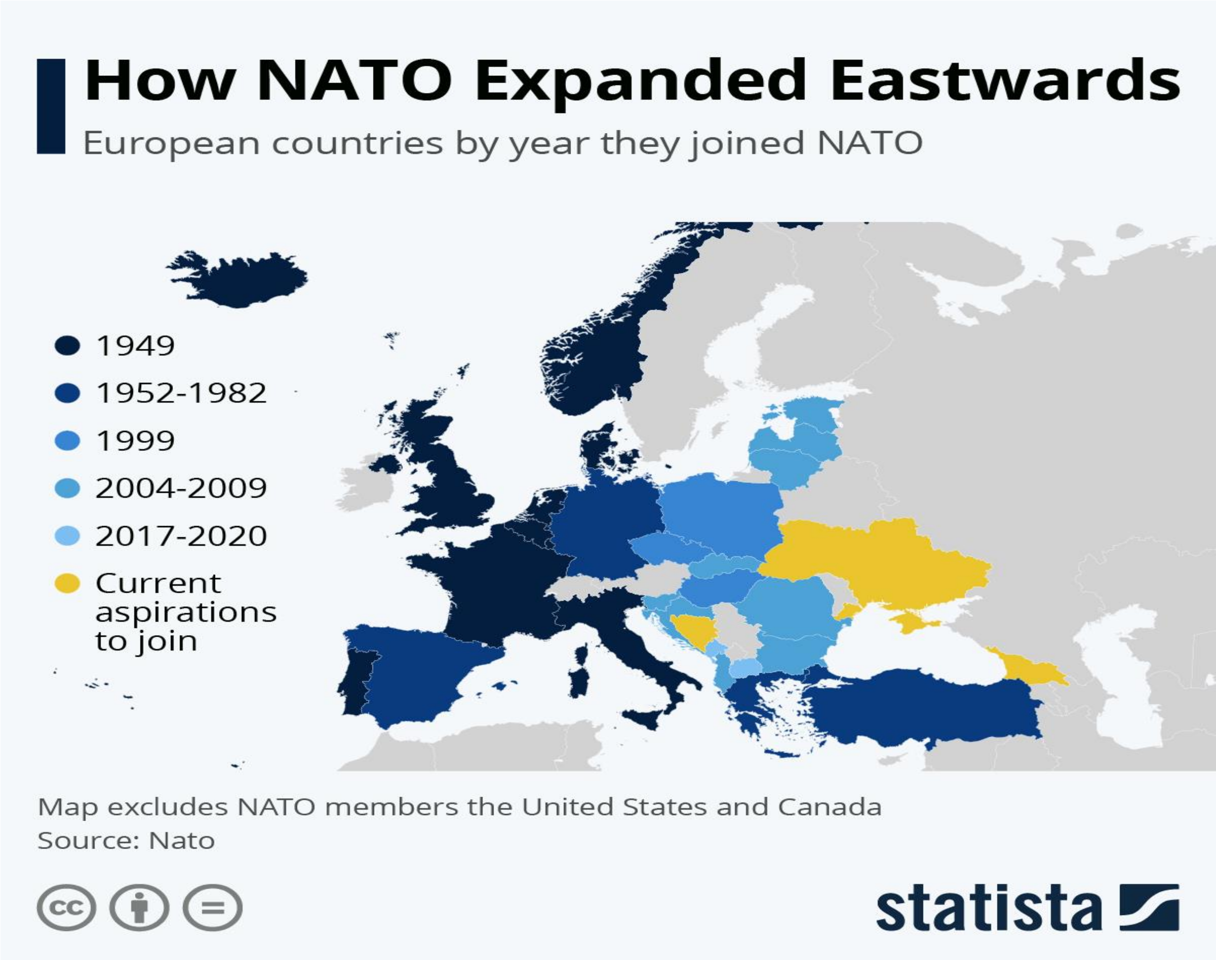
01

Implications of Ukraine invasion

NATO became the flash point for Russia & Ukraine

Russia watched with mounting resentment as the transatlantic alliance has nearly doubled its membership since the end of the Cold War

NATO's Post-Cold War expansion – 15 new members since the end of the Cold War



NATO

Post–Cold War expansion

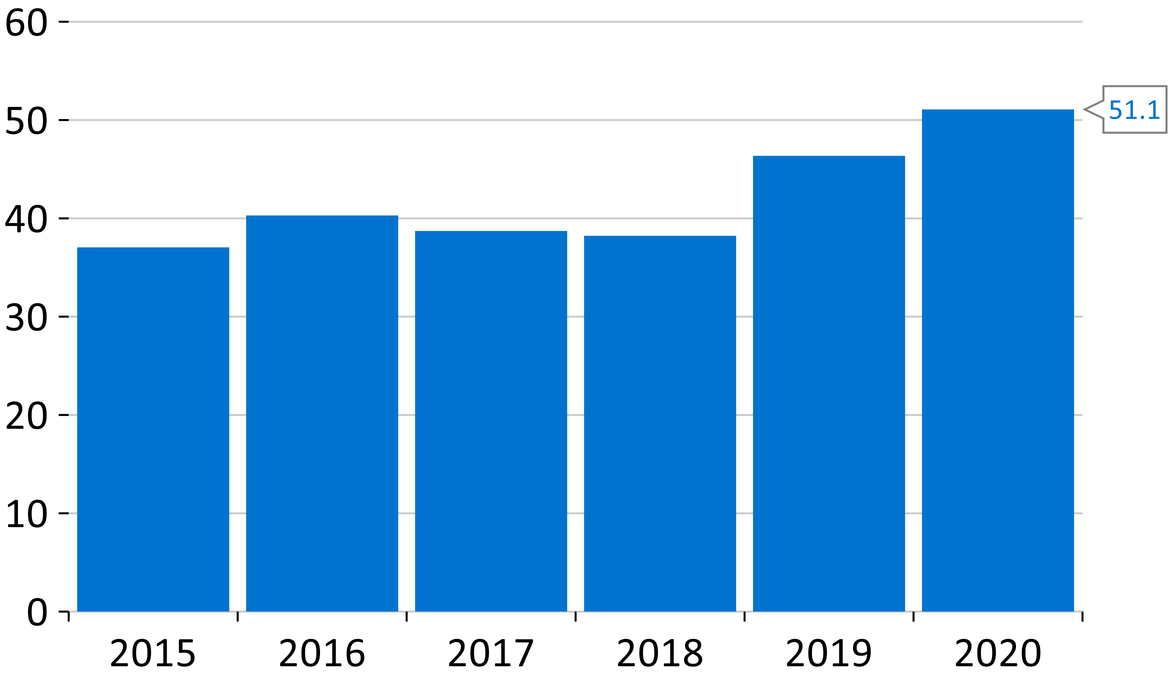
1990	Germany*
1999	Czech Republic Hungary Poland
2004	Bulgaria Estonia Latvia Lithuania Romania Slovakia Slovenia
2009	Albania Croatia
2017	Montenegro
2020	North Macedonia

Source: Statista/Council on Foreign Relations Feb 2022

1: Russian Economy: 2% of world GDP - more than 50% of European gas & 25% of oil imports – China a key partner

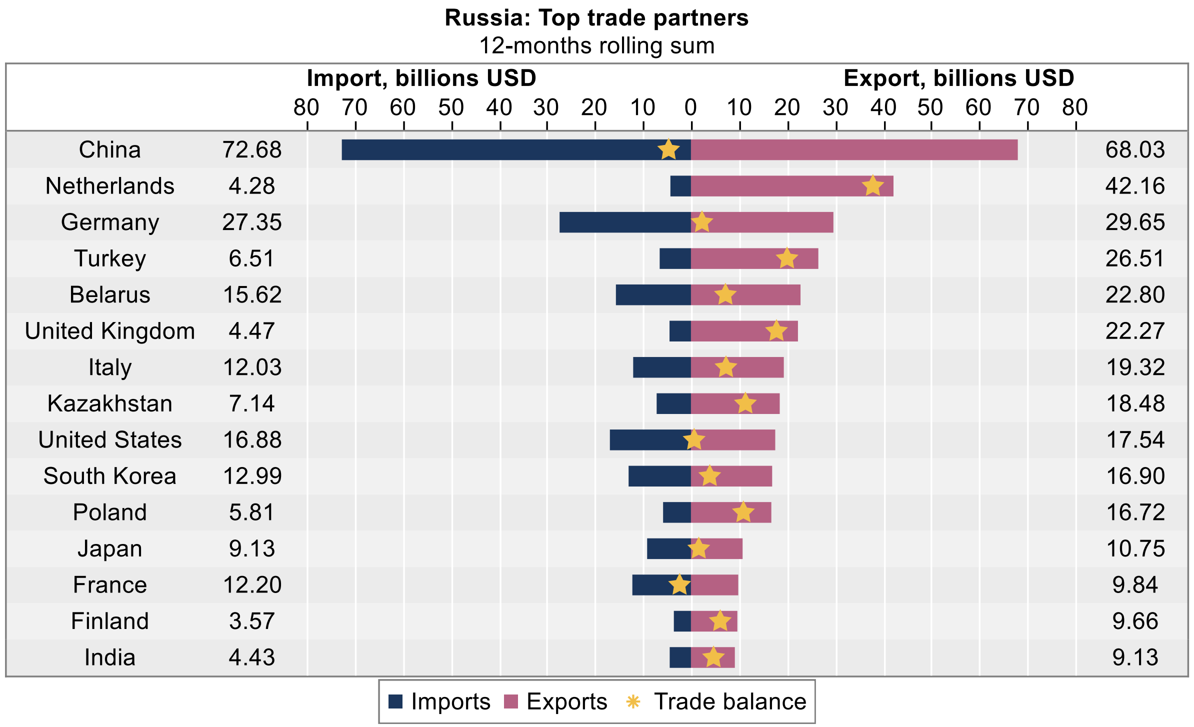
European reliance on Russian gas has been rising

EU - Share of natural gas imports from Russia



Source: Macrobond, 11.03.22

China a key partner



Source: Macrobond, 08.03.22

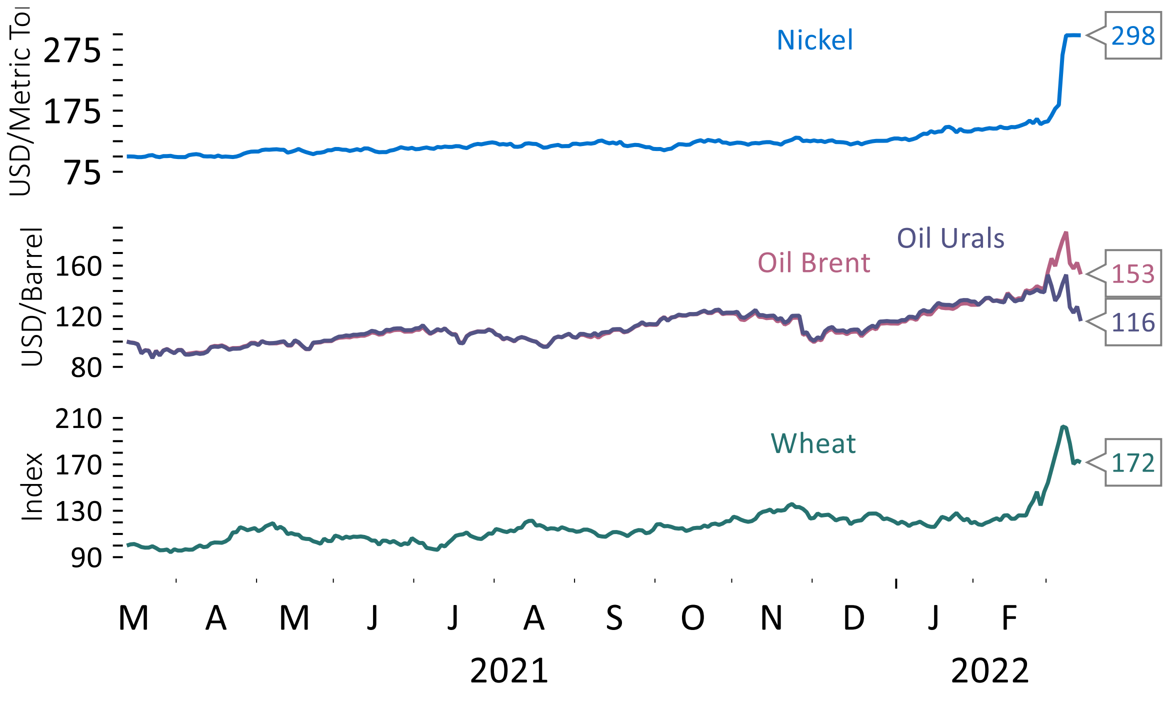
> “If the EU is forced or willing to bear the cost, it should be possible to replace Russian gas already for next winter without economic activity being devastated…but on the ground, dozens of regulations will have to be revised…a lot of money quickly spent and hard decisions taken.” Brugel Feb 2022

2: Ukraine crisis is adding to global inflation fears

Base effects still mean pricing pressures ease over time

Key Russian commodity prices

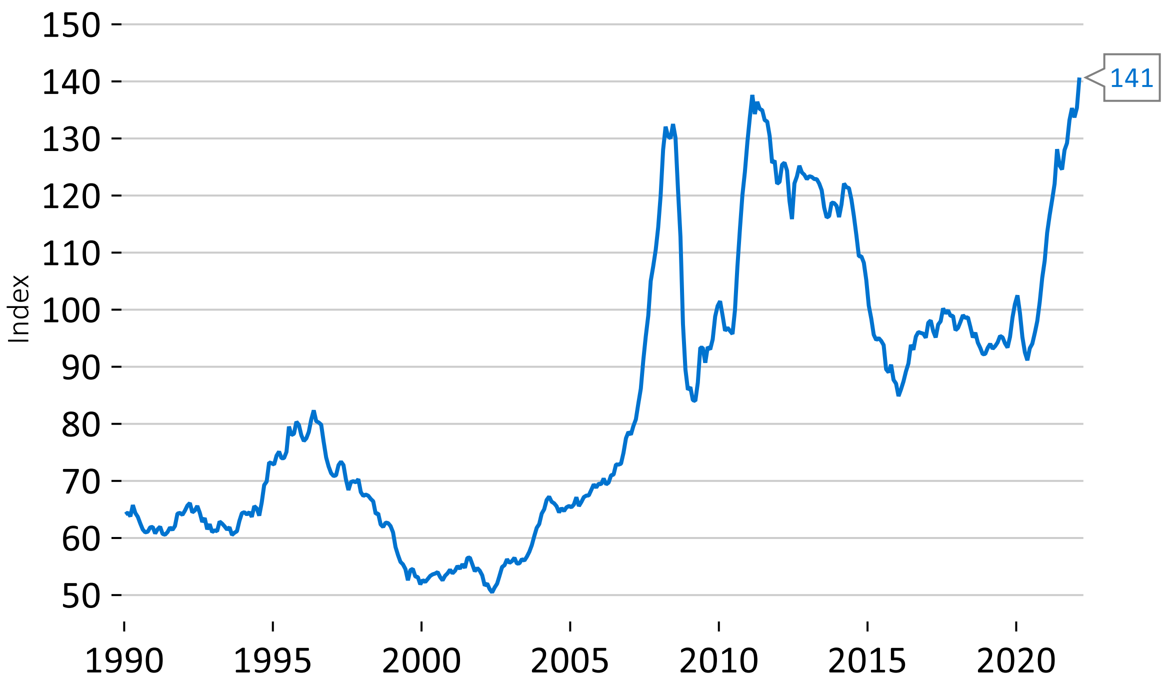
Russian Key Export Commodity Prices (1Y Change)



Source: Macrobond, 15.03.22

Food prices exceed 2011 highs risking EM food crisis

FAO, Global Food Price Index



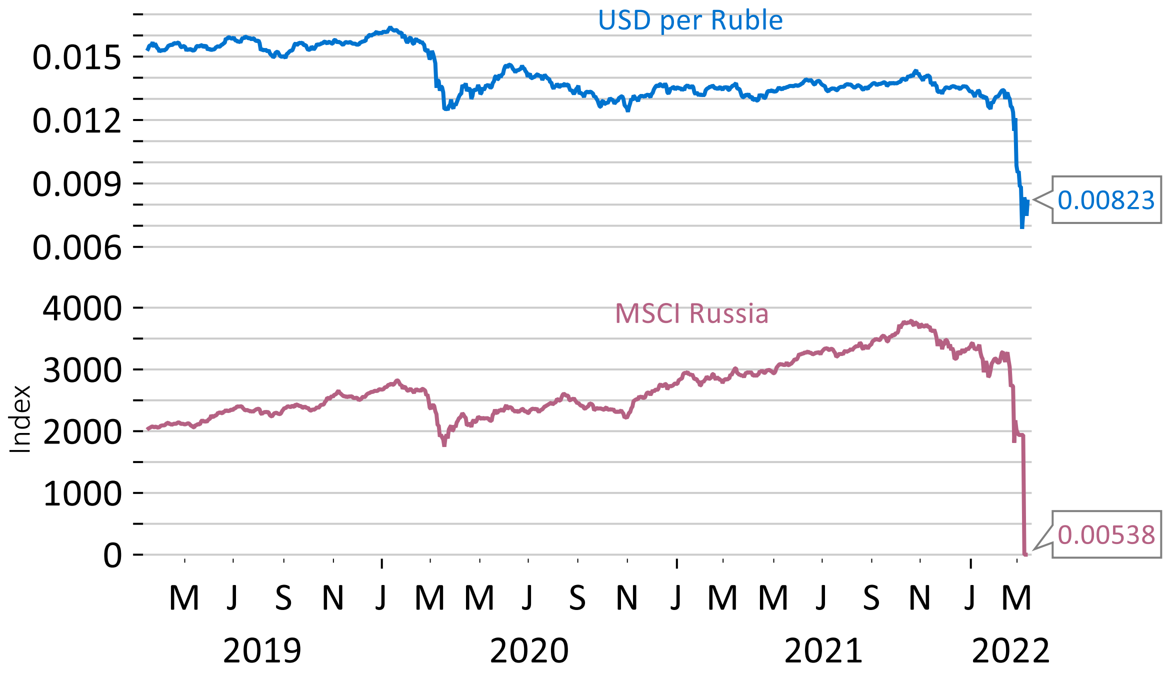
Source: Macrobond, 15.03.22

World Food prices now close to 2011 levels which contributed to political uprisings in Libya and Egypt & across the Emerging World

3. Russia: Sanctions, SWIFT exclusion, and frozen Central Bank reserves may trigger domestic economic collapse

CBR increases policy rates to 20% to defend currency

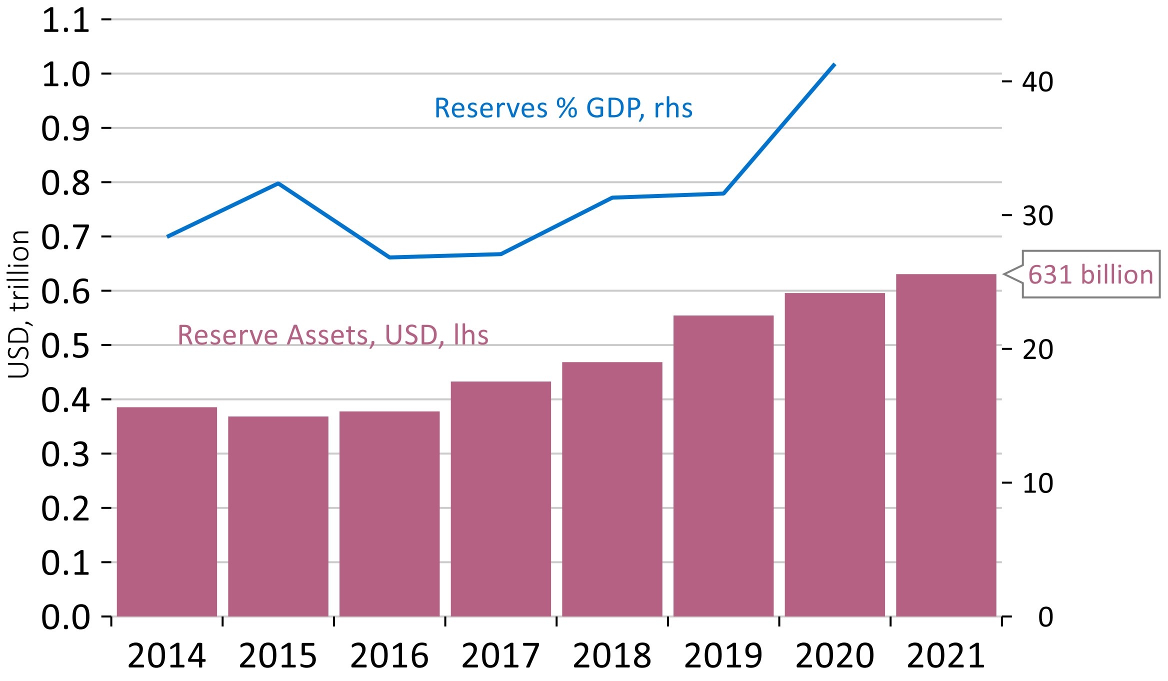
Russia currency & equities



Source: Macrobond, 15.03.22

Russian Central Bank reserves (50-70% likely frozen)

Russian Central Bank Reserves & as % of GDP



Source: Macrobond, 15.03.22

Currency Composition

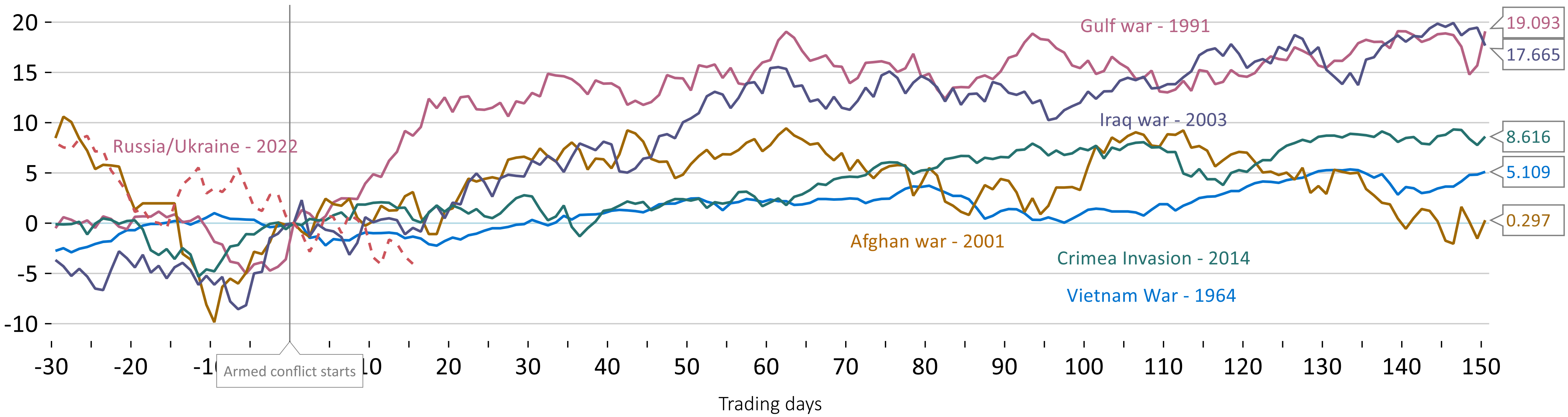
EUR 32%, Gold 21%, USD 16%, CNY 13%

Equity markets are typically resilient at the start of armed conflict

Performance of the US equity market in the six months following the start of a major conflict

S&P500: Equity performance during recent conflicts

Rebased at the start of armed conflict



Source: Macrobond, 15.03.22

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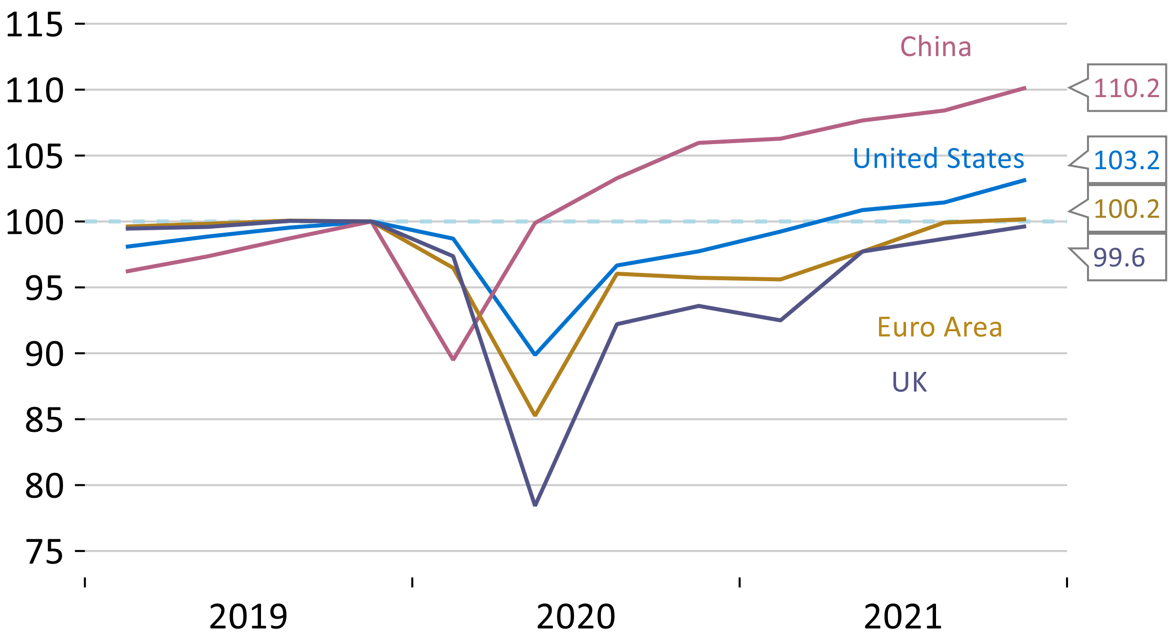
02 Global economy

A robust global recovery but at the cost of higher inflation

IMF forecasts for 2022 world growth down from 4.9% to 4.4% - no recession risk yet

Most major economies at or above pre-COVID GDP levels

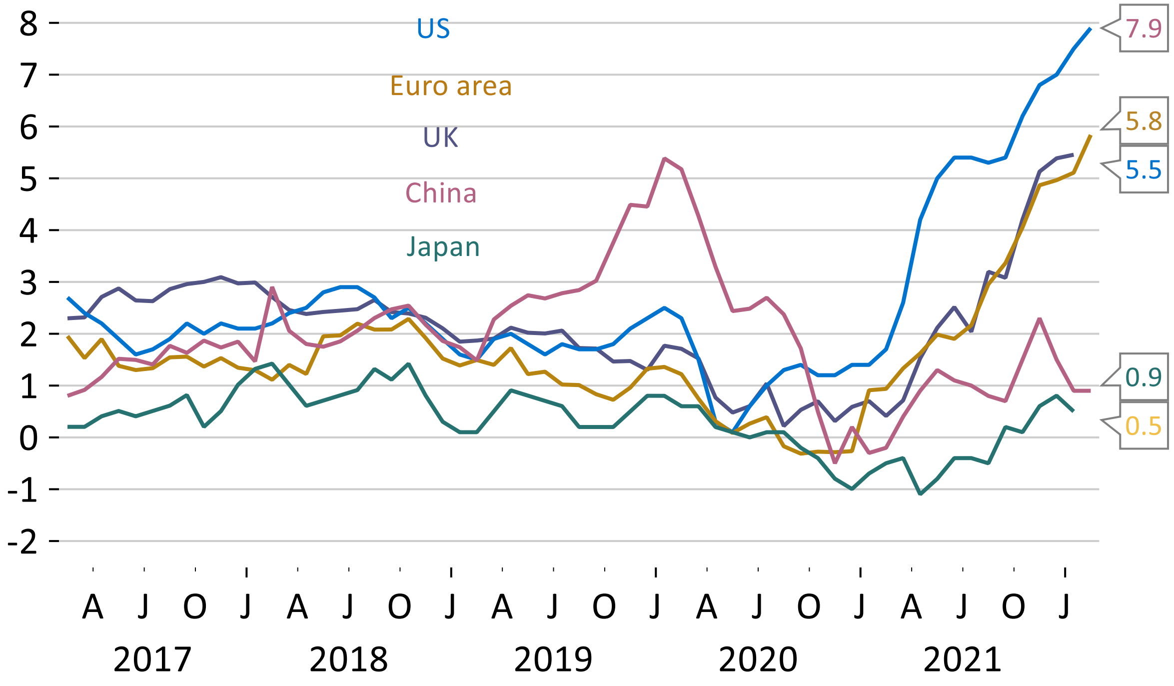
GDP in selected countries
Indices: 2019 Q4=100 (the start of COVID)



Source: Macrobond, 15.03.22

Consumer price inflation (yoy)

Global Inflation Rates

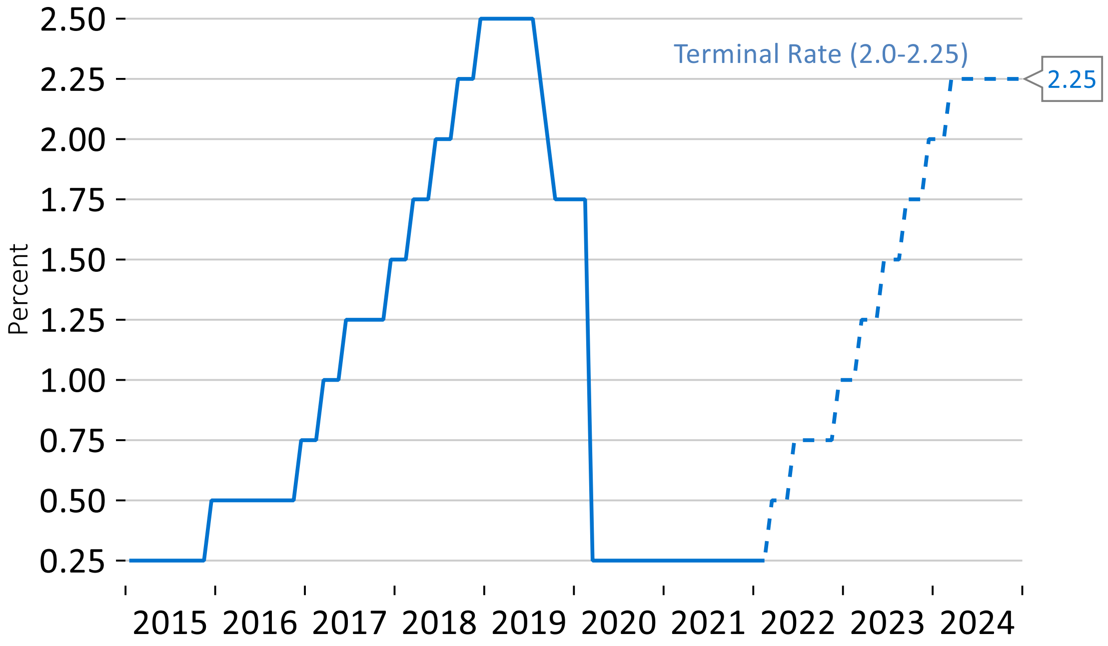


Source: Macrobond, 15.03.22

Interest rate rises still likely be faster and balance sheet run-off (QT) sooner than in previous cycles

Expect 5 hikes in 2022 and terminal rates to reach 2.25%

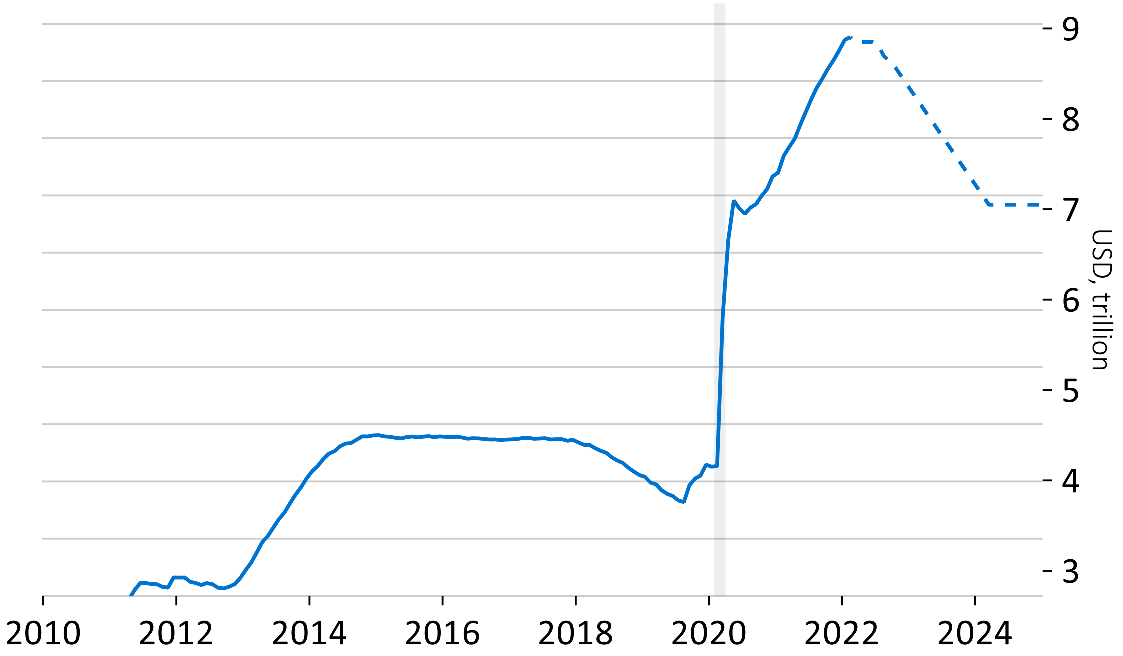
Path of policy normalisation in the US



Source: Macrobond, 15.03.22

Balance sheet run-off in July 2022 & terminal size $7tn

Quantitive Tightening of US Fed Reserve Balance Sheet



Source: Macrobond, 15.03.22

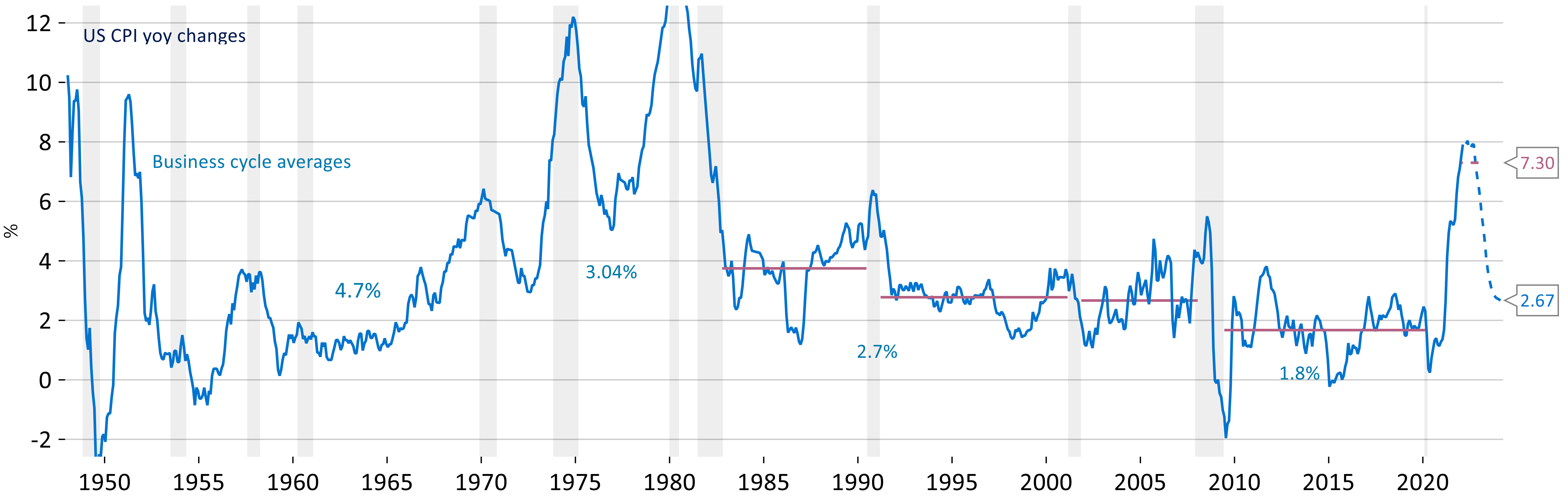
Central bank forecasts 2022

- **Global Interest rates** 4-5 rate rises US, 3 UK , None Euro
- **QE**: To fall significantly from $2.9tr in 2021, to $470bn in 2022 & *negative $ 1.1 trillion (QT) in 2023*
- **QT:** BOE begins Q2 2022, Fed Q3 and ECB stops bond purchases Q3

Long term inflation settles at 2000's levels

US inflation to average 7.1% in 2022 (peak at 8% - year end 5.4%)

US CPI settles at 2.7-3% in the medium term

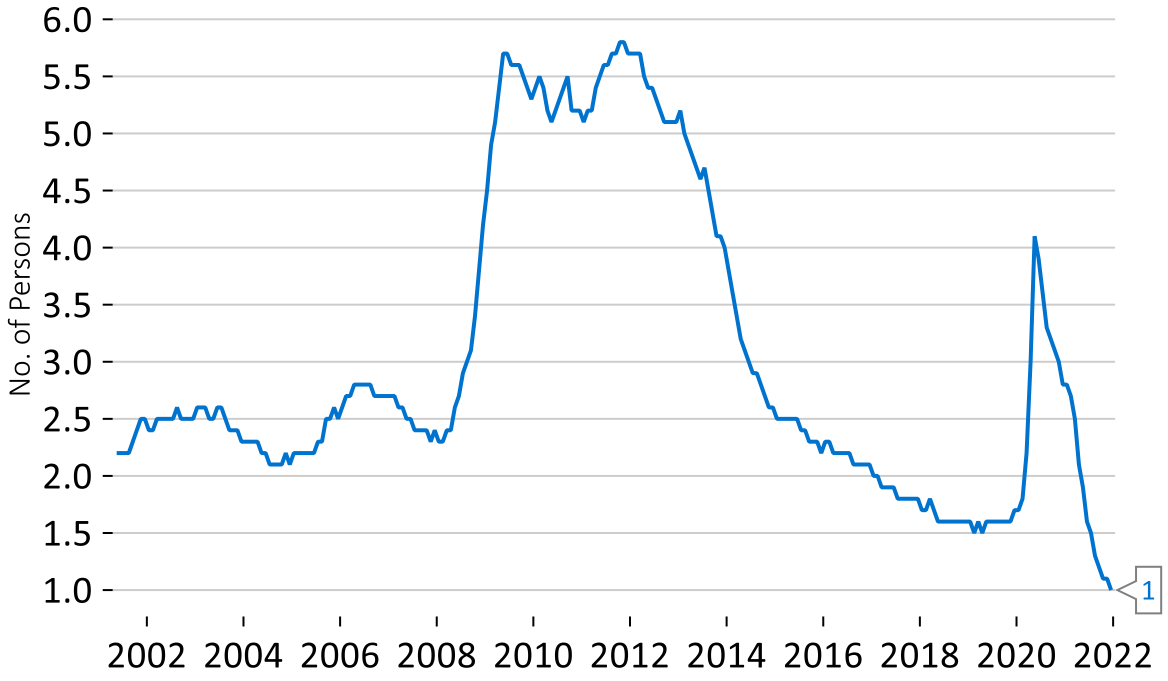


Source: Macrobond, 15.03.22

Where is the greatest UK inflation risk now - most likely in labour markets?

Just one person chasing every vacancy – a record

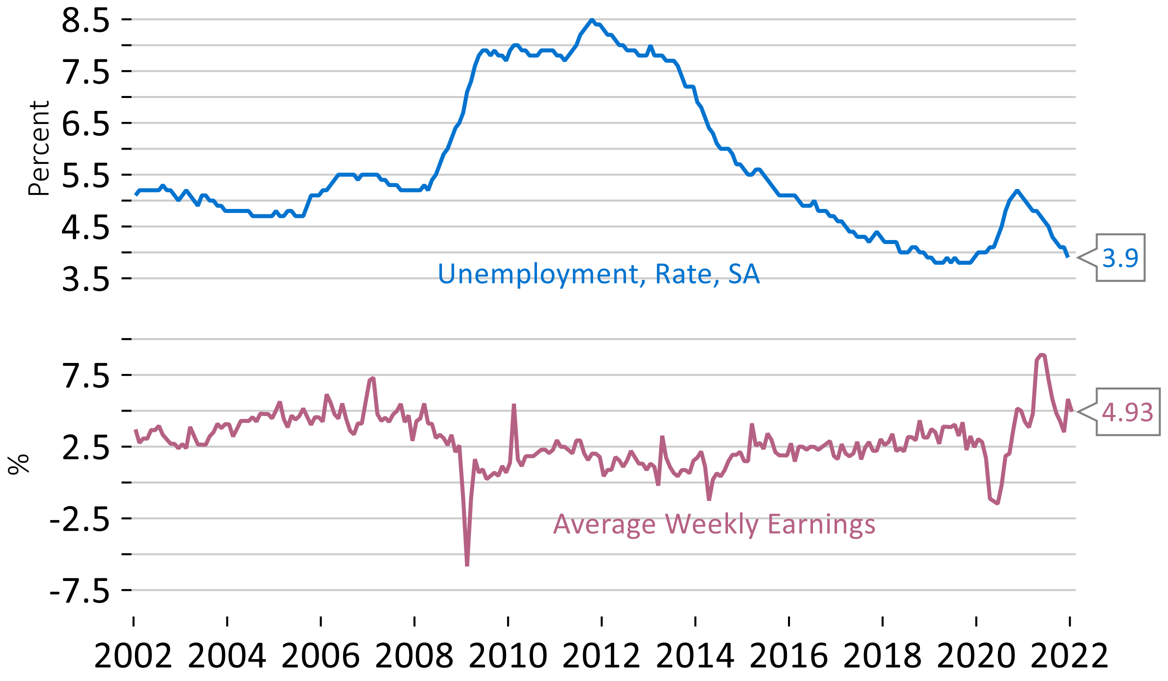
UK Number of Unemployed People Per Vacancy



Source: Macrobond, 15.03.22

Weekly average earnings are climbing as unemployment falls

UK Unemployment and Earnings



Source: Macrobond, 15.03.22

It’s tightness in the labour market that concerns me most”

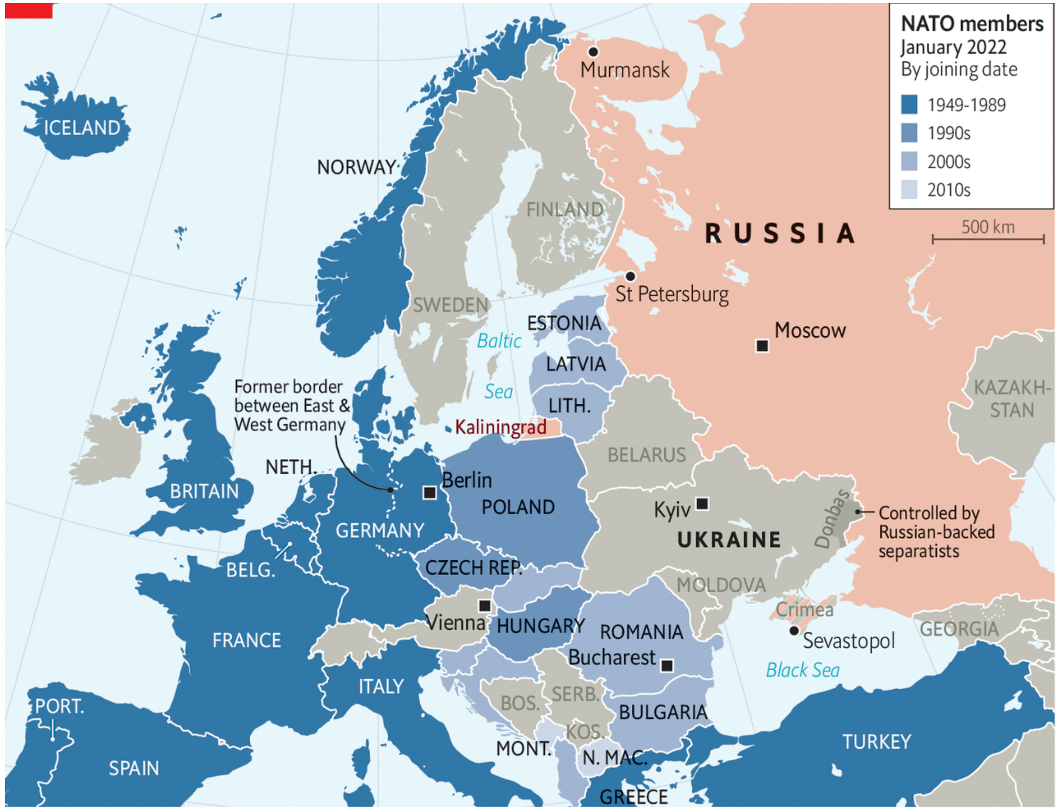
Andrew Bailey BOE Nov 2021

Source: BOE Monetary Policy Report Nov 2021

03 Key risks

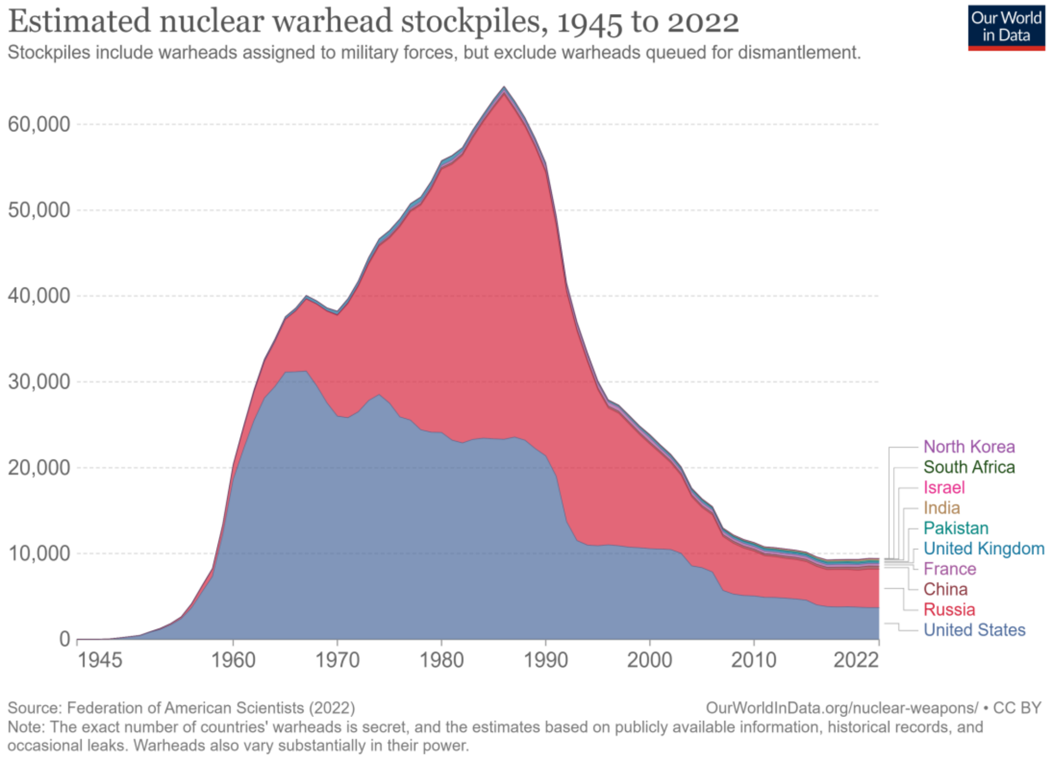
Risk 1: Escalation of Russian military conflict and associated nuclear risks

7 NATO countries on Russia/Belarus border



Military spend as percentage of GDP 2020
Saudi 8.5%, Russia 4.3%, Ukraine 4.1%, US 3.7%, UK 2.3%
Germany 1.4%

Russia now has largest global stock of nuclear warheads



Nuclear Warheads
Russia 4,477. US 3,708, China 350, France 290, UK 180

Source: Economist/Our world in data Feb 2022

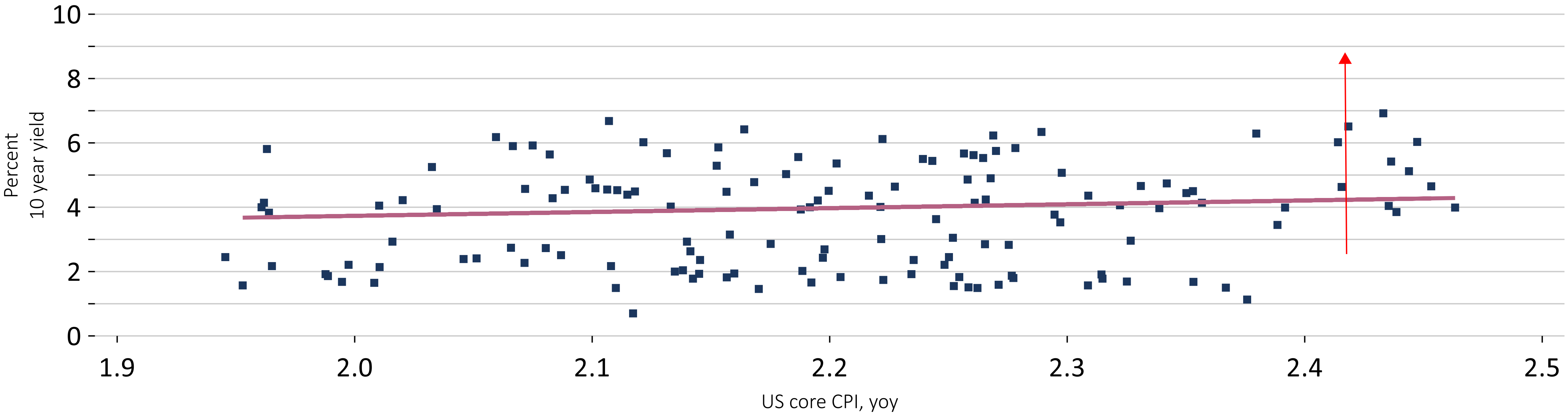
Risk 2: Bond yields normalise

Bond yields could rise sharply as central banks reduce balance sheets

Today's positioning of bond yields and core inflation is in 'unknown territory'

US: 10-year yields vs core CPI inflation

U.S. Bureau of Labor Statistics (BLS), U.S. Department of Treasury 1990 to date



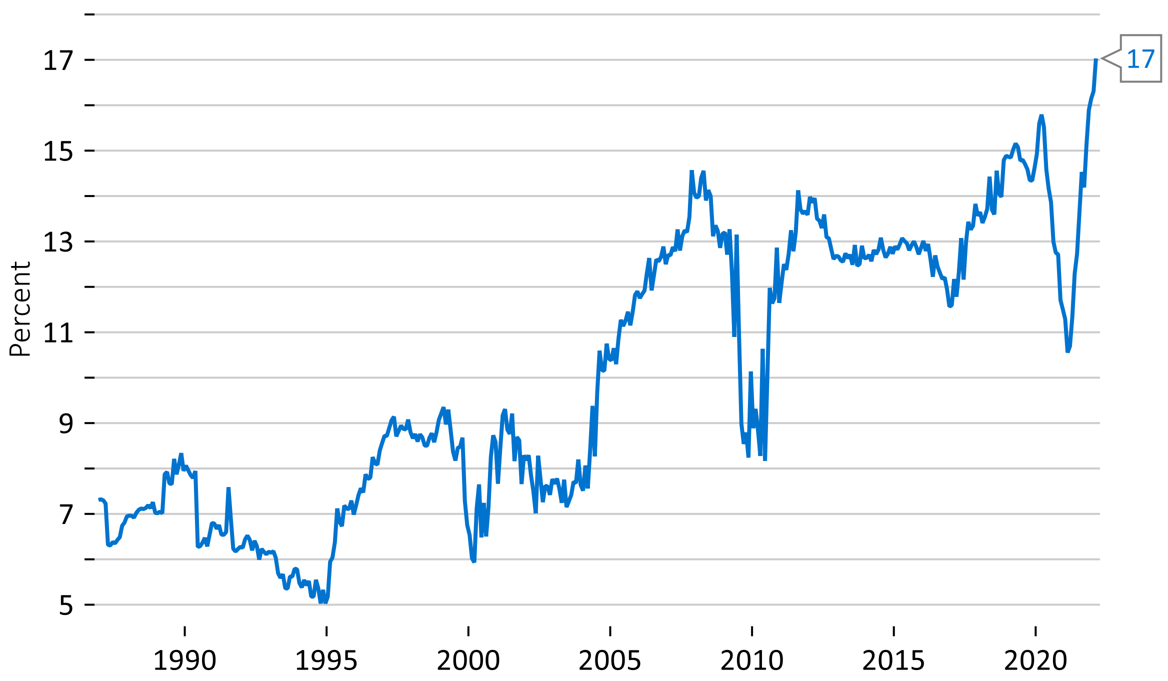
Source: Macrobond, 15.03.22

Risk 3: De-rating of equities continues – margins at record highs

As policy rates normalise COVID-led PE multiple expansion is already reversing

Margins for global equities look abnormally high

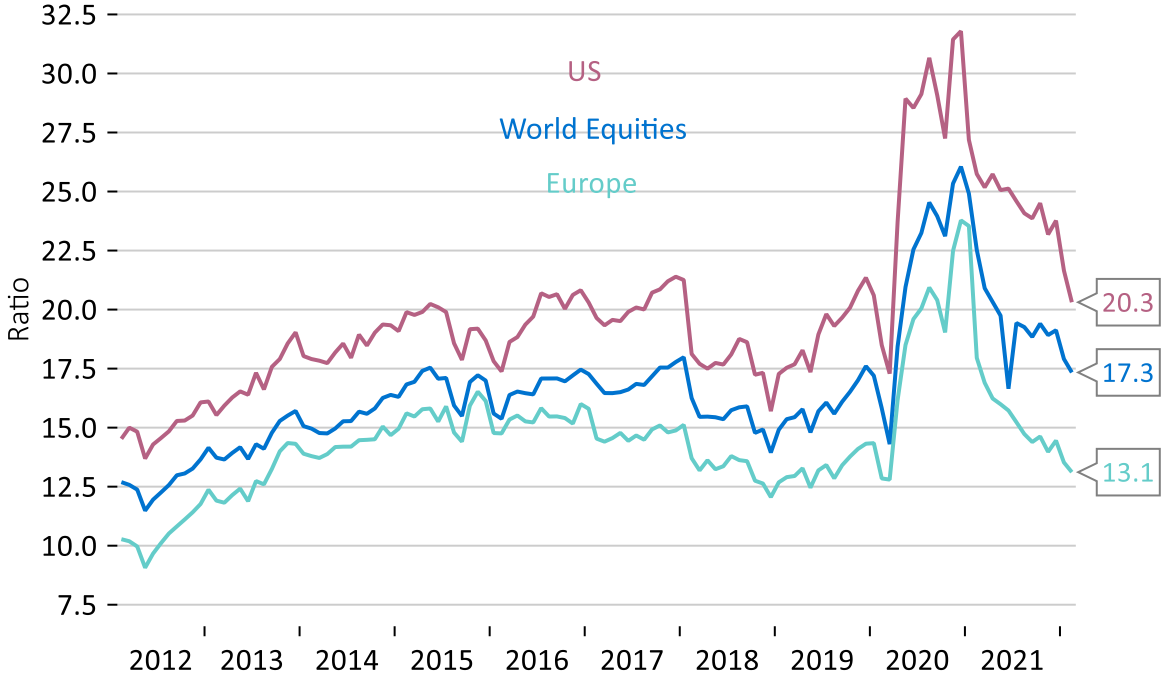
Net Margins for World Equities (FactSet)



Source: Macrobond, 08.03.22

Global valuations are already declining

Equity Indices 1 year forward PE (Factset)



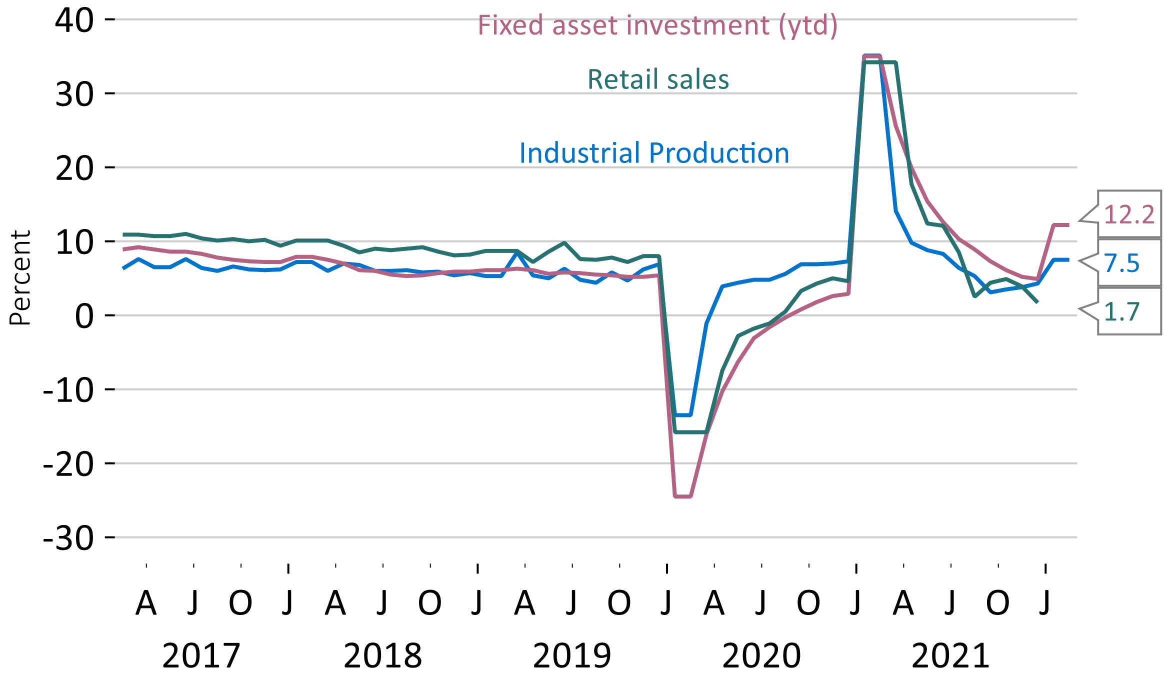
Source: Macrobond, 08.03.22

Risk 4: China - a worrying confluence of shocks

Ukraine, regulation, energy, property funding, Omicron infections, Taiwan tensions

Key economic indicators continue to weaken

China Economic Indicators



Source: Macrobond, 15.03.22

Strains in property sector spread across bond market

China and US high yield bonds

Source: Macrobond, 08.03.22

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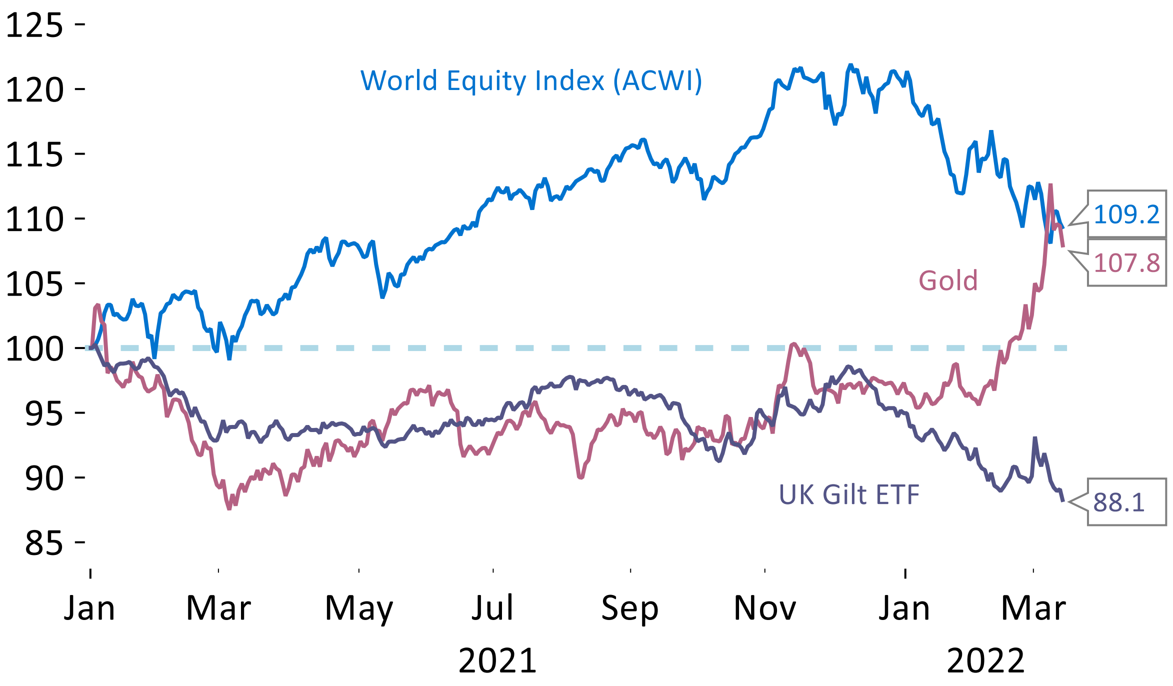
04 Policy implications

Asset class performance 2021 to-date

Equities still supported by strong earnings and generous monetary conditions but risks are rising

Equities rally, bonds & gold decline

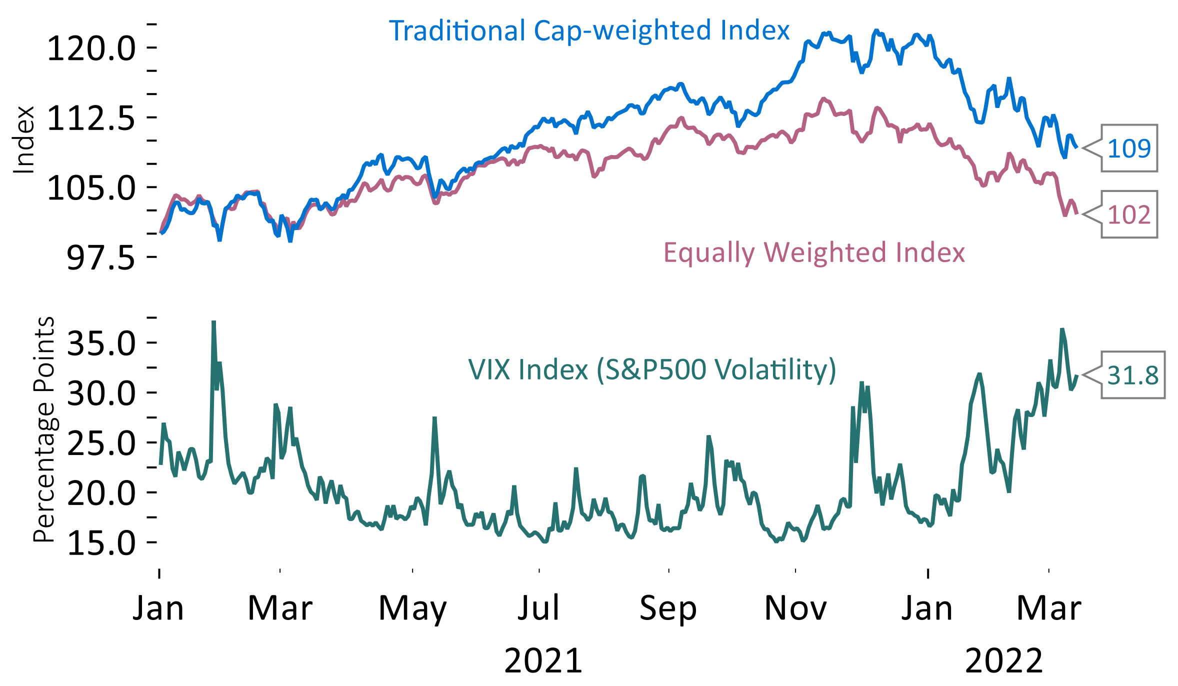
Global Asset Class Returns 2021 (GBP) to date



Source: Macrobond, 15.03.22

Mega-cap leadership starting to weaken – VIX elevated

MSCI World equities & VIX Index



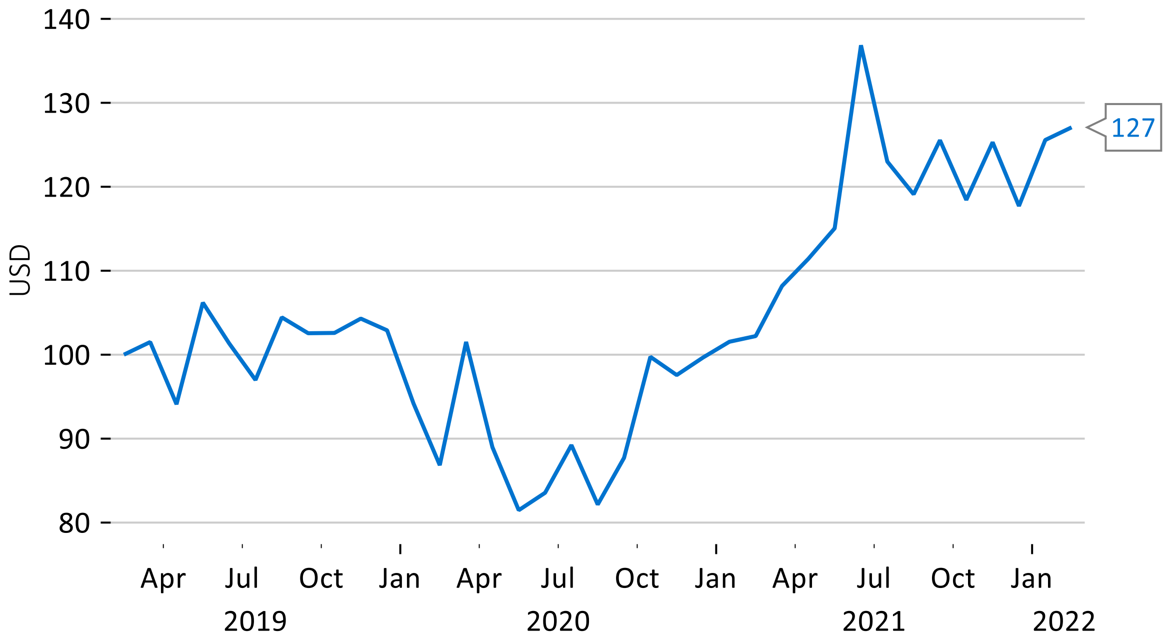
Source: Macrobond, 15.03.22

Where do we see opportunities in risk assets?

1. Corporate earnings and dividends have recovered rapidly and forecasts are robust

Global earnings (ex China) now well surpass pre-COVID levels

Global Earning Per Share (EPS) 1 year forward (Factset 31/12/2018 = 100)



Source: Macrobond, 08.03.22

Extraordinary recovery in global dividends

Global Dividend Growth Rate 1 year forward (FactSet)

Source: Macrobond, 08.03.22

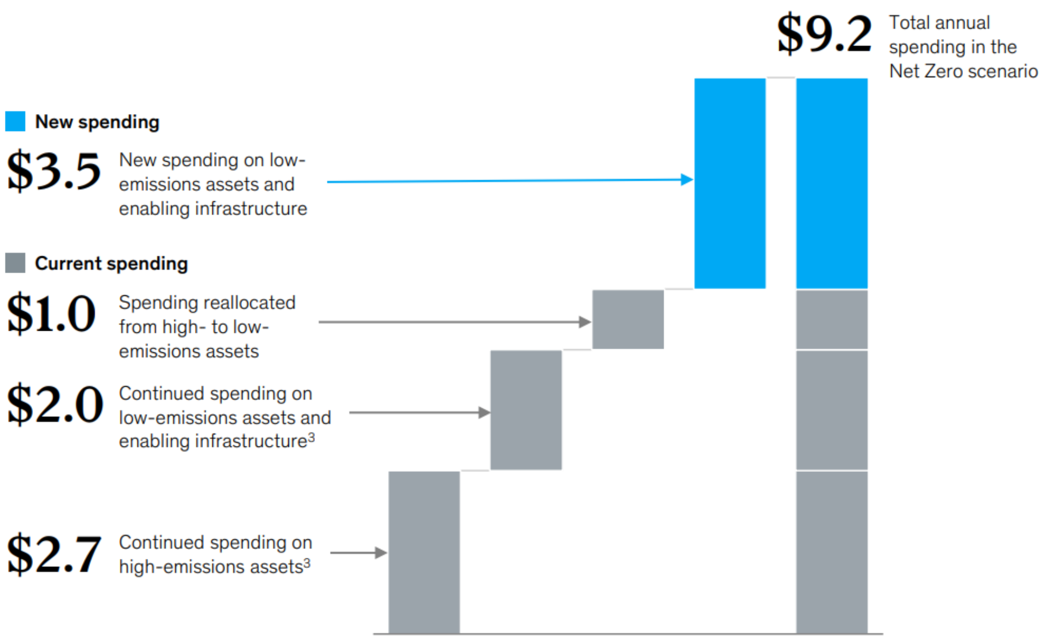
Achieving net zero by 2050 will require a transformation of the global economy & unprecedented capital spend

Net zero 2050 needs $9.2tn pa of spending on physical assets

Exhibit E5

Spending on physical assets for energy and land-use systems in the NGFS Net Zero 2050 scenario would rise to about $9.2 trillion annually, or about $3.5 trillion more than today.

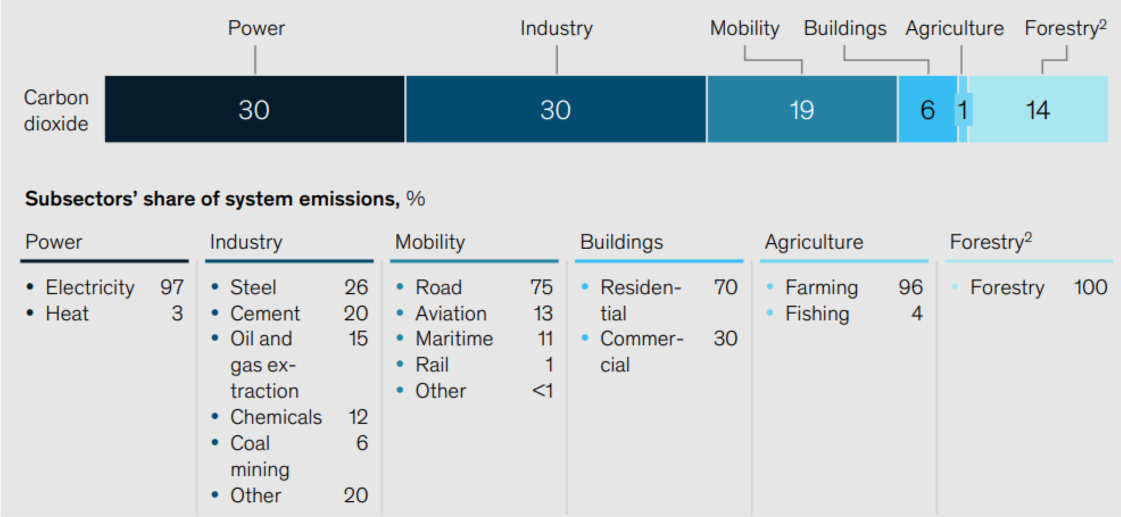
Annual spending on physical assets for energy and land-use systems[1] in the Net Zero 2050 scenario,[2] average 2021–50, $ trillion



All global sectors will need to act together to meet 2050 goals

Power and industry are major energy consumers and together generate about 60 percent of CO_2 emissions.

Share of emissions[1] per energy and land-use system, 2019, %



Source: McKinsey Center for Future Mobility Electrification Model (2020); McKinsey Hydrogen Insights; McKinsey Power Solutions; McKinsey–Mission Possible Partnership collaboration; McKinsey Sustainability Insights; McKinsey Agriculture Practice; McKinsey Nature Analytics; McKinsey Global Institute analysis

Outlook: Early stages of energy price shock – global economy still remains robust – European assets under pressure

Global strategy update – March 2022

Bonds	Strong underweight • Strong UW Government Bonds – global inflationary pressures remain elevated • UW Investment Grade Credit – yield spreads too narrow – UK charity & infrastructure issues offer social impact benefits
Equities	Neutral • Global Neutral – earnings remain robust but central bank liquidity support fading • UK Neutral - dividend support and valuation attractive – M&A likely • EM Neutral - policy tightening and virus risks still acute – political risk on the rise
Alternatives	Strong Overweight • OW Other Alternatives– infrastructure and renewables beneficiaries of fiscal spend – liquidity issues remain • OW Uncorrelated Alternatives – gold positions as hedge against central bank policy error
Cash	Strong Overweight • No currency preference • Consider portfolio insurance
Risks	Current: Valuations stretched, bond market risk as policy tightens, inflation higher for longer on energy shock Longer-term: Central bank policy error, China/Taiwan, real bond yields normalise, climate transition risks Ukraine: Russia ceases European gas exports, NATO dragged into border war, further nuclear warnings

Source: Sarasin & Partners, March 2022

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Juxon House
100 St Paul’s Churchyard
London
EC4M 8BU

T: +44 (0) 20 7038 7000
www. sarasinandpartners.com