

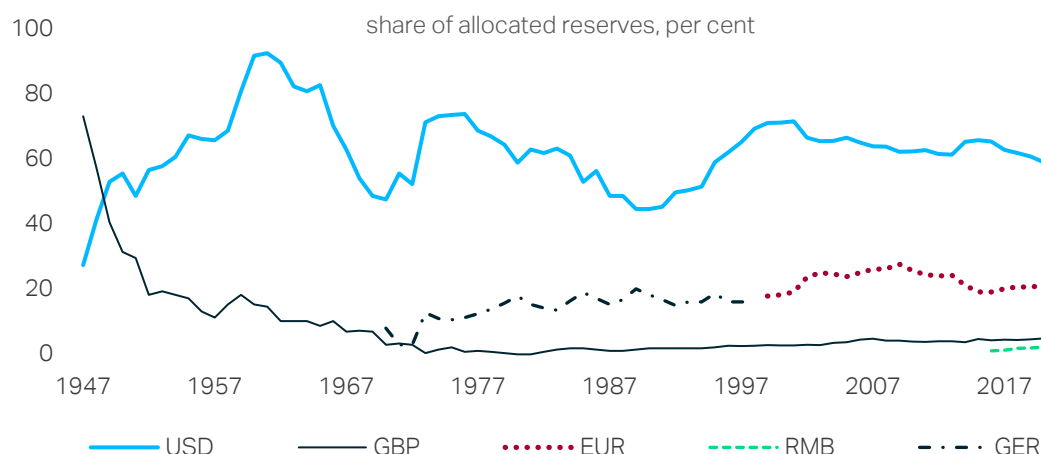
Macro Picture

USD WEAPONIZATION & THE 'TANGIBLE 20s'

Dario Perkins

The US and Europe have weaponized global finance in response to Russia's attack on Ukraine. The policy will have a powerful impact, both short and longer-term. While there is no immediate threat to the dollar's reserve status, the conflict could enhance various structural themes that have emerged from the COVID crisis, delivering a new market environment: the "tangible 20s".

Chart 1: WILL USD DOMINANCE FADE?



Sources: IMF, TS Lombard, "International currencies – past, present and future".

FINANCIAL WMDs

The war in Europe has been happening on two fronts: the military conflict in Ukraine and NATO's retaliatory economic and financial "siege" of Russia. We focus on the latter. While investors are worried about the short-term impact of the sanctions – for Russia and the rest of the world – the "weaponization" of the global monetary system could also have longer-term consequences.

USD RESERVE STATUS

Pundits warn that NATO's response to Russia has undermined the dollar's "reserve status". It is true that strategic, diplomatic and military power influence the international monetary system. Some countries – notably China – now have an incentive to reduce their USD dependence. Yet the dollar remains unrivalled as a source of liquidity, network effects and global export demand.

THE TANGIBLE 20s

While the war in Ukraine is not an imminent threat to dollar dominance, it will have a lasting impact in other areas, including via: (i) higher defence spending; (ii) a faster transition away from Russian energy; and (iii) added impetus towards deglobalization. This will amplify secular shifts that were already emerging in the post-COVID economy, producing a new regime for markets.

FINANCE AS A WEAPON & THE “TANGIBLE TWENTIES”

The war in Europe is happening on two fronts: the military conflict in Ukraine and NATO's financial “siege” of Russia. We focus here on the impact of the economic war. While the sanctions on Russia are not unprecedented, this is the first time such severe restrictions have been levied on a large and highly integrated capitalist economy, in effect wrenching the country out of the networks of the international financial system. And, unlike most previous conflicts, the financial war with Russia is taking place in an age of social media, which means it is having a powerful impact on public opinion, prompting companies from all over the world to sever their ties with the country. Voluntary sanctions have not only amplified the immediate impact of the official measures, they may be harder to reverse – even if there is a military ceasefire. Inevitably, the repercussions for Russia's economy look far-reaching. The ruble has plunged, inflation has surged, and severe shortages of many imported goods (including industrial components, consumer products, medicine and some foods) are looming. Russia's financial sector is experiencing serious stress, with asset prices crashing, dollar liquidity evaporating and a run on the domestic banking system. While financial contagion from Russia to the rest of the world has been less extreme than many investors feared, there are still several major vulnerabilities.

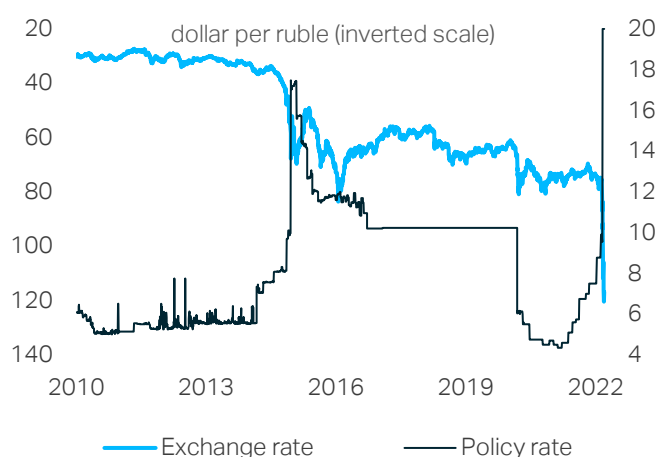
The point of the sanctions, of course, was to inflict financial pain on Russia, with the US and Europe prepared to accept a short-term economic hit in order to achieve their political objectives. Yet there are some pundits who believe the West's actions will also have longer-term, unintended consequences. By “weaponizing” the international monetary system, NATO countries have raised fresh doubts about the long-term sustainability of the dollar standard, perhaps even threatening the reserve status of the US currency. History suggests we should take these warnings seriously. By shifting political alliances, previous conflicts often altered global financial linkages and redirected trade, which, in turn, affected the relative importance of the major currencies. And the financial siege on Russia could certainly encourage some parts of the world (particularly China) to diversify out of the dollar as a matter of national security. Yet the threat to the dollar's reserve status is neither immediate nor inevitable. We should remember that much of the world is united in its stand against Russia and that the US currency has crucial advantages over all its rivals, especially in terms of liquidity, the depth of US capital markets, network effects and the importance of US demand as a source of global economic activity.

In focusing on the perceived threat to the dollar standard, investors could be missing other, more important long-term implications of the war in Ukraine. They include: (i) permanently higher defence spending, especially in Europe; (ii) an acceleration in the search for alternative energy sources (requiring massive public and private investment); and (iii) the likely contraction in global supply chains/reconfiguration of international trade into regional blocs. These shifts strengthen our view that the secular macroeconomic backdrop is going to look quite different in the 2020s. Governments are set to provide a more meaningful catalyst for economic growth, inflation is going to be higher (but much more volatile) and secular stagnation – the dominant theme of the previous decade – will begin to lose its grip on the macro narrative. From a market perspective, the implications could be profound: interest rates will trend higher, bond markets will suffer disastrous real returns and the recent rotation in equities from “growth” to “value” is probably just the start of a deeper secular theme. After the dominance of US tech and “intangible” financial assets in the post-GFC era of perma-zero interest rates, the 2020s could be a decade of sustained outperformance in real-economy assets – the “Tangible 20s” have arrived.

1. FINANCIAL WMDs

The war in Ukraine has entered its fifth week and is now considerably longer than most military analysts expected when Russia first invaded. Ukraine's resistance to the Russian onslaught has been fierce. But there are, in fact, two fronts to the conflict: the devastating physical war on the ground and the financial "conflict" that has seen most of the world lay "siege" to Russia's economy. The sanctions the West has imposed on Russia over the past month are out of an increasingly familiar playbook. They began by targeting Russian individuals and businesses, as in the past, and were quickly ratcheted up to incorporate entire sectors of Russia's economy, with the ejection of Russian banks from the SWIFT messaging system and the freezing of the central bank's overseas assets. This is not the first time such sanctions have been deployed. Russian individuals faced similar restrictions in 2014 during the invasion of Crimea, Iran was kicked out of the SWIFT system in 2012 and the Federal Reserve froze the assets of the Afghanistan central bank in 2021, redistributing some of the proceeds to the victims of 9/11. In short, financial sanctions – or the "weaponization" of the international monetary system – is now an important tool to "police" the global community and ensure compliance with democratic values.

Chart 2: Another invasion, another crash



Sources: Datastream, TS Lombard.

Chart 3: Start of a banking crisis?



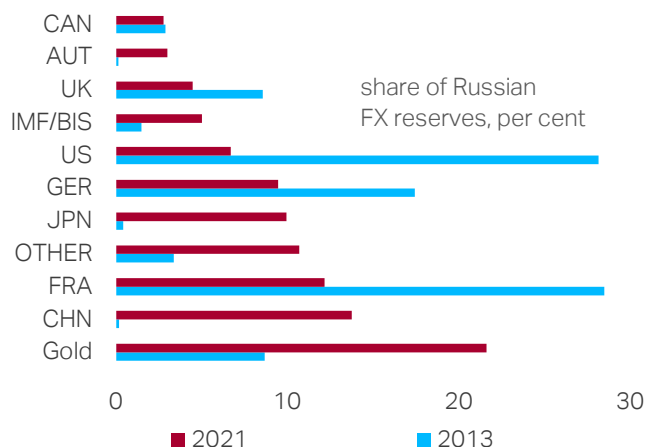
Sources: Datastream, TS Lombard.

Russia under siege

While the sanctions on Russia are part of an increasingly familiar playbook, this is the first time such measures have been deployed against a large and highly integrated capitalist economy, wrenching the country out of the networks of the modern international financial system. Russia accounts for around 3% of global GDP and a much larger share of international food and energy production. Its import share is more than 20% of its GDP, the highest in the BRICs. In many ways, cutting Russia off from the rest of the world is a modern, less violent alternative to the military sieges of the past. It is firmly in the tradition of the Battle of Megiddo in Palestine of the 15th century B.C. (the first example in recorded history) or the Venetians' 13th century siege of Constantinople or, more recently, the siege of Leningrad during WW2. The objective is to undermine the morale of the Russian population, by inflicting enough economic hardship to erode Putin's military capacity, encourage a diplomatic solution or force a regime change in Russia. While it is doubtful the sanctions will achieve these lofty ambitions – economic restrictions are rarely effective in forcing political change – there is no doubt they are having a powerful impact on Russia's economy. The country appears to have entered a serious crisis.

Chart 4: Russia built up its defences – or tried


Source: Bloomberg.

Chart 5: Russia diversified out of USD


Source: Bloomberg.

The impact on Russia

After just one month of sanctions, it is difficult to assess the precise impact of the financial siege on Russia's economy. It does not help, of course, that the government has cut external access to many of the country's economic and financial statistics. But we do know the following:

- (i) **The ruble has plunged:** With the Russian Central Bank unable to use its vast FX reserves to defend the exchange rate, the currency is down around 25% since the start of the conflict. To the extent anyone is still willing to export to Russia, this will intensify post-COVID imported price pressures. Weekly CPI data showed a 6% rise in prices (not annualized) during the first two weeks alone of the Ukraine invasion. This price surge could signal the start of a serious inflationary spiral.
- (ii) **Supply shortages:** In addition to the official sanctions, many Western companies are voluntarily boycotting Russia. The combined impact of these actions – which came as a “sudden stop” on trade – has caused widespread shortages. Before the crisis, Russia was a big importer of clothing, electrical equipment, consumer durables and many of the components used in the domestic industrial sector. OECD data show that foreign “value added” contributes around 20% of Russia's final demand, though it is much higher in areas such as machinery (75%), pharmaceuticals (57%), electronics (65%) and manufacturing (40%). And the sanctions will even hit essentials such as food and medicine, especially in the short term because it will take time for domestic producers to raise their output. No less than 35% of Russia's imports are from the EU and medicine is one of the largest categories¹.
- (iii) **Financial and banking crises:** Financial conditions have tightened aggressively. Asset prices have plunged, the central bank has raised interest rates to 20% and domestic financial institutions face serious stress, as access to international funding (particularly US dollars) has evaporated and Russian citizens have tried to withdraw their money from domestic banks (the classic bank run). Despite the

¹ [Click here](#) for a complete breakdown of Russia's trade with the rest of the world.

central bank's efforts to provide ruble liquidity to Russian institutions, it is likely that access to credit has largely disappeared, causing another economic squeeze.

- (iv) **Second-round effects:** Plunging demand, tight credit and severe supply shortages will cause many Russian businesses to shut down, triggering a significant rise in unemployment and another wave of bankruptcies and economic pain. The Russian economy is likely to suffer both a large contraction in GDP and high inflation. And since Russia's exclusion from the international economy partly reflects Western companies' voluntary boycotts, the economic hit will not necessarily disappear even if a ceasefire is reached. The number of employees in foreign and mixed-ownership firms in Russia is 5 million – some 10% of the workforce. Being cut off from the international community could also affect Russia's long-term productivity.

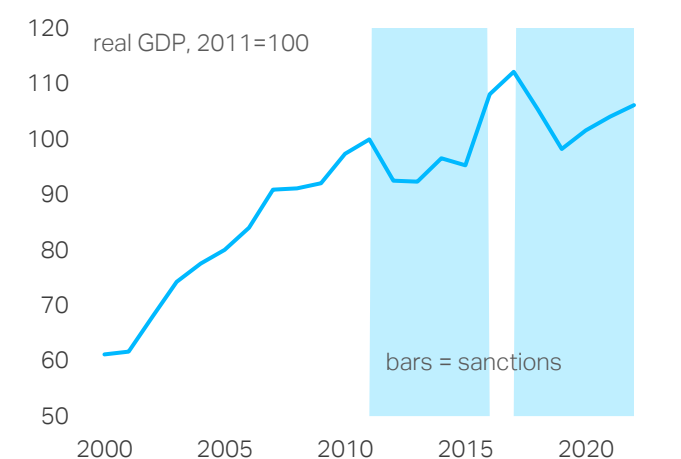
Since we have never seen the deployment of "financial warfare" on this scale, it is difficult to know how much these sanctions will affect the Russian economy. But the impact could be orders of magnitude worse than what happened to Iran in the 2010s, which had a lasting impact on GDP (Chart 7) and, according to the CEPR, caused 44,000 excess deaths in that country. Russia's main advantage, of course, is that the West – especially Europe – remains dependent on the country's exports of oil and gas, which have not yet been included in the sanctions. Higher energy prices help, too: every \$10 hike in oil price gives Russia around \$20 billion in additional current account inflows per year. But there is still the possibility of a further escalation in the economic conflict and many countries – especially in the EU – are now accelerating their effort to end their dependence on Russian energy, which will inflict further long-term damage.

Chart 6: Russia struggled post-Crimea



Sources: IMF, TS Lombard.

Chart 7: Sanctions hit Iran hard

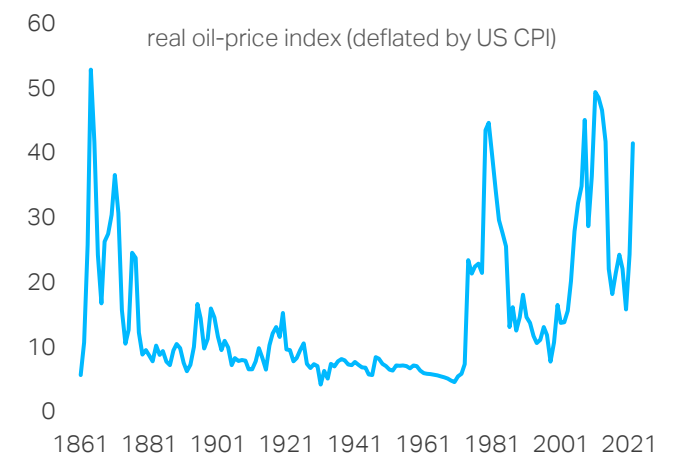


Sources: IMF, TS Lombard.

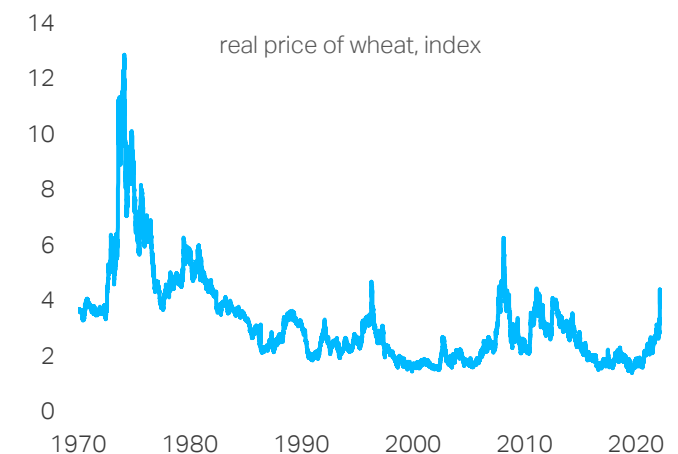
The impact on the rest of the world

When the US and Europe imposed sanctions on Russia, they knew these restrictions would also damage their own domestic economies. Energy prices have surged – particularly in Europe – which has squeezed household's real incomes, exacerbating a problem that started in the autumn. Inflation across the region is set to hit 8%, while wages are barely growing. And since Russia and Ukraine are also an important source of wheat and fertilizers, global food prices have risen sharply, too (a serious problem for developing nations, where households typically spend more than half of their monthly earnings on these basic items). This clearly poses a recessionary threat to the world economy. If people are spending more on food and energy, they have less

money left to buy other goods and services, causing a contraction in aggregate demand. Yet international policymakers are also monitoring various risks to financial stability, which have the potential to turn any near-term economic contraction into something worse.

Chart 8: Oil prices at historical levels again


Sources: Bank of England, TS Lombard.

Chart 9: Food prices have surged, too


Sources: Datastream, TS Lombard.

The financial risks include:

- (i) **Cascading losses in commodity markets:** there is stress in commodity markets. Some firms were expecting to take ownership of Russian/Ukrainian commodities and have sold those products forward in future markets to other intermediaries or refineries in the US and Europe. With sanctions cutting their access to the commodity, they face both losses on their original capital (since Russian producers are unlikely to give them their money back) and margin calls on their futures (which are linked to commodity values – as prices rise, their losses accumulate)². Worse, many of these transactions happen over the counter, which means there is limited transparency about counterparty risk. This can cause liquidity to evaporate – analogous to what happened after Lehman failed in 2008. And since every layer of commodity trading relies on leverage, there could even be spillovers to the banking sector (especially European banks, which are an important source of global trade finance). [Press reports](#) confirm commodity firms such as Trafigura Group ([which are facing intense funding pressures](#)) have already requested a central-bank backstop.
- (ii) **Bank and non-bank exposure:** Some European banks have large exposures to Russia and Ukraine, either because they have made loans to those countries (which face write-downs) or because they have foreign subsidiaries. While direct exposures are not large because most EU and US banks cut their Russian business after the 2014 invasion of Crimea, there are exceptions: Austria, Italy and France have relatively large assets in these countries and have suffered a sizeable stock-market hit. But it is not just banks that face a financial hit from what is happening in Ukraine. Some asset managers and “non-banks” are threatened with significant write-downs. Data from Risk.net highlight significant exposure through derivatives such as FX

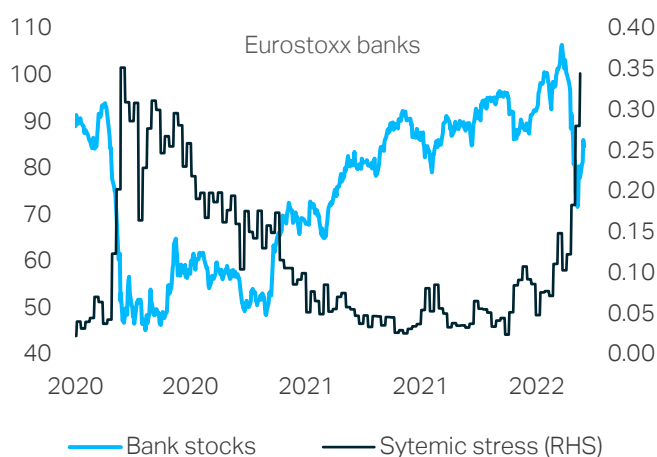
² Initial margin requirements are already 6-10 times higher than before the crisis. Since there are tensions across a broad range of commodities and total turnover in these markets is worth around \$700 billion a year globally (plus trillions more in derivatives), there could be systemic repercussions. This is something officials are monitoring closely, although so far they have been reluctant to backstop the market, which would involve “bailing out” highly speculative activities.

swaps, interest-rate products and Russia CDSs (including \$3.75 billion for Pimco, \$550 million for Western AM and \$337 million for Legg Mason).

- (iii) **The loss of petrodollar:** More generally, [as Adam Tooze points out](#), Russian reserves have been an important source of petrodollars. Though Russia has reduced its direct US Treasury holdings over the past decade, it moved this cash into offshore markets and short-term money funds. These reserves of Russian cash were not simply pools of money sitting idly; they were part of complex chains of transactions that are now in jeopardy as a result of the international sanctions. It is possible that the elimination of these funds could have wider, unpredictable market implications.
- (iv) **Broad tightening in financial conditions:** In any military conflict, there is a possibility of further escalation and unexpected developments. The war in the Ukraine could spill over into neighbouring NATO countries or lead to a more direct confrontation between Putin and the United States/Europe. The Russian president has already put his nuclear deterrent on standby, which highlights the potential seriousness of the situation. In the short term (at least), this warrants an additional risk premium in financial markets, which should cause credit spreads to widen, the US dollar (and other “safe-haven” currencies) to appreciate and equity values to decline. For the US economy, a broad tightening in financial conditions (“risk off”) would generate the most important macro spillover, since direct trade and banking links are modest.

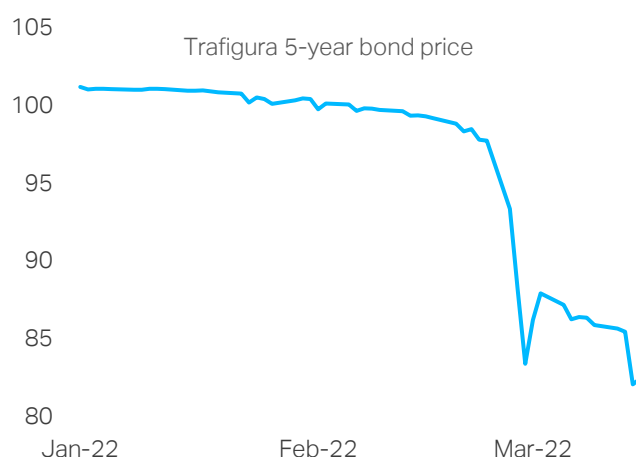
The war in Ukraine, and the associated financial “siege” of Russia could yet trigger a broader downturn, especially in Europe, which is most exposed to the crisis. But Western policymakers will take comfort from the relative resilience of global markets. Financial conditions have tightened, but not in a disorderly way; and there is no sign of a “Lehman moment” in commodity markets or the European banking system. And with Russia and Ukraine apparently willing to make concessions in their ongoing negotiations, there is even the prospect of a near-term de-escalation in the conflict. Yet the nature of this crisis – especially the West’s willingness to weaponize the international monetary system – could also have unintended consequences that go beyond the immediate risks to the global economy. In the extreme, the war in Ukraine could prove the catalyst for a major reconfiguration in international trade and finance.

Chart 10: Financial risks in EU banks



Sources: Datastream, ECB, TS Lombard.

Chart 11: Stress among commodity firms

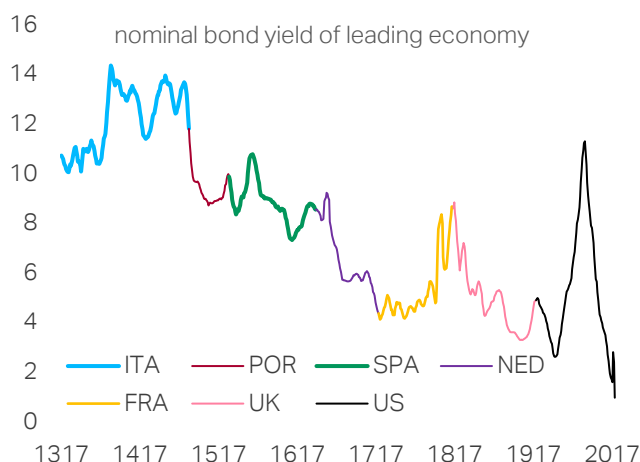


Sources: Datastream, TS Lombard.

2. USD RESERVE STATUS

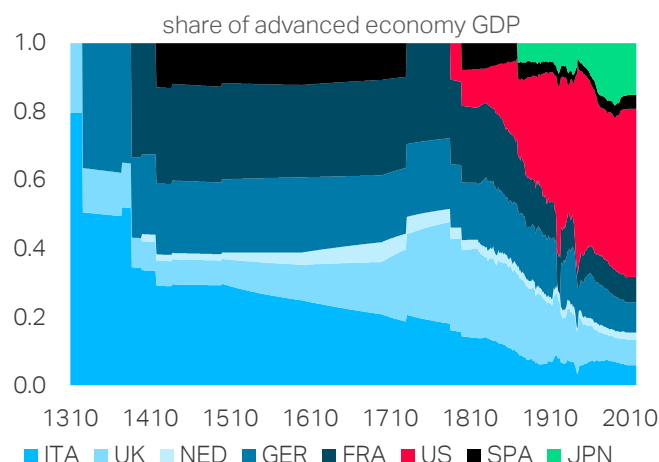
The sanctions on Russia – particularly the freezing of the central bank’s assets – has triggered an uneasy reaction from some Wall Street’s pundits. They believe weaponizing the international monetary system has undermined its long-term stability, perhaps even threatening the status of the US dollar. Former Fed insider Joseph Wang called these actions “financial WMDs” and warned that “foreign sovereigns must now diversify [out of dollars] as a matter of national security”. Other “financial plumbers” agree, with Zoltan Pozsar declaring the end of Bretton Woods II (the post-1971 monetary system based on pure fiat currency and the dominance of the US dollar): “Bretton Woods II was built on inside money, and its foundations crumbled a week ago when the G7 seized Russia’s FX reserves”. Outside money refers to assets owned by an individuals, corporates or public entities that are liabilities of someone else (which means those external bodies can freeze or default on them). This compares with “inside money”, such as gold held in the central bank’s vault. If outside money is no longer secure, the old monetary system could unravel. Crypto enthusiasts also describe NATO’s actions a “quiet USD default”, analogous to Nixon’s decision to “suspend” gold convertibility of the dollar.

Chart 12: Global reserve currencies



Sources: Bank of England, TS Lombard.

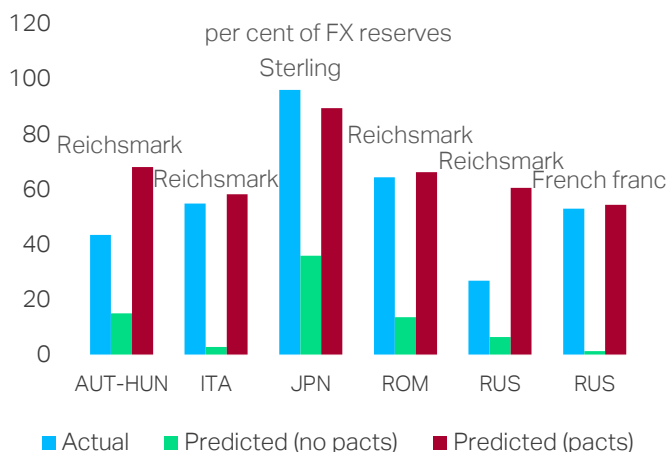
Chart 13: Leading DM economies



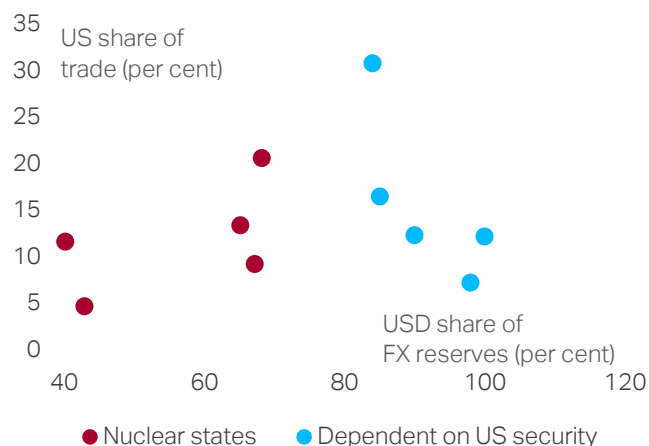
Sources: Bank of England, TS Lombard.

Politics matters for reserve currencies

Warnings about the dollar losing its reserve status are not new – they have been a reoccurring theme in every international crisis of the past 30 years. After the 2008 crash, some policymakers, including Chinese ones, even announced they would prefer an alternative, more stable monetary system. Yet the dominance of America’s exchange rate increased, with the Eurodollar system (US currency held outside the States) recently migrating from the traditional banking sector to global capital markets. The question, of course, is whether this crisis is different – because it is essentially political in nature. We know from history that while shifts in reserve status are rare, they are always associated with big political developments, especially military conflicts. Chart 12 plots the global reserve interest rate, based on Paul Schmelzing’s influential work. His data track all the great monetary regimes of the last 800 years, starting with the financial and military dominance of the north Italian cities, such as Venice. Thereafter we have the reserve currencies of the Spanish (plus Spanish-Portuguese union), the Dutch and the British regimes, monetary transitions that were always linked to shifting geopolitical “power”.

Chart 14: Political pacts drove FX reserves


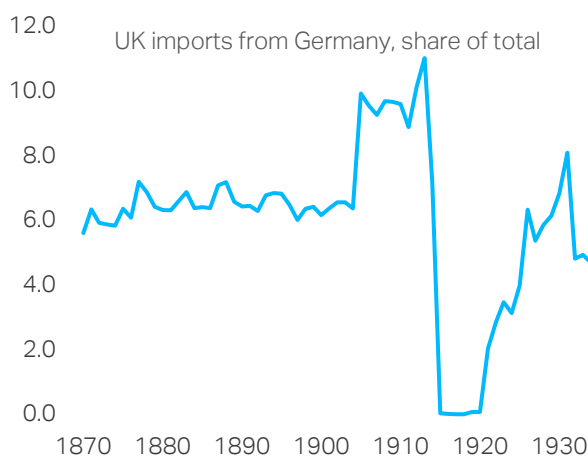
Sources: Eichengreen, Mehl, Chitu (2017).

Chart 15: Reserves linked to military affiliation


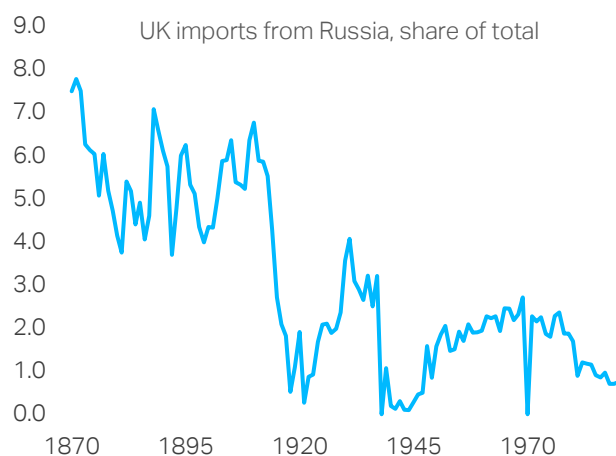
Sources: Eichengreen, Mehl, Chitu (2017).

Evidence from the past

Academic research highlights the important role “politics” can play in how central banks allocate their reserves – particularly strategic, diplomatic and military ties. [Barry Eichengreen \(2017\)](#), for example, examines the period before WW1, when Europe splintered into two main groups: Germany and Austria-Hungary on the one side and France, Russia and Great Britain on the other. He found that this reconfiguration of power accounted for a third of central banks’ reserve allocations. Intuitively this makes sense. It explains why, today, Japan holds a larger share of its foreign reserves in dollars than does China, and why Saudi Arabia holds the bulk of its reserves in dollars, unlike Russia, which exports essentially the same goods. And as Eichengreen points out (Chart 15), there is even a correlation between central banks’ dollar reserve holdings and whether their governments have nuclear weapons, a proxy for their dependence on the US for their national security (compare France and Germany, for example). We can also see the importance of political allegiances in global trade patterns. Take UK trade with Germany around the two World Wars (Chart 16) or US-Russian trade during the long Cold War (Chart 18).

Chart 16: Germany-UK trade around WWs


Sources: Bank of England, TS Lombard.

Chart 17: UK trade with Russia plunged


Sources: Bank of England, TS Lombard.

Chart 18: Trade disappeared during Cold War


Sources: Datastream, TS Lombard.

Chart 19: Loss of sterling's reserve status


Sources: Bank of England, TS Lombard.

Watershed moment?

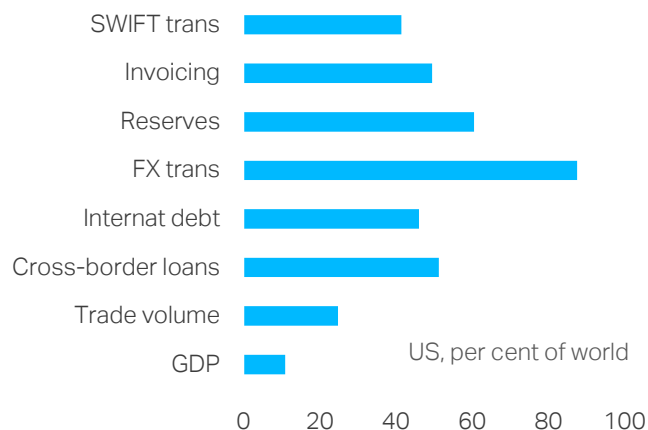
The West's decision to freeze the Russian Central Bank's assets certainly feels like a watershed moment in the international monetary system. While US officials have long been worried about the impact of these sorts of sanctions (as previously deployed against Iran and Afghanistan), the latest weaponization of the dollar is on an entirely different scale. Not even Nazi Germany was fully exiled from the international monetary system (relations between the Bank of England and the Reichsbank persisted well into the 1940s, while the BIS allowed the German central bank access to its clearing and settlement facilities throughout the entire war³). It seems inevitable that at least at the margin, the current sanctions will encourage some parts of the world to diversify out of their US dollar holdings, especially if there is also a reconfiguration in global trade. We know from the Cold War that hard-power political divisions amplify economic divisions, encouraging countries to align their financial systems with their primary military protector. Countries in Africa, Latin America and South Asia switched the focus of their exchange-rate targets and currency pegs when realigning their policies with either the USSR or the US.

Bilateral trade between Russia and China had already migrated away from the dollar in recent years, with RMB taking over as the main "numeraire". The war in Ukraine could accelerate this transition, particularly if it also encourages closer economic and financial ties between the two countries. Russia could sell more of its energy to China (without breaking the sanctions – since they exclude energy), while Chinese banks are keen to enter Russia's financial sector, replacing Western credit card companies, which have suspended their activities in Russia⁴. Even before COVID-19 and the war in Ukraine, we thought the world would "deglobalize" and splinter into two trading blocs, one oriented around China and the other around the US (with Europe mostly, but not wholly, aligned with the latter). The crises of the last two years will reinforce this theme. COVID-19 exposed the inherent vulnerabilities in long, complex supply chains, while the

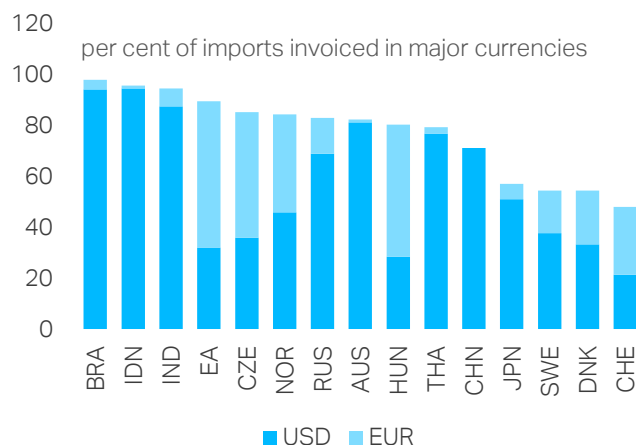
³ One infamous case in 1939 involved the clearing of looted Czechoslovak Central Bank gold via the BIS in cooperation with the Bank of England.

⁴ As many commentators have noted, China's role will be crucial in deciding how the geopolitics of the war in Ukraine plays out. US intelligence reports that Russia has already requested assistance from China and – of course – the countries were planning a closer political and financial alliance before the conflict in Ukraine. Yet we have always expected China to adopt a policy of "strategic neutrality" in this crisis, since economically China benefits from a stable global environment. That does not mean, however, that China will not want to take advantage of Russia's weak position by purchasing Russian energy at a discount, especially as this sector is excluded from current NATO sanctions.

tensions with Russia have highlighted the dangers of Western democracies being overly reliant on the food and energy resources of autocratic nations.

Chart 20: USD domination


Sources: Bank of England, TS Lombard.

Chart 21: USD invoicing of trade


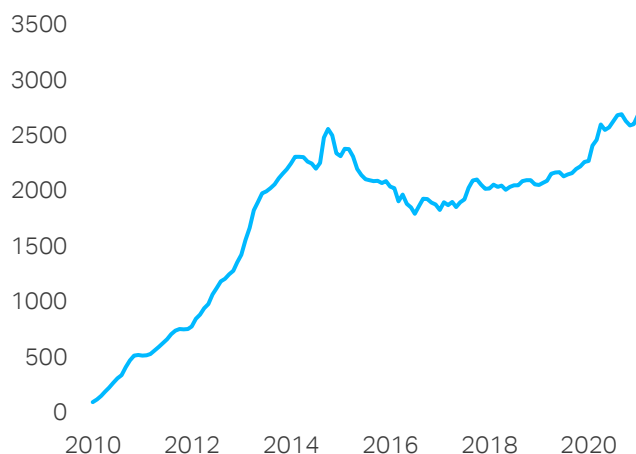
Sources: IMF, TS Lombard.

RMB alternative to USD

So, RMB's role in the global economy is set to increase. In addition to Chinese diversification out of dollars, there are already reports that both Saudi Arabia and India could start invoicing their energy trades in China's currency. This would suit Chinese officials, who have always had the aim of making RMB more international. And they have been making steady progress: the Chinese currency recently pipped Japan's yen in Swift's international payments rankings to take fourth place for the first time, while Standard Chartered's "RMB globalization index" is trending higher (which means the currency is becoming more widely accepted in offshore transactions)⁵. China, too, harbours the ambition to move beyond its dependence on Western-controlled financial infrastructure such as Swift. That is why it has spent years building out its RMB-denominated

Chart 22: China & Russia diversifying away


Source: FT.

Chart 23: RMB 'globalization' on the rise


Source: Standard Chartered.

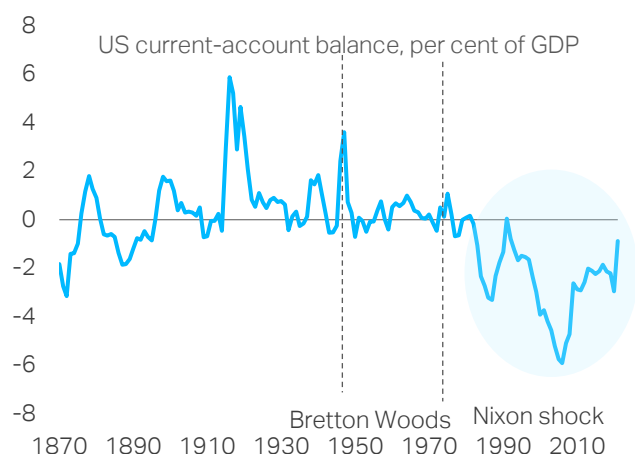
⁵ The index covers RMB deposits outside China, plus trade settlements, "dim sum" bonds (denominated in RMB and issued in Hong Kong), certificates of deposits and FX finance.

Cross-Border Interbank Payments System (CIPS), which reached the equivalent of \$7.1 trillion in 2020 (a 20% increase compared with 2019). So, could RMB take over the dollar's position as the world's leading currency? This seems unlikely. While the role of RMB will continue to grow, particularly in some parts of the world, China's currency is not yet a threat to the USD.

Don't write off USD just yet

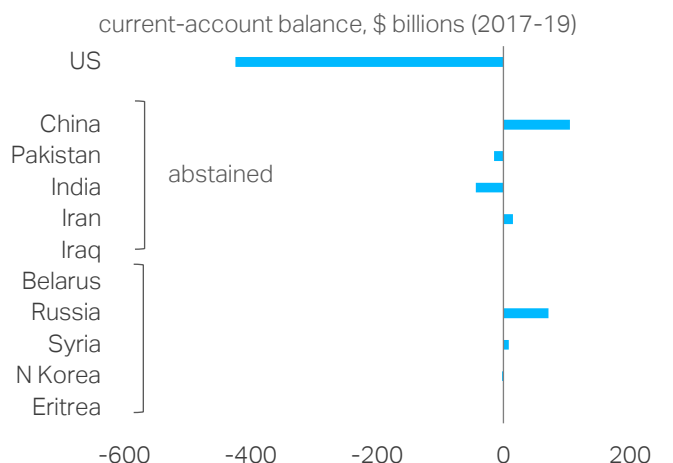
There are two reasons why the dollar's demise is not imminent. First, while [China's "strategic neutrality"](#) has undermined the West's tough stance on Russia, it is unlikely that the countries that have supported (even tacitly) Russia's actions can afford to cut themselves off from the rest of the world. China, India etc may want to pursue closer economic ties with Russia, but it is not in their interest to turn their backs on the prevailing international monetary system. US demand is crucial to global growth and it is clear that the countries that have taken Russia's side could not possibly replace their dependency on exporting to the US, individually or as a new trading bloc (Chart 25). Remember, a reserve country must be willing to run large and persistent current-account deficits to provide the rest of the world with their currency needs. Only the US can currently play this role, not least as China has failed to "rebalance" its economy – the current property slump in China is only going to make this more challenging in the early 2020s.

Chart 24: The burden for a reserve currency



Sources: MacroHistory, BLS, TS Lombard.

Chart 25: Russia's 'friends' need US demand



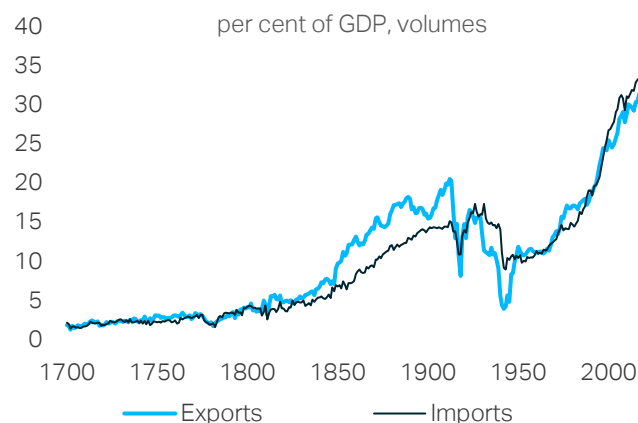
Sources: IMF, TS Lombard.

The second reason why the US will not lose its dominance quickly is that the dollar enjoys powerful "network effects", including deep capital markets, critical lender-of-last resort facilities and the provision of financial services to the rest of the world. Because of China's closed capital account, foreign investors do not have easy access to RMB-denominated bonds and bank deposits on the scale necessary⁶. As long as China prevents people from freely taking assets out of its financial system, external investors and central banks would be swapping the threat of Western sanctions for even greater policy uncertainty in Beijing – it was not that long ago that there were doubts about whether foreign lenders to the country's largest real estate developer, Evergrande, would make good on the company's overseas debts, with the State prioritizing

⁶ Dim sum bonds (RMB-denominated bonds traded offshore in Hong Kong and elsewhere) and offshore renminbi bank deposits are accessible, but other instruments less so. Although Hong Kong and Shanghai operate a Bond Connect through which overseas investors can invest in Mainland China's interbank bond market, few, if any, central banks are on the list of approved investors authorized to participate in the scheme. And as Barry Eichengreen points out: every leading international and reserve currency in history has been the currency of a political democracy or republic, where there are credible institutional limits on arbitrary action by the executive. Under President Xi Jinping, China has, of course, been moving in the opposite direction – away from such limits.

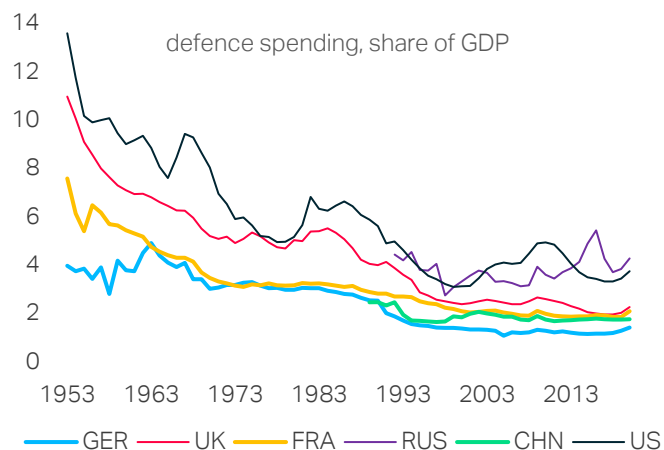
domestic stakeholders. Full liberalization of China's capital account could trigger dangerous capital flight, causing a depreciation of RMB – which would not help the country's reserve status.

Chart 26: Read for deglobalization 2.0?



Sources: Bank of England, TS Lombard.

Chart 27: Time to rebuild the military?



Source: worldpopulationreview.com.

3. THE 'TANGIBLE 20s'

While the war in Europe is unlikely to undermine the dollar's status as the world's reserve currency, it could have other long-term implications for global markets. We see it enhancing some of the secular trends that have already emerged from the COVID-19 pandemic, reinforcing a new macroeconomic regime of faster growth, higher interest rates and more volatile inflation. Governments are set to spend more on national defence and public infrastructure, while curbing their reliance on imported energy/food and accelerating the transition to green technologies. And supply chains will shrink and realign around regional trading blocs, with globalization shifting more decisively into reverse. This is an environment where investors will want more exposure to real/tangible assets rather than the "intangibles" (US tech etc.) that dominated the bizarre perma-zero interest rate environment of the 2010s.

New macroeconomic regime

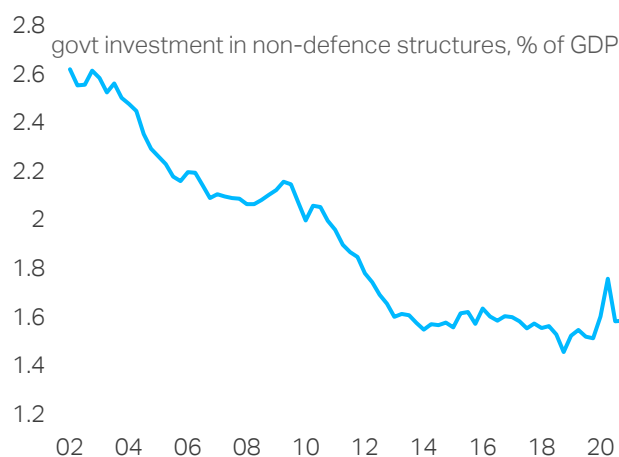
Last summer, we argued that rather than try to figure out "where we are" in the business cycle – which made no sense in a COVID-distorted economy – investors should focus on how macroeconomic conditions might change in the 2020s (versus the 2010s). Since then, we have analysed various forces – larger government deficits, stronger housing markets, improving productivity, massive investment (public and private) in green technologies/infrastructure and deglobalization – that are likely to drive up equilibrium interest rates (r^*) over the next decade. Even if the Ukraine conflict ends soon, which remains highly uncertain, it seems likely to reinforce many of these themes, adding to mild secular "reflation". Crucially, the "structural" impact of this crisis is likely to be most profound in Europe, which would otherwise face a significantly weaker growth trajectory than the US. European governments – especially Germany – have been most responsive to Russia's aggression and are now planning big public investment in defence and energy. There is even talk of mutual bond issuance ("Eurobonds") to finance the

transition away from Russian commodities. As we have pointed out [in previous research](#), Europe needs big public investment if it is to have any chance of escaping the lower monetary bound.

Secularly higher yields and commodities

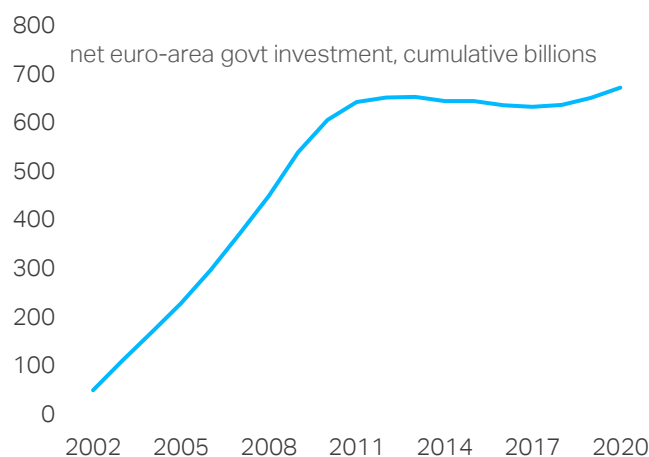
This political response to Russia's invasion makes us more convinced than ever that we are at a secular turning point in inflation and interest rates. While consumer prices will slow from their current readings, inflation is likely to settle around 100-200bps above the levels of the 2010s. Central banks will surely accept this outcome, rather than try to force inflation back to their 2% targets ([since this would probably require a recession](#)). Bond yields are likely to trend higher, but the authorities will suppress such moves by remaining relatively dovish. Inevitably, this means horrible real returns in bond markets over the next five to 10 years, especially as consumer prices are likely to remain highly volatile – there will be many more instances of “transitory” inflation. And commodity prices are a big part of this story. Climate change – [both the physical disruption from extreme weather and the transition to a low carbon economy](#) – will trigger further, powerful swings in food and energy prices while simultaneously raising their average growth rates over time ([see here for more](#)).

Chart 28: The age of austerity in the US



Sources: BEA, TS Lombard.

Chart 29: No net EA investment since 2008!

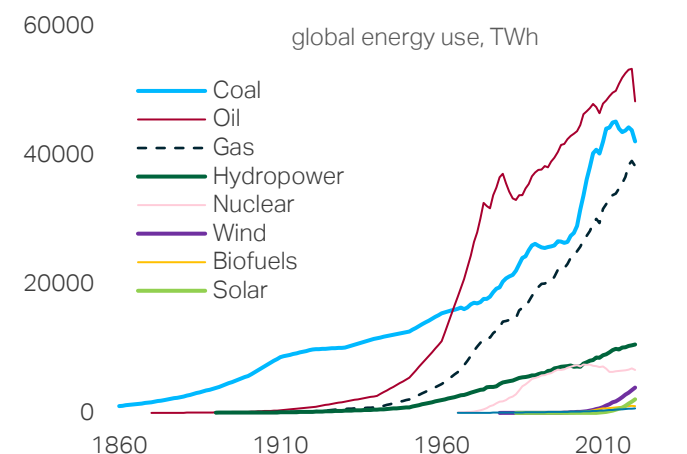


Sources: Eurostat, TS Lombard.

A new equity-market regime

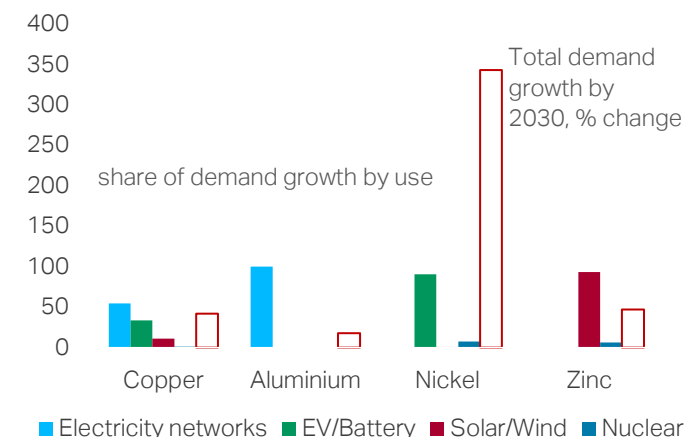
While the repercussions for bond markets and global commodity prices seem clear, there is less recognition about what this new macro regime means for equity markets. Secular stagnation had a profound impact on the relative performance of different stocks, and an era of “secular deflation” could produce a very different type of stock market. We see this most clearly in the decade-long outperformance of “growth” vs “value” stocks. ‘Growth’ stocks are those that have relatively high market-to-book values, priced this way presumably to account for their superior long-term growth prospects. They include companies like Tesla, which have relatively low earnings today but (supposedly) fantastic future prospects. “Value” stocks are the opposite: they have a low market-to-book value, presumably because their future revenue performance looks weaker. Yet it is important to stress how unusual the last decade has been, much to the frustration of traditional “bottom-up” stock-pickers. The growth sector’s continuous outperformance has bucked the “megatrend” of the last 50 years at least, [if not even longer](#).

Chart 30: Time to make the transition



Source: OurWorldInData.com.

Chart 31: Massive demand for commodities

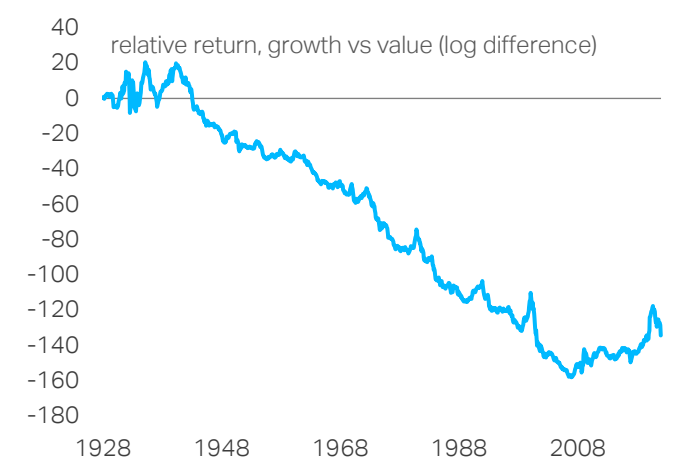


Sources: IEA, TS Lombard.

Secular stagnation: 'growth' outperformed

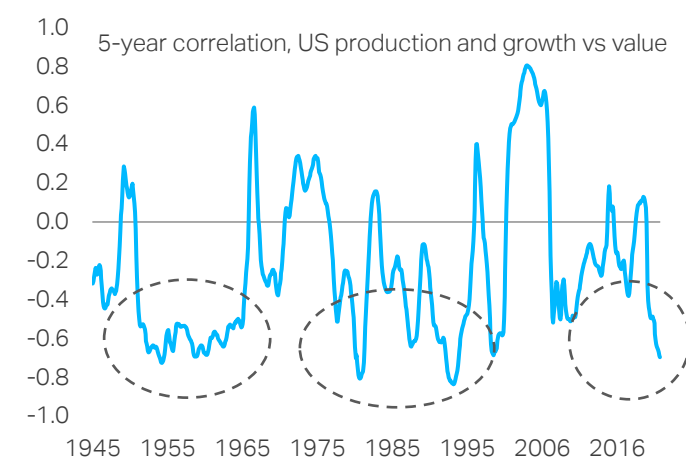
The secular stagnation regime favoured "growth" stocks for two main reasons. First, it delivered lower nominal GDP growth: it seems obvious that if economic growth is secularly scarce, investors will pay a premium for those companies that promise to perform better. Chart 33 plots the long-term historical pattern, which shows there has generally been a negative correlation between secular periods of industrial strength and "growth" performance. The "high-pressure" economies of the 1950s, 1960s and 1990s provided the ideal macro backdrop for "value" outperformance. The second reason secular stagnation favoured "growth" stocks has to do with interest rates. When investors expect rates to stay chronically low, they will place a higher value on companies (and investment projects) that promise strong returns in the future, even if those returns are a long way off. This is just arithmetic. Growth stocks are "longer duration", which means valuations rise disproportionately for a given decline in bond yields ([see this example of how the maths works](#)). Chart 34 shows a negative correlation between interest rates and "value".

Chart 32: The 2010s were a bit weird



Source: Fama/French database, TS Lombard

Chart 33: High-pressure economy suits value



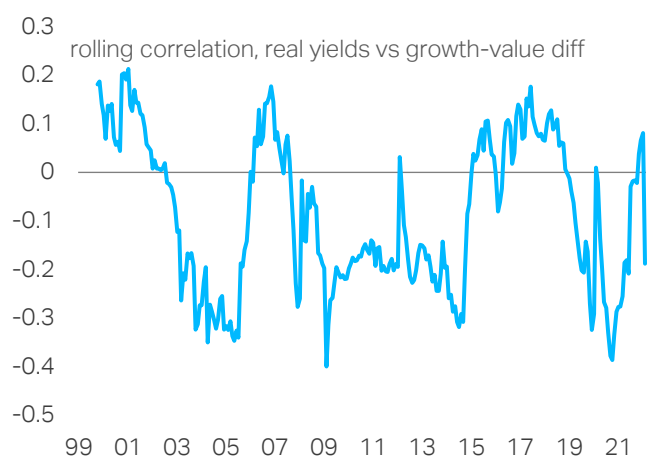
Source: Fama/French database, TS Lombard

Secular reflation: 'value' and 'tangibles'

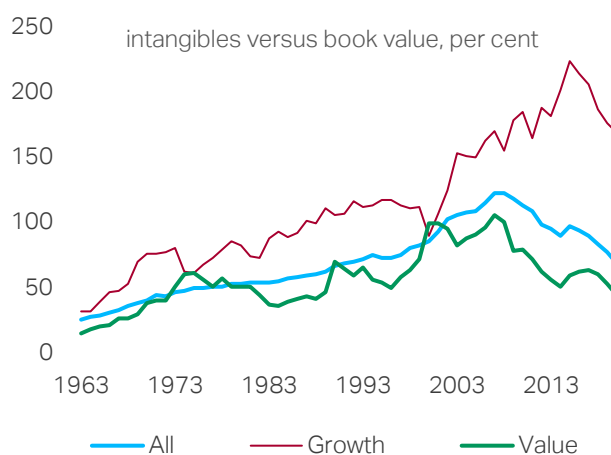
Just as secular stagnation and zero interest rates favoured growth stocks, an era of secular reflation and rising yields should favour value stocks. So, the recent "rotation trade", which has

mainly been about the reopening of the economy after COVID-19, is just the first instalment of a broader structural theme. And we can also think about this issue another way, in terms of "tangibles" and "intangibles". The growth stocks that were dominant over the past decade were big investors in intangible assets. As [Vincent Deluard points out in a recent podcast](#), the S&P 500 index can be broken down into two parts: the 15 largest intangible companies (the FAANGs, big pharma, VISA and MasterCard) have a capitalization of \$15 trillion despite reporting just \$2.5 trillion in assets, while the remaining 485 companies control \$40.4 trillion in assets but are worth just \$26 trillion. Tangible companies are businesses that "make stuff with other stuff". The value of intangibles is not derived from their balance sheet; rather, it comes from their intellectual property, branding, market power, "good will" and distribution networks.

Intangible assets have four main characteristics: (i) large sunk costs (they have limited resale value); (ii) strong scalability at zero/low marginal costs; (iii) powerful synergies (intangible assets feed on each other); and (iv) strong spillovers (intangible assets can have various different applications). Subdued inflation and low interest rates favoured intangible assets, but this advantage disappears in a reflationary environment. This is not just because intangible assets have a longer duration; it is also because a higher-pressure economy would raise the scarcity premium on physical assets, increase the uncertainty about future returns, erode the nominal value of debt (tangible businesses have more collateral and higher debt ratios) and discourage the various forms of "financial engineering" that boosted intangible valuations during the 2010s. The scalability of intangible businesses meant that they also benefitted disproportionately from globalization, which is an advantage they will lose in the era of deglobalization.

Chart 34: Higher rates also suit value


Sources: Fama/French database, TS Lombard.

Chart 35: Intangible dominance to end?


Sources: Robert Arnott, Campbell R. Harvey, Vitali Kalesnik & Juhani T.

The return of the real economy

In short, tangible assets have a closer link to the "real economy". And when we think through the secular growth themes that are emerging out of the chaos of the past two years, it is clear that there are important sectoral "winners", which will experience a revival in the 2020s, namely:

- (i) Higher interest rates – banks, financials, healthcare
- (ii) Infrastructure spending – industrials, materials, commodities
- (iii) Defence spending – defence, aerospace, materials
- (iv) Global housing revival – banks, materials, commodities
- (v) Deglobalization – industrials, capital goods

(vi) Climate change – commodities, metals, energy

In the 2010s, the decade of secular stagnation, investors could earn outsized returns simply by investing in “growth” stocks, especially US tech. We are not particularly pessimistic about those companies – they could continue to enjoy decent earnings. But their post-COVID valuations fully reflect those future growth prospects (perhaps they are even over-valued). Now the big investment opportunity is shifting back to the “real economy”, areas that could enjoy a secular revival. Investors should seek exposure to “tangibles”, such as commodities, real estate and many traditional “value” parts of the equity market, which are likely to gain from this transition.

Bottom line

The weaponization of the international monetary system against Russia could have serious implications, both short and longer term. The immediate effect is to trigger an economic crisis in Russia, which is having financial spillovers to the rest of the world, especially Europe. Western policymakers, who are monitoring these risks closely, will be relieved that – so far – there have been no systemic consequences for markets. But there is widespread concern, especially in the world of Wall Street punditry, that NATO’s aggressive sanctions could undermine the stability of the dollar standard, especially the central role of the US currency as the world’s main reserve currency. These worries are understandable: history shows that politics has an important influence on both the configuration of trade and the status of the major currencies within it. And it seems reasonable to think some parts of the world – particularly China – will accelerate their efforts to reduce their USD dependency. It would be premature, however, to conclude that USD is about to lose its position as the world’s primary currency. Currently, there is no clear alternative to the US dollar, particularly given the importance of US demand to global growth and the country’s deep and liquid capital markets. China’s RMB is still a long way behind. The more relevant “structural” theme from the war in Ukraine is that it seems destined to enhance post-COVID secular reflation. This new macro regime has important implications for where investors should put their money over the next five to 10 years. Welcome to the ‘Tangible 20s’.