# Twin Shocks and Fiscal Dominance II

*Antifragility and Convexity in a New Macro Regime*

**Reframing Portfolio Construction in a Nonlinear World**

In my previous article, “Twin Shocks and Fiscal Dominance: Reframing Portfolio Construction in a New Macro Regime”, I introduced the concept of antifragility as a response to the emerging macro environment shaped by pandemic aftershocks and geopolitical disruption. This follow-up builds on that foundation - moving from philosophical framing to portfolio architecture. Implementation will follow in the next installment.

The regime shift forced by Covid-19 and Russia's war on Ukraine has both exposed the limits of monetary policy independence and accelerated the onset of fiscal dominance. The resulting policy mix has driven significant changes in both real interest rates and trend inflation, breaking with the gravitational pull of the zero lower bound in official interest rates.

Asset prices since 2022 have marked this change. Investors must now rethink their portfolio construction assumptions and traditional hedging methods to achieve expected return durability in a world where volatility is embedded in the regime, not cyclical. While headline volatility metrics may appear subdued, the underlying market structure has become more fragile—marked by unstable and shifting correlations, fragmented liquidity, and more active central banks.

**From Passive Allocation to Regime-Aware Design**

Pulling free from the zero lower bound and the deviation in inflation away from the 2.0% target has demanded central bank intervention so that inflation expectations remain anchored on the inflation target. However, fiscal policy is failing to achieve debt sustainability and is complicating many central banks' abilities to manage inflation.

Portfolio design must be sensitive to persistent volatility and policy divergence, especially given a highly divided electorate and the pursuit of unorthodox economic policy in the US. This demands a portfolio that is robust to big and unanticipated swings in macroeconomic structure and policy direction relative to expectations.

Precision is no longer the goal—resilience is. Portfolios that cling to predictive frameworks remain exposed to regime shocks. The task is not to anticipate every scenario, but to construct an allocation framework that adapts across a wide range of possibilities - minimizing reactive behavioural responses and preserving design discipline.

This shift in design logic demands a new lens—one that interprets macro signals not as trades, but as regime indicators.

**Macro Factor Aids in Regime Identification**

Applying top-down context as a factor in portfolio construction and risk management acknowledges the

need to understand the underlying regime. Each regime delivers its own distinct set of forces that shape
asset behaviour—both independently and in cross-asset relationships. These forces dictate key considerations such as policy reaction functions, correlations, volatility and liquidity dynamics.

This approach differs from using macro-related signals as a standalone investment strategy. Instead, it provides the interpretive lens through which to allocate risk. Correctly employed, this factor enhances portfolio durability by reducing fragility without disrupting core allocations. It reframes how allocators interpret valuations, positioning, and asymmetry—each now shaped by prevailing regime dynamics.

Attuned investors assess whether asset prices reflect the dominant structural environment, not whether they appear “cheap” in isolation. Valuation is context dependent. Crowded trades signal fragility risk when regime conditions shift. The goal is to capture asymmetry - small downside, large upside - often revealed in such shifts or consensus narratives.

The emerging environment requires integration of regime-aware inputs as a key portfolio building block. Portfolios built without reference to these inputs risk instilled fragility when dominant forces shift.

True fiduciary discipline calls for regime awareness. Adapting to the prevailing macro environment is not a tactical choice—it’s a foundational imperative. It is important to make a clear distinction: this is not macro top-down context as a trade. Instead it is about infusing regime awareness into every layer of portfolio design - from asset allocation to manager selection. Directional exposures may emerge but they are regime-anchored, not speculative. This is a framework for interpreting structural forces and allocating risk accordingly.

Once macro awareness is embedded, the next step is execution—translating design into performance through convex exposures.

**Forecasting in the Face of Uncertainty**

Economic and policy upheaval brings instability and uncertainty, complicating efforts to forecast its duration and outcome. Crucially, regime shifts are not linear, making asset price reaction difficult to predict.

In “*Radical Uncertainty: Decision Making for an Unknowable Future”* (2020), Mervyn King and John Kay distinguish between risk and uncertainty. Risk can be modeled with probabilities; uncertainty resists quantification. Forecasting amidst uncertainty requires more information and a different mindset - one that prioritizes resilience over precision. Embracing optionality and adaptive portfolio design is essential.

**The USD as a Signal of Structural Fragility**

Unpredictability around U.S. policy has introduced uncertainty into asset markets. While broad U.S. cross-asset performance and valuations may not yet fully reflect this, a deeper look at the market substructure suggests some caution.

The USD offers a useful lens. In 2025 to date, it will have lost approximately 6.6% of its value on a

trade-weighted basis (Source: https://fred.stlouisfed.org/series/DTWEXBGS). In his article *"The New American Geography: Who Profits in a Post-American World?"* (Foreign Affairs, Sept/Oct 2025), Adam
Posen argues that the new administration's policies have altered the value proposition of holding USD assets.

Historically, the U.S. provided economic insurance to trading partners via rules-based trade, USD liquidity, and institutional stability. This structure supported global growth and reinforced the USD's role as a safe haven. In return, the U.S. benefited from capital inflows, lower financing costs, and geopolitical leverage—benefits now at risk as structural credibility erodes.

Today, that bargain appears to be fraying. Arbitrary tariffs, pressure on central bank independence, and vague proposals such as compelling foreign holders of U.S. Treasuries to extend existing holdings to longer-dated or perpetual debt are examples of rising uncertainty and contract abrogation.

**Engineering Resilience Over Precision**

Managing this uncertainty should now be central to portfolio design. As uncertainty rises, portfolio integrity must be prioritized to acknowledge that the non-linearity of regime change can be highly disruptive to return outcomes. As such, tail risks need to be managed.

Identifying key regime signals is essential to navigating instability. Incorporating this macro awareness as a factor not only improves durability—it also enables portfolios to remain architecturally aligned with performance objectives, even if regimes shift.

Antifragility must be designed into portfolios as a complement to core holdings. Safeguarding against unknowns has high value in times where forecasts are less accurate and confidence in them has declined. Portfolio success is no longer about timing the market—it's about thriving across volatility regimes through intentional design.

**Convexity as a Structural Response**

If antifragility is the philosophical foundation for portfolio resilience in a nonlinear macro regime, then convexity provides the mechanics to deliver the required structural expressions. These are implemented not to predict shocks but to position a portfolio to benefit from them.

Unlike linear exposures that rely on stable relationships and the capture of incremental returns, convex structures are designed to respond asymmetrically to volatility, dispersion, and regime shifts. They allow portfolios to gain more than they lose when the environment becomes unstable. In this way, convexity is not a bet—it's a design principle enabling portfolios to have greater adaptability and resilience amidst different risk scenarios.

Convexity can be expressed through a range of tools, broadly grouped into three categories:

● **Volatility-Responsive Structures:** Instruments that benefit from large moves, dispersion, or volatility clustering, e.g. options and volatility overlays.

● **Asymmetric Positioning Techniques:** Strategies that offer nonlinear payoffs or convex carry, for example FX trades structured to benefit from dollar fragility under fiscal dominance.
● **Dynamic Allocation Mechanisms:** Rules-based systems that adapt to macro signal thresholds, for example overlays that tilt exposures when FX volatility spikes or yield curves invert.

While they may resemble tactical hedges, these are expressions of convexity in action - designed to capitalize on dislocation, not merely endure it.

**Case Studies in Convexity**

Recent market dislocations have already demonstrated the value of convexity. In 2022, as bond-equity correlations broke down, long volatility and dispersion trades captured the widening spread in relative asset pricing dynamics. During the March 2020 liquidity shock, portfolios with deep out-of-the-money protection monetized the volatility spike and redeployed capital into distressed assets. These examples demonstrate how regime-aware design translates into real-world performance capturing dislocation, redeploying capital and reinforcing the portfolio's ability to adapt and scale during regime disruption. These outcomes reflect not just protection, but intentional design where resilience becomes a source of capital and convexity transforms volatility into opportunity.

**From Protection to Positioning**

Convexity thrives in environments where outcomes are nonlinear, discontinuous, or regime-defining. For allocators, this presents both a challenge and an opportunity. These exposures often sit outside traditional benchmarks and may be difficult to explain within legacy mandate frameworks or to certain audiences. Nevertheless, in a world shaped by persistent macro forces and unpredictable regime shifts, neglecting asymmetry may be the greater risk.

The goal of portfolio construction is not to replace core exposures, but to complement them - to build portfolios that can accumulate returns through calm and chaos alike. Convexity shifts the focus from precision to preparedness, from forecasting to positioning.

In this regime, owning asymmetry is no longer optional. It is crucial to delivering portfolio integrity. In the next installment in this series, we'll explore in more detail how convexity can be implemented across asset classes - mapping strategies to specific macro shocks and regime dynamics, and examining how allocators can embed antifragility into portfolios without disrupting mandate discipline.

David Page
Capital Markets Professional
Toronto
Linkedin: https://www.linkedin.com/in/davidcpage/
Substack: @davidcpage