

Twin Shocks and Fiscal Dominance

Reframing Portfolio Construction in a New Macro Regime

Introduction

The early 2020s witnessed two major shocks—the COVID-19 pandemic and Russia's invasion of Ukraine—that marked a decisive inflection point in the global macroeconomic environment. Together, they catalyzed a regime shift that eventually lifted interest rates off the zero-lower bound and ushered in a new era of policy behaviour. This was not merely a cyclical adjustment, but a structural transformation in how economies function and how investors must respond.

A defining feature of this new regime is the reactivation of central banks as dominant macroeconomic agents. Their renewed assertiveness has re-established global macro as a critical factor in active management and portfolio construction. Delivered inflation has consistently realized above target, borrowing costs have risen, and public debt dynamics have deteriorated across many developed economies. These forces have triggered cross-country divergences in macroeconomic policy objectives, creating a relative value opportunity set not seen since the years preceding the Global Financial Crisis (GFC).

This article introduces a framework for navigating this new regime. Future pieces will explore how to capture emerging opportunities and extract value across asset classes and strategies.

From Disinflation to Divergence

The prior macroeconomic regime was anchored by secular disinflation, globalization and rapid technological adoption. These forces drove risk-free rates steadily lower across the globe, enabling governments to finance expanding debt loads with minimal friction. Investor behaviour adapted accordingly: capital was pushed out along the risk spectrum in search of yield and the low-rate environment fostered a sense of stability that suppressed volatility.

Stable central bank policy rates and market indifference to sovereign fiscal positions created a backdrop that was unusually supportive of financial assets. Volatility fell, and investors grew comfortable assuming return distributions were normally shaped. Tail risk management became an afterthought. But now, with the foundational assumptions of that regime disturbed, the case for reintroducing tail risk management as a core pillar of portfolio construction has grown substantially.

Inflation targeting had long served as a successful monetary anchor, with realized inflation typically hovering near the 2% target across advanced economies. Implied breakevens in rates markets reflected investor confidence in central bank independence and execution. But this benign outcome was largely driven by globalization and the efficient distribution of production across borders. While the benefits of globalization were broadly shared, the costs of adjustment were disproportionately borne by advanced economies—fueling economic and political tensions that have since erupted.

Populism has gained traction, disrupting policy and legal norms as governments respond to rising domestic pressures. The perceived loss of inflation control and a demonstrable rise in the cost of living have intensified these tensions. Support for globalization has waned, and in the U.S., substitution policies have emerged as a response to socio-economic dislocation. Empirical evidence suggests these measures may worsen, rather than alleviate, underlying conditions.

The Rise of Fiscal Dominance

The post-GFC and post-pandemic periods saw a dramatic rise in government debt issuance. As inflation and interest rates ultimately climbed, the fragility of these debt dynamics was exposed—yet political recognition of the problem remains largely absent across party lines.

Economic theory tells us that fiscal policy must ensure that debt ratios remain manageable so that monetary policymakers can operate independently and maintain their inflation targets. Yet, interest rates are on the verge of outpacing economic expansion rates with the US deficit already at ~6.2% of GDP. The combined effect will be to accelerate the rate of debt to GDP growth rendering a greater risk of fiscal calamity. In such a scenario, the Federal Reserve may be forced to subordinate its inflation mandate to the imperative of minimizing fiscal funding costs—a state known as *fiscal dominance*.

This environment implies structurally higher average inflation and greater inflation volatility. Investors must reassess whether their portfolios offer sufficient inflation protection and whether prevailing valuations are appropriate. Recent government funding decisions have laid the groundwork for a prolonged period of fiscal dominance, challenging long-held assumptions about asset allocation, trade structure, and risk management.

This article frames how fiscal dominance is reshaping term premiums in sovereign bond markets—particularly U.S. Treasuries, but also witnessed in other markets, for example, UK Gilts and Japanese Government Bonds(JGBs). The reordering of decades-long trade agreements, supply chain fragilities exposed by the twin shocks and other structural factors have all contributed to the resurgence of inflation relative to the prior regime.

The Breakdown of Diversification

The evolving policy environment places risk management at the centre of portfolio decisions. Investors must now accept that return distributions will be less stable and that the cost of suppressing volatility is higher than in the past. The previous macro policy balance—where central banks could intervene to stabilize markets—is no longer assured as there is now a greater inflation challenge. Investors must now manage risk themselves.

For multi-asset managers, diversification begins with identifying assets that ideally exhibit negative correlation. But correlation alone is insufficient. Volatility must also be considered. For example, if equities sell off more than bonds rally, the portfolio must hold disproportionately more bonds to offset losses—complicating return generation.

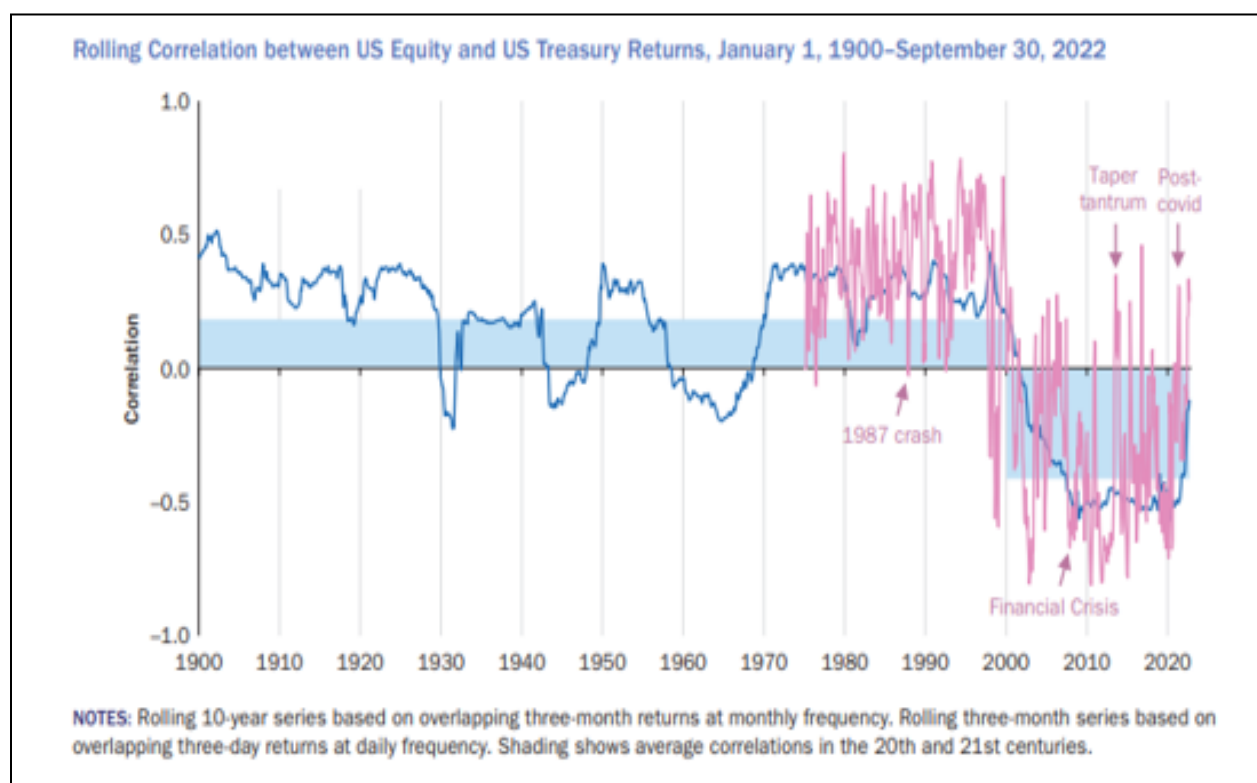
During the prior regime, the persistent negative correlation between equities and bonds underpinned asset allocation models like the Risk Parity “All Weather” portfolio pioneered by Bridgewater. Diversification benefits were harvested by allocating risk rather than capital, aiming

for a stable total portfolio volatility profile. Fixed income exposure offered antifragile properties—providing ballast during equity drawdowns.

Nassim Taleb's concept of antifragility highlights how portfolios can be structured to thrive in volatility rather than merely survive it. Antifragile strategies reduce behavioural biases that lead managers to make suboptimal decisions under stress. But the negative correlation between equities and bonds that offered this required benefit has now become episodic and unreliable.

For most of the 100 years prior to 2000, equity-bond correlation was positive—meaning combined exposure added to risk rather than reducing it. The past two decades of sustained negative correlation were the exception, not the rule. If the macroeconomic regime has indeed changed, we should expect policy conduct—and relative asset returns—to diverge from recent experience.

Figure 1: Rolling 3-Year Correlation Between US Equities and Treasuries (1900–2022)



Source: FT.com

Evidence is mounting. Since the twin health and geopolitical shocks, equity-bond correlation has become increasingly volatile. Bonds have failed to provide diversification during key stress periods, e.g. Q1 & Q3 2022, Q3 2023 and the cross-asset turmoil of early 2025 following new U.S. tariff and trade policies. While the 60:40 mix rebounded aggressively, in Q4 2023 for example, such volatility reduces the reliability of this asset pairing.

Beyond Bonds: Rethinking Asset Relationships

Leverage further complicates matters. From its peak in February to its low in April of this year, the SP500 delivered a total return of ~ -17% (data source: <https://finance.yahoo.com/>) while

10-year US Treasuries returned a little above 1% (data source: <https://fred.stlouisfed.org/>) over the same specific period. Volatility measures, (5 year lookback), were sitting at approximately 16% for equities (data source: wallstreetnumbers.com) and 6.2% for Treasuries (data source: <https://streetstats.finance/>). A portfolio would have needed significantly more bond exposure than standard risk weighting suggests to offset the equity decline. This highlights the failings in relying upon historical correlation assumptions in a regime where macro forces are shifting rapidly.

The case for alternative assets and strategies is rising. As diversification benefits deteriorate, allocators must explore new portfolio construction techniques to deliver lower volatility and more consistent returns. These will be explored in future articles.

Importantly, the breakdown in correlation is not limited to equities and bonds. Consider gold and real interest rates. Historically, ultra-low real rates justified gold ownership as the rate structure made the opportunity cost of owning a non-interest bearing asset relatively attractive. Yet today, real rates have normalized, while gold sits at all-time highs. This suggests renewed uncertainty about macro policy objectives and the fiat system. Crypto may, to a lesser degree, be viewed through a similar lens.

In 2025, the U.S. Dollar's relationship to other assets has also shifted. The deterioration in its negative correlation with risk assets reflects changing global growth composition expectations and capital flows driven by concerns over differing fiscal health across countries.

Looking Ahead

Central bankers have had some success in constraining post-shock inflation, but persistent inflation in key sectors remains a challenge. At the August Jackson Hole Symposium, Fed Chair Powell warned of headwinds to U.S. potential growth—driven by demographic shifts (a rising dependency ratio) and reduced immigration. These factors constrain labour supply and threaten inflation outcomes unless demand slows to match the slower rate of growth in supply potential. They also complicate the administration's pursuit of 3% GDP growth—a critical goal in managing the fiscal deficit.

The macro regime has changed. Correlations are unstable. Fiscal dominance is rising. Investors should expect a reduction in diversification benefits which will require them to manage downside risk deliberately.

My subsequent articles will explore solutions for the faltering benefits of fixed income and discuss multi-strategy approaches designed for resilience in this new world.

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