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WEALTH MANAGEMENT



FISCAL DOMINANCE, INFLATION AND THE FUTURE OF PORTFOLIO CONSTRUCTION

June 2026

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THE REGIME HAS CHANGED

We believe we are navigating a regime of fiscal dominance where government spending and borrowing play a bigger role in influencing financial assets than monetary policy. In our view, this theme will only accelerate in the months and years ahead. How should multi-asset investors respond?

The structural conditions that made passive, benchmark-hugging portfolios so effective for the better part of three decades have shifted in a fundamental way. Global inflation is proving stickier than expected, while fiscal deficits are running at levels that put bond markets under persistent pressure. Meanwhile, geopolitical developments are redrawing supply chains. Central banks, despite their rhetoric, are finding their room to manoeuvre increasingly constrained by government spending. In light of these developments, multi-asset portfolios should be aligned to a very different future regime.



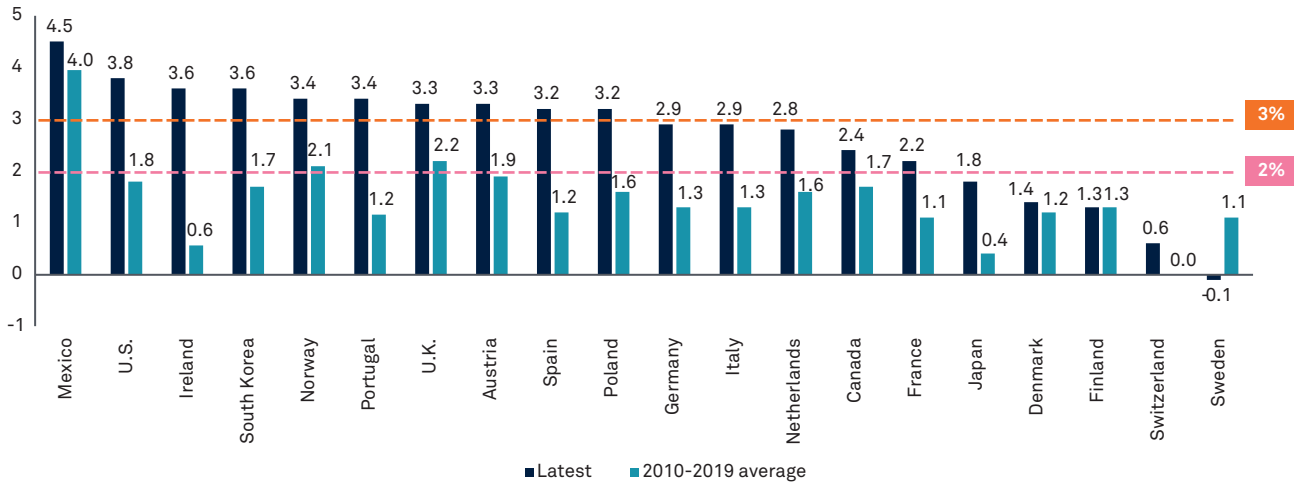
> “Global inflation is proving stickier than expected, while fiscal deficits are running at levels that put bond markets under persistent pressure.”

FROM MONETARY TO FISCAL: UNDERSTANDING THE SHIFT

We believe that the concept of fiscal dominance is key to understanding how conditions have changed. Essentially, fiscal dominance refers to the situation where fiscal policy – government spending and borrowing – plays a bigger role in influencing financial assets than monetary policy does. Central banks are no longer leading the way; instead, they are reacting to the actions of governments.

Governments are operating with substantial fiscal deficits and high debt burdens, while inflation remains embedded at 3-4% or higher, rather than the near-2% levels we were accustomed to in the period prior to the pandemic. This environment presents political and practical challenges to tightening monetary policy significantly, particularly over an extended timeframe.

Figure 1: Consumer price inflation, percentage change year on year



Source: Bloomberg. Most recent available data to 13 May 2026 for each country or region. Chart is for illustrative purposes only.

In this context, a key challenge for investors is that many portfolios were built for – and implicitly still assume – a world of low inflation and one in which central banks are the dominant policy actor.

KEY STRUCTURAL DRIVERS OF PERSISTENT INFLATION

Fiscal dominance does not exist in a vacuum. Several macroeconomic trends are reinforcing it and stacking upward pressure on prices in ways that are unlikely to resolve quickly.

Deglobalisation and the shift to protectionism

The world spent several decades optimising supply chains for efficiency, with 'just-in-time' delivery, lean inventory approaches, and global sourcing. However, that model is now in reverse. Countries are reshoring, stockpiling and building redundancy into their supply networks at significant cost. This transition from 'just in time' to 'just in case' is inflationary and structural and will take many years to work through.

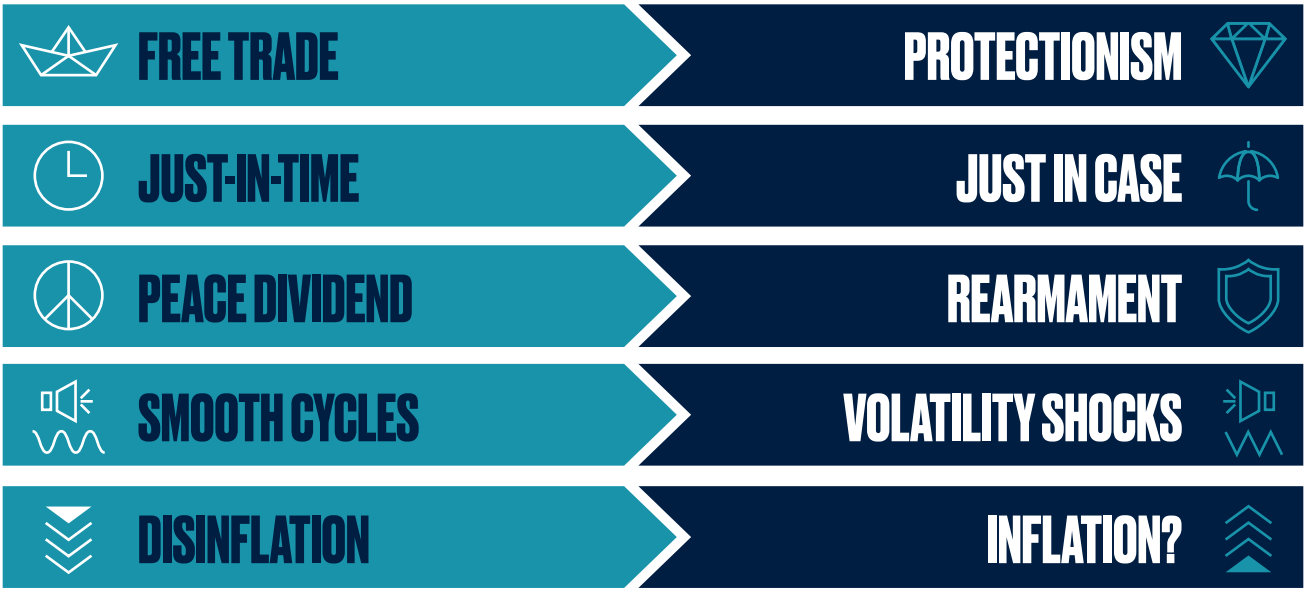
Defence spending

The conflict in Ukraine has accelerated a rearmament cycle throughout Europe and beyond. This increase in defence expenditure is not a temporary measure; NATO obligations, national security priorities and the emergence of a multi-polar geopolitical landscape indicate that sustained fiscal investment in defence will remain a prominent aspect of government budgets for the foreseeable future. Demand-side pressures driven by government spending are unlikely to be significantly reduced by a few interest-rate increases.

Energy constraints

The energy transition is capital-intensive, politically complex and moving more slowly than headline targets suggest. In the meantime, supply constraints, whether from geopolitical disruptions in the Middle East, underinvestment in fossil-fuel capacity or the intermittency challenges of renewables, are keeping energy prices elevated. Governments are responding to any price shocks by increasing fiscal spending, which only embeds the inflationary cycle further.

Taken jointly, these factors indicate that the period of persistently low and stable inflation has ended. The current evidence suggests that a return to pre-2020 conditions may be less straightforward than some investors continue to expect.



Source: Newton, 2026. For illustrative purposes only.

RETHINKING THE ROLE OF BONDS IN PORTFOLIOS

For much of the last three decades, the 60/40 equity-bond portfolio was close to optimal. Equities provided growth; bonds provided a cushion and typically rallied when equities fell, providing genuine diversification. The negative correlation between the two asset classes was not a fundamental principle; rather, it reflected the characteristics of a disinflationary, low interest-rate environment. As market conditions have shifted, this characteristic is no longer present.

In a world of fiscal dominance and sticky inflation, bonds face persistent structural selling pressure from governments issuing more debt than the market can absorb at elevated prices. In this environment, duration can become a risk rather than protection, and the negative equity-bond correlation can break down when both asset classes are affected by rising yields.

The shift away from the traditional 60/40 portfolio does not mean eliminating bonds altogether. In our view, short-duration positions and high-quality spread exposure, where carry is generated without significant duration risk, can play an important role. High-yield assets, when managed carefully for duration sensitivity, can continue to provide compelling carry opportunities. There is a strong case for approaching duration exposure as an intentional, strategic decision rather than as a passive byproduct of benchmark allocations.



THE STAGFLATION SCENARIO

Stagflation – a mix of persistent inflation and slowing growth – appears to be one macro scenario for which markets may be less well prepared.

The scenario is easy to imagine. An energy supply shock – such as the partial closure of a key route or an escalation in the Middle East – keeps oil prices elevated. Higher energy costs weigh on consumers and businesses, slowing growth. Central banks are unable to cut rates aggressively because inflation remains persistent. Governments respond with more spending, deepening deficits and adding further pressure to bond markets.

If stagflation takes hold, markets may prove to be too heavily positioned in assets vulnerable to that backdrop – notably growth equities and bonds – and insufficiently exposed to those better placed to perform, such as investments that offer some inflation protection and real assets. Investors already positioned in those areas may therefore stand to benefit.



A DIFFERENT OPPORTUNITY SET

The opportunity set is changing, making active, selective positioning increasingly important and shifting the focus towards assets more likely to prove resilient in an environment of persistent inflation and fiscal pressure.

Commodities and real assets

The case for commodities and real assets is structural rather than tactical. Demand is being supported by several long-term forces: the rebuilding of supply chains, the expansion of industrial capacity, the energy requirements of artificial intelligence (AI), infrastructure spending and the energy transition. At the same time, years of underinvestment have left supply constrained in several key markets. Together, these dynamics point to the early stages of a commodity super cycle. Gold and silver offer potential exposure to this theme, while energy equities could benefit from constrained supply and stronger pricing. Metals such as uranium may also offer longer-term appeal as part of the evolving energy mix, albeit in a less liquid market.

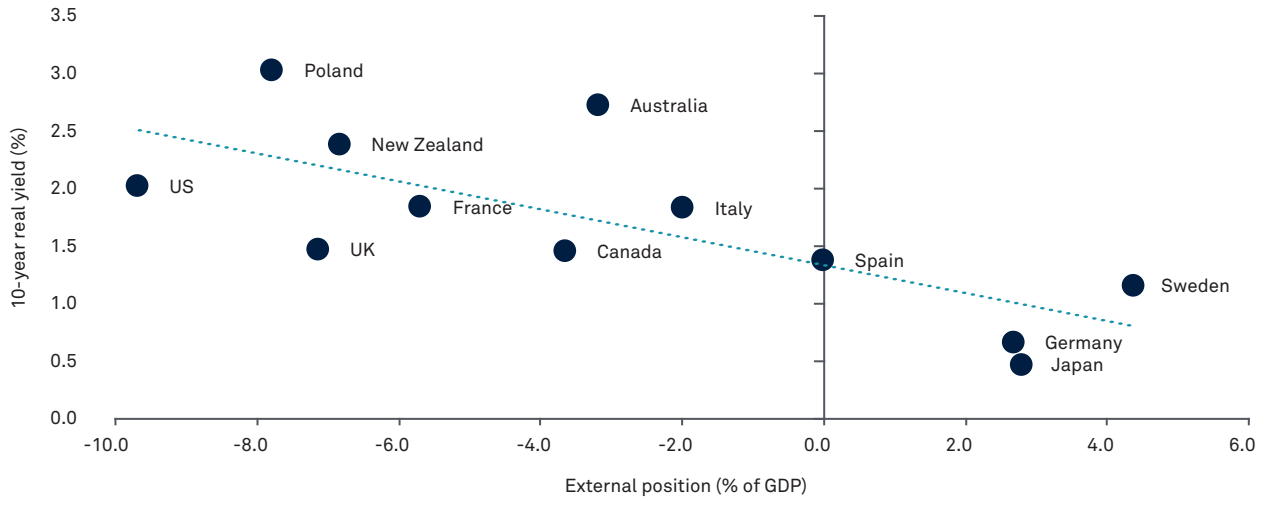
Equities with pricing power and real-economy exposure

In a fiscal dominance regime, stock selection becomes more important. Companies with pricing power, meaningful international revenues and exposure to real assets are likely to be better positioned than asset-light, high-multiple growth stocks. We see banks, healthcare and European defence as areas where the backdrop appears favourable. Technology and AI can still play an important role – earnings growth in these areas remains strong – but selectivity and valuation discipline will be essential.

Local-currency debt with supportive fundamentals

A short-duration approach in fixed income can still leave room for selective local-currency debt, particularly in resource-producing economies with solid external balances. Countries such as Australia, New Zealand, Poland, Sweden and the Czech Republic offer a combination of relatively stable external positions and comparatively high real yields (see Figure 2). By contrast, a more cautious approach to duration may be warranted in markets where fiscal strain is more pronounced, such as the UK, the US and France.

Figure 2: Sovereigns – external positions vs. 10-year real yields



Source: Bloomberg, 28 February 2026. Chart is for illustrative purposes only.

BUILDING RESILIENCE INTO PORTFOLIOS

The challenge for investors is not simply choosing the right assets but constructing a portfolio that can participate in the upside while withstanding sharp drawdowns that may result from a recession scare, a policy error or a geopolitical shock that turns out to be deflationary rather than inflationary.

One way to address this is through explicit tail-risk management. Passive index exposure leaves portfolios inherently vulnerable to downside shocks. By contrast, an active approach can deploy options and convex hedges more efficiently than by buying costly index puts, seeking to cushion losses in periods of stress. Combined with genuinely diversified sources of return across equities, bonds, currencies and commodities, this can help investors participate in upside while aiming for a lower overall risk profile than broad market exposure alone.

A portfolio with an absolute-return objective needs to be constructed differently from one designed to track or beat a benchmark over short periods. That perspective matters because it centres the process on client-relevant outcomes, not relative returns that may owe more to benchmark risk exposure than genuine differentiation.

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THE INVESTMENT IMPLICATIONS

The investing environment has changed in structural – not cyclical – ways. In our view, fiscal dominance is becoming more entrenched, inflation is proving stickier than many models anticipated, and bonds may no longer offer the same protection when growth slows. Investors may want to think differently about asset allocation: shorter duration, more real assets, selective equities with pricing power, and explicit protection against downside risks that passive portfolios often leave unhedged. In a more demanding regime for portfolio construction, active management can become more valuable.



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