

The Regime of Fiscal Dominance

Why bond market stability, the power crunch, and the return of cash-flow discipline are doing more to shape asset prices right now than any central bank statement.

"The central bank sets a rate; the treasury sets the constraint. Increasingly, it is the second one that decides what the first one is allowed to do."

THEMES AT A GLANCE

Five macro forces, one regime

THEME	WHAT'S CHANGED	READ
Fiscal Dominance	Hotter CPI (3.7%) and rising Treasury yields confirm debt financing needs still constrain monetary policy more than inflation targeting alone	STRUCTURAL
Bond Market Vulnerability	Leveraged basis trades + sharp yield spikes after the CPI print make volatility a financial-stability risk, not just a pricing event	FRAGILE
AI Capital Allocation	Liquidity-fuelled capex build-out continues; conviction remains tilted toward infrastructure over pure applications	TWO-SIDED
The Power Crunch	AI compute, EVs, reindustrialisation + elevated Brent (~\$105) are compounding electricity and energy-cost pressures simultaneously	STRUCTURAL
Quality & Cash Flow Pivot	Rising cost of capital (higher real yields) continues to favour businesses past their heavy capex cycle over those still mid-build	DEFENSIVE
Currency & Commodities	Hard assets and select EMs retain a bid as inflation re-accelerates and confidence in pure fiat debasement-proofing weakens further	EMERGING

01 – THE REGIME SHIFT

Fiscal dominance and bond market vulnerability

The global financial landscape remains firmly in a regime of fiscal dominance. Government treasury policy, debt management, and bond-market stability continue to outweigh traditional interest-rate guidance as the primary drivers of asset prices. The latest U.S. CPI print (3.7% year-on-year for September, hotter than the 3.6% consensus and up from 3.4% previously) has sharpened this constraint.

WHAT FISCAL DOMINANCE MEANS

Fiscal dominance describes a regime in which monetary policy becomes subordinate to the government's financing needs. A central bank cannot raise rates as far as inflation would otherwise warrant without blowing up the sovereign's interest bill or destabilising the bond market on which it depends to keep issuing debt. The market shorthand — that the Treasury Secretary now matters more than the central bank chair — remains a fair description of the practical effect.

That constraint tightened further this week. The hotter CPI reading triggered a sharp, rapid rise in U.S. Treasury yields. The 10-year yield moved higher into the mid-5% range, making risk-adjusted returns on U.S. government bonds more attractive relative to volatile equity positions in emerging markets. This dynamic has already translated into renewed FII outflows from Indian equities, as global capital rotates toward higher-yielding, lower-volatility sovereign paper.

WHY THE BOND MARKET ITSELF IS VULNERABLE

The vulnerability continues to stem from widespread basis trades employed by highly leveraged participants. These positions often run 25x or more. When bond-market volatility rises — as it did after the CPI surprise — margin calls force liquidations that can cascade. Because a large share of sovereign debt is still financed at the short end, any sustained yield spike quickly inflates government interest obligations. Policymakers therefore retain a strong incentive to keep the MOVE Index well-behaved and prevent a forced unwind.

KEY WATCH — Fiscal dominance is a slow-moving regime, but it is confirmed or disconfirmed by fast-moving events. The post-CPI yield spike, any weak sovereign auction, a sharp MOVE Index jump, or central-bank backstopping of a dislocation would all signal that the financing constraint is binding in practice, not just in theory.

02 – CAPITAL ALLOCATION

The AI cycle and the capital funding it

Artificial intelligence remains a transformative technology, yet market dynamics continue to show signs of liquidity-fuelled exuberance and aggressive capital expenditure. The risk of malinvestment — capital chasing hype rather than durable cash-flow generation — has not disappeared. The practical response remains a pivot toward the foundational infrastructure that AI requires regardless of which model or application ultimately wins.

THE PIVOT TO PICKS AND SHOVELS

Semiconductors — the physical backbone. Capital continues to flow toward high-performance chip manufacturing and design rather than purely speculative software layers.

Energy systems — the safer bet. Rapid scaling of AI data centres has created unprecedented electricity demand. Grid modernisation, power generation and storage remain high-utility exposures because these resources are required irrespective of which AI models succeed. Elevated Brent crude prices near \$105–106 reinforce the urgency of reliable, diversified power.

This is second-derivative thinking: rather than asking which AI company wins, ask what must be built regardless of who wins, and position there.

03 – THE POWER CRUNCH

Energy security and the electrification tailwind

Energy security has moved from a niche geopolitical concern to a central macroeconomic priority. Modern economies are energy-intensive systems; reliance on external sources creates vulnerability to supply shocks and geopolitical volatility. The current combination of AI compute demand, EV penetration, reindustrialisation and still-elevated oil prices (Brent near \$105–106) is compounding electricity and energy-cost pressures simultaneously.

Ensuring stable, affordable and preferably domestic energy access is now essential for economic stability (shielding against commodity-price inflation), national competitiveness (reliable power as a core industrial input) and strategic autonomy (reducing dependence on foreign suppliers). Electrification remains the primary mechanism of this reorganisation — spanning manufacturing, heating, transport and the digital sector.

Investment implications remain clear: long-term commitments to grid infrastructure, advanced storage, diversified generation and the commodity producers that feed the new energy value chain. In a capital-intensive regime, the ability to secure energy supply is directly correlated with macroeconomic viability.

04 – PORTFOLIO CONSTRUCTION

The pivot toward quality and cash flow as capital turns scarce

As the cost of capital continues to trend higher — driven by fiscal deficits, reindustrialisation needs, hotter inflation prints and the end of the ultra-low-rate era — portfolio construction must adapt. Businesses heavily reliant on external debt for ongoing capital expenditure face rising financial burdens. Companies with strong free cash flow that have already completed major capex cycles are structurally more resilient.

Reduced debt sensitivity — Established free-cash-flow businesses do not need to tap expensive, scarce credit markets simply to maintain operations. They can focus on generating returns rather than servicing new debt.

The historical outperformance of free-cash-flow-oriented strategies versus broader market indices remains consistent with this regime, though any single-factor claim should be verified against current data rather than treated as a permanent rule.

INDIA MARKET CONTEXT — TAX POLICY UNCERTAINTY

Domestic equity markets experienced a short-term cheer following comments from the Finance Minister acknowledging debate around Long-Term Capital Gains (LTCG) tax and Securities Transaction Tax (STT). Benchmarks rallied on hopes of possible relief. However, no definitive policy commitment was made. Until a clearer, intent-driven government stance emerges (most likely in the upcoming Budget process), this remains a source of uncertainty rather than a durable positive. Market participants should treat the rally as temporary sentiment and remain cautious on the policy front.

Separately, elevated Brent prices near \$105–106 continue to act as a negative cue for India: they risk exacerbating domestic inflation pressures and weighing on the broader economic outlook, even as refiners maintain diversified supply sources.

05 – CURRENCY & COMMODITIES

The pivot toward hard assets

In a regime of fiscal dominance, rising cost of capital and re-accelerating inflation, the roles of currencies and commodities continue to shift. Traditional reserve currencies face ongoing scrutiny as debt supply expands. Investors retain a structural bid for hard assets and for jurisdictions characterised by relative fiscal discipline.

Commodities essential to industrialisation and energy transition (copper, uranium, energy inputs) benefit from three drivers: scarcity (new supply is harder and slower to finance at higher capital costs), strategic demand (electrification, defence, re-industrialisation), and their role as an inflation hedge that cannot be diluted by balance-sheet expansion.

Emerging-market resilience remains a country-by-country picture rather than a uniform trend. India's dynamic autonomy and diversified energy sourcing provide relative buffers, but higher global yields and oil prices still transmit through FII flows and inflation expectations.

KEY WATCH — The claim that emerging markets are broadly outperforming developed markets on growth and debt management remains a live, contested thesis. It holds for some EMs and not others, and should be tested against current country-level data before acting on it.

CONCLUSION — The crisp version

Every thread here still traces back to one constraint: governments cannot let borrowing costs rise freely, and that constraint is now the dominant force shaping rates, currencies and capital allocation — more so than any single central bank decision. The latest CPI surprise and the resulting yield spike have simply made the constraint more visible. The practical response is not to bet on the AI theme, the power theme or the commodity theme in isolation, but to position at the layer beneath each of them: the infrastructure AI needs regardless of which model wins, the power generation electrification needs regardless of who builds it, the balance sheets that do not need cheap credit to keep growing, and the hard assets that do not depend on a government's promise to hold their value. In a regime defined by scarcity of capital rather than abundance of liquidity, resilience remains the return.

METHOD & DISCLAIMER

This note synthesises macro themes and house views circulating in current market commentary as of mid-October 2026. It incorporates the September U.S. CPI print (3.7%), the subsequent rise in Treasury yields, elevated Brent crude levels near \$105–106, and short-term Indian equity market reaction to official comments on LTCG and STT. It is prepared for educational and informational purposes only and does not constitute investment advice, a recommendation, or a solicitation to buy or sell any security, currency or commodity. Views on regime shifts, fiscal policy and market structure are inherently uncertain and subject to change as new data emerges. Claims describing historical performance or macro comparisons should be verified against current data before being relied upon. Always conduct independent research and consult a qualified professional before making financial decisions.

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