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Sponsoring Mutual Fund Dealer



2025.10.29

There are just five ways to bring to an end to the Developed World's (Canada included) unsustainable accumulation of debt. Big cuts in government spending, extraordinary economic growth, large tax increase, default or large-scale money creation -aka inflation.

Cuts in spending are unlikely given aging populations and the political power of the elderly. Economic growth will not likely solve the problem, as a future artificial-intelligence boom is likely to raise interest rates, making increases in GDP across the broader economy more moderate rather than exceptional.

That leaves three unpalatable options: higher taxes, default and inflation. The most likely is inflation—a danger looming over all investors who buy long-term bonds today.

There is an outside chance that higher taxes may become a reality. America has a relatively low tax burden by international standards. It has no value-added tax for example (a tax on consumption). Yet regardless which political Party is in power the rallying cry of the American Revolution seems to be now “no taxation *with* representation”.

Europe's position is politically better but fiscally worse. Better because raising taxes is not quite as anathematic as it is in America. But worse because, in part as a result of that amenability, Europe already has very high taxes. In France, government revenue is 52% of gdp. **A well-known result in economics is that the damage a tax does rises quadratically with the tax rate.** If high-tax economies address their budget woes by raising revenues, they could slow economic growth. Japan is an intermediate case. Its taxes are lower than Europe's—and its budgets less strained—but its debts are higher, making it more vulnerable to shocks.

Across the rich world there is a growing likelihood that bondholders will bear the brunt of policymaker's decisions. Creating money to pay off debts results in creditors historically suffering from inflation, which erodes real returns. This is what happened in the first few decades after the second world war, in which inflation played a major role in reducing the debts that war had built up.

When price rises are anticipated, bond investors account for that by demanding higher yields from the outset. Yet there is precedent for government action which precludes this. In the post-war period various restrictions stopped bondholders being compensated in this way, including in the United States where the Federal Reserve capped long-term bond yields from 1942 to 1951. For decades Regulation Q banned



banks from paying interest on deposits, ensuring that there would be an appetite for Treasuries at artificially low yields. Banks were often forced to hold large quantities of government debt and capital controls made it difficult for investors to sell up and flee to other markets.

Governments still have the tools to inflate away debt. Central banks have become used to buying bonds with newly created money, called reserves, which earn interest. The more bonds a central bank buys, the more directly it controls the government's interest expenses. A combination of bond-buying and holding interest rates beneath the rate of inflation would therefore cause debts to shrink in real terms. Inflation, like spending cuts and tax rises, is unpopular. But unlike fiscal moves, it happens by accident as well as by design. When politicians misjudge or conceal the consequences of their actions, inflation becomes the measure of their contradictions—and by the time it appears, it is too late to stop. Nobody intended the high inflation of the 1970s, which politicians fought with harebrained schemes like price controls.

It is our position that the jolt in inflation of the 2020s that followed pandemic money-creation and fiscal stimuli was just a taste of what is to come. In the absence of bold action by governments, more inflation is coming. Buyers of long-term bonds today will be unhappy, and the wider world will be worse off for it.

So what are fixed-income investors to do? For one, shorten duration to maturity and invest in bond funds with set maturity dates. The certainty of one's interest -and the return date of one's principal, lowers the risk that inflation represents. This is a strategy we have implemented across our asset allocations, and we remain committed to a balanced approach to building client wealth, where bonds play an important role in total portfolio returns.

Thanks for reading!

Martin

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Source: The Economist (<https://www.economist.com/special-report/2025-10-18>)

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