THE GROUNDWORK — ARTICLE 04

Risk and Supply/Demand

What drives risk premiums up and down, and why it matters for your portfolio

In the previous article, we explained what risk premiums are and why they differ across asset classes. We showed that each asset compensates you for a distinct type of discomfort, and that a portfolio harvesting multiple premiums simultaneously is more robust than one relying on any single source. But we left a question unanswered: *what causes risk premiums to change over time?*

Risk premiums are not static. They expand and contract based on forces that are, at their core, forces of supply and demand. Understanding these forces will not make you a market timer — nobody can reliably predict short-term moves — but it will help you understand why your portfolio behaves the way it does, why certain environments favour certain assets, and why patience during uncomfortable periods is not just emotionally difficult but economically rational.

The Supply of Risky Assets

Every asset that exists in a market must be held by someone. When governments issue more bonds, the total supply of fixed-income assets increases. When companies go public or issue new shares, the supply of equities increases. When miners extract more gold or producers bring more oil to market, the physical supply of commodities increases.

If the demand for these assets does not increase at the same pace, prices must fall to attract buyers. Lower prices mean higher future expected returns. In other words, **an increase in the supply of risky assets, all else equal, pushes risk premiums higher**.

This is not abstract theory. It is playing out in real time in the bond market. Governments around the world are running historically large fiscal deficits, financed by issuing enormous quantities of government debt. The US alone has over $36 trillion in outstanding Treasury securities, with annual deficits adding over $1 trillion per year. This flood of supply means that bond investors must be compensated with higher yields — higher risk premiums — to absorb the new issuance. The same dynamic applies in reverse: when central banks buy bonds through quantitative easing, they reduce the available supply, compress yields, and shrink the term premium.

> *Every asset that exists must be held by someone. When supply increases and demand does not follow, prices fall and risk premiums rise. This is not theory. It is the basic mechanics of every financial market on earth.*

The Demand for Safety

On the other side of the equation is the demand for cash and safe assets. When investors are confident, they are willing to hold risky assets at relatively slim premiums. They accept lower expected returns because the discomfort feels manageable. Valuations rise, spreads tighten, and the world looks benign.

When confidence breaks — a recession, a financial crisis, a pandemic, a geopolitical shock — investors rush to the safety of cash and government bonds. This flight to quality drives risky asset prices down and safe asset prices up. The risk premium widens dramatically. Expected returns from that point forward are much higher, but the experience of getting there is deeply unpleasant.

This is the cruel arithmetic of investing: the best time to buy risky assets is when everyone else is selling them. The worst time to buy is when everyone is confident and prices are high. Most investors do the opposite — they buy after prices have risen and sell after prices have fallen — because their emotions override their analysis. This behavioural tendency is one of the main reasons that the average individual investor underperforms the very assets they invest in.

Central Banks: The Biggest Player in the Room

No discussion of risk premiums would be complete without addressing the role of central banks. Through their control of short-term interest rates and their ability to buy and sell assets in open markets, central banks are the single most powerful force acting on risk premiums.

When a central bank cuts interest rates, it reduces the return on cash. This pushes investors into riskier assets in search of yield, compressing risk premiums. When a central bank raises rates, cash becomes more attractive, demand for risky assets falls, and premiums widen. The effect is mechanical and observable.

Quantitative easing (QE) amplifies this effect. When a central bank buys government bonds or mortgage-backed securities, it removes supply from the market, driving up bond prices and pushing yields down. This forces investors further out on the risk spectrum — into corporate bonds, equities, real estate — in search of returns. The entire structure of risk premiums across all asset classes compresses.

Quantitative tightening (QT) does the opposite. As central banks shrink their balance sheets by allowing bonds to mature without replacement (or by actively selling), supply returns to the market. Yields rise. Risk premiums across the board have room to widen.

The era from 2009 to 2021 was defined by unprecedented QE. Central banks around the world bought trillions of dollars in assets, suppressing risk premiums to historically low levels. The era we are now in — characterised by elevated fiscal deficits, QT, and structurally higher inflation — is one in which risk premiums are likely to be structurally higher. For a beta investor, this is actually good news: higher risk premiums mean higher expected returns from passive exposure.

> *The era of suppressed risk premiums through QE is over. Higher fiscal deficits, quantitative tightening, and structurally higher inflation all point to wider risk premiums ahead. For a beta investor, this is good news.*

Fiscal Policy and the Supply of Bonds

Central banks are not the only actors. Governments matter too, through fiscal policy. When a government runs a deficit, it must borrow by issuing bonds. The larger the deficit, the more bonds it issues, and the more investors must be compensated to absorb them.

We are living through a period of historically large fiscal deficits in nearly every developed economy. The US, the UK, the eurozone, Japan — all are running deficits that would have been considered extraordinary a decade ago. This matters for portfolios in two ways.

First, the supply of government bonds is enormous and growing. This should, over time, push the term premium higher, meaning that bonds offer a better return relative to cash than they did during the QE era. For a portfolio that includes bonds, this is constructive.

Second, the method of financing deficits matters. If deficits are financed by issuing long-term bonds, duration supply increases and the term premium rises. If deficits are financed by issuing short-term bills — which has been the recent tendency — the duration supply impact is smaller, but the rollover risk increases. The composition of government issuance is a technical detail, but it has real consequences for the risk premium embedded in bonds.

Inflation: The Hidden Tax on Safety

Inflation plays a dual role in the risk premium framework. On one hand, it directly erodes the value of cash and nominal bonds. On the other, it creates demand for real assets — equities, commodities, gold, inflation-protected bonds — that can preserve purchasing power.

When inflation is low and stable, investors are comfortable holding nominal assets. Cash feels safe. Bonds deliver reliable real returns. The inflation risk premium is small.

When inflation is elevated and uncertain, the calculus changes. Cash is visibly eroding. Nominal bonds may deliver negative real returns. Investors demand higher yields to compensate for inflation uncertainty, and they allocate more to real assets. The inflation risk premium widens, and the assets that benefit — TIPS, commodities, gold — see their risk premiums adjust accordingly.

This is precisely why a diversified beta portfolio includes inflation-sensitive assets alongside equities and nominal bonds. In a world where inflation is no longer anchored at 2%, the assets that protect against purchasing-power erosion carry a premium that may be larger and more persistent than it was in the 2010s. Owning them is not a bet on inflation. It is a hedge against the cost of being wrong about inflation.

> *Owning inflation-sensitive assets is not a bet on inflation. It is a hedge against the cost of being wrong about inflation. In a world of fiscal excess and uncertain price stability, that hedge has never been more relevant.*

What This Means for Portfolio Construction

The forces we have described — asset supply, demand for safety, central bank policy, fiscal deficits, and inflation — do not operate in isolation. They interact, reinforce, and sometimes counteract each other. But the portfolio implications are consistent:

- Diversify across risk premiums. Because different forces drive different premiums at different times, a portfolio spanning equities, bonds, TIPS, commodities, and gold will always have some engine running, even when others are stalled.
- Do not try to time premiums. The forces that move premiums are visible in hindsight but extremely difficult to predict in real time. The best approach for most investors is to maintain a balanced allocation and allow premiums to compound across cycles.
- Understand that uncomfortable periods are the price of admission. When premiums widen, it means expected returns have risen — but it also means current prices have fallen. The temptation to sell is strongest precisely when prospective returns are highest.
- Recognise the structural backdrop. We are in a period of higher fiscal deficits, reduced central bank support, and elevated inflation uncertainty. This is an environment where risk premiums should be wider than the post-GFC norm. For patient beta investors, this is a favourable starting point.

The Desert Frontier Beta portfolios are built with this framework in mind. Each asset class is included because it contributes a distinct risk premium. The allocation is weighted by risk contribution, not by capital, so that no single force dominates the portfolio's behaviour. And the modest tactical flexibility in the Desert Frontier Beta portfolio allows us to tilt cash levels and sub-portfolio weights in response to meaningful shifts in the macroeconomic landscape — not to time markets, but to acknowledge that the balance of risks does change.

The Bottom Line

Risk premiums are determined by the interaction of asset supply, investor demand for safety, central bank policy, fiscal conditions, and inflation dynamics. They expand and contract over time, but they do not disappear. The forces that drive them are structural and self-reinforcing.

For a beta investor, the key takeaway is this: you do not need to predict these forces to benefit from them. You need to own a portfolio that is positioned to collect premiums across a range of

environments, and you need the discipline to hold it through the uncomfortable ones. The premium is the reward for that discipline.

In the next article, we will turn to diversification itself — the mathematics of combining assets with different return profiles, the concept of correlation, and why a portfolio of five imperfect assets can be more reliable than a single "perfect" one.

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*This article is part of **The Groundwork** — a series by Desert Frontier Advisors covering the foundations of beta investing. Next in the series: **Why Diversify? The Free Lunch That Actually Exists**.*