



Source: Unsplash

# Investing on the edge

30 May 2023, 1:37 pm CEST, written by UBS Editorial Team

**Though the political tug of war over the debt ceiling in the US may create volatility in the short term, the direction the markets take in the medium term will be determined by other factors. We continue to recommend a defensive portfolio positioning.**

The present financial system is based on the premise that US government bonds—the embodiment of a “risk-free investment”—will always be redeemed in full and on time. Little wonder then that Treasury Secretary Janet Yellen has warned of an “economic catastrophe” if Congress cannot reach an agreement on raising the debt ceiling and the US were to default. The Treasury currently estimates that the US authorities could run out of options for meeting their obligations by 1 June.

In our baseline scenario, we still expect Congress to agree on raising the debt ceiling, as it has done 89 times since 1959. However, should Congress not manage to come to an agreement before the deadline, we would expect the Treasury to primarily use incoming tax receipts to guarantee coupon payments while the administration makes drastic cuts to expenditures in other areas. We would also expect the Fed to feed liquidity into the financial system, thereby seeking to prevent turbulence on the markets for short-term financing.

However, if the administration is forced to cut state transfer payments, that could lead to a rapid loss of trust on the part of consumers and firms as well as a collapse in demand and a heightened risk of recession. As a consequence, we believe that the S&P 500 could easily drop by more than 10% in this scenario, as the markets would reassess growth prospects and elevated systemic risks. However, such a setback would probably largely be made up for again if the turbulence on the markets forced Congress to reach an agreement. Investors wishing to mitigate the volatility on the equity markets should consider structured investments or shifting their exposure into more defensive sectors.

Medium-term trends on the markets will be less affected overall by the issue of raising the debt ceiling. They will depend much more on whether the US central bank, the Fed, is able to bring about a soft landing for the US economy or whether the US will slide into a full-blown recession as a result of the banking crisis and a squeeze on lending.

We believe that the US equity markets in particular have been overly complacent in waving aside these risks thus far. We therefore continue to see a better risk/return relationship in bonds than in equities. High-quality fixed-income investments still offer attractive returns and provide a good hedge against growth risks and financial market instability, in our view. Furthermore, within the equities universe, we regard the US equity market as vulnerable, and we recommend strategies to hedge against downside risks. The market is rising on the back of a small number of stocks, valuations are elevated, and tighter lending conditions are weighing on corporate earnings. We favor emerging market equities, which should benefit from the expected decline in interest rates in the US, higher commodity prices, and the recovery in China.

Main contributor: Daniel Kalt

Please read the legal [disclaimer](#) applicable to this publication.

**Important information**

As a firm providing wealth management services to clients, UBS Financial Services, Inc is registered with the U.S. Securities and Exchange Commission (SEC) as an investment adviser and a broker-dealer, offering both investment advisory and brokerage services. Advisory services and brokerage services are separate and distinct, differ in material ways and are governed by different laws and separate contracts. It is important that you carefully read the agreements and disclosures UBS provides to you about the products or services offered. For more information, please visit our website at [www.ubs.com/workingwithus](http://www.ubs.com/workingwithus).

© UBS 2021. All rights reserved. UBS Financial Services Inc. is a subsidiary of UBS AG. Member FINRA/SIPC.

There are two sources of UBS research. Reports from the first source, UBS CIO Global Wealth Management, are designed for individual investors and are produced by UBS Global Wealth Management (which includes UBS Financial Services Inc. and UBS International Inc.). The second research source is UBS Group Research, whose primary business focus is institutional investors. The two sources operate independently and may therefore have different recommendations. The various research content provided does not take into account the unique investment objectives, financial situation or particular needs of any specific individual investor. If you have any questions, please consult your Financial Advisor. UBS Financial Services Inc. is a subsidiary of UBS AG and an affiliate of UBS International Inc.