For the time being, investors should not overreact to the current bout of intense media scrutiny, says the UBS Chief Investment Office. (ddp)

Another debt ceiling debate

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Federal Reserve monetary policy will compete with the debt ceiling for investor attention for the next couple of months, but it is worth noting that there is already preliminary evidence in the T-bill curve that investors are demanding higher yields for securities maturing in August.

The calm before the storm

The media attention now devoted to the issue is, counterintuitively, a positive development (Debt Ceiling Deja Vu, 20 January). We believe it may force members of Congress to remain more attentive to the adverse ramifications associated with a failure to reach agreement.

The extraordinary measures now being undertaken by the Treasury Department will allow Congress to debate policy proposals for another few months. The political rhetoric today is combative, but that is not a new development in Washington. It is possible that Congress could suspend the debt ceiling for a short time to coincide with the end of the fiscal year, but we think it is more likely that a deal will be reached to raise the debt ceiling in an amount sufficient to carry the federal government through the next presidential election. This would necessitate an increase in the range of USD 2 trillion.

For the time being, investors should not overreact to the current bout of intense media scrutiny. Most members of Congress understand the economic and market peril of not raising the ceiling while longer term solutions to the escalating deficit are identified.

Investment implications

How to prepare for a debt ceiling stalemate

The most likely scenario is an eleventh-hour agreement to raise the debt ceiling with modest constraints on discretionary expenditures. The narrow Republican majority in the House will constrain Speaker McCarthy's ability to negotiate an earlier resolution to the stalemate, which suggests to us that investors must be prepared for a period of elevated volatility this summer.

Monitoring developments in Washington has become increasingly essential but abrupt changes to long-term financial plans based on political developments can be detrimental to portfolio performance. For this reason, an early assessment about the probable impact of a debt ceiling stalemate on investment performance is a worthwhile exercise.

Base case: Agreement at the eleventh hour

- For conservative investors eager to minimize their exposure to volatility, we recommend swapping shorter-term fixed income instruments with maturities coming due this summer for longer-dated securities that bypass the potential for temporary illiquid markets as the X-date approaches. Increasing the portfolio's allocation to cash and cash equivalents until the debt ceiling stalemate is resolved is another prudent step for investors with elevated liquidity needs. Finally, a modest pick-up in equity market volatility as the X-date approaches is possible. Buying puts on the performance of the S&P 500 through the end of the summer offers a hedge against temporary declines in the value of an equity portfolio.
- For investors with higher risk tolerance, the anticipated tumult surrounding the debt ceiling debate may pose less concern. We expect fixed income and equity markets to function reasonably well again after the political disputes over the budget are resolved. In the meantime, we believe hedge funds offer uncorrelated returns and better downside protection in the event of a prolonged stalemate. Specifically, Macro and Relative Value funds tend to perform better in higher yield environments as idle cash is less of a drag on performance, thereby allowing managers more flexibility in terms of timing and opportunity to capture trends and mispricings in global rates and credit. Aggressive investors willing to tolerate brief bouts of illiquidity might also take the advantage of the elevated yields we expect to accompany the runup to the X date.

Downside case: No agreement by the X-date

- This scenario poses a much bigger risk to investor portfolios. While less likely to occur, the consequences are more severe. The Fed would be expected to prioritize the payment of interest on the national debt, but other operating expenses of the government would not be paid in full. We believe equity prices would plunge and fixed income yields would rise. Spreads would increase and credit conditions would tighten appreciably. We expect the stalemate would then be resolved relatively quickly because the adverse consequences would be self-evident and require a congressional response. Even so, the economic damage would take some time to resolve.
- Conservative investors who assign a higher probability to this outcome will want to take some of the same steps mentioned above but also begin to reposition their equity portfolio away from economically sensitive segments of the equity market and bank stocks in particular. Reducing exposure to more speculative parts of the market such as non-profitable or highly leveraged companies would also be appropriate. Bank deposits and timed certificates of deposit are alternatives worth considering in this worrisome, albeit less likely, scenario.
- More aggressive investors conceivably could take a more nuanced view of the opportunities presented by erratic markets. As stock prices decline, there will be opportunities to be greedy while others are fearful. However, investors who buy into the sell-off should be prepared for a period of heightened volatility that could lead to near-term losses but the opportunity for longer-term gains. Again, hedge funds offer an avenue for diversification and a downside protection strategy.

Read the full report **Another debt ceiling debate: Market volatility expected as an impasse looms on the horizon** 10 March 2023.

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