Special Report

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OCBC Bank

US Debt Ceiling - Potential Implications on Rates and FX

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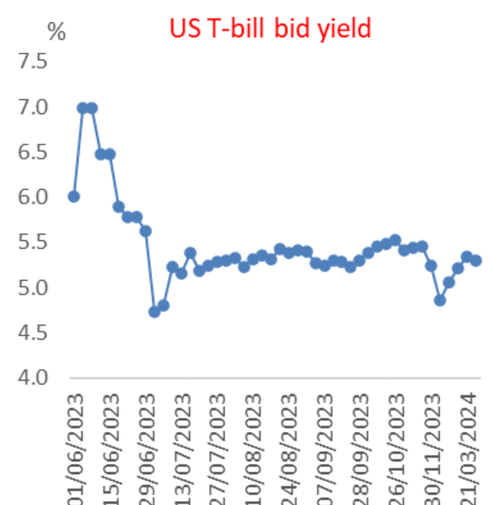
Treasury Secretary Yellen has put her estimate of the “x-day” – the day on which the US Treasury runs out of cash – as early as on 1 June. While we see a fair chance that Treasury’s cash is enough to sustain payment till mid or end of June, the irregular nature of fiscal receipts and outlays has kept investors nervous before a deal is reached. We see 3 potential scenarios:

1. **As and when the debt ceiling is raised,** bills and bond supply will come back to the market. The T-bill yield curve, which is deeply inverted now, is likely to normalize/steepen as supply comes alongside an increase in the debt ceiling. While the impact of bond supply and potential reversal of safe-haven flows may be for bond yields to go higher, given how much UST yields have risen over the past sessions, we suspect reaction in USTs will be muted. On FX, we expect USD to ease lower and revert back to trading alongside the broader macro thematics, with a focus on FOMC policy decision and forward guidance (13 -14 Jun).

2. **If the debt ceiling is suspended**, this simply means the issue is being delayed. The high point on the T-bill yield curve will then be pushed to around the date when the debt ceiling suspension. FX price action is likely to be similar to that in scenario 1 where the debt ceiling is raised. But as the can is kicked down the road, the issue is still not resolved. Intermittent fears and uncertainty may linger (but to a lesser extent). We should expect modest USD strength to return when the debt ceiling issue comes into focus again.

3. **In the event that US Treasury runs out of cash before a deal is reached**, the knee-jerk reaction is likely spikes in T-bill yields and USD. In the unprecedented scenario where more payments are missed, then the spikes in yields will likely spread beyond bills onto USTs, amid credit concerns and USTs may no longer attract safe-haven flows. On FX, this would become a medium-term negative for USD as this could potentially bring about further US rating downgrade, accelerate the de-dollarisation story and undermine USD's safe-haven characteristic.

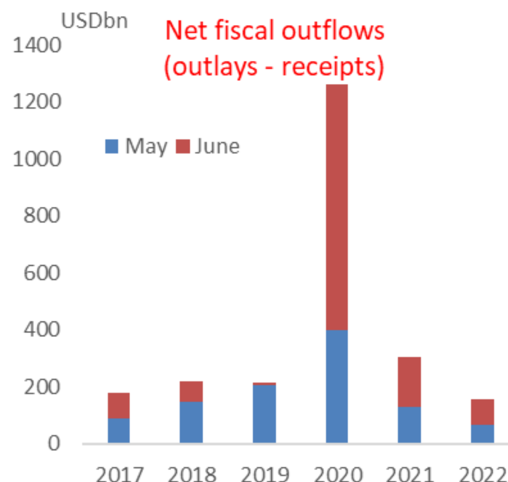


Source: Bloomberg, OCBC Research

Our base-case is the debt ceiling will be either suspended or raised, before US Treasury runs out of cash.

Rates implications

The X-day. When we compared TGB balance at end-April which was USD316bn, to past monthly fiscal receipts and outlays in the months of May and June, excluding the year 2020 which saw huge fiscal spending amid COVID, we saw a chance that the cash balance was enough to sustain through mid or end June. Granted, the irregular nature of fiscal receipts and outlays has kept investors nervous as the "x-day" looms. TGB balance has been edging up from the recent low of USD57bn to the latest USD76bn as of 23 May, as extraordinary measures have allowed for some net bill/coupon bond issuances. Market closely watches as to whether cash is enough to sustain till 15 June – if by then an agreement is still not agreed on, when another batch of tax inflows is expected.



Source: US Treasury, OCBC Research

Bill yield premium that are required in view of the debt ceiling issue have risen, more materially of late. The bid yields on the bills that mature on 6 June and 8 June were quoted at above 7% at one time on Thursday, but they have since retraced mildly lower upon constructive headlines on the debt ceiling talks. Yields for bills that mature from July onwards were meaningfully lower. The shape of the T-bill yield curve reflects investor concerns over brief settlement/liquidity disruptions, rather than the risk of a prolonged default.

Source: Bloomberg, OCBC Research

1. **As and when the debt ceiling is raised**, in addition to fund fiscal spending, US Treasury is likely to look to replenish its cash position. Treasury's quarterly refunding plan has an estimate of its cash balance at USD550bn by end-Q2 and USD600bn by end-Q3 – although the rebuilding of cash may be paced out through Q3 after the recent developments. Treasury's quarterly refunding plan has an estimate of its cash balance at USD550bn by end-Q2 and USD600bn by end-Q3 – although the rebuilding of cash may be paced out through Q3 after the recent developments. The T-bill yield curve, which is deeply inverted now, is likely to normalize/steepen as supply comes alongside an increase in the debt ceiling, and part of the yield premium at the very front end is removed. While the impact of bond supply and potential reversal of safe-haven flows may be for bond yields to go higher, given how much UST yields have risen over the past sessions, we suspect reaction in USTs will be muted. Also, bond yields did not appear to be affected much on a sustained basis in past episodes of debt ceiling issues.

2. **If the debt ceiling is suspended**, the high point on the T-bill yield curve will then be pushed to around the date when the debt ceiling suspension expires – and we would have certainty on this timing by the time the suspension is agreed on, unlike the uncertainty surrounding the "x-day" currently. At this juncture, in case of a suspension, we expect it to expire some time in Q4,

if not, then Q1. Bill supply will also come back, but mostly to match fiscal outlays rather than to replenish cash positions.

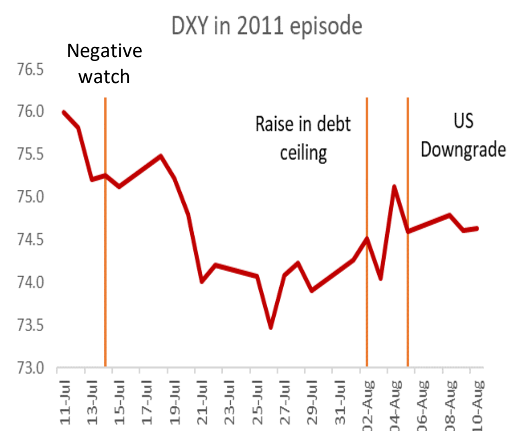
3. **In the event that US Treasury runs out of cash before a deal is reached**, the knee-jerk reaction is likely spikes in T-bill yields and USD. In the unprecedented scenario where more payments are missed, then the spikes in yields will likely spread beyond bills onto USTs, amid credit concerns and USTs may no longer attract safe-haven flows.

FX Implications

We retain the view that talks to resolve debt ceiling remain fluid and to some extent, theatrical. Bill markets may be more sensitive, but FX markets have been largely less sensitive. It probably will matter more for FX markets when no deal happens at X-date. But until then, the bias is that debt ceiling issue should come to pass. *Congress has always acted when called upon to raise the debt limit. Since 1960, Congress has acted 78 separate times to permanently raise, temporarily extend, or revise the definition of the debt limit – 49 times under Republican presidents and 29 times under Democratic presidents. Congressional leaders in both parties have recognized that this is necessary*[1]. That said we think there is no room for complacency. We lay out 3 potential scenarios:

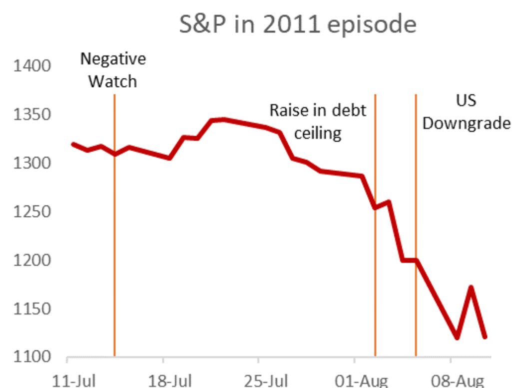
1. **Debt ceiling is raised**. This should remove most fears and uncertainty. And USD could ease lower and revert back to trading alongside the broader macro thematic, with a focus on FoMC policy decision and forward guidance (13 -14 Jun).
2. **Debt ceiling is suspended**. FX price action is likely to be similar to scenario 1 whereby debt ceiling is raised. But as the can is kicked down the road, the issue is still not resolved. Intermittent fears and uncertainty may linger (but to a lesser extent). Vols could rise again we could expect modest USD strength to return when the debt ceiling issue comes into focus again.
3. **Treasury runs out of cash before a deal is reached**. Knee-jerk reaction on the day Treasury runs out of cash before a deal is reached should see risk-off trades favouring USD upside but subsequently, a resolution briefly past the date should see panic ease and USD gains to reverse. And in that unprecedented scenario that more payments are missed, then this would become a medium-term negative for USD as this could potentially bring about further US rating downgrade, accelerate

USD Strengthened when US was placed on 'Negative watch' in 2011



Source: Bloomberg, OCBC Research

Risk Sentiments Soured amid Debt Ceiling Concerns



Source: Bloomberg, OCBC Research

[1] https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/debt-limit

the de-dollarisation story and undermine USD's safe-haven characteristic.

On another note, if we consider USD positioning and FX price action, pre-emptive warnings from Fitch Ratings (25 May) that it may downgrade US's AAA rating and Moody's recent comments that US must make good on its interest payment in mid-Jun to avoid losing its AAA status may have marginally contributed to USD strength (risk-off sentiment channel).

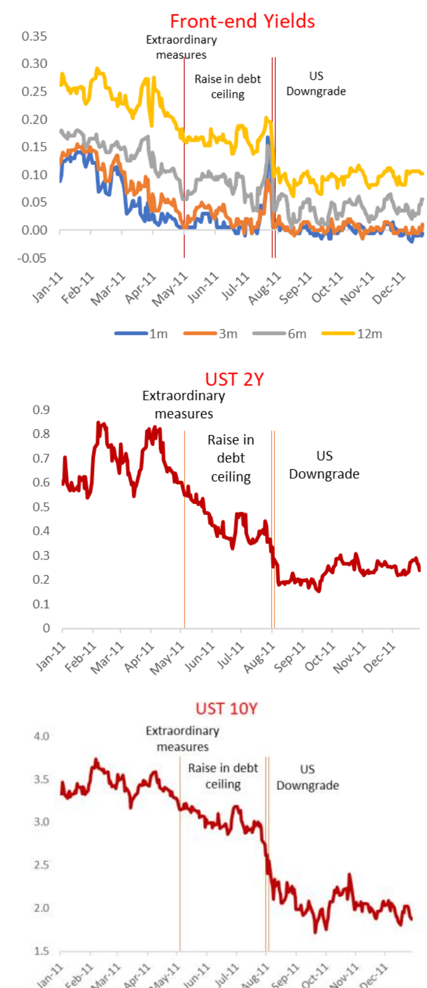
Recall in 2011-episode, S&P had also placed US on negative watch in mid July 2011 before making the decision to downgrade US 3 weeks later in early Aug 2011. In sum, we believe some of the fears may already be in the price and hence reaction on X-date or downgrade may be less volatile than imagined, if history and current market positioning is a guide. That said, we need to caveat that month-end FX flows have a tendency to distort price action.

2011 episode

On 16 May 2011 US Treasury hit the debt ceiling. To avoid a default, they started implementing extraordinary measures. Just two days before the "deadline", on 31 July Congress came to an agreement to raise the debt ceiling. But the then President Obama only signed it on 2 August, the X-day itself. Three days later, on 5 August, S&P downgraded US credit rating from AAA to AA+ after placing US on rating watch negative earlier on 14 July.

Front-end yields started rising two weeks before the X-day. The spikes in the 3M yield were temporary from the bottom in mid-July to the peak on 2 August. Soon after the increase in debt ceiling, the yield dropped on 4 August, back to early July levels. A similar pattern was observed for other short-end tenors. The downgrade in US credit ratings (5 August) did not have much effect on bill yields. Overall market's reaction did not last for long, front-end yields fell back on track with the overall downward trend, being driven by macro factors, quickly moving away from the debt ceiling issue.

In the months leading up to the X date, UST yields had already been on a downtrend. The 10Y yield peaked in early February and fell 94bps by end July. On 2 August when the debt ceiling was raised, yields continued to fall by a further 13bps from the previous day. The reaction in 2Y UST was more muted; the 2Y yield peaked in early February, falling 50bps by end July, before it fell another 5bps on 2 August from the previous day. Overall, UST yields were already on a downtrend, and upon the increase in the debt ceiling, the downtrend was extended.



Source: Bloomberg, OCBC Research

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