28 July 2021

Research US

No re-suspension of the debt limit near-term but expect a deal eventually

- **The US debt limit suspension expires on 1 August. The extraordinary measures are likely exhausted in October or November, where we expect a re-suspension.**
- **US Treasury expects a cash balance of USD450bn by the end of July and a cash balance of USD750bn by end of September in case the debt limit is re-suspended.**
- **We expect limited near-term market impact, but a re-suspension of the debt limit could come in conjunction with Fed starting to taper QE and result in tighter USD liquidity conditions in Q4, which is not fully priced in the market in our view.**

The US debt limit suspension expires on 1 August. If the debt limit is not increased or re-suspended, the US can no longer issue bonds (besides replacing maturing debt) and needs to rely on so-called extraordinary measures to finance deficit. The debt limit issue is not the same thing as a government shutdown, which occurs when there is no budget.

Extraordinary measures include the G Fund, the Exchange Stabilization Fund and the cash balance (among others). According to the Congressional Budget Office, the extraordinary measures are likely exhausted in October or November (although COVID-19 makes it harder to predict than usual), see *CBO analysis*. US Treasury Secretary warns that the extraordinary measures may be exhausted earlier, see *Letter to Congress*.

Unlike previous rounds of debt limit problems, US Treasury does not need to draw dawn the cash buffer to the level prevailing before the debt limit was suspended (around USD118bn). Still, US Treasury is not allowed to issue a lot of bonds ahead of the expiration of the suspension and hence US Treasury expects a cash balance of USD450bn by the end of July. US Treasury expects a cash balance of USD750bn by end of September in case the debt limit is re-suspended, which is more than enough to cover 1-week outflows.

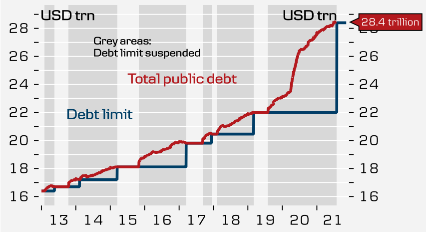
In the very near-term, a bipartisan deal seems unlikely. There are already discussions about a bipartisan deal on infrastructure but the Republican leadership is upset about the Democrats' wish to increase spending (and taxes) further focusing on social and health care.

Senate Minority Leader Mitch McConnell (Republican) said he "cannot imagine a single Republican" voting to raise the debt limit due to the Democrats' "free-for-all for taxes and spending", see *CNBC*.

However, we also know that no one is interested in an US default, which is the outcome if the extraordinary measures run dry. So also this time around we expect a solution to be found eventually (although we may have to get very close to the deadline), which is probably also the reason why risk sentiment is so far unaffected by the political turmoil.

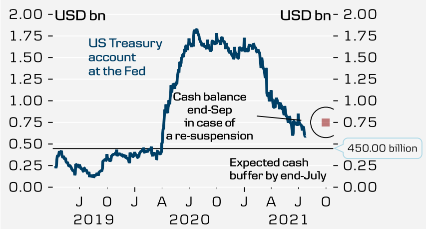
Besides a bipartisan deal on re-suspending the debt limit, the Democrats may also choose to "go alone" including a solution in a reconciliation bill, possibly in connection with one of President Biden's spending packages. That requires that Democrats quickly find common ground on what they want to achieve on spending before the extraordinary measures.

US debt limit is set to be reinstated around USD28.4trn



Sources: US Treasury, Macrobond Financial

US cash balance to fall to around USD450bn by the end of July ahead of the expiration of the debt limit suspension



Sources: US Treasury, Federal Reserve, Macrobond Financial

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Market pricing turnaround in USD liquidity conditions in Q4

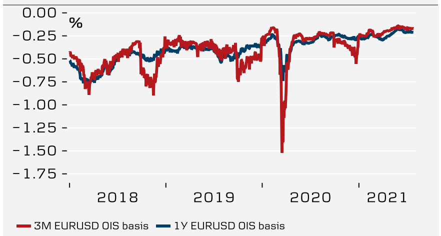
The debt ceiling issue in the US has become a repeated game; hence, the market is well aware of the dynamics, e.g. the fall and rise in the cash balance and a deal to suspend the ceiling will come eventually. I.e. we do not expect it to be major market mover. That said the timing of the debt ceiling issue in conjunction with the path forward in Fed's bond purchases is worth keeping in mind.

We look for Fed to announce and initiate tapering of its bond purchases around the November and December meeting. Hence, there could potentially be two events, which speaks of tighter USD liquidity conditions in Q4 – a solution to the debt ceiling and subsequent rise in the cash balance and tapering of bond purchases.

The Fed Funds futures curve is slightly inverted in the front out to around the November and December meeting. We interpret this as an expectation in the market of benign USD liquidity conditions until Q4 before they will start to turn less favourable. It fits well with our outlook for both the debt ceiling and tapering.

Even if the market has priced the timing of a turnaround in USD liquidity conditions about right, there is room to price a faster tightening after this. Year-end in EUR/USD FX forwards could be first place to look. Overall, EURUSD OIS basis remains quite tight priced, including around year-end. The premium on EUR/USD FX forwards over year-end is priced cheap-to-neutral from a historic point of view. Hence, we see potential for EURUSD OIS basis to widen on 3M3M horizon and further out the curve.

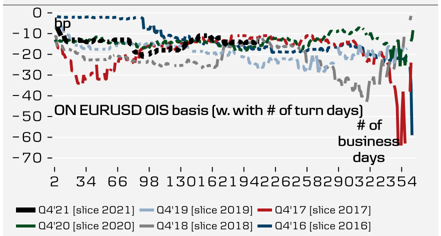
Tight EURUSD OIS basis curve



Source: Macrobond and Bloomberg

Note: Past performance is not a reliable indicator of current or future results.

Year-end relatively cheap priced



Source: Macrobond and Danske Bank

Note: Past performance is not a reliable indicator of current or future results.

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Mikael Olai Milhøj, Chief Analyst, and Jens Nærvig Pedersen, Chief Analyst.

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