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FX Insight

Another Looming US Debt Ceiling Crisis

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Debt Ceiling Crisis Brews in Washington, D.C.

As it has been the case every few years, we are once again dealing with the US debt-ceiling crisis. This time around, markets have generally been unfazed with a fall in UST yields and low VIX levels. The DXY too appears to be driven more by expectations of an end to the Fed tightening cycle and recession fears. Technically, the US had already hit the debt ceiling of $31.4tn on the 19 Jan 2023 and currently, the government is exercising "extraordinary" measures in order to prevent a binding of the ceiling. However, this can only occur for so long and we now are crucially looking out for when the so called "X-date" would fall. The date itself marks the day when the US government not have enough cash on hand anymore to meet its obligations and would have to raise the debt ceiling.

The implication of not raising the debt ceiling can be far and wide ranging as the US government would end up defaulting on its debt, which could damage the economy, increased borrowing costs for the government, corporations and general public, shutdown of government operations, the gradual erosion of the USD as the world's reserve currency among many other things.

However, we see this as an extremely unlikely scenario as history has shown the US government would eventually raise the debt ceiling even if it is done at the 11th hour. Regardless, the worsening of the political stalemate together with credit rating downgrades fear (we do not think this would happen though) can risk leading to some interim volatility for the DXY. Hence, we are pricing in some level of weakness into the DXY within periods of the coming months assuming the rest of the world are unaffected, even if we believe that in the medium – long term overall, there would be little impact from this debt ceiling crisis.

Chart 1: US 1Y CDS spikes this month as debt ceiling crisis continues to brew though DXY has been ranged traded

Source: Bloomberg, Maybank FX Research

Introduction

As it has been the case every few years, we are once again dealing with the US debt-ceiling crisis. However, this time around, markets have generally been unfazed (although we note that US CDS have shot up in April). Focus has mainly been on an ending to the Fed's tightening cycle and the risk of a recession. UST yields have recently been falling, VIX levels have been low and the DXY strength still holding up. This would be contrary to how we would logically think asset prices would move during a looming debt ceiling crisis given the risk of a US default. In this piece, we will explain about what a debt ceiling crisis constitutes and an analysis of its impact on the currency historically. We will then look at the various scenarios that could emerge this time around before highlighting some trade recommendations.

Background

Prior to this year, a debt ceiling crisis has emerged on several occasions with the most recent being in 2011 and 2013. As a note, the debt ceiling has actually been increased multiple times in history but on those occasions, the sitting President has been able to raise debt ceiling without a crisis occurring.

Technically speaking, the US government has already hit the debt ceiling of $31.4tn on 19 Jan 2023 except that the government is now exercising "extraordinary measures" to prevent a binding of the ceiling. Such measures are wide-ranging and include shifting money between government agencies to meet more crucial obligations, suspending certain types of investments in government workers' savings plans or retired postal workers' health plans and halting daily reinvestment of securities held by the Treasury's Exchange Stablization Fund. Essentially, it involves undertaking measures that can reduce what would count against the debt limit.

However, such measures can only be done for so long and we now crucially look out for the so-called "X-date", which marks the day the US government does not have enough cash on hand anymore to meet its obligations. This date actually effectively marks the final day of which the US government would have no choice but to raise the debt ceiling. Determining when such a date would fall would be difficult to do given that it depends on how the inflows Federal tax payments would be from month to month. As such estimates of the date would usually fall in a range. Delays in the tax filings such as due to weather disruptions in certain states can also only complicate the estimates. As it stands, Treasury Secretary Janet Yellen has said that the "X-date" in the worst case scenario would fall on the 5 June 2023. An article from Brookings Institution dated on the 25 Jan 2023 has said that the date could fall any time between early June to early fall. Estimates from various market players have also been wide and ranging with some believing it would be in August and others seeing it in July. The Treasury Department itself is reportedly expected to release its own estimate of the date this week or the next with the 18 April Federal income tax returns deadline already having passed.

Currently the impasse on the debt ceiling revolves around the Republicans led by House Speaker Kevin McCarthy refusing to agree to raising it unless certain spending cuts are undertaken (targeted at Biden's policies). Not surprisingly, Biden has rejected such proposals from MaCarthy. However, MaCarthy has successfully managed to pass his debt limit bill or so called "Save, Grow Act of 2023" through the narrowly controlled Republican house. The bill is likely to have little chance of passing the Democrat controlled Senate although it simply just means the Republicans are starting with tougher terms in the negotiations. As a result, this may risk leading to a longer drawn out impasse over the debt ceiling matter.

What would be the implication if the US debt ceiling binds?

Again, the outcomes here can be varied. One option the government could pursue if they hit such a scenario could be similar to a contingency plan they had pursued in 2011. Under this plan, there would be no default on Treasury securities and interest would still be paid when it comes due. As securities mature, Treasury would simply just pay off the principal by auctioning new debt of the same amount. At the same time, Treasury would also try to delay payments for various other obligations to avoid increasing the debt amount and meet the existing debt interest payments. However, this also means that this plan cannot be carried out perpetually and simply only buys the government more time. In essence, such a plan only prevents debt cost from rising as the government continues to meet its debt obligations.

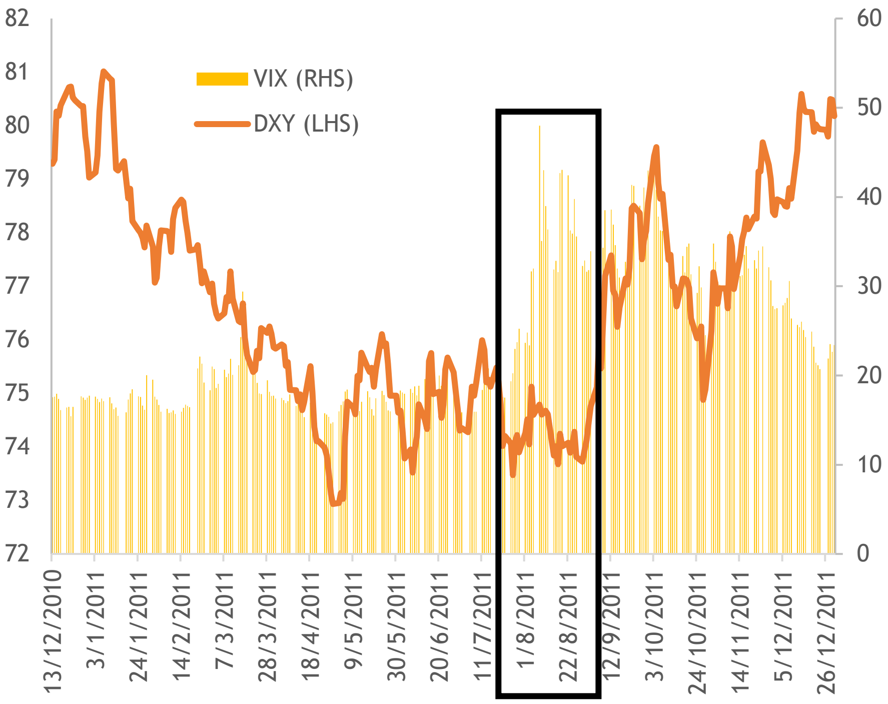
The other outcome is a default by the US government. This would be the worst thing to happen as it would lead to credit ratings downgrades, higher UST yields, increased borrowing costs for the government, corporations and general public, shutdown of government operations, the gradual erosion of the USD as the world's reserve currency among many other things. The impact on the US economy would be detrimental, which can have spillover effects on the rest of the global economy. It could be especially bad if a default does happen in this current economic environment where rates are currently high and there is a rising risk of a recession.

The US could also engage in a "technical default". They delay payments on certain treasuries, putting it into default but eventually make good on it once the impasse is over and the debt ceiling is raised.

What happens to the currency historically?

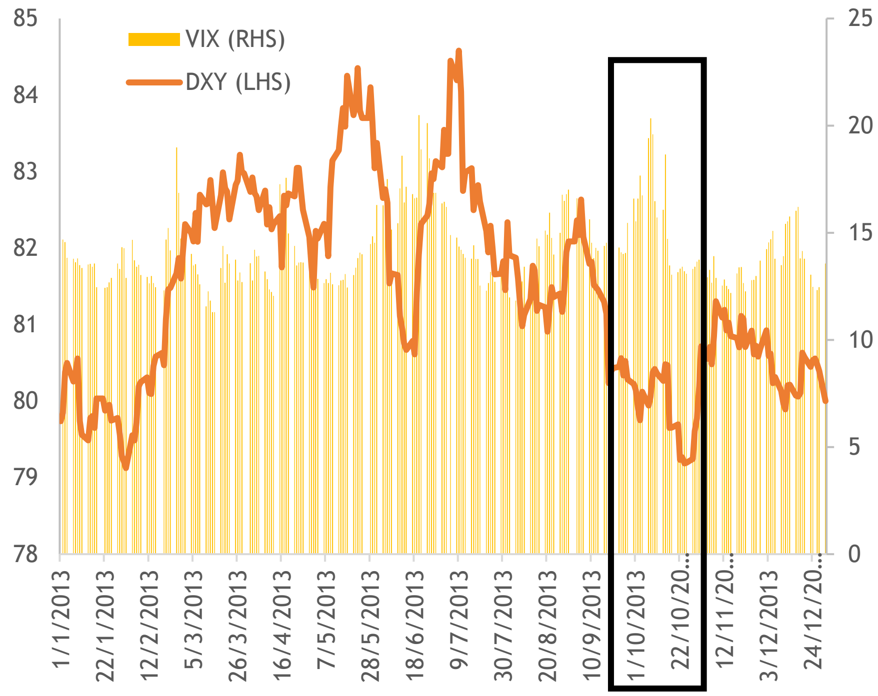
Historically, we observe that there is a more pronounced reaction in the USD when rating agencies start adjusting their rating of US government debt. In both 2011 and 2013, the DXY was weaker compared to other periods of safe haven demand (with the VIX and 1Y CDS at elevated levels) when the rating agencies had lowered their ratings.

Chart 2: S&P Downgrades US Credit Rating from AAA to AA+ in Aug 2011 with VIX Becoming Elevated But DXY Subdued



Source: Bloomberg, Maybank FX Research

Chart 3: Similar Scenario Happens in Oct 2013 when Fitch Placed the US under a "Rating Watch Negative"



Source: Bloomberg, Maybank FX Research

Scenarios

Below, we highlight a few scenarios that could happen this year with regards to the debt ceiling crisis in addition to the likelihood of their occurrence and the implications.

Table 1: Potential scenarios - their implications and probability

No.	Scenario	Implication on the FX	Probability
1	US begins to defaults on some debt obligations	• There would be a knee jerk downward decline in the DXY although it should eventually retrace some of its losses • Given the USD's outsized position as a global reserve currency and the high foreign holdings of US treasuries, the DXY would only gradually decline in the long term as countries, corporations and individuals offload their USD denominated assets overtime	5% likelihood We see it as extremely unlikely that the US would default on any of its debt obligations given the economic and political (e.g. weakening of their international standing) implications it would have on themselves
2	Credit rating downgrade but debt ceiling is raised	• Just as it has happened in history, the DXY would be more subdued during the period of the downgrade but then it should eventually move in line with other macro developments again	25% likelihood This looks unlikely to happen given that the rating agencies for now are expecting the US to raise its debt ceiling and avoid a default of any sort whilst still having a capacity to repay
3	Debt Ceiling is raised (even if it occurs close to the "X-date") and any sort of default is avoided (Our base case scenario)	• Little impact in the medium to long term on the DXY given that it would just be business as usual • However, we do note that in the interim, there could be DXY volatility arising from a worsening of the political stalemate together with credit rating downgrades fear and hence, we are pricing in some weakness into the DXY within the coming months	70% likelihood This looks likely to happen given that history has shown the US government eventually successfully raises the debt ceiling even if it happens at the 11th hour

Trade Recommendations

Overall, as we believe that the debt ceiling is likely to be raised without any sort of default or credit rating downgrade occurring, we therefore see there would be likely limited impact in the medium - long term on the USD (DXY) from this impasse. However, we do note that some volatility can emerge in the interim from the political stalemate together with credit rating downgrades fear. Therefore, we are still pricing some weakness into the USD within the coming months as long as the rest of the world's growth remains intact and unaffected.

Overall, we see that the USD would be driven more by an end to the Fed tightening cycle and falling UST yields throughout most of this year. Hence, we stick to our existing key trade recommendations for this year that include short USDJPY, long AUDUSD and short USDSGD.

As a note, in the scenario that a US debt default of some sort does happen, we would favour going long on the safe havens of gold, JPY and CHF.

Table 2: Timeline of key dates

Date	Event
19 Jan	US government hits debt ceiling of $31.4tn and exercises "extraordinary" measures to prevent binding of the ceiling
18 April	Federal income tax filing return deadline which helps government to get some estimate of the "X-date" (Treasury should release some forecast of the "X-date" soon)
15 June	Quarterly tax payments are due which can provide an inflow of cash for the US government
30 June	Treasury Department able to extract $140bn in borrowing power from a key Federal retirement fund
31 July	Federal Government can risk running a deficit by this date, which makes the default a possibility at around this point
August	Congress in recess
15 Sept	Another quarterly tax payment is due and can keep the US government afloat if they still do not default by this point
October	No substantial revenue coming in this month putting the US government in a very likely position of default if they last this far into the year
July - October	**"X-date" can therefore possibly fall at any point during these months as highlighted by the purple coloured section of this timeline**

Source: Various Websites, Maybank FX Research

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