Mizuho Chart Speak: USD Liquidity

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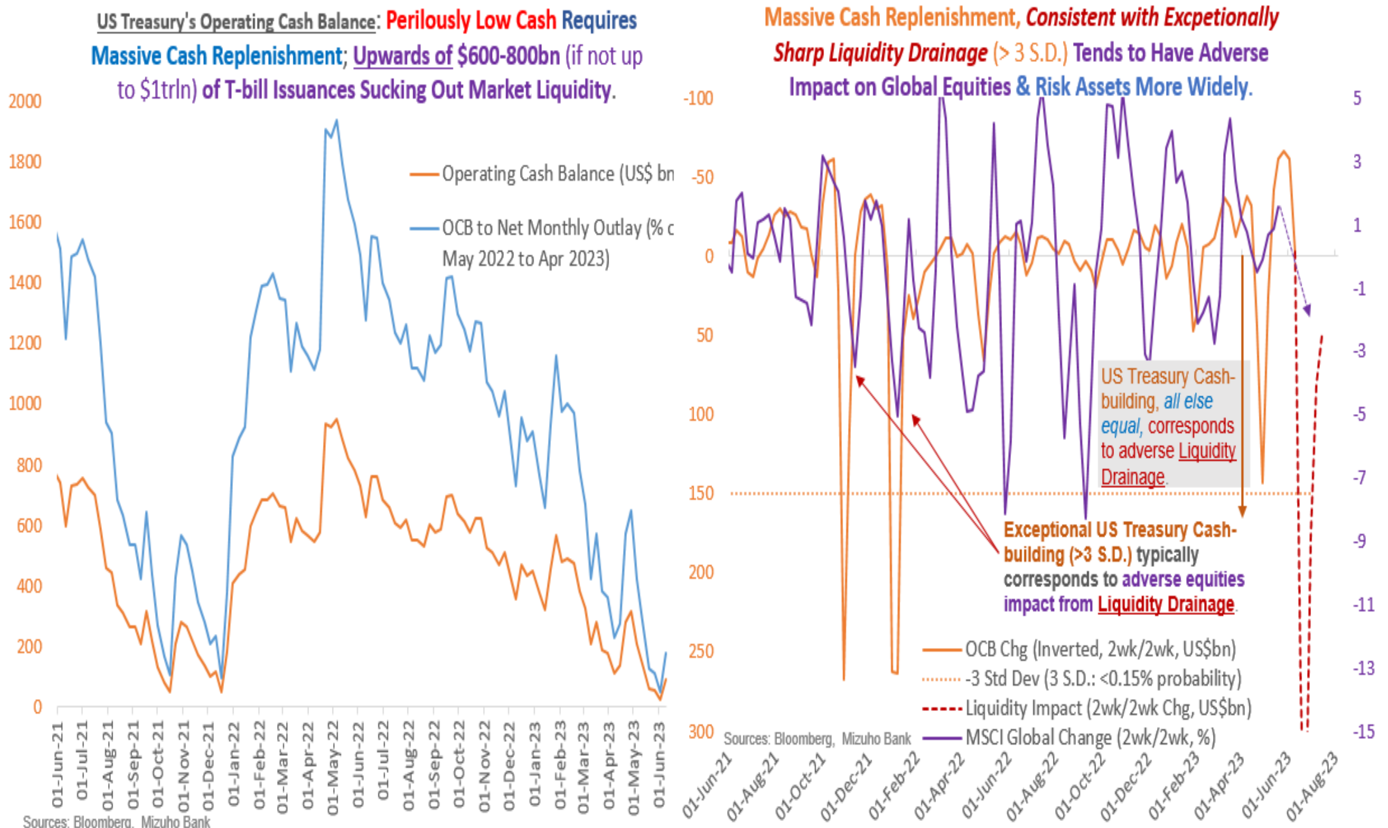
Swapping (Debt) Ceiling Risks for Liquidity Crunch



“Today is the sort of day where the sun only comes up to humiliate you” - Fight Club

Admittedly, **resolution of the debt ceiling crisis** *ostensibly defuses most of the extreme risks of financial failure*. But closer scrutiny reveals that debt ceiling risk, **whilst considered to be predominantly defused, are in fact only deferred** to be more precise. And ***crucially***, it is **far from disarmed**.

Point being, **financial market woes are not fully eradicated**. *Instead,* ***(US) credit risk are at least partially swapped out for liquidity risks***. Especially **as markets struggle to side-step** an **acute liquidity squeeze** *that is ironically triggered by the debt ceiling resolution making way for the US Treasury to urgently replenish its depleted coffers* (after cash plunged sharply to ~$20bn at the climax of the stand-off, just 3% of comparable $750bn average for Q2 2022).

Accounting for on-going operational cash draw-down, *upwards of $600-800bn* in T-bill issuances is not outlandish; even if revenue collections are up. In fact, *markets expect a more severe $1trln in USD drainage*. This **squares with an acute liquidity squeeze** in the offing; with **sharp consequences for the market**.

Big picture on impact would be for higher yields (as a function of aggregate Treasury paper supply mopping up liquidity), wider (risk) spreads and USD strength from USD funding demand.

Higher Yields: In particular, **front-end yields would be most acutely impacted** given the likelihood of

most of the liquidity being mopped up by T-bill issuances. This **will of course transmit across the curve**, but will be ***dampened at the 2Y*** insofar ***as approaching Fed (peak) rate expectations temper;*** and even **more so at the longer end by recession risks** being priced incrementally.

Risk Spread: With the US Treasury mopping up liquidity, **risk re-pricing though may be more accentuated**, **with widening credit spreads more discernibly amid a liquidity squeeze**. Especially *as rising yields on "safe" US bills compete with, and displace, risk assets*; further **accentuated by the Fed's on-going QT** that is effectively draining $95bn/mth from markets.

Banking Risks/Credit Spreads: What's more, **insofar that the US Treasury bill issuances compete for USD funding in the money markets**, *banks could also unevenly feel the liquidity squeeze.* This will in turn **accentuate credit premiums across USD funding capability, organic cash-flow strength and risk beta** (should this re-trigger US regional bank jitters).

USD Strength: Finally, the **rush for USD funding will boost USD strength**, *accentuated by "risk off" from (T-bill induced) liquidity squeeze;* even as post-debt ceiling short squeeze fades.

Mitigating Factors, Not: The *silver-lining* is that *insofar that the liquidity squeeze is widely anticipated, the resultant response of precautionary positioning will mitigate pain and tail risks.* Crucially, *spare liquidity in reverse repo* (some $2.5trln) may be *tapped on to avert an all-out financial calamity.*

Nonetheless, a **bumpy path in coming weeks** (into July/August) **amid heightened liquidity stress** remains **par for the course**; with **volatile yields entailing 50-100bps of upside**, **dented risk assets**, smaller/less well-funded banks subject to *USD funding risks* and *a strong USD cutting risk currencies.* The upshot is that ***while debt ceiling resolution is not a "false dawn"*** per se, ***it a perverse version of the proverbial sunshine;*** baking in a run of liquidity risks (albeit of a relatively lower-order threat), where debt ceiling risks left off.

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