20 October 2026

Reading the Markets USD

Republican agenda for the lame-duck session

If Democrats win a majority in at least the House in the November midterms, the outgoing congress will face a busy schedule for its final few weeks. At the very least, Republicans will aim to pass the full-year government funding package when the current stopgap bill expires on 11 December.

Republicans extended last year's funding in September to avoid a government shutdown just ahead of the elections. But if they fail to pass appropriations bills in December, Trump and Republicans would have to negotiate them also with House Democrats. This would not only risk another spiral of continuous shutdowns through early 2027 but could also force Republicans to make concessions.

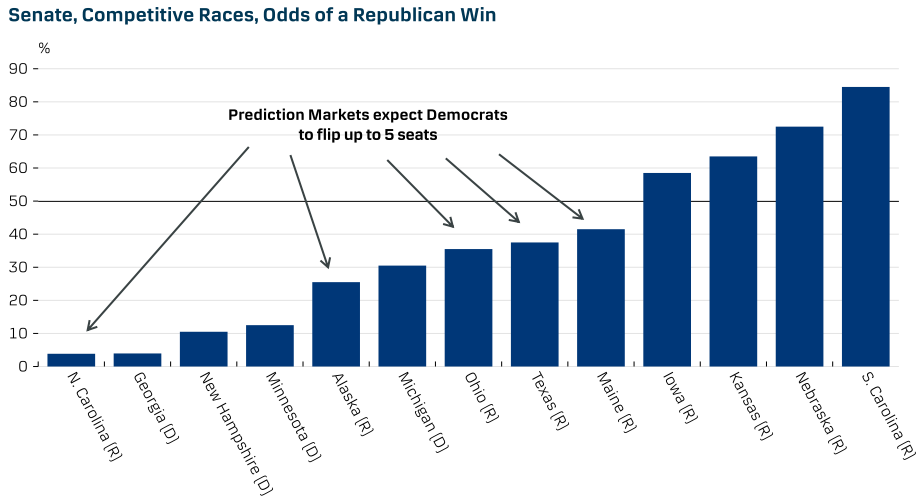
A more ambitious goal would be to pass one final reconciliation bill "3.0". The reconciliation process allows Republicans to pass changes to the budget with only a simple majority in the Senate, but this will no longer be possible if Republicans lose control of either chamber. The contents of the bill remain unclear, but would be likely to include at least some additional funding for the Iran war as well as another increase to the debt ceiling.

We doubt that the possible spending increases would have a significant impact on either macro or the Treasury market outlook. The early framework that the House passed back in July included USD95bn of new spending, of which USD73bn was earmarked for Iran war-related costs. Even the early proposal was criticised by Republican fiscal hardliners, so we think the risk of a larger spending increase appears small. And assuming the bill passes at all, this would only mark a one-off deficit increase of less than 0.3% of GDP.

Key views

- **Macro:** Cyclical outlook remains healthy, even if stagnant labour supply growth weighs on real growth. GDP +2.1% in 2026 in line with consensus.
- **The Fed:** 25bp hikes in December and March. Rates held at 4.25-4.50% for the rest of 2027 (below market pricing).
- **EUR/USD:** Relative macro and monetary policy outlook to fuel USD strength. 12M EUR/USD target at 1.12 reached ahead of schedule, risks still tilted to the downside. View is below consensus (1.18) and forward (1.14).
- **10Y UST:** 5.20% in 12M (below forward at 5.43%).

Chart 1: Democrats need 4 flips to win the Senate, markets predict up to 5



Source: Macrobond, Polymarket, Danske Bank

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Lifting the debt ceiling is not as urgent as passing the government funding, but the pressure to do so before year-end stems from the same reason. Having to agree on the raise with bipartisan support would hand over political leverage to Democrats that they would otherwise not have. Even if Democrats win both chambers, Trump can always veto any Democratic budget proposals and overturning the veto would require a supermajority in the Senate.

The total amount of debt subject to the ceiling is currently at USD40.2trn, while the limit stands at USD41.1trn. CBO estimates 2026 and 2027 budget deficits at just below USD1.9trn per year, so a linear forecast would predict that the ceiling will be hit around early April next year. But in reality, drawing down the Treasury's cash balance (currently at USD880bn), tax revenues from December and April tax dates (historically around USD75bn and USD300bn, respectively) and using other 'extraordinary measures' will delay the 'X-date' until H2 27.

The final topic on Republicans' year-end agenda relates to Lisa Cook. In early October, Trump established a committee for investigating the mortgage fraud allegations made against Cook. As a reminder, the Supreme Court allowed Cook to remain on the Fed Board of Governors earlier this year but did not rule whether she had committed fraud or not. The committee will conduct a hearing on 5 November and then report back to Trump by 10 November. He will then evaluate whether there is sufficient 'cause' for ousting Cook from the Board.

No matter the outcome, the final verdict will again be up to the Supreme Court. But the timeline suggests Trump is concerned about losing control of the Senate. In a hypothetical scenario where Trump is allowed to fire Cook, he still needs the Senate to confirm the nomination of whoever he chooses as the replacement. Getting the approval from a Democrat-controlled Senate would be significantly more difficult.

For now, 13/35 Senate races are considered competitive. Republicans currently hold 9/13 of these seats. To win the majority, Democrats need to hold all of their current seats and flip at least four more. Prediction markets currently expect up to five flipped seats, which would leave Democrats with a 52-48 majority in the Senate.

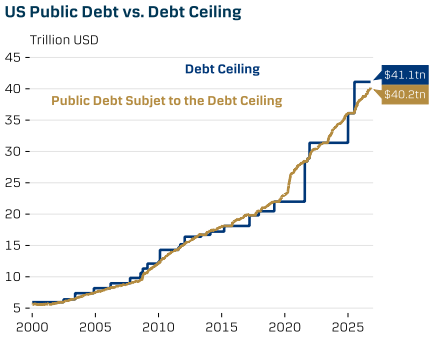
US money market implications

If Republicans fail to lift the debt ceiling this year, the likely prolonged bipartisan effort to do so would give a temporary boost to USD liquidity conditions around mid-2027 as the cash balance gets drawn down.

For now, the outlook for liquidity conditions around upcoming year-end remains steady judging from both the EUR/USD XCCY basis and the SOFR – EFFR spread (Charts 3 & 4).

There are also two other factors that could affect liquidity conditions towards year-end. First, the Fed is *reportedly* planning a reform to US banks' liquidity coverage ratio (LCR) requirements. The reform would not lower the LCR requirement itself, but it would recognise banks' capability to borrow liquidity from the Fed's discount window as part of their high-quality liquid assets (HQLA). In practice, this means banks would be required to hold less reserves or Treasuries to fulfil the LCR requirement. This does not affect funding conditions in itself, but assuming banks choose to either shrink their balance sheets or tilt the composition towards lending or other assets, the amount of cash available for repo funding could decrease. The timeline for implementing the changes remains uncertain.

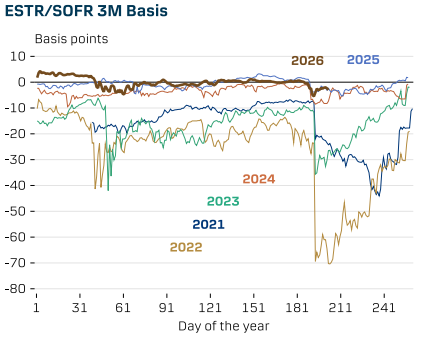
Chart 2: US public debt to hit the ceiling again during 2027



Sources: US Treasury, Danske Bank

Note: The debt can exceed the limit when it is suspended

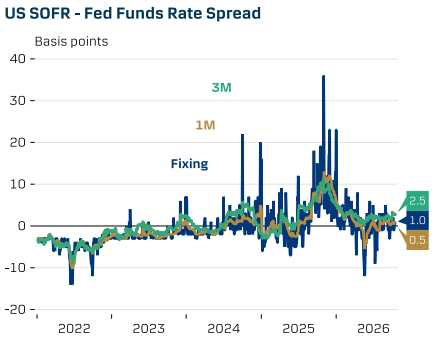
Chart 3: No significant year-end premium in XCCY basis



Sources: Macrobond, Bloomberg, Danske Bank

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

Chart 4: US repo markets remain calm for now



Sources: Macrobond, NY Fed, CME, Danske Bank

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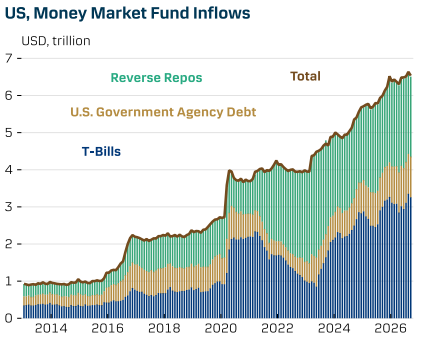
In addition, markets are focusing on the upcoming Quarterly Refunding Announcement from the US Treasury during the first week of November. In August, Treasury made a small, but potentially important, tweak to its forward guidance, when it wrote that it "continues to evaluate potential future **changes** to nominal coupon and FRN auction sizes" (prev. "increases").

Together with the increased buyback volumes, this has driven speculation that the Treasury could temporarily reduce long-end issuance to curb the rise in yields, or even halt issuance of 20Y Treasuries completely. This, in turn, would increase the share of T-bill issuance from an already elevated level. If the market has to absorb even larger T-bill supply, the borrowing capacity for repo markets could shrink. The fact that *NY Fed* remains on the sidelines with its Reserve Management Purchases does not help the situation either.

For now, shifts in USD liquidity conditions have not meaningfully affected the FX hedging cost of USD-denominated assets. The EUR/USD FX forward curve has both risen and steepened during the fall, primarily as markets have repriced the Fed's terminal rate expectation higher relative to the ECB. We remain relatively more optimistic on US macro and think that the ECB might be forced to conclude its tightening cycle already after December. This means we see a good chance that the FX forward curve could rise further.

The XCCY basis has widened marginally in October, though so far driven purely by the French fiscal stress. But the conclusion is that there is also a risk that USD liquidity conditions could still tighten towards year-end. Hence, we recommend EUR-denominated investors hedging USD-assets to take advantage of current relative rates pricing and benign funding conditions, and extending maturing hedges over year-end.

Chart 5: Money market funds have absorbed T-bill supply with new inflows, but also by reallocating funds from the repo market



Sources: Macrobond, ICI, Danske BAnk

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Report completed: 19 October 2026 at 17:35 CET
Report disseminated: 20 October 2026 at 06:00 CET