First Trust
Monday Morning OUTLOOK

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Government Is Too Darn Big

Two weeks ago, the yield on the 10-year Treasury Note was hovering around 5%, and the S&P 500 was in contraction territory, down over 10%. But last week, the 10-year yield dipped to 4.6%, while the S&P 500 saw a 6% gain. This market volatility is attributed to changing sentiments: 1) There was a belief that the Federal Reserve had lost control, but now, 2) it seems the Fed has achieved a "soft landing," bringing a semblance of stability.

While this may hold some truth, we remain cautious. If we step back and look at the US economy from a distance, things don't really look so great. Our worries have roots all the way back in 2008, when the Fed altered its approach to monetary policy. The Fed shifted from a "scarce reserve" model to an "abundant reserve" model when it initiated Quantitative Easing, fundamentally changing how interest rates are determined.

In the past, banks occasionally lacked the reserves they were legally required to hold, prompting them to borrow from other banks with excess reserves through their federal funds trading desks, thus determining the federal funds rate through an active market. Today, banks are flush with trillions of excess reserves, eliminating the need for borrowing and lending reserves. Consequently, the federal funds trading desk has become obsolete.

So…if banks are not creating a market for federal funds, were does the rate come from? The answer: the Fed just makes it up. Literally makes it up. And, over the past fifteen years, the Fed has held the funds rate below inflation 83% of the time.

The last time the Fed kept rates artificially low was in the 1970s. The result was inflation, but even more importantly, banks and Savings & Loans lent at rates lower than they should have. The ultimate result was the dramatic downfall of the S&L industry, along with many banks, as the losses incurred from offering high interest rates to depositors while getting low rates from borrowers steadily eroded their capital.

Today, US commercial banks carry an estimated $650 billion loss in their "held to maturity" assets…but they don't have to mark them to market. Just imagine if this was 2008 and Treasury Secretary Hank Paulson, Fed Chair Ben Bernanke and FDIC Chair Sheila Bair were in charge. They would have insisted on mark-to-market and we would need TARP 2.0 to bail out the banking system.

What the Fed will do is pay these private banks and other institutions roughly $300 billion this year just to hold reserves. Without this payment from the Fed to the banks, profits would be much lower and the losses on their books would be more painful.

The point we are making is that the Fed has made a mess of the banking system. While we've averted major crises thus far, it's the taxpayers who ultimately bear the burden. The $300 billion the Fed pays to banks doesn't appear out of thin air, and unless interest rates decrease significantly, these losses will accumulate. Why isn't Elizabeth Warren fuming over this?

Like the 1970s and 1980s – because we don't have mark-to-market accounting on these held-to-maturity assets – the banks can eventually earn their way out of this abyss. So, this doesn't mean the economy will suffer, other than the fact that banks have less ability to make new loans.

This is exacerbated by the Fed engineering a decline in the M2 measure of money, which has fallen by 3.6% in the past year, the most substantial drop since the Great Depression.

Some of this decline is because since 2008 the Treasury Department has started holding a great deal of cash in its checking account at the Fed. For decades it held just $5 billion as a cash management tool. This number soared after QE started, and as of November 1, 2023, the Treasury General Account (TGA) at the Fed held $820 billion. This money is part of the Fed's balance sheet, but does not count as M2. So, when the Treasury borrows from, or taxes the private sector, and then puts that money aside in its own TGA, it will lower M2. In other words, the Treasury has helped engineer a decline in M2. The Treasury could use this $820 billion to reduce debt, but it hasn't, and taxpayers will pay roughly $40 billion per year in interest, just so the Treasury/Fed can hold this cash.

This new method of managing monetary policy appears fraught with risks. Instead of stabilizing banks, it has introduced instability, proved costly to taxpayers, and contributed to the worst inflation since the 1970s.

We aren't saying that the economy can't survive, but the idea that everything will turn out perfectly seems like wishful thinking. The government has expanded significantly since 2008, with federal government spending growing from 19% of GDP in 2007 to 25% last year, and the Fed's balance sheet has expanded from 6% of GDP in 2007 to 33% of GDP.

It's evident that we no longer operate in a free-market capitalist system. While government involvement in the economy is not new, it has reached unprecedented levels.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-7 / 7:30 am	Int'l Trade Balance – Sep	-$59.6 Bil	**-$59.8 Bil**		-$58.3 Bil
2:00 pm	Consumer Credit – Sep	$9.8 Bil	**$10.0 Bil**		-$15.6 Bil
11-9 / 7:30 am	Initial Claims – Nov 4	219K	**215K**		217K
11-10 / 9:00 am	U. Mich Consumer Sentiment- Nov	63.5	**63.5**		63.8

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.