First Trust Weekly OUTLOOK

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The Fed Chose Politics

After more than a decade of analyzing, writing, speaking, warning, and complaining about the Federal Reserve's use of an "Abundant Reserve" monetary policy we are glad to finally see more focus on its impact. Treasury Secretary Scott Bessent, Senator Rand Paul, Senator Ted Cruz, and now Representative Thomas Massie have weighed-in during recent weeks about many serious issues.

Secretary Bessent said "If I want a new chair in my office…I have to go through the appropriations process….The way the Fed works there are no appropriations. They just print the [money]."

Senator Paul and his staff found that the Fed was paying private banks (including many foreign banks) $100s of billions to hold reserves. Senator Cruz argued that by losing money on its portfolio, the Fed was costing taxpayers potentially trillions of dollars over a decade. And now Representative Massie says the Fed's Quantitative Easing fueled excessive government spending and debt. And don't forget inflation.

All these political leaders are correct. As we have written before, the Fed's Quantitative Easing programs essentially turned the Fed into a huge hedge fund. It created trillions of new dollars by increasing bank reserves and used them to purchase Treasury debt and mortgage-backed securities.

Both the 2008-2015 and the 2020-2022 episodes of QE coincided with huge government deficit spending programs. This wasn't a coincidence. If the private financial system were expected to finance the lockdown of the economy and the paying of people to stay at home, it would have charged the government more than the Fed charged.

But the Fed bought short-term government debt (T-bills) at essentially 0% rates and 10-year debt at 2% yields, or less. Because the Fed cannot buy directly from the Treasury, it used banks as intermediaries. The banks knew that when they bought Treasury debt at auction, they could immediately sell that debt to the Fed. The Fed bought the debt from the banks by creating massive amounts of reserves.

Because the Fed was given the go-ahead by Congress to pay banks interest on reserves, the banks took that risk-free cash. Banks were perfectly willing to do this because they thought bond yields alone were not compensating them for the risk.

The Fed thought it could borrow short and lend long with no inflationary consequences. Of course, as we pointed out, and forecasted, the Fed was wrong. And when interest rates rose with inflation, the Fed's balance sheet turned upside down. Now, the Fed has $856 billion in unrealized losses on its bond portfolio.

Moreover, over the past seven quarters, the Fed has paid private banks and institutions roughly $360 billion to hold reserves, but only earned $270 billion in interest from its bond holdings. In other words, the Fed lost roughly $90 billion.

The Fed doesn't care if it makes a loss because it never has to mark anything to market prices and can just create money at will to pay its expenses. In 2007, the Fed's balance sheet was $850 billion. Today it is $6.6 trillion. And with this increased balance sheet leaving trillions sloshing around, the Fed's management has become lax. It went from 17,100 employees in 2012 to 21,000 employees today even though technology has increased productivity (for example, we now clear checks electronically and the Fed doesn't do it with a fleet of jets).

And lax may be the wrong word. The Fed actually went "woke." It used its swollen balance sheet to do "research" on climate change, and declared it a risk to banks. It only rescinded its official guidance to banks about accounting for climate change when Donald Trump became President. The Fed also hired people to manage DEI programs.

In other words, the Fed became political. Two other events also took place. It cut interest rates before the November election. And Chairman Powell ignored all previous Fed guidance about staying out of fiscal policy and said very publicly that Trump's tariffs would be "inflationary."

The reason we mention all this is that Fed leadership, some lawmakers, and many in the press are complaining about recent political pressure on the Fed. But by choosing to facilitate a larger government and not limiting its work to its statutory mandate, the Fed has been delving into politics on its own.

We'd prefer an independent Fed that pursued a monetary policy with zero to minimal inflation. Hopefully the next leader of the Fed will bring us closer to that ideal.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-21 / 9:00 am	Construction Spending – Oct	+0.1%	**+0.2%**		+0.2%
1-22 / 7:30 am	Initial Claims – Jan 17	209K	**205K**		198K
7:30 am	Q3 GDP Final Report	+4.3%	**+4.3%**		+4.3%
7:30 am	Q3 GDP Chain Price Index	+3.8%	**+3.8%**		+3.8%
9:00 am	Personal Income – Nov	+0.4%	**+0.4%**		+0.4%
9:00 am	Personal Spending – Nov	+0.5%	**+0.5%**		+0.4%