THREE ON THURSDAY

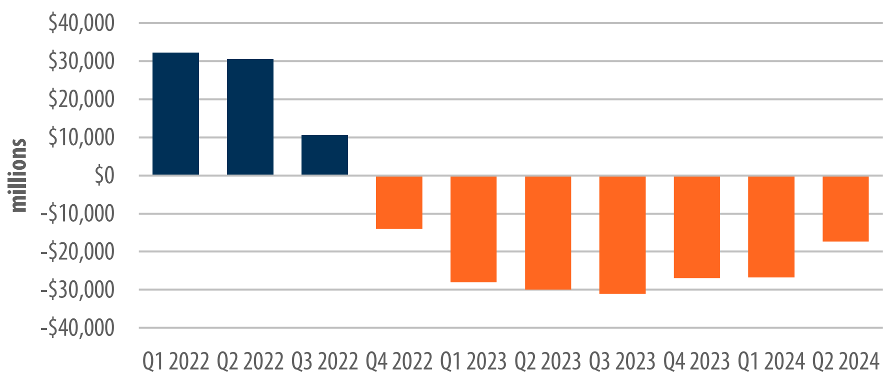
First Trust

FIRST TRUST ECONOMICS

September 5, 2024

In this week's edition of "Three on Thursday," we look at the Federal Reserve's financials through the second quarter of 2024. Back in 2008, the Federal Reserve (the "Fed") embarked on a novel experiment in monetary policy by transitioning from a "scarce reserve" system to one characterized by "abundant reserves." In addition to inflation, this experiment has resulted in some other developments that are worrisome. Higher interest rates have resulted in substantial unrealized losses on the Fed's securities portfolio. Simultaneously, they have caused the Fed to pay out more in interest to banks than it is earning, resulting in sizable and ongoing losses. To offer deeper insights into where things stood through the second quarter of this year, we have included the two charts and table below.

Net Earnings Remittances to the Treasury



Source: Federal Reserve Board, First Trust Advisors. Data from first quarter 2022 through second quarter of 2024.

Before 2022, the Fed earned more from its Treasury and mortgage-backed securities (MBS) than it paid banks. Now, it pays banks 5.4% annually to hold reserves, exceeding its income from these assets, leading to significant quarterly losses for seven consecutive quarters. While losses will persist, they may lessen as the Fed is likely to cut rates soon. These losses are recorded as a deferred asset on the Fed's balance sheet, only to be repaid when the Fed returns to profitability. In Q2 2024, net earnings remittances to the Treasury were -$17.3 billion, with the deferred asset at $179.1 billion.

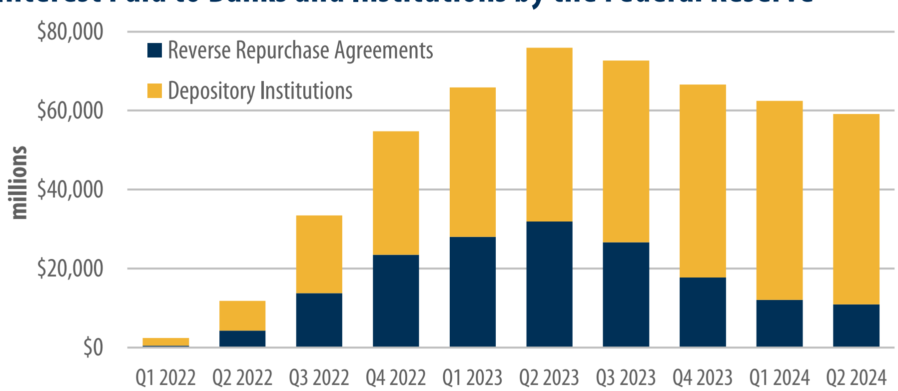
Federal Reserve's Portfolio Holdings (in millions)

Treasury Securities	Amortized Cost	Fair Value	Cumulative Unrealized Losses
Bills	$192,928	$192,930	$2
Notes	$2,563,479	$2,367,963	-$195,516
Bonds	$1,889,750	$1,432,284	-$457,466
Total Treasury Securities	**$4,646,157**	**$3,993,177**	**-$652,980**
Federal Agency and GSE MBS			
Residential	$2,373,961	$1,952,531	-$421,430
Commercial	$8,779	$7,360	-$1,419
Total Federal Agency and GSE MBS	**$2,382,740**	**$1,959,891**	**-$422,849**
GSE Debt Securities	$2,543	$2,625	$82
Total Domestic SOMA Portfolio Securities Holdings	**$7,031,440**	**$5,955,693**	**-$1,075,747**

Source: Federal Reserve Board, First Trust Advisors. Data as of second quarter of 2024. The domestic portfolio holdings of the Federal Reserve's System Open Market Account (SOMA). GSE stands for Government Sponsored Entity.

The Federal Reserve has over $1.0 trillion in unrealized losses on its balance sheet, but it's important to note the unique position it's in. Unlike many financial institutions, the Fed doesn't face solvency concerns because it's not required to mark its portfolio to market values. The Fed has the option to hold its securities until they mature, and there's no regulatory agency that can intervene and force it to shut down due to accounting losses. With total reported capital of just $43 billion in Q2 of 2024, the Fed's unrealized loss of $1.08 trillion represents a staggering 24 times its capital.

Interest Paid to Banks and Institutions by the Federal Reserve



Source: Federal Reserve Board, First Trust Advisors. Data from first quarter 2022 through second quarter of 2024.

The real beneficiaries in recent years have been banks and financial institutions, which earned $59.1 billion in Q2 alone from holding reserves and reverse repos. The market currently expects the federal funds rate to drop by 100 basis points by year-end. This, along with a shrinking Fed balance sheet, will reduce the Fed's interest payments to these institutions. However, costs are still projected to remain high, we estimate between $200 billion and $250 billion for 2024, signaling continued significant payouts in the second half of the year—expenses ultimately borne by taxpayers.