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FED SHADOW

The Fed is Silicon Valley Bank

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The Fed has trashed its own income statement and balance sheet. It has to stop. Now.

The Fed is insolvent in all the ways and for the same reason that Silicon Valley Bank was.

The Fed's income statement shows losses of about $8.5 billion per month. Cumulatively these losses have already wiped out the Fed's capital.

- *We estimate it earns about 2.3% income* from a $7.88 trillion asset portfolio of Treasuries and MBS. *But it must pay an interest rate of 4.9%* to the depositors who fund those assets in the form of $3.34 trillion in excess reserves and $2.76 trillion in reverse repurchase agreements (it pays no interest to those who hold $2.32 trillion in coin and currency).

Generative AI token: "The Fed is insolvent, income statement, balance sheet, pixel art"

Source: DreamStudio running SDXL Beta

Update to strategic view

FEDERAL RESERVE: The Fed's income statement shows net interest margin losses of $8.5 billion per month, a cumulative loss of $48.3 billion, which exceeds the Fed's paid-in capital. Its securities portfolio is depreciated, we estimate, by about $737 billion below the face value reported on its balance sheet. That's enough to redeem excess reserves and reverse repos, but not coins and currency in circulation. These are the same realities that drove Silicon Valley Bank to failure. They are the result of the Fed's own decision to undertake one of the biggest and fastest hiking regimes in history. The Fed's so-called "gold stock" is illusory and cannot help now. Many banks are suffering from these same problems, and they look to the Fed as a backstop to retain depositor confidence, but the Fed's credibility is impaired. A debt ceiling crisis could worsen the situation if it drives yields higher. The Fed must stop, for its own sake. The March hike was the last.

[Strategy dashboard]

- *The Fed's earning power is locked down*, because it derives from a portfolio acquired over 14 years of quantitative easing episodes, during all of which long-term yields were lower than today's. Its average maturity is 8.6 years. 45% of it matures within the coming year, but under the present quantitative tightening regime, maturity payments will not be reinvested, so the Fed has little opportunity to take advantage of today's higher yields.
- *This is precisely what happened to Silicon Valley Bank* (see "It's Over For SVB – And the Fed" March 13, 2023). Its net interest margins fell, and ultimately went negative, when it was forced to pay its depositors – most of whom were large, and had strong bargaining power – interest rates in line with today's high fed funds rate (which was zero just a little more than a year ago). Yet SVB had no power to earn commensurately more from its asset portfolio which, like the Fed's, was invested in long-term securities that locked in the very low yields of recent prior years.
- *The Fed's accumulated net income deficit is now $48.3 billion, which as a legal matter is a debt of the Fed to the US Treasury.* It is greater than the $41.80 billion paid-in capital reported in the Fed's most recent annual audited financial statement.

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[About us]

The Fed's balance sheet is underwater, we estimate, by about $737.7 billion.

- The Fed reports its assets at "face value." It does not report a mark-to-market value, and as of this writing has been unresponsive to our requests to do so. We don't have the data resources to precisely price the portfolio ourselves, but based on its average maturity, and on its yield which we can infer from its net-income shortfall, we can make a credible guess.
- *With face value of $7.88 trillion, we estimate market value at $7.14 trillion*. The Fed's liabilities to depositors of excess reserves and reverse repos are $6.11 trillion, so the securities portfolio still has it covered with $1.03 trillion to spare. Furthermore, $312 billion of the $3.34 trillion in excess reserves arise from post-SVB rescue programs that are covered by borrower obligations outside the securities portfolio (see "Video: What you're not hearing about the Fed's exploding balance sheet" April 11, 2023). So call the margin of error $1.32 trillion.
- But $2.32 trillion in coins and currency are the Fed's liabilities too, and the public that holds them can opt not to at any time. So *the Fed is, in fact, short by about $1.01 trillion*.
- *This, too is precisely what happened to Silicon Valley bank* (again, see "It's Over For SVB – And the Fed"). When its concentrated and undiversified depositor base wanted its money back, the market value of SVB's liquid asset portfolio wasn't sufficient to cover the outflow.
- In the aftermath of SVB, the Fed created the Bank Term Lending Program under which depreciated Treasuries and MBS can be pledged for cash loans from the Fed at face value. If this program had been in place earlier, SVB need not have failed. *But what*

institution can lend the Fed 100 cents on the dollar for a long-term Treasury priced now at 90 cents?

- *And remember, that $737.7 billion in mark-to-market losses in the Fed's securities portfolio are losses that the banking system would be bearing if the Fed had not done QE in the first place. The Fed effectively took a bullet for the banking system. But at some point, given these losses, the Fed will not be able to do it again even if it's really needed.*

The gold held by the Fed is not an effective backstop.

- The Fed reports its "gold stock" as valued at $11.04 billion. That assumes a gold price of $42.22 per troy ounce. At current prices above $2000, the Fed's 8,133 tons of gold are in fact worth $527.47 billion, or $516.43 billion more than the Fed reports. That would seem, at first, to cover a lot of the $737.7 billion loss we estimate for the Fed's securities portfolio.
- *But the Fed actually owns no gold at all*. It relinquished all its gold to the US Treasury in 1934. In exchange, it got "gold certificates" issued by the Treasury with a face value of $11.04 billion. Those certificates are not redeemable for physical gold. They entitle the Fed only to $11.04 billion of other US Treasury obligations – not $527 billion of anything.
- For the Fed to call those gold certificates its "gold stock" is, well, just a lie.

The cause in common for the income statements and balance sheet of both Silicon Valley Bank and the Fed is… the Fed.

- *We don't blame the Fed for the low long-term yields* over 2020 and 2021 which virtually ordained that the vast quantity of new-issue bonds in those years would show sharp losses as soon as yields normalized. Instead, we blame the spasm of risk-aversion triggered by the reckless lockdown of the global economy in response to exaggerated fears upon arrival of the Covid pandemic.
- *But we do blame the Fed for the speed and magnitude of its reckless scorched-earth tightening regime*, another too-costly response to another exaggerated emergency: an inflation that, all along was destined to recede with or without the Fed simply because the vast array of pandemic stimulus programs had ended (see "Why Inflation Is on the Way Down" July 25, 2022).
- The cost of funds for banks, and for the Fed, has risen from 37 bp a year ago, right after the March 2022 lift-off from zero, to about 5% today. *That's tied for the third biggest-ever one-year upward move in rates*.
- But the two bigger ones – in 1980 and 1981, both under the Fed chairmanship of Paul Volcker – started from far higher baselines, 10.0% and 9.5% respectively. *So the devastation in long-term bond prices has been far greater in the present episode – a record for any four-quarter period*. Last year the Bloomberg Aggregate Long-Term Treasury Index fell 29%, almost twice the previous record

loss of 16% for the four quarters ended Q1-1980.

- *If Fed Chair Jerome Powell wanted to be the next Volcker, well, he's more than gotten his wish – at the price of trashing the income statements and balance sheets of America's banks, and indeed its central bank*.
- We're not saying the Fed should not have lifted off when it did in March 2022, nor that it shouldn't have normalized policy. We are saying that normalization should not have happened at abnormally high velocity, and then blow through normal policy parameters into ranges that the Fed itself acknowledges are "restrictive."
- The Fed could have done all the same things more slowly and given the banking system – and itself – more time to gracefully deal with the consequences.

The failure of Silicon Valley Bank, while very likely not systemic, nevertheless arose from factors that remain reflected to varying degrees in every other bank in the US. But *should those banks run into difficulty, they will turn to the Fed – which is itself in difficulty*.

We're not trying to tell an end-of-the-world story about the survival prospects of the Federal Reserve. It has powers and resources unique among banking institutions, drawing on the resources of the nation itself. But it runs on credibility, just as commercial banking runs on confidence. *How much credibility can the Fed lose – seriously, considering that it is now technically insolvent – and still be able to confer confidence on the banking system?*

- *With the coins and currency of the US lacking collateral backing by the central bank that issued them, it's an inconvenient time for Republicans and Democrats to have a showdown over suspending the debt ceiling and avoiding a Treasury default.*
- *It wouldn't help commercial banks, or the Fed, already crippled by an historic back-up in Treasury yields, to see those yields leap higher this summer if there is a bargaining failure over the debt ceiling.*
- *The Fed can't make Republicans and Democrats work together. But it can stop the rate hikes that brought us to this perilous pass to begin with.*
- *We reiterate our call that the rate hike at the March FOMC was the last one* (again, see "It's Over For SVB – And the Fed"). It is inconceivable to us, at this point, that the Fed would do more of the same thing that has brought the banking system, and itself, to the brink.

Bottom line

The Fed's income statement shows net interest margin losses of $8.5 billion per month, a cumulative loss of $48.3 billion, which exceeds the Fed's paid-in capital. Its securities portfolio is depreciated, we estimate, by about $737 billion below the face value reported on its balance sheet. That's enough to redeem excess reserves and reverse repos, but not coins and currency in circulation. These are the same realities that drove Silicon Valley Bank to failure. They are the result of the Fed's own decision to undertake one of the biggest and fastest hiking regimes in history. The Fed's so-called "gold stock" is illusory and cannot help now. Many banks are suffering from these same problems, and they look to the Fed as a backstop to retain depositor confidence, but the Fed's credibility is impaired. A debt ceiling crisis could worsen the situation if it drives yields higher. The Fed must stop, for its own sake. The March hike was the last.