

Cash Flow and Carey



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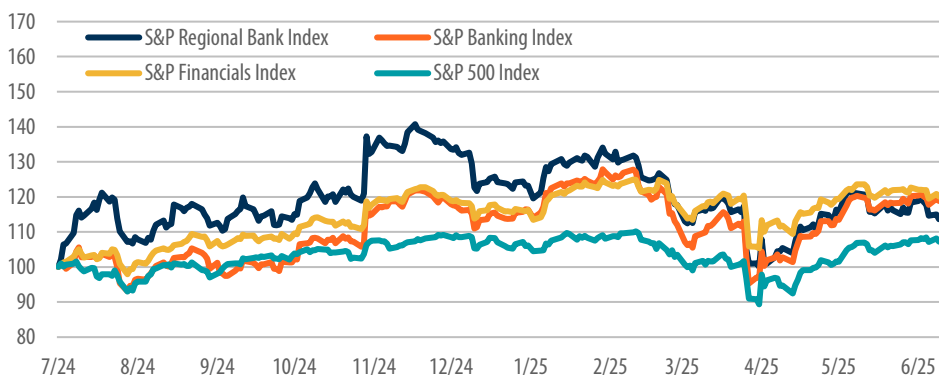
6/24/25

The S&P 500 Index is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. The S&P 500 Financials Index is a capitalization-weighted index of companies in the S&P 500 Index that are classified as members of the GICS financials sector. The S&P 500 Banks Index is a capitalization-weighted index. The S&P Banks Select Industry Index comprises stocks in the S&P Total Market Index that are classified in the GICS Asset Management & Custody Banks, Diversified Banks, Regional Banks, Diversified Financial Services and Commercial & Residential Mortgage Finance sub-industries. The S&P Regional Banks Select Industry Index is comprised of stocks in the S&P Total Market Index that are classified in the GICS regional banks sub-industry.

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Financial Exuberance?

Price Returns 7/9/24 – 6/20/25



Source: Bloomberg. Daily price returns, normalized to a factor of 100. **Past Performance is no guarantee of future results.**

View from the Observation Deck

Today's post seeks to investigate the impact of changes (real or anticipated) in U.S. policy rates on the country's banking and financial sectors. The chart above plots the price-only returns of the S&P Banks GICS Level 2 Index, S&P Regional Banks Index, and S&P 500 Financials Index against the broader S&P 500 Index. Our observations begin on 7/9/24, the day after Federal Reserve ("Fed") Chairman Jerome Powell's testimony to Congress that the U.S. economy no longer appeared to be "overheated". We chose this date because we view it as the Fed's initial signal that interest rate reductions were likely imminent.

The Fed reduced its policy rate three times in 2024, bringing the federal funds target rate (upper bound) from 5.50% to 4.50% where it has remained since the start of the year.

As many investors likely know, these lower policy rates helped end the longest yield curve inversion in U.S. history. That said, the yield curve has yet to fully normalize. As of 6/23/25, the spread between the 2-year and 10-year Treasury notes stood at 48 basis points (bps), well below the 25-year average of 110 bps. We believe financials - specifically those institutions that earn a spread from lending deposits - may benefit as this spread widens to historical norms.

Earnings estimates for the S&P 500 Financials Index underwent substantial upward adjustments in the wake of Powell's Congressional testimony, but current-year estimates have faded in recent months.

On 6/20/25, analysts estimated that the S&P 500 Financials Index would see year-over-year (y-o-y) earnings growth of just 3.34% in 2025, down from 7.20% on 12/27/24. As we see it, stalling earnings growth rate estimates reflect the reduced number of interest rate cuts expected in 2025. On 6/20/25, the federal funds rate futures market revealed that investors expected just two rate cuts through December 2025, down from three cuts on 3/31/25.

The total returns for the four indices in today's chart from 7/9/24 – 6/20/25 were as follows:

S&P 500 Banks GICS L2 Index: 24.84%

S&P 500 Financials Index: 22.12%

S&P Regional Banks Index: 19.41%

S&P 500 Index: 8.37%

Takeaway

As today's chart reveals, U.S. banking and financial institutions continued to outperform the broader S&P 500 Index in the wake of Powell's testimony last year. That said, current-year earnings data hints at potential headwinds. In June, analysts revealed that earnings for financial firms are estimated to grow more slowly in 2025 than what was reported in December 2024. Even so, investors appear to be discounting for a more accommodative Fed and continued normalization of the Treasury yield curve. In our view, historical inflation data lends support to this view. While the Fed would like to see inflation below 2.0%, the metric averaged 2.6% over the 25-year period ended May 2025. Furthermore, while current-year earnings estimates for Financials have come down, estimates for 2026 earnings per share are higher today than at the start of the year. As always, risks in the form of economic deterioration, protracted international wars, and the potential for restrictive lending standards remain. We will report back as developments warrant.