Market Commentary Blog

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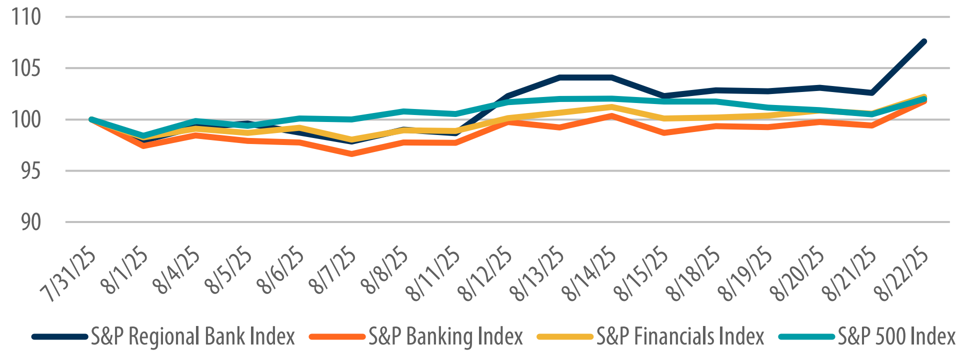
Financial Exuberance?

Price Returns 7/31/25 – 8/22/25



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 expected) 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 from 7/31/25 to 8/22/25. We changed the time frame covered by today's post (from previous versions) to cover recent and more relevant changes in interest rate expectations. Please click here for our last post on this topic.

The federal funds target rate has been stagnant this year, unchanged from 4.50% where the Federal Reserve ("Fed") set it back in December 2024.

Forecasting changes in Fed policy rates is notoriously difficult, especially during periods of economic volatility. That said, Jerome Powell's comments at the Fed's annual symposium in Jackson Hole on 8/22 have investors increasingly certain of a September rate cut. At the end of July, the federal funds rate futures market implied a 39.8% likelihood of a rate cut at the Fed's next meeting in September. That figure surged to 81.3% in the wake of Powell's commentary.

For a myriad of reasons, interest rate policy may have an outsized impact on financial firms.

Take the banking sector, for example. Many banks (especially smaller, regional ones) earn significant profit on the spread between interest paid to depositors and the (generally greater amount of) interest earned on loaned assets. As Fed policy rates decline, that spread can increase, leading to improved financial conditions for these banks. Notably, the S&P Regional Bank Index is the top performer among the Indices covered in today's chart. This phenomenon may not always hold for larger, over-capitalized banks that hold excess reserves at the Fed, since a declining federal funds target rate often equates to decreasing profitability on those reserves. We believe this is reflected in the chart. While still positive over the time frame, the broader S&P 500 Banking Index was the worst performer among today's set of observations.

Earnings estimates for the S&P 500 Financials Index improved substantially since our last post.

On 8/22/25, analysts estimated that the S&P 500 Financials Index would see year-over-year (y-o-y) earnings growth of 7.42% in 2025, a substantial improvement from 3.34% on 6/20/25 (data from our last post on this topic).

The total returns for the four indices from 7/9/24 – 8/22/25 were as follows (note - the starting date for this metric goes back to 7/9/24, which coincides with our previous posts on this topic).

S&P 500 Banks GICS L2 Index: 37.59%	S&P Regional Banks Index: 36.93%	S&P 500 Financials Index: 30.34%	S&P 500 Index: 17.66%

Takeaway

As today's chart reveals, each of the Indices we track saw prices increase in the wake of Powell's comments last week. Regional banks fared the best, surging by 7.62% (price return) over the period, followed by the S&P 500 Financials Index at 2.22%. From our perspective, investors are likely discounting for a more accommodative Fed and continued normalization of the Treasury yield curve. As mentioned above, we expect declining short-term rates to usher in a period of increasing profitability for regional banks and financial institutions. Additionally, current-year earnings estimates for Financials have recovered since our last post, with the sector's estimated earnings per share 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.