Market Commentary Blog

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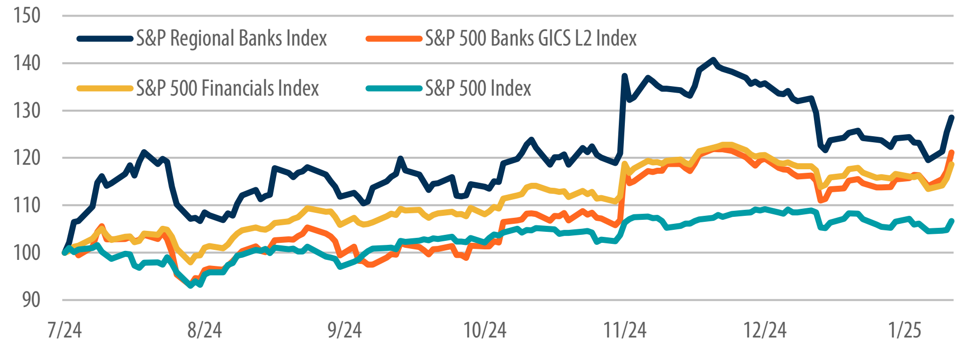
Financial Exuberance?

Price Returns 7/9/24 - 1/15/25



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

View from the Observation Deck

Like many of you, we have been closely watching the economic impact of changing policy rates (real or implied) in the U.S. over the past several years. We even wrote several pieces highlighting the effect of these changes on the broader equity markets (click here for a recent example). For today's post, we will investigate the influence of these policy changes on a smaller subset of the equity market, namely the banking and financial sectors. To do so, we plotted 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 Chairman Jerome Powell's testimony to Congress that the U.S. economy no longer appeared to be "overheated".

Powell's initial comments sent interest rate expectations sharply lower. By the end of the year, however, implied interest rates surged amidst stronger than expected economic data.

On 7/8/24 (the day of Powell's address), the federal funds rate futures market implied that the federal funds target rate would decline to 4.67% by 1/29/25. For comparison, the federal funds target rate (upper bound) stood at 5.50% that same day. The market adjusted quickly in the wake of Powell's comments. On 9/30/24, the same market predicted the federal funds target rate would decline to 3.82% by 1/29/25. These expectations waned in the months since, challenged by better-than-expected economic data, stubbornly high inflation, and persistent consumer spending. As of 1/16/25, the futures market implied that the federal funds target rate would decline to 4.32% on 1/29/25. For comparison, the federal funds target rate (upper bound) was 4.50% on 1/16/25.

On 9/4/24, after 783 consecutive days, the longest yield curve inversion in U.S. history ended.

At market close on 9/4/24, the yield on the benchmark 10-Year U.S. Treasury Note (T-note) closed at 3.76%. Notably, the yield on the 2-Year T-note also stood at 3.76% that day, marking the end of the longest yield curve inversion in U.S. history. As many investors are likely aware, a "normal" yield curve is one where investors demand a premium to lend assets over longer time frames. When the yield curve is inverted, shorter dated maturities command a higher premium than longer dated ones. This situation is particularly trying for companies in the financial and banking sectors, who earn profit by borrowing money from the Federal Reserve at short term rates and lending it to customers over longer terms. Understandably, as the yield curve normalized, banks' expected profitability increased.

Earnings estimates for the S&P 500 Financials Index underwent substantial upward adjustments in the wake of Powell's Congressional testimony.

On 1/17/25, analysts estimated that the S&P 500 Financials Index would see calendar year earnings growth of 14.30% in 2024, up substantially from when earnings were estimated to grow by just 6.86% on 7/5/24. Notably, the lion's share of this increase can be attributed to surging earnings estimates for banks and financial services companies. On 1/17/25, analysts estimated an earnings growth rate of 3.18% for banks and 20.37% for financial services companies in 2024, up from -5.22% for banks and 12.39% for financial services on 7/5/24.

The total returns for the four indices in today's chart from 7/9/24 – 1/16/25 were as follows:

S&P Regional Banks Index: 29.26%
S&P 500 Banks GICS L2 Index: 22.46%
S&P 500 Financials Index: 20.27%
S&P 500 Index: 7.18%

Takeaway

From our perspective, the yield curve's normalization in the wake of Powell's testimony was a significant catalyst to the banking and financial services companies that comprise the S&P 500 Financials Index. Case-in-point, valuations surged amid a rapid recalculation of earnings estimates for these companies (see above). Notably, the S&P 500 Financials Index has been the top performing subsector in the broader S&P 500 Index, posting a total return of 20.27% between 7/9/24 (the day after Powell's testimony to Congress) and 1/16/25. For comparison, the Communication Services and Information Technology Sectors, which were the top performers in 2024, posted total returns of 8.68% and -0.03%, respectively, over the same period. That said, risks in the form of economic deterioration and the potential for restrictive lending standards remain. We will report back as developments warrant it.

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.