

2026-9-24

ZCO

Financial stocks are falling as rates rise. Why that's a problem for the broader market.

Story by Michael Kramer 2026-9-23

The Fed's current rate-hiking cycle may not usher in a prosperous period for bank stocks as interest rates rise and the yield curve flattens, which could be a problem for the broader stock market. *Note*

While the 10- and 30-year rates have gotten all the attention, the real show is happening at the front of the yield curve — the spread between longer-term and shorter-term yields — with the 2-year yield climbing even more than the 10-year. *Note*

It is easy to see; just look at the spreads between the 10-year and the 2-year. The spread has narrowed to just 21 basis points (0.21 percentage points), compared with more than 70 basis points before the U.S.-Iran war started.

This could significantly affect financial stocks, as higher rates could slow loan growth and raise banks' funding costs, while a flatter yield curve could pressure net interest income, all of which could negatively impact bank earnings. Net interest income is the spread between what a bank receives in interest payments on loans and what it pays out in interest on deposits. *Note*

And that matters for not only for the broader stock market, but also for the economy. If banks pull back on providing loans because they become unprofitable, companies will have less capital available to them to grow their businesses and consumers will have a more difficult time borrowing money to spend.

The flatter curve impacts

While investors cheer the S&P 500's recent gains and moves toward record highs, the Financial Select Sector SPDR Fund is almost 6% off its highs. The sector's decline began on Sept. 4, the day the market received the strong August jobs report. From there, the bond market started to take the Fed seriously as it neared a rate hike.

It is no surprise that banks have struggled, as the XLF ETF has traded closely with changes in the yield curve over the past three years, and even longer, depending on how far you want to look. The 5-year Treasury rate minus the 2-year Treasury rate shows that the XLF ETF has moved right along with changes in the yield curve over time.

Financials could face a considerably challenging period if the Fed hikes more in the coming months, which seems likely given the hawkish outlook the Fed laid out through its "dot plot" and press conference, and the current path of inflation.

Financials may head lower

Currently, the spread between the 5-year and the 2-year is only 9 basis points, so an inversion of the yield curve — when shorter-term rates rise above longer-term rates — is a strong possibility, and it could mean the decline in the XLF is not over. Note

Read more: [The bond market is flashing a warning for stocks. These sectors are already wobbling.](#)

The technical chart shows that the XLF ETF is vulnerable to further downside. It recently found support at a technical gap created on July 2, around \$55. The 100-day moving average also sits near that level. For now, the ETF is bouncing off those two support levels. However, the ETF has also broken through an uptrend that formed off the March 2026 lows and has been seeing strong resistance at the 10-day moving average.

If the U.S. yield curve flattens further, the ETF and the sector could fall, with the ETF potentially dropping to its next major support level at \$53.25, which also coincides with the 200-day moving average.

Really, what financials need is for the yield curve to stop flattening, or a break in the economic data that causes the Fed to back off rate hikes. However, given that the Fed has only started hiking and inflation shows no signs of backing off, the prospect of the Fed pausing rate hikes appears limited.

Ultimately, how far the financial sector will decline will largely depend on the yield curve, and with the hiking cycle still in its early innings, the curve appears to be headed toward an inversion.

Michael Kramer is the founder of Mott Capital Management and a long-only investor focused on macroeconomic themes. He analyzes long-term macro trends and short-term market risk using technical analysis, fundamentals and options-market positioning. [See here for further disclosures.](#)