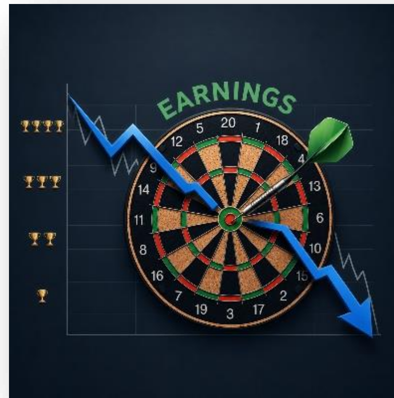
INSIGHTS

July 2, 2026



Earned, not Awarded

by Ryan Seale, BBA, CIM – Chief Investment Officer with PMI

The new Fed Chair and what the market is pricing

Kevin Warsh's first FOMC meeting as Fed Chair on June 17 left the funds rate unchanged at 3.50-3.75% in a unanimous 12-0 vote, but the message underneath the hold was hawkish. The committee's Summary of Economic Projections pushed the median end-2026 rate projection up to 3.8% from 3.4% in March. A count of the SEP's own dot plot shows nine of the eighteen participants who submitted projections favoring at least one hike this year, eight favoring a hold, and one favoring a cut. Warsh himself did not submit a projection, a deliberate break from the practice of every participant filing a dot. The market has repriced accordingly. As of 2 July, CME fed funds futures assign only a 22.4% probability that the funds rate is still at 350-375bp after the December 9 meeting, implying a 77.6% chance of at least one hike by year-end, with a 35.6% probability on two or more. The distribution has centered on a single 25bp hike, priced at 41.9%.

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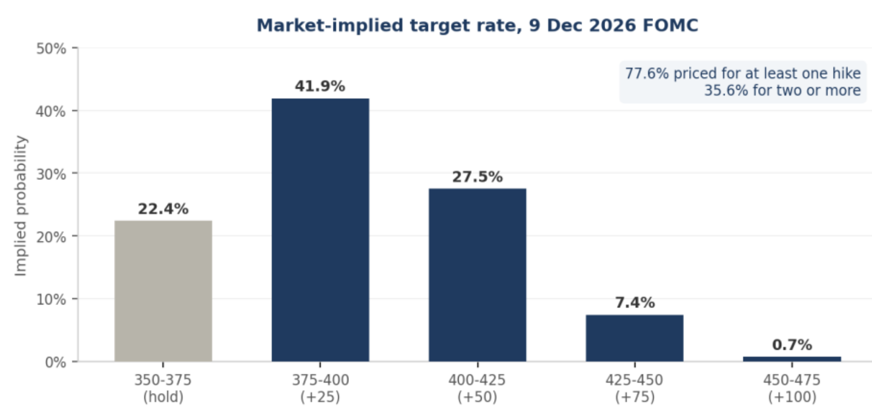
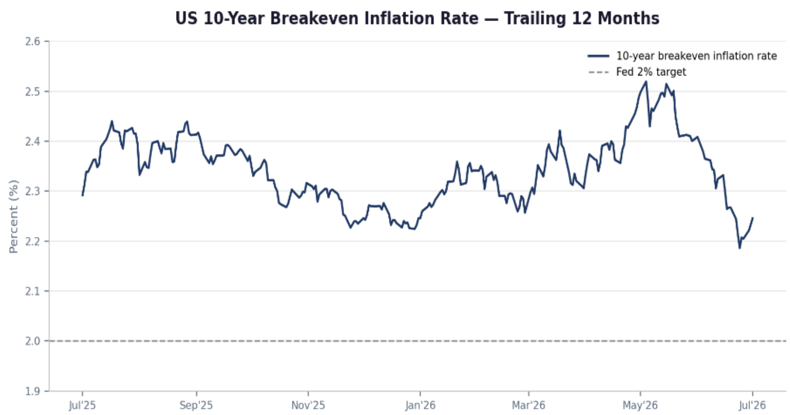
Exhibit 1



CME market-implied probability distribution for the fed funds target rate after the 9 December 2026 FOMC, as of 2 July 2026.

Why higher rates aren't automatically bad news

Exhibit 2



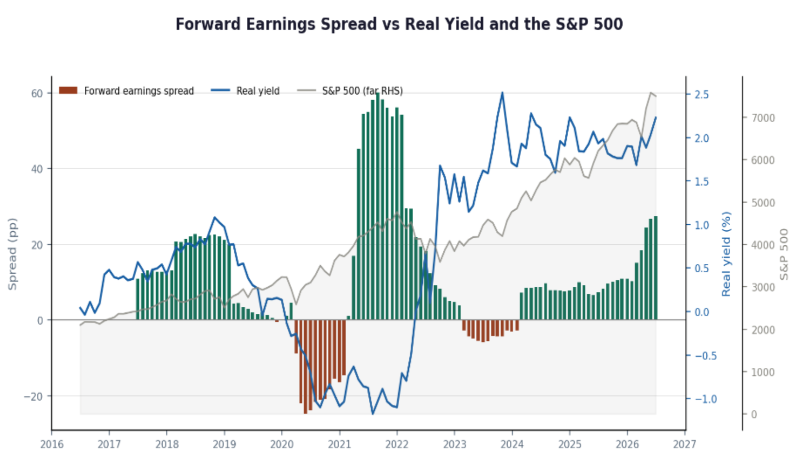
US 10-year breakeven inflation rate (USGGBE10), daily, trailing twelve months to 30 June 2026, versus the Fed's 2% target. Source: Bloomberg.

A hiking Fed is not, by itself, a reason to de-risk. What matters for equities is not the direction of nominal rates but the composition of the move, specifically whether it's being driven by rising real yields or by inflation expectations coming unanchored. Real yields rising on their own reflect the market pricing a higher cost of capital against a still-intact growth and inflation outlook; breakevens blowing out would signal the market losing confidence in the Fed's ability to hold the line. As of the latest data, 10-year real yields sit at 2.226%, near the top of their ten-year range, against a 10-year breakeven ***(Exhibit 2)*** that has held in a tight 2.19%-2.52% band over the past twelve months and shows no sign of accelerating despite the Iran-driven energy shock and the hawkish repricing since Warsh's confirmation. Essentially all of the recent move in nominal yields has come through the real-rate channel, not through inflation psychology. And the growth side of any stagflation worry is not in the data either: Q1 GDP came in at 2.1%, accelerating from 0.5% the prior quarter. That is the difference between a healthy repricing of the discount rate and a genuine stagflationary scare, and it is why the right question for equities isn't “are rates rising” but “is earnings growth outrunning that higher discount rate.”

What the forward spread is telling us

The forward spread as we use it here, is the gap between the growth the market expects from forward earnings and the real yield it must discount them at, a single read on whether earnings optimism is outrunning the rising cost of capital. The key consideration is not its level, but how it moves relative to real yields. Looking back over the last 10 years ***(See Exhibit 3)***, periods when the forward earnings spread has widened alongside rising real yields i.e., earnings optimism outpacing the increase in the discount rate, have generally lined up with a more constructive equity backdrop, as have periods when both fell together. The precarious setup is the divergence: the forward spread compressing while real yields

Exhibit 3



Forward EPS spread versus the real yield and the S&P 500, monthly to 30 June 2026, from June 2016. Source: Bloomberg/PMI.

climb, earnings optimism fading just as the discount rate becomes a bigger headwind. As of June 2026 we are in the constructive camp. The forward spread has widened from 18.5pp to 27.4pp over the trailing three months even as real yields moved higher, earnings momentum outrunning the rate pressure rather than losing to it. This is a directional read rather than a back-tested signal, one input among several, and we would flag a change in that direction, the spread beginning to narrow as yields rise, as the signal worth watching from here.

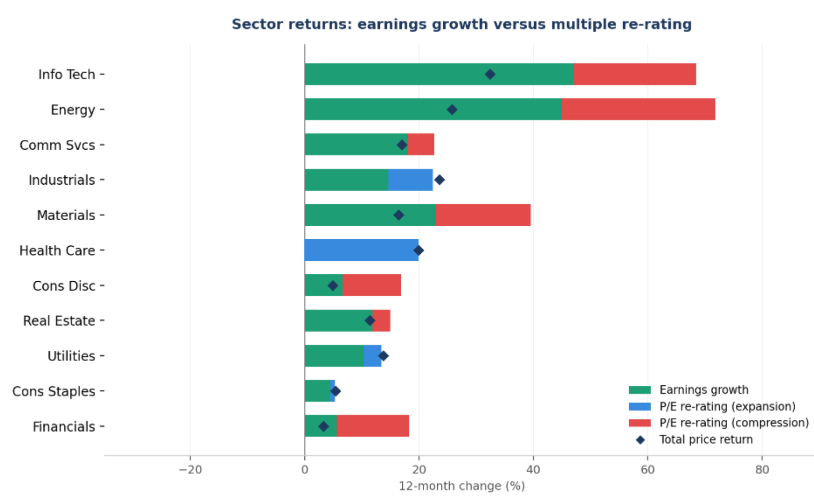
From the index to the sectors

The forward spread answers the top-down question: at the index level, earnings momentum is outrunning a rising discount rate, which keeps the environment constructive for equities even with the Fed leaning hawkish. But a constructive index masks a wide dispersion underneath it, and that is where the return actually accrues. The same twelve months that produced a healthy market produced very different outcomes sector by sector, and the difference is not who rose most, but who earned their rise. From here we turn our focus to the sectors, decomposing each one's return into the growth in its expected earnings and the multiple the market paid for them, to separate the sectors that were rewarded for that growth from those that were denied it, and both from the ones paid for growth they did not produce.

Earned, not awarded: decomposing the sector returns

A sector's price return over the year is driven by two factors: the growth in its earnings and the change in the valuation multiple applied to those earnings. Here, earnings refer to the consensus forward estimate, so earnings growth reflects analysts revising their forecasts higher, typically in response to stronger than expected results and company guidance. Because price is just earnings times the multiple, the two account for the whole move. ***Exhibit 4*** runs that split across all eleven sectors, and it tells the same story as the index. This was a market that rose on earnings, not on a willingness to pay more for them. Ten of the eleven sectors grew their forward earnings, and in most cases the multiple actually fell while the price rose, the market banking the earnings and marking down what it would pay at the same time. Health Care is the lone exception, its price rose purely because the multiple expanded, on earnings that barely moved. The interesting names are the cyclicals. Materials, Financials and Energy all grew earnings materially and were handed heavy multiple compression in return, they did the work and the market withheld the reward. That withheld reward is what a rotation is there to collect, but only where the earnings are durable and the macro is not the reason the multiple fell in the first place.

Exhibit 4

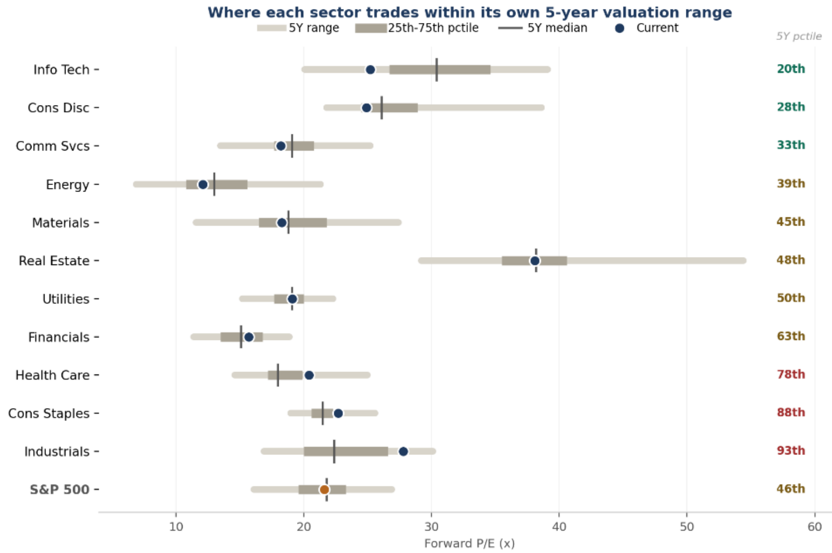


Twelve-month GICS sector return decomposition into growth in the consensus forward EPS estimate and P/E re-rating; bar lengths show each component's own 12-month change, and the diamond marks the exact total price return. Weekly data twelve-month window to the week ending 26 June 2026. Decomposition via (1 + price) = (1 + EPS growth) × (1 + P/E change). Source: Bloomberg/PMI.

Valuation: how much is already priced in

A withheld reward is only worth chasing if the sector is not already expensive to begin with. ***Exhibit 5*** places each sector's current multiple against its own five-year range, which sidesteps the question of whether a sector is structurally dear and asks a simpler one: is it dear relative to where it usually trades? Most sit in the middle of their own range. Materials sit almost exactly on its five-year median, so the compression has left it at fair value, not distress, and a reversal, if it comes, would not require paying up. Technology is the surprise; it has led the market all year yet trades near the bottom of its own five-year range. At the other end, Industrials and Consumer Staples are the genuinely expensive names, both near the top of their ranges with little room left.

Exhibit 5

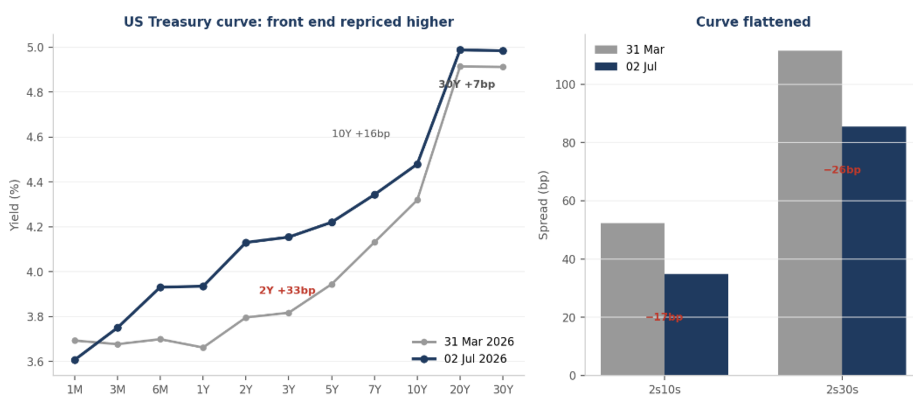


Current forward P/E versus five-year range by sector: full range, interquartile band, median, and current multiple, with the percentile rank. Bloomberg weekly data; five-year window to the week ending 26 June 2026. Percentile = share of weekly observations below the current multiple. Source: Bloomberg/PMI.

The macro overlay: a bear flattener

One more input has to be laid over the screen, because it exists to separate compression that is temporary skepticism from compression the macro justifies, deciding which denied multiples are worth owning and which are traps. The rate move since the March quarter-end is a bear flattener: the curve from two years out to thirty has sold off, the front end far more than the back ***(See Exhibit 6)***. The two-year yield has risen 33 basis points to 4.13% while the ten-year rose 16 and the thirty-year just 7, compressing the 2s10s spread from 52 to 35 basis points. The rate-sensitive sectors feel this two ways. For the bond proxies, Utilities and Real Estate, the headwind is the rising level of yields: their income competes with a two-year now paying 4.1%, and their long-dated

Exhibit 6



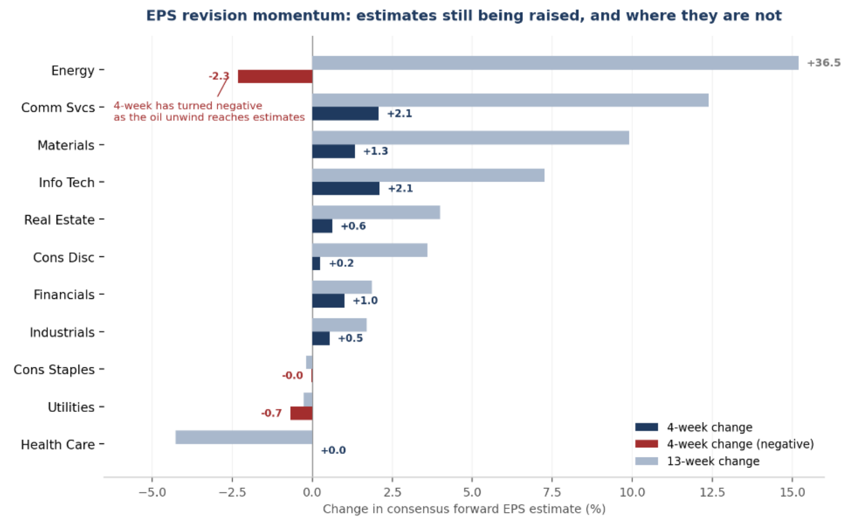
US Treasury curve, 31 March versus 2 July 2026, and the compression in the 2s10s and 2s30s spreads. Bloomberg, US Treasury actives curve, mid YTM, as of 2 July 2026. Source: Bloomberg/PMI.

cash flows are discounted harder. For the banks, it is the flattening itself, because they fund short and lend long, so a compressing spread squeezes the margin directly. Either way the rate-geared sectors carry the headwind from here, while the sectors that answer to demand rather than to the curve do not. One reading note: this is a three-month rate development laid over twelve-month evidence. Over the trailing year the bond proxies' multiples actually held up, Utilities' even expanded, while the cyclicals compressed, because that compression was earnings skepticism, not rates. The overlay is about what the curve does from here, not what explains the past year's de-rating.

Where the rotation actually pays

The bear flattener splits the field: a headwind for the rate-sensitive sectors, a non-event for those geared to demand. The same strong economy that keeps the Fed restrictive is the economy that drives the demand-geared cyclicals, so for them the regime is a tailwind read through activity even as it is a headwind read through rates. The rotation worth owning is a denied multiple in a sector the curve leaves alone. The catalyst, where there is one, is the revision trend itself: estimates still being raised are what pull price back toward earnings and ***Exhibit 7*** shows where that trend stands. ***Exhibit 8*** sorts every sector on the combined test; the paragraphs below draw out the calls that matter.

Exhibit 7



EPS revision momentum: change in the consensus forward EPS estimate over the trailing 4 and 13 weeks, by sector. Bloomberg weekly data to the week ending 26 June 2026. Energy's 13-week surge predates the oil unwind; its 4-week change has turned negative. Source: Bloomberg/PMI.

Exhibit 8

Sector Opportunity Ranking

Combined decomposition, valuation and macro view | Bloomberg, weekly to the week ending 26 June 2026

#	Sector	Verdict	Price %	EPS %	P/E chg %	Gap	5Y val	Rationale
BEST - BUY THE REVERSAL								
1	Materials	Buy	+16.4	+39.5	-16.6	+23.1	45th	Wide denial, sits on its 5Y median, demand-geared with the ISM in expansion a sixth straight month and input prices easing. The cleanest.
2	Cons Disc	Buy	+4.9	+16.8	-10.2	+11.9	28th	Denied and cheap. Price faded so the gap widened; falling gasoline aids the consumer.
3	Comm Svcs	Buy	+17.0	+22.7	-4.6	+5.7	33rd	Multiple has flipped to compression in recent weeks; now cheap with the strongest clean revisions.
SPECIAL CASES								
4	Info Tech	Hold+	+32.4	+68.5	-21.4	+36.1	20th	Cheap in its own range, but rewarded not denied. A leadership trade, not a reversal.
5	Financials	Split	+3.3	+18.3	-12.7	+15.0	63rd	Buy via the non-bank lines; hold the banks, already paid at the 87th pctile of their own range (Figure 9).
WORST - AVOID								
6	Health Care	Avoid	+19.9	-0.1	+19.9	-20.0	78th	The inverse trade. Re-rated 20% on flat earnings, richened, estimates still cut.
7	Energy	Avoid	+25.8	+71.8	-26.8	+46.0	39th	Screens best on the gap, but the 4-week revision has turned negative as the oil unwind reaches estimates.
8	Industrials	Avoid	+23.5	+14.6	+7.8	-8.9	93rd	Already rewarded (multiple expanded) and the most expensive sector in its own range.
9	Cons Staples	Avoid	+5.4	+4.5	+0.9	-0.9	88th	Slowest earnings, multiple expanded. Nothing denied, nothing to release.
10	Real Estate	Avoid	+11.4	+15.0	-3.1	+3.6	48th	Minimal denial at a mid-range valuation, and long-duration cash flows carry the level headwind.
11	Utilities	Avoid	+13.7	+10.4	+3.0	-3.3	50th	Nothing denied, the multiple expanded, and the rising front end competes directly with its yield.

Sector opportunity ranking, combining the return decomposition, five-year valuation percentile and the rate overlay, weekly data as of the week ending 26 June 2026. Gap = growth in the consensus forward EPS estimate minus price return. Tier order reflects combined judgment across the four criteria, not a sort on any single column. Source: Bloomberg/PMI.

The buys are Materials, Consumer Discretionary and Communication Services.

Materials is the clearest of the three. Its earnings ran well ahead of its price over the year, it trades right at its own five-year median, and demand is holding up: June's ISM marked a sixth straight month of manufacturing expansion, just off May's four-year high, with input-price pressure easing as the prices index fell nine points. Because the sector tracks the economy rather than interest rates, the hawkish Fed does not work against it. The one caveat is that the case depends on the industrial recovery holding up. Consumer Discretionary is a similar story on a smaller scale: earnings outpacing price, a cheap valuation, and cheaper gasoline putting money back in the consumer's pocket. Communication Services is the newcomer, and the reason is recent: its multiple has flipped from expanding to compressing, its valuation has come in, and analysts are still raising their earnings estimates, which is what now qualifies it as a buy.

Information Technology sits apart from the buys.

Information Technology looks cheap against its own history, trading below where it stood in roughly four of every five weeks over the past five years. But cheap on valuation is not the same as denied on earnings: unlike Materials, Tech has already been fully rewarded in price, up more than 30% over the year, the market has already paid for its growth. That makes Tech a bet on whether its leadership continues, a different question from the one this framework is built to answer. Financials needs a section of its own, because the sector-level verdict and the sub-industry reality pull in different directions.

A closer look at Financials

Financials warrant a closer look, because the sector-level call and the sub-industry reality diverge more here than anywhere else, and they diverge along exactly the axis this note is built on. The sector was denied along with the rest of the cyclicals and its estimates are still rising, which argues for a buy. But split it into its five GICS industry lines, in ***Exhibit 9***, and the opportunity is not where the rate story would put it.

Exhibit 9

Financials by Industry

Decomposition, revision and valuation, weekly to the week ending 26 June 2026

Industry	Verdict	Price %	EPS %	P/E chg %	Gap	5Y val	Rationale
Insurance	Buy	-1.2	+19.6	-17.4	+20.9	8th	8th percentile of its 5-year range; earnings delivered per consensus, price flat; float gains from higher yields.
Diversified Fin.	Buy	-7.5	+9.5	-15.5	+17.0	15th	Denied multiple, near the bottom of its own range, estimates still rising.
Capital Markets	Buy	+1.0	+17.7	-14.2	+16.7	59th	Earnings growth delivered against a compressed multiple; mid-range valuation, little curve exposure.
Consumer Finance	Watch	+3.8	+41.6	-26.7	+37.8	75th	Cheap on the gap, but valuation is full and estimates are still repairing a cut taken a quarter ago.
Banks	Hold	+21.9	+23.3	-1.2	+1.4	87th	Already paid: multiple barely moved. Expensive on own history, and the flattener is the risk from here.

Financials by GICS industry (mortgage REITs excluded): twelve-month decomposition, denial gap and five-year valuation percentile, weekly to the week ending 26 June 2026. The banks are already paid and expensive; the denied multiple sits in the non-bank lines.
Source: Bloomberg/PMI.

The banks are the sector's rate-sensitive component, and they are the one part with no opportunity left. They rose 22% on 23% earnings growth, so the multiple barely moved; they were paid almost exactly for what they delivered, and at the 87th percentile of their own five-year range they are expensive on their own history. On top of that already-full valuation sits the risk the flattener poses to net interest margin, a risk that has not yet shown in their still-rising estimates. Paid, expensive, and carrying the most direct rate exposure in the sector, the banks are a hold.

The denied multiple the framework hunts for sits in the non-bank lines, none of which lean on the curve the way the banks do. Insurance is the clearest: earnings up 20% while the price went nowhere, a 17-point multiple compression that leaves it at the 8th percentile of its own range, cheaper than in more than nine-tenths of the past five years, with estimates still rising and float that earns more, not less, as yields climb. Capital markets and diversified financials tell the same story of earnings delivered into a compressed multiple, at the 59th and 15th percentiles. Consumer finance screens cheap on the gap but is the one line we would leave aside, its valuation already full at the 75th percentile and its estimates still repairing a cut taken a quarter ago.

So the Financials call is not simply to avoid the sector because higher rates pressure the banks. It is to own the non-bank industries, where earnings have been delivered but valuations have yet to reflect them, while holding the banks, which have already been rewarded, look expensive, and face the sector's clearest rate headwind. That distinction matters in practice: a cap-weighted sector ETF puts the banks back into the mix, so the view is better expressed through the industry groups than the sector as a whole. This is the only point in the note where looking below the sector level changes the conclusion. We looked because Financials is the only sector split cleanly by interest-rate exposure. What emerged was a valuation gap large enough to change the investment case, with banks trading near the top of their historical range while the non-bank industries sit much closer to the bottom. Other sectors also contain internal differences, but none combines them with such a clear rate divide, which is why the sector-level view remains appropriate everywhere else.

The avoids divide into two kinds. The first is the already-paid. Health Care rose on a higher multiple while its earnings went nowhere and are still being cut, the opposite of what we want to own. Industrials and Consumer Staples are simply expensive, trading near the top of their own ranges with nothing held back to release. Industrials benefits from the same factory strength that helps Materials, the four-year high in activity is real, but unlike Materials that strength is already in the price, sitting at the top of its five-year range rather than the middle. The demand call and the valuation call point opposite ways, and here the valuation wins. Utilities and Real Estate round out this group for a different reason: neither was meaningfully denied, and both carry the level headwind the overlay describes. The second kind is more instructive, and Energy is the example. On the numbers it looks like the best opportunity in the market, huge earnings growth against a collapsed multiple. But those earnings were built on the wartime oil price, and that price is now unwinding: Brent has fallen by slightly more than a third from its March peak as Gulf shipping resumed, and Energy's own share performance has already begun to roll over. The estimates are only beginning to adjust: the 13-week revision still shows the old surge, but the 4-week change has already turned negative (Figure 7), the first cuts arriving. It is the one sector a mechanical screen would buy and judgment has to refuse.

Bringing it together

The two readings point to the same conclusion. At the index level, the forward spread is widening even as real yields rise, keeping the backdrop constructive despite a hawkish Fed. This is a rotation view, identifying the sectors most and least attractive from here under the current macro backdrop, not a blueprint for building a portfolio from scratch, where diversification and long-term factor exposure still argue for owning some of what the rotation would underweight.

At the sector level, the best opportunities are where earnings have grown but valuations have yet to catch up, provided the macro is not the reason for that discount. That leads us to Materials, Consumer Discretionary and Communication Services as buys, while Health Care, Energy and the rate-sensitive bond proxies remain avoids in the current environment. Financials is the exception that rewards a closer look: the opportunity lies in the non-bank industries, where earnings have been delivered into lower valuations, while the banks remain a hold after already being rewarded and now facing a flatter yield curve. The same falling oil price that supports Materials and the consumer weighs on Energy, while the same hawkish rate backdrop leaves demand-driven sectors largely unaffected but continues to pressure the banks. The screen identifies the candidates; the macro, and sometimes the detail beneath the sector, determines which ones are worth owning.

Market Update - 9 July 2026

This note was originally prepared using market data through 2 July 2026. Since then, developments in the Middle East provide a live test of the framework in this note and warrant one adjustment to our sector views.

On 7 July, Iran struck three commercial vessels in the Strait of Hormuz. The United States responded with strikes on Iranian targets over the following two nights, and on 8 July the ceasefire was declared over, the naval blockade was reinstated, and the waiver on Iranian oil sales was withdrawn. Brent crude subsequently moved higher to around $77 per barrel.

The key question is whether this escalation changes the broader market framework outlined in this note. At this stage, the answer is no. The central argument was that the recent rise in yields was being driven primarily by higher real rates rather than a renewed inflation shock. The market's response to the oil move provides an important test of that view.

The 10-year inflation breakeven rate, the indicator we identified as the key risk to monitor, increased only modestly, from 2.23% on 30 June to 2.27% on 9 July. It remains approximately 25 basis points below the upper end of its twelve-month range. Inflation expectations therefore remain well anchored despite a renewed geopolitical shock and higher crude prices.

This supports the original conclusion that the move higher in yields has been primarily a real-rate story, rather than a reacceleration in inflation expectations.

The main adjustment is to our Energy sector view. The previous cautious stance toward Energy was based on the expectation that the Gulf risk premium would continue to unwind and that oil prices would remain under pressure. That assumption has changed. With crude prices now reflecting renewed geopolitical risk, we move Energy from avoid to neutral, pending clarity on the conflict path. The sector is now more dependent on the path of the conflict than on the earnings revision trends that previously guided our view.

The impact on other sectors is more limited. The potential consumer benefit from lower gasoline prices is likely delayed rather than reversed, while the broader valuation framework, sector rotation analysis, and Financials outlook remain unchanged. The forward-spread signal also remains intact, as the analysis is based on monthly data through 30 June. July data will provide the first monthly reading on whether the spread is still widening alongside rising real yields, as the constructive case requires, or beginning to narrow, the divergence we flagged as the signal to watch. PMI