Research @ Citi Podcast, Episode 61: Bullish with a Seatbelt — Risk Assets and Investment Themes for 2026

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Transcript:

Rob Rowe (0:00)

Hi everyone. I'm Rob Rowe, U.S. Regional Director of Research. Welcome to our Research @ Citi podcast. My guest, which I'm very excited about today, is Lucy Baldwin, who is the global head of Citi Research. Lucy, welcome to the podcast today.

Lucy Baldwin (0:16)

Thanks, Rob. Great to be on our own podcast.

Rob Rowe (0:18)

Yeah, isn't this exciting? And we're going to be talking about our investment themes for 2026, and also about risk assets in general, too, because I think that's on everyone's minds. Before we get started, maybe you can give me an idea of what you think and what our research thinks about the backdrop for 2026. Because maybe we should set context, just as a monologue in the beginning of a Shakespeare play. Let's set the scene about what 2026 is going to look like, because that'll actually predicate what we're going to think about all these assets and the themes for 2026.

Lucy Baldwin (1:03)

It's hard to think about 2026 without thinking about what's gone before, right? And we've had this kind of everything rally this year. Credits rallied, equities have rallied, gold's rallied 60%. It's quite an extraordinary year. And as you say, when you think about then how risk assets might perform into 2026, it's somewhat of a conundrum. I talk to a lot of equity investors who sit there thinking, "Gosh! Is there any way the S&P can have another blockbuster year after printing several good years already?" It would be quite unusual for it to extend gains into 2026 just based on history alone.

But of course that's exactly what we think, and many people think. And to some degree, Rob, we've talked a lot about how this year has been the year of resilience for the global economy. We obviously had an awful lot of excitement around the new administration and the various policy pillars that came in: fiscal, tariffs, immigration, deregulation, and what that would mean in terms of the mix of growth and inflation, and therefore what

would happen to policy rates around the world. And essentially, although everybody expected this year to see some softening in growth and some stickiness in inflation, particularly in the U.S. on the back of the tariffs, it has been a remarkably good year for the U.S. economy.

But I think the thing that we're all grappling with has been this notion of a jobless boom in the U.S. And so although we've seen good growth, a lot of the growth in the U.S. economy, as you know, has been underpinned by the many investments and capex that's gone into the AI boom. And that has probably masked some underlying weakness in the consumer in the U.S. And I think everybody's pretty concerned about the health of the consumer, about the health of the jobs market, as we go into next year.

And we do indeed think that the Fed will be suitably concerned. Certainly we think they will be concerned enough to put through two more cuts in the early part of 2026. And then that gives us this concept of cutting into what we think will be a resilient economy because obviously you've got things like impacts of One Big Beautiful Bill tax cuts coming into the first part of next year and various other things that are going to help the consumer in terms of feeling a little bit better off, hopefully.

So the net effect of all of this is we think you've got a reasonably resilient/growing economy in the first part of next year. Globally as well, by the way. We think it'll be a resilient economy as well, and you've still got that central-bank stimulus coming through. And that is one of the reasons we've got conviction that things will be pretty good from a risk-asset perspective.

I think when you think about the S&P, one of the big questions is the earnings growth and how resilient that corporate earnings growth can be. But again, as you know, we think that the AI trade has further to run. We think that the investments that have been made there, although there's many questions about the leverage starting to build in the system, we feel that long term you are going to get productivity benefits. You will see a number of companies in the corporate sector seeing genuine efficiencies, genuine savings, genuine revenue synergies as well.

That means for us, we're quite bullish in terms of corporate profits. And that's really the source of the upside. So, we've got double-digit upside again, 7,700 target for the S&P next year. And that's really predominantly driven by those strong earnings growth numbers that we expect to see coming through next year.

So it's really quite an extraordinary year that we think we're going to see again, Rob. But I would say the one area where we would suggest some caution because of all of these risks that are on the horizon, and we can talk about more, is to hedge. And we think one of the best ways to hedge that equity risk is with credit. Because we do feel that on the credit side, it's fair to say that although equities and credit have become increasingly

interconnected, that distribution of possible outcomes from the AI boom is probably going to be skewed more negatively for credit relative to equity.

So we would think about that. Because clearly, if you saw more AI in credit, it means that the AI companies are issuing more debt, and that's probably not going to be a good thing for credit.

Rob Rowe (5:32)

When we look at the equity markets in general ... it's interesting because what you're also citing is that our fixed-income markets might be under pressure, either on the credit side or even on the public-debt side, because there are considerations there, which we can talk about in a second. But when we think about the U.S. equity markets, how is it going to play out this year?

I mean, obviously last year AI was a big driver of equity returns. It was concentrated among some very large stocks, and it was also predicated a lot on enormous capex, which was cash-driven. How will that be different in this coming year?

And also, another consideration early on last year was that we were really overemphasizing or over-allocating more to the European equity markets. And I don't think we're doing that as much this time, but we seem to be fairly bullish on all three regions if you think about Asia, Europe, and the U.S.

So how do we differentiate there? But also, how are we looking at the U.S. equity markets in terms of returns?

Lucy Baldwin (6:39)

It's a good question, Rob, because I think you're right. We think you can have your cake and eat it, right? We think you can stay long U.S. tech and U.S. growth names, because we actually think when you look at the Mag 7, there's really only two names that have had an extraordinary year in terms of performance. And we should probably say we're recording this in December '25 — so, when I say "this year," I mean '25.

You've only really seen two of the Mag 7 do incredibly well. Five of them really had like low-single-digit to sort of low-double-digit performance, so nothing perhaps extraordinary despite the kind of bubble rhetoric that we hear. And again, I think what we would say in terms of why we think that a number of those tech/AI-driven names can continue to do so well next year is really the earnings growth, right? We continue to see people underestimating the earnings growth of those names and of course the capex revisions up, the earnings growth revisions up, have continued some momentum in a number of areas in the market.

I think what we would say around this question of a bubble is that very, very recently of course it has all been funded out of operating cash flows, and these big hyperscalers

have continued to pay dividends, do buybacks. And that's been a very healthy and different backdrop vs. the early 2000s, and I think you know clearly, we have entered in the last month or two a bit of a different paradigm. A bit of a shift toward some leverage starting to build up in the system, and we've obviously also started to become more focused on a number of smaller names who aren't the big hyperscalers being able to fund this out of cash flow. And I think that shift is important because I think it reflects a broader shift from many years of fiscal expansion and stimulus post-COVID into maybe a new era of increased credit expansion.

And so I think that is something to watch as an investor. It doesn't mean to say the fiscal story's gone away. Of course it hasn't. I think there's a number of areas where there is fiscal space out there and where countries will need to use it in order to keep their electorate happy and in order to get things going. We could talk about Germany being a good example for that within Europe, and we think that's still part of the story for Europe over the next few years in terms of growth upside and earnings growth from the corporate sector.

So I think you've got that interesting backdrop, Rob. Where we think yes, the big tech names can actually continue to do really well, can lead the market higher. And generally, for people that do believe that we're in more bubble territory based on the performance of the market overall relative to history, you would understand if you're in that camp that it's unlikely that the leadership of the market is going to change. Of course, that creates complexities with hedging, and that's one of the reasons why we would suggest hedging that exposure to equities with credit.

But I think what's also really interesting is we feel that the broadening thesis can play out alongside this, too. And again, the Fed rate-cutting cycle, although I think it's fair to say globally we're not going to see as much cutting going into '26 as we've seen in '25. There's obviously more central banks getting to the end of that cutting phase, one or two now need to be hiking into next year. But I do think it's important that as you get to this point in the cycle, you start to see some of that broadening come through.

And we think that in the context of other sectors in the U.S., whether that's looking at sectors like financials that are cyclical, we do think you'll get some good cyclical performance given that backdrop. Economically we've talked about, but also sectors that have underperformed, been unloved, such as health care. You might want to start to think about that broadening thesis, not just within the U.S. equity market in terms of sector exposure and market-cap size, but I think it's also important to think about it globally.

And as you say, there's a number of places that look interesting in the rest of the world. I think China is absolutely one, because although it is an AI-driven market (and it's one of the reasons why we like that market), it is quite different and distinct from the U.S. and

not that well correlated. And it gives you a different exposure to AI that is high-quality AI, and obviously open source and at a different price point than the U.S. version.

So I think quite an interesting way to think about that diversification and broadening out is to look at a market like China. But as you say, Europe as well offers opportunity for a different range of factors.

Rob Rowe (11:07)

Two points that are good that you brought up. One is valuation. I think in China, the valuations seem cheaper, so that's a way of doing the AI story at a cheaper valuation. But also, we don't want to overshadow — and this is, I think, what happens when people are focusing too much on whether we're in a boom or bubble with AI — the fact that we're also looking at a cyclical recovery and that pertains to not just the equity markets but to other markets as well, such as commodities and fixed income.

So we are looking at that cyclical recovery if we think that the U.S. will be having policy easing that will see some benefits from deregulation, which may actually be hard to quantify, but also whether we'll see any marginal benefit from past tax bills that came out last year that would affect this year coming up now. So there are areas where we may see a cyclical recovery.

On this jobless recovery bit, though, we are continuing to see unemployment rising. Our U.S. economists would say that we're looking at 1.9% real GDP growth. From your personal perspective, do you think that's underestimated in the U.S?

Lucy Baldwin (12:20)

It's an interesting question, Rob. I think that the scenario you may well see is that you get these continued upside surprises to U.S. GDP for some of the factors we're talking about, whether that's around fiscal and policy support, whether that's around the investments in the AI boom. But the challenge is whether you end up seeing good growth but really, really tough employment stats.

And that can be obviously less hiring, lower quit rates, and then you start to see the layoffs come through. That's the big risk. And I think that's the big conundrum, not just for the U.S., by the way, but for lots of economies. I mean, China is absolutely going to face the same, and it's particularly prevalent in terms of the younger cohorts of the population in terms of the job market, and you see it already.

Of course, you see it in the tech sector, almost at the epicenter of this in terms of where your greatest unemployment rates are, and I think that's going to require a lot of social-policy innovation around the world to think about how we address this. Now, the more bullish way of looking at this from an economics perspective is to assume that there's a whole host of other jobs, new jobs that get created on the back of this, and they more than offset the jobs that are being lost or disrupted by AI.

And I think that is absolutely possible. But by definition, in many cases, they're hard to predict, and we don't know what they're going to be. So I think the question for a lot of people as we go into next year is to try and get your head around what you might see in terms of employment data, and whether that is enough ultimately to enable continued cutting from the Fed and from other central banks because the job market is weak.

But you're able to have this Goldilocks scenario of cutting because of the job data being weak, but the growth is actually pretty good and inflation manages to stay largely under control. But it is not without cost, because from a political perspective it's going to be very, very difficult if you have continued challenges and pressures around employment, particularly in your younger demographics.

What do you think, Rob? It's a big question, isn't it? And obviously, there's a lot of expectation that the productivity you're going to see from AI is going to be driven by people essentially being able to do the same amount of work. But how do you think about it?

Rob Rowe (14:48)

Well, I do think that the two ends of the spectrum for me are the CBO call on real growth rates in the U.S., which are very similar to where we are, which is about 1.92%. Let's say that's continuous over the next three years. I don't think that accounts for any productivity gains as a result of AI. And then you look at where the CEA has U.S. growth, which is probably more like a 4.5% to 5% handle. If you hear some of the folks in the Trump administration talking, they'll tell you they think that you would definitely be north of 3% over the next three years.

So there's a big gap between where all that is. I think when you think about the CEA, they think that there's going to be more factory production, more manufacturing revival, as opposed to by AI. Adoption rates and labor productivity are something we covered in one of our Must Cs called *AI and Productivity*. I think from Nathan Sheets's standpoint, who's our global chief economist, he would say that adoption happens slower than people think it will, maybe over the next three to five years as opposed to immediate.

But what I noticed in one chart was that labor productivity is already rising and it's already rising faster than it did during the internet bubble. So it has the potential to contribute somewhere around 1% to 1.5% to real GDP growth. So if we're looking at a 2% baseline from CBO or from our estimate, and depending on where you think labor productivity will come in, it is increasing. Let's say it's contributing, say, 0.6%, and if it has another 1 % to go over the next three years, then I would suggest it's something north of 2%. Maybe it's 3% for next year.

Mind you, I know that third-quarter GDP this year was 3.3%. And that was driven mostly ... I mean, not mostly, but some contribution from capex spending and the

infrastructure build-out in AI. And if we see that continuation next year, then I would think that we could have an upside surprise in terms of real GDP growth. That's the way I would look at it.

Lucy Baldwin (17:06)

Yeah, I think it makes a lot of sense. I think the big conundrum for everybody is how well supported the U.S. consumer is going to be next year, and whether the job losses that you may see as a result of AI as we move through this phase are significant enough to cause downward pressure on consumption. Or, to your point, all of the wealth effects and everything else that you get by the S&P continuing to move up — corporate earnings moving higher, margin expansion, all those things coming through — whether that can offset enough of that softness. And exactly where that tension is and how that lands, I think, is going to be a really big question as we go into next year.

Rob Rowe (17:46)

And Lucy, how are we looking at commodities? And what are our folks telling us?

Lucy Baldwin (17:56)

Doesn't it feel like everything comes back to the AI trade, Rob? I mean, look, it's an interesting one. Obviously gold's had an extraordinary year around the debasement trade. It's up 60%. You know, it's been even moving up every year for the last couple of years. Everybody knows the well-understood structural drivers of central-bank buying and all of those sorts of things.

Diversification from an asset-allocation perspective, whether you're a big sovereign wealth fund or an individual, I think it's a well-understood story now. I think what's really interesting for us is we think, actually, maybe this next year is going to be the year of base metals rather than precious metals. So we think one of the best ways to play a cyclical rebound, if you believe in that too, would be through copper. It's probably one of the purest plays on that.

Again, you've got things like the potential for some of the geopolitical tensions to be resolved. Russia and Ukraine is one that obviously people are expecting to see maybe a resolution to as we move into 2026. Aluminium, I think, is another really interesting case in point because it's almost in effect competing, if you like, for power demand. You've got this AI power-demand crowding thesis going on. And obviously, you've got Chinese aluminium production capacity capped by policy trade-offs on power usage in the environment.

And if you think about it from a power pricing perspective, if you look at it more in line with data centers, then costs can add really, really significantly to those production costs for aluminium. And that will ultimately filter through into pricing there.

So we're really bullish, basically, on both copper and a sort of cyclical perspective, but also on aluminium from an, if you like, AI trade perspective. So we'd rather be there in those sorts of base metals than gold from here. We think it's much harder to see the next leg for gold. I think you probably have to really believe in a different economic backdrop to us for gold to do another big leg, or at least to have enough significant questions over things like Fed independence to want to really be putting a new gold trade on from here, Rob.

But what would you add to that, do you think?

Rob Rowe (20:10)

What I was going to ask next, and we can talk about it a little bit, is it's interesting because I think our commodity folks are focusing more on the cyclical recovery than they are on the AI story. Base metals fits both because there's demand in terms of the infrastructure buildout for copper. And aluminum or aluminium is also a big cyclical recovery story as well. So base metals fits both stories extremely well.

The gold call is really an out-of-consensus call. I think everyone remains bullish on gold, I think we're probably one of the groups that are kind of neutral on gold at this juncture, given the dynamic rise that gold has taken place. And I don't know how much more buying central banks can do. Maybe they can do even more. But if you also have an out-of-consensus call on the U.S. dollar, where we're very bullish on the U.S. dollar, then that would probably be another good argument to be neutral gold as well.

We didn't really talk about the out-of-consensus call on the U.S. dollar. Do you want to cover that, Lucy?

Lucy Baldwin (21:20)

It's a good question. I was smiling because you're talking about how we've gone from being very bullish gold to being now probably, relative to the Street, more cautious and more bearish. It's a bit like with oil: We've gone from being very bearish on the oil price because of oversupply to now everybody else coming around to that way of thinking and we're arguably at the more constructive end of the spectrum as to where the Street has landed on that. Albeit clearly we see oil here somewhat range-bound over the course of 2026.

On the dollar, look, I think this is a great debate, and I think lots of people have been asking us how and why we've got such a bullish view on the dollar into next year. Particularly when we still got two more cuts from the Fed in our house view, and how and why we can see that. Part of it is this economic recovery that we're talking about, the inflows that we expect to continue to see into dollar assets as we go into next year. That's also linked to our constructive view on the S&P. I mean, we haven't really talked

about the crypto space or stablecoin, but clearly stablecoin being another driver in terms of incremental dollar demand, at least that's how it looks to us.

One of the ways that I like to think about it, Rob, is the way that our global macro team with Dirk Willer, Adam Pickett articulate the view on the dollar next year, given some of these complexities. They talk about it being a year of three thirds, right? At the beginning of the year there is that risk you get a bit of dollar weakness because you've got the Fed still cutting, but then quite quickly we can move into that middle third of the year, if you like, going into the summer where you could really see the strength come back to the dollar on the back of all the things we've talked about in terms of inflows into the dollar assets, strength into the economy, Fed past cutting, etc.

And then they think about the back end of next year being more of a risk for dollar downside. Probably that risk of rising yield curves, steepening yield curves, which of course is a big factor. Whilst we're very bullish on risk assets pretty much across the piece here, one of the big things that we are grappling with is whether that at some point, if the back end of the curve starts to steepen really notably and people worry again, perhaps about the U.S. debt position, or Fed independence worries rear their head again as we think about a new Fed chair, at a certain point that would be problematic for risk assets. But I don't know how you've thought about that, Rob.

Rob Rowe (23:52)

Well, I think on the public side, we probably do have some concerns given that we're going to see probably increased issuance in several countries, most notably the U.S., the UK, France. A lot of the G10 will actually be issuing into this market. And so we are very, very pro-steepeners in a lot of these different countries. There will be some policy divergence if you look at Japan; Japan's going to be probably in a hiking cycle. The ECB is likely to be static. You look at the U.S. and UK: UK just cut rates today, and you look at the U.S., we all know about the discussions going on about the next Fed chair, and we also know that most likely we're going to be in an easing cycle — whether that's a pronounced easing cycle or not, it's still debatable.

But what that means for us is less to do with where long-end rates are going to be, because that could actually be somewhat static. But really, the shape of the curve is the way we're focusing on that. So we think we're going to see steepeners in a lot of different public markets, which means that there's actually a positive story to say about the two-to-five-year area of the curve, because that area could essentially either be well anchored or could rally, whereas the long end of the curve could either sell off or stay kind of anchored.

We have an out-of-consensus call there in the sense that our call on 10-year for 2026 is 3.75%. And that is actually more out of consensus, where others feel that issuance going forward will drive that rate a little higher or keep it about where it is, let's say four

and a quarter. So I think that that isn't enough of a move that you would necessarily be worried, even when you're looking at consensus call on the 10-year.

In terms of credit, though, what we're worried about is the net issuance that we may be seeing from AI, which could be significant. And also, we're unsure in terms of credit how ratings could be affected by the eventual adoption of AI. There could be certain companies that if they're not competitively in the swing could get downgraded. And so, a lot of people say, "Is there a switch from IG to high-yield here that may take place?" And so we're a little bit worried about credit spreads. We're also worried about them because they're at all-time heights.

And that's why, as you mentioned previously, they play a good hedge to being bullish in the equity markets. I think if you're looking at potential returns, you want to actually be more allocated into equities vs. fixed income at this juncture.

Well, we've covered a lot today, Lucy. I think we've also covered most of our out-of-consensus calls on the market, which I think is sort of neutral gold. We're bullish the dollar. And we're also over the course of 2026. And I think essentially another out-of-consensus call on 10-year rates is at 3.75%. So, we have a couple of those: mostly bullish on base metals within commodities, which I think is a good call, and we love the equity markets, which I think is a good call as well.

Lucy Baldwin (27:04)

It's been a great conversation, Rob. Look, I think the big the big question for everybody in many ways is going to be around AI and how that plays out. And, personally, one of the things I find fascinating is the debate between China and the U.S. and who's going to lead which parts of that ecosystem. I think we're going to learn a lot more as to not just who's winning and leading in the technology but the application, the infrastructure layer.

And again, some of the developments that we're seeing come through from China in terms of the new economy that they're developing really starting to make inroads and be able to compensate for some of the weaknesses that they've got in the property sector and in their consumer environment. I think that's really, really fascinating. They're going to grapple with many of the same challenges from a job perspective as the U.S. But I think seeing how that evolves is going to be really fascinating.

Rob Rowe (27:54)

Lucy, thanks so much. We didn't even cover quantum computing, by the way. We can do that at another session. But thanks so much for being with us today.

Lucy Baldwin (28:02)

Great conversation, Rob. Always a pleasure to talk to you. I could talk to you for hours, as you know.

Rob Rowe (28:08)

This episode of Research @ Citi was recorded on Thursday, Dec. 18, 2025. I'm your host, Rob Rowe.

Disclaimer (28:24)