Research @ Citi Markets Edition: Halloween Pullback — Tactical or Something More Sinister?

Recorded: Nov. 2, 2026

Published: Nov. 3, 2026

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Transcript:

Opening Teaser: (00:00)

Research @ Citi Markets Edition.

Dirk Willer (00:03)

Welcome to Research @ Citi Markets Edition, where we break down global macro in 10 minutes or less. I'm your host, Dirk Willer, Citi's Global Head of Macro, and with me today is Alex Saunders, our Quant Macro Head.

We are recording this podcast at 8.30 a.m. on Monday, Nov. 2, 2026.

The equity markets had a bad week, in particular the Nasdaq. Fears are related to AI financing but also to oil. So what's next for equities?

Here at Citi, our POLLS indicator triggered on Oct. 13. That's an indicator that suggests usually the S&P to be down by 3% or 4% in the following month, so it is a purely tactical indicator. And we are, of course, already down 3%. However, it's worthwhile to highlight that the indicator has a pretty negative downside skew in terms of S&P returns.

So we are taking it seriously. Two reasons, of course. One, the war risk, which might increase after the midterms. And B, the financing risks, where there are two aspects to that: the neo-cloud financing aspect, but also the broader AI universe and its reliance on the venture-capital funds, really.

I think last week, one of the things that happened was that financing fears got maybe accelerated by the idea that cash flows were worse than expected in some of the legacy businesses of some of the hyperscalers. So I think all that still adds up to some caution in the short term.

But in the bigger picture, of course, the main question is, “Is the peak in the AI bubble really in?” And this is, I think, where reasonable people can have an argument. I mean, one way to look at it is that in the end, it's all about excess compute, and we don't seem to be anywhere close to that.

Demand drivers are just very strong. Physical AI is only getting started because of self-improvement. RSI by agents is only getting started, and both are, of course, very

compute-intensive. Rental prices for chips appear to be relatively firm. And the financing problems are really only at the fringe in some sense.

It's the poor balance sheets that have a problem, and that maybe in the end might have to be restructured. But the solid balance sheets still have plenty of leeway to borrow. And so it's not clear that this will really end the AI boom. We also have remarked for a while that sentiment is just not as bullish as you typically see at the top of the market, certainly when it's driven by such a powerful new investment opportunity.

And then liquidity still seems plentiful. I mean, the Fed has only hiked once. It took a lot more than that in the 2000 episode, for example.

Alex Saunders (02:29)

Dirk, to take the other side of that, just on credit spreads, I agree they're not tight, but they've certainly been tightening. As you know, we run this macro regime model, and that's giving some late-cycle indicators. Yeah, inflation is above average, growth is strong, but when financial conditions tighten that can be a difficult time for risk assets, and the model indeed moved underweight equities after being overweight for most of the year

I know the credit spread tightening is somewhat tautological in a way, right? But even when we look at trading signals for the VIX, if you exit the market when you have VIX jumps, those signals are much more powerful when credit spreads are tightening. And the other thing is we have seen some bubbly conditions, so we had very large moves in the KOSPI, and semiconductors index.

And purely based on price trends, I think in the U.S. we are on a popular bubble metric. We're more than two standard deviations away from the long-term trend, So what do you think about that?

Dirk Willer (03:28)

Fair point, Alex. And obviously there are some yellow lights, for sure. I mean the whole thing is of course really quite circular too, in the sense of if something were to shatter the confidence and stop the inflows to the AI sector, then certainly you could see a situation where it's getting harder to finance it. And so it becomes a bit self-fulfilling.

But it just seems to me that at this stage, we haven't yet had this type of shock that really makes people unwilling to still believe in the upside of some of these things. I mean, it's true that certainly the SOX chart is more like the type of chart you'd expect when the bubble is peaking, much different than the NASDAQ chart. So we have to be a little bit open-minded on that front.

I mean, I would say that certainly if the oil fear disappears on us, if there should be an Iran deal, or some ratcheting down of those tensions – in the equal way that S&P might do quite well in that case. And because there will be massive sector rotation out of tech and into all the various other sectors, and they benefit more from low oil prices.

But again, I totally agree with you that we are in a bubble and in the end we will overdo it and overbuild capacity. I'm just not convinced we are there yet in terms of overbuilding capacity.

I agree with you: Some yellow lights certainly when credit is trading poorly, you have to take notice of that, but seems to me we need a bit more evidence for calling the top in the AI bubble.

Alex Saunders (04:47)

So when would that happen? How would you measure that — the overcapacity, or the overbuild, or the fact that we'd gone too far?

Dirk Willer (04;55)

Yeah, most important question, right?

I do think we obviously have to rely a little bit on our fundamental analysts who tell us just how these buildouts work. But I mean, the important thing is that some of what we've seen in the last month or so is really increasing the tightness, if you like, right?

Because if it should be the case that the weaker balance sheets won't be able to finish some of the buildout that they had envisioned in terms of the data centers, then it would make this compute even more scarce and might push out the peak maybe even more.

So that is really important to keep in mind as well. I mean, there's obviously no silver bullet to know when this thing is over. And whenever you're in a bubble, you have to be more cautious than when you're not.

So I take your point. We have, of course, the metrics that is trying to get us out, which is linked to the leaders, the generals starting to fail. And some of them have. So it's an open question from that point of view.

But let's just move quickly to the Fed, because that is the other question, right? Part of the financing worries really happened because the Fed was quite hawkish, but the last meeting was much less so. So how do you see the Fed here?

Alex Saunders (05:57)

I mean, from my perspective I don't take that much away from Warsh's press conferences. I mean, he's literally told us he doesn't want to give forward guidance. But I do think that it's important the market's sort of learning his reaction functions.

Your idea of having a shadow frame of things that he has mentioned is a really interesting one. And on that learning process, I think the first few speeches, he's oscillated between dovish and quite hawkish. I think the market's taken it that way when you see the reaction.

I'd say that more recently he's maybe had a bit more discipline after seeing that reaction post his comments. For me, I thought the comments on financial conditions tightening

and the fact that conditions were not tight but they were tightening is relevant. But maybe that's because it resonates with the regime work.

But otherwise I don't take too much from the press conferences, especially the more recent one. But what about you, Dirk?

Dirk Willer (06:56)

Yeah. I found it very hard, I have to say. I mean it's a lot of back and forth here, and I thought there may be three potential reasons — and one is maybe the committee is just difficult to control, and therefore it's not that easy for him. And the other one is, of course, maybe we were just a little bit too close to the election for comfort. Or really, I mean the only thing that changed in terms of our shadow Warsh framework was really that credit spreads moved, right? So yeah, maybe he is getting concerned about credit spreads in some sense.

It's probably a mixture of all three of these things. And my guess would be with the election out of the way, the case for flipping back to hawkishness is relatively high unless the equity market really is causing more trouble from here. But if that is the case, I mean, if the AI bubble should have burst, we still think that the short end of the U.S. curve will be a great hedge for that.

So in summary, we've been technically cautious on equities, but open minded for the bigger picture as the AI bubble peak may not be in yet. The right strategy, I think, would be to buy the dip if the run fades. In that case, probably more the equal-rated S&P, or of course when AI financing voice faded, more NASDAQ trade. Now, if the AI bubble has not peaked Fed, hawkishness is likely to come back sooner, rather than later.

With that, thank you for joining us today. This episode was recorded on Nov. 2, 2026, so just one day before the midterms, which also play a role. And I'm your host, Dirk Willer.

For more details, Citi clients can check out our report on the Citi Velocity portal. Next week's Research @ Citi Markets Edition will be hosted by Beata Manthey, Citi's Global Head of Equity Strategy.

And check out our Research @ Citi podcast, which you can view on the same channel. The macro strategy team will be back in two weeks. Stay sharp!

Disclaimer (08:38)

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