Research @ Citi Markets Edition: AI’s Subtle Impact on the Equity Market

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Transcript:

Opening Teaser: (00:00)

Research @ Citi Markets Edition.

Scott Chronert (00:03)

Hi, I'm Scott Chronert, Head of U.S. Equity Strategy at Citi Research. Welcome to Research @ Citi Markets Edition, covering various topics at work within the U .S. equity markets.

With me today is Pat Galvin, my colleague in our U.S. Equity Strategy team here at Citi Research, and who I often refer to as the brains of the operation. I've invited Pat here today to talk about our cluster approach and our differentiated view of the impact on AI on the equity stock indexes.

Welcome, Pat. Thanks for joining.

Patrick Galvin (00:31)

Thanks for having me, Scott.

Scott Chronert (00:33)

There's an old adage in life that what you see is what you get. But is that true when it comes to equity investing? The simple answer is yes and no.

Many financial advisors and market pundits may say that for U.S. equity exposure, just own the S&P 500. There's a lot to this, and we don't disagree. But what is critical to this view is that you have to know what it is you're buying.

The focus of today's podcast is to dive into this and explain just how the S&P 500 has evolved over time and what that means for broader exposure to U.S. equities and the AI theme in general.

Quite simply, the high-level takeaway is that the index has undergone a major evolution over the past 30 years. We address this by dividing the index into what we call clusters. Pat, can you step in here and give us a quick explanation of this approach and with some immediate observations from this?

Patrick Galvin (01:26)

Yeah, we've been using this cluster approach now for over three years and have found it to be a very helpful mechanism to break down the market. More helpful than a traditional Value vs. Growth style breakout. And we can go into that.

But the beauty of the industry-group cluster approach is the simplicity. We just assign each S&P 500 industry group into one of three buckets: either Cyclicals, Defensives, or Growth. And we do this based on the relative macro sensitivity, as well as exposure to secular or thematic fundamental growth drivers.

Somewhat subjective in the bucketing there, but for example, we'd put semis in the Growth cluster, we'd put utilities in Defensives, we'd put energy in Cyclicals, just to give an example there.

And what this gives us is three market-cap-weighted slices of the index that together add back-up to the index. And why that's important is it really helps us do attribution work, decomposing both index-level performance as well as index earnings growth one step below the index. Helps us look at what's happening under the index surface.

It's also helpful to understand valuations relative to history using the industry-group indices to build this approach. We can create very long histories of valuations, fundamental series, which just gives us a great perspective to decompose the market and find out what's happening under the index surface.

Scott Chronert (02:43)

Great. So the high-level takeaway of this work is that when we look at this Growth cluster — which we would say, generally speaking, is going to be that component of the index that is AI-influenced — it comprises roughly 55% of the index. Now, this is up from less than 20% 30 years ago.

So the high-level takeaway here is that as the market has evolved over the past 30 years, the Growth influence on the index has significantly changed. And so, what you get from an incremental and higher Growth component is a smaller influence of both Cyclicals and Defensives.

And this is where for us it begins to get pretty interesting. So Pat, as we go through this, let's start adding a little bit of perspective here on this Growth cluster, how it's evolved and how you see it and we see it shaking through in terms of the index behavior.

Patrick Galvin (3:35)

Yeah, sure thing.

I mean, something we've covered at length in our work is really, as you mentioned, the changing index composition through time. I think the cluster has given you a really great look at this. As you mentioned, 30 years ago, that Growth cluster cohort was about 17%

of the index market cap. Now it's like 55%. So we've seen that Growth weight in the index triple over 30 years and nearly double in just the last 10 years.

And with that comes a number of implications. I would say first, it's reduced cyclicality of the index. Those Growth names, they carry a little bit less macro sensitivity when we're either looking at macro sensitivity of returns or earnings growth. And really this 20-percentage-point decline in the Cyclicals weight that's moved over to Growth, just really setting up for a little bit less macro-sensitive index.

The second part I would say is index valuations certainly need context given this composition shift, something we've talked about at length, but really, it's not sufficient to say, for instance, that index multiples are stretched today relative to history if the index composition today looks nothing like it did 30 years ago.

So, we have this larger earnings weight and market-cap weight in the Growth names, and those Growth stocks have historically carried a consistent valuation premium relative to the broader index. So an interesting exercise we did a couple of weeks back was just looking at, Could we restate the index forward PE historically, using just today's index composition? So today's cluster earnings weights and their actual historical valuations through time.

And we created this monthly series back 30 years. And it's very interesting to find that if we had something that looked more like today's index historically, the 30-year average forward PE for the index would have been about 1.2 multiple turns higher than the actual average.

So context is definitely necessary when we're thinking about the shift through time in the index and looking at valuations.

Scott Chronert (05:22)

So the setup then as we pivot over to this AI discussion is that, OK, we're going to describe this Growth cluster component as, broadly speaking, AI-influenced, because it's going to capture all of these different industry-group and mega-cap stock influences. And so, what ends up happening is that you get more Growth and then therefore you get less Cyclicality, economic connectivity, of course. And then the Defensive component also takes on a different profile.

But, flipping over to another dynamic that unfolds is — and this is something that we've written more recently on — well, so what happens as the index takes on a higher Growth influence? Well, historically, Growth stocks tend to run with higher beta — we sometimes refer to realized volatility is a way to explain this.

But, essentially what's happening under the surface is as this Growth component increases, the underlying volatility dynamics at work in U.S. equities get higher. And so what you start comparing stock betas to is a moving target in terms of the index influence.

So Pat, as we go down this path, how do we think about navigating that in terms of putting some construct around this, and what else does it lead to in terms of investment implications for us?

Patrick Galvin (06:39)

I think to us, it's kind of like the index is becoming riskier under the surface, particularly that Growth cohort, as you mentioned, carries a higher beta, but the beta has been increasing of late. The Growth cluster has about a 1.2 beta, Cyclical is about a 1 beta, and Defensive is about a 0.6.

So as we've had this composition shift from Cyclicals and Defensives into Growth, the index has kind of gotten more risky. And it's a difficult concept because we think of the benchmark as the benchmark, and the benchmark can't get riskier … but the evidence that we found is, it is.

At the stock level, we've seen the index weight to stocks with a greater than 1.5 or greater than a 2 beta increase significantly through time, but more so, as of late. And alongside this, we've seen significant dispersion under the index surface.

So a theme this year: We're seeing daily moves in the S&P that are less than 50 basis points, less than 1% day over day, an extreme single-stock dispersion, but also very large industry-group dispersion. So looking at, say, the best-performing industry group vs. the worst-performing industry group on a daily basis, seeing much wider moves for just a small move in the index.

So I describe that as more potential energy under the index surface, somewhat of a rubber band that's kind of stretching. It doesn't necessarily mean that we get this cascading move, but it just means there's a little bit more potential energy.

Scott Chronert (07:58)

OK, so where we end up going with this is that the S&P 500 in our work is getting incrementally riskier down this volatility beta discussion path, if you will. The Growth influence is how you end up getting the bulk of the, let's call it the AI influence, to the AI enablers.

Ultimately, this may transfer down to the AI user discussion, but what it means is that as you look at the S&P 500, you have to recognize that you are getting this type of exposure. And what it begins to set us up for — just in the interest of time and to wrap up our diatribe on this — is that what you get with S&P 500 is something that you've got differently 30 years ago, and is a bit more risky.

However, it doesn't completely solve for things like economic sensitivity, macro influences. And so the way we're navigating this, is that in looking at the U.S. equity landscape, yeah, you start with the S&P 500. In our work, it's sort of, “know what it is that you're getting here,” but it does open the door for looking at the U.S. equity complex more holistically.

We're talking much more about small/mid-cap this year. Why is that? Small/mid-cap doesn't have the same magnitude of AI influence via this Growth cluster as does large-cap. And so what you get as you go down-cap is a bit more direct exposure to traditional macro influences, whether it be economic conditions, interest rates, and so forth. And so what this sets up for is a broadening picture across the U.S. equity landscape for thinking about U.S. equity exposure.

So high-level takeaway here, yep, what you see is what you get. What you're getting out of the S&P is something that has changed vs. 30 years ago, inherently a little bit more risky, a little bit more directly exposed to this AI influence. But at the same time, what that does is also open the opportunity for expanding the toolkit into other parts of the U.S. equity markets, such as small/mid-cap.

In the interest of time, we'll leave it here. Again, we've written a fair amount on this and be happy, obviously, to provide any other information from that perspective.

And in closing, this podcast was recorded on Aug. 4, 2026. Thanks for joining us today. Be sure to be on the lookout for our next Markets podcast featuring Dirk Willer, Citi's Head of Global Asset Allocation.

And thank you, Pat, for your time today. Also, be sure to watch for our other Research @ Citi podcast series, which you can also view on the same channel. Thanks, and have a great day.

Disclaimer (10:26)