

Research @ Citi Markets Edition: Expect a Persistent, But Volatile Bull

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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 my longstanding colleague, Drew Pettit, and we're here to talk about our outlook for U.S. equities for 2026.

Essentially, what we're looking for and expecting is a fourth year to this ongoing bull run. Our target for the year is a base case of 7,700, which puts us somewhat ahead of sell-side strategy consensus. Driving that is a high-in-the-Street earnings expectation of \$320 at the index level.

And it reflects our view that, yes, we get it, higher-valuation starting point. The way you navigate a higher valuation-starting point and still have an up year, in our view, is with a sustainable upward bias to earnings expectations. Now, going into this year, it's important to recognize a couple of things.

First, we're officially retiring the Mag 7 cohort, and are replacing it with the Elite 8. Those eight stocks comprise about 40% of the S&P 500 capitalization. The other 60% is going to represent sort of everything else.

So there are a couple of things going on here. We're looking for a broadening into that other 60% this year, that can be played via other large-cap U.S. sectors, can even be played down in the U.S. small/mid-cap space. But in essence, what this does is force us to make two calls, if you will. That 40% of the market, let's say, is AI affected. There we see an ongoing beat-and-raise dynamic that will continue to support that, much like we saw last year.

The other 60% is where it's going to get interesting and tricky, and that is that we're looking for this broadening fundamentally that's going to be a function of ongoing soft-landing characteristics, but combined with a still somewhat accommodative Fed where the house view is for two, if not three more Fed cuts this year. And then with it, ongoing fiscal stimulus measures either tagging on from last summer's budget deal or, as we go down the path toward this year's midterms, an expectation that the Trump administration will be fairly aggressive on that front. All of which we think should contribute some form of earnings tailwinds.

Now, again, how to position for this? And this is where I'm going to bring Drew into the discussion. Very high level, we are arguing that you can maintain a very strong position in that Elite 8 "AI enabler" cohort, but we're also looking to broaden down into the, let's call it "AI adopter and AI user" category. But then, as I mentioned, we're also looking for this broadening to take place more from a traditional sector or even size and style perspective.

So at this point, I'm going to hand it over to Drew and get some initial thoughts in terms of how we're thinking about the positioning setup in terms of specific courses of action.

Drew Pettit (03:05)

Yeah, thanks Scott.

Look, it's funny. We expect a bull market. It may not be, let's just call it, equally felt across the index. But what we want to do is actually buy risk. We're pretty comfortable with risk, even though we think the year is going to be pretty volatile, given the starting-point valuation and sentiment.

So, the first side — and Scott alluded to this — it's that growth side of the market, that "AI, AI, AI." We get the story, that narrative is still out there. It's a secular trend, it's not going away.

But when you're in that space looking for stocks specifically, you've got to find the stocks that are giving you the best incremental growth in operating cash. So again, we're not talking about earnings here. Who's actually going to grow their cash position the fastest, relative to all the investments that they're making in their business?

And it's funny, when you think about that, it does lead you to a lot of these Elite 8 types of stocks and some of the ones that are, I would say, closely on their tails from a performance perspective. So that large-cap growth momentum angle, again, give me the ones that are generating the best cash for the investments they're making in their business.

Now, the other side, it's almost like this completely different corner of the market. So you've got these large-cap growth stocks on one side, and then the real aggressive way to play to the broadening is give me the small value stocks. And when we screen in that world, we're looking for stocks that have not had the earnings tailwinds.

When you look at the cyclical parts of the U.S. market, most of them for the past three years have actually seen their earnings decline. It's been a downward trend, even though we've seen index earnings go up and to the right. So as long as the economy holds in there and we get some tailwinds, as Scott alluded to, from policy and from interest rates, you can actually see that downward trend flip around and become a positive one.

Well, we are being picky in that group. What we really want to find is companies where that downtrend not only turns to an uptrend, but where that uptrend is sharper. And we want to see that new earnings level reach a new high. So again, it's not just about whose growth is going to turn from negative to positive, but who can actually earn more money than they did coming out of the pandemic.

So again, to tie this all together from a positioning standpoint, we're comfortable with the large-cap growth names, and we want to couple those together with the small-cap value names. And we think that gives you a really interesting portfolio to navigate 2026.

Scott Chronert (05:36)

So under the surface here, what we're really getting at is we've been using this term "idiosyncratic behavior" quite a bit in our work. So the way we're talking about this is not "one size does not fit all." Essentially, when we look at that mega-cap growth tech/AI cohort, much like last year we would suggest that these names will continue to act according to their own idiosyncratic drivers as we move down this next phase of this AI playbook.

Similarly, within the broader market, whether it's in other large-cap sectors or down into SMID, it's going to be the same storyline. You have to have a fundamental catalyst to provide an ongoing tailwind.

Now, in general, stepping back and looking at the action the first couple of weeks of the year, we're getting hit with a number of new ... let's call it "volatility episodes." And this is something that is in our outlook title, "Expect a Persistent, But Volatile Bull." Much like last year, we are also of the view that as we move down this path this year, we're going to see an ongoing influx of policy-related dynamics thrown at us. And it's very, very easy to react to each input in any number of forms.

What we keep coming back to, though, is our view that we're going to use fundamentals as our guiding light here. So as to not get whipsawed, much like it was easy to do last year around a lot of the events related to tariffs, as an example.

So here, too, the point of this is going to be: eye on fundamentals, we get to think more idiosyncratic behavior. But in general, the path should be up and to the right in terms of earnings growth, accelerating to a level beyond what we saw in 2025. All of this sets up for what we think can be another decent year for U.S. equities.

Anything I'm missing, Drew, tail end?

Drew Pettit (07:26)

No. Honestly, it's messy. Look, we've talked about that a ton. A lot of risks out there, they haven't really gone away. But again, how you manage those risks, fundamentals? It's earnings growth. That's how you get through a lot of this mess.

Scott Chronert (07:39)

Got it. OK, so with that in mind, the high-level takeaway here: We're looking for a fourth year of an ongoing bull market for the S&P 500. It's going to be increasingly earnings-driven as a way of navigating the valuation circumstance.

I would point out as one final thought on this, coming back to this Elite 8 vs. the rest of the index, it's quite interesting: When you look at the growth expectations for that cohort, it's been surging off of the April 25 tariff lows. And what that has done has enabled earnings to run ahead of the stock-price action.

So when we look across the board, we look at the P/E to growth ratio for that part of the market to actually be the most attractive it's been since the pandemic recession. My point here being valuation tells you one story, but it always has to be in the context of what growth drivers you're looking at there.

Again, this points to idiosyncratic behavior, but what it also does is set up, in our view, for an ongoing dynamic where, show me the growth, you ought to get rewarded.

This podcast was recorded on Jan. 20, 2026. Thanks for joining today, and be sure to be on the lookout for our next Markets podcast featuring Dirk Willer, Citi's Head of Global Asset Allocation. And be sure to watch for our other Research @ Citi podcasts, which you can also view on this same channel. Thanks, and have a great day.

Disclaimer (09:08)

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