

Research @ Citi Podcast Markets Edition: The Revenge of Risk Parity

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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 Quantum Macro Head. Welcome to the show, Alex.

Alex Saunders (00:16)

Thanks, Dirk.

Dirk Willer (00:17)

We are recording this podcast at 9 a.m. on Monday, Feb. 23, 2026.

There's much to discuss. Equity-market jitters have continued, and under the hood, sector rotation has been violent. At the same time, the bond market has performed quite well against consensus.

So, let's start with the general interplay between bonds and stocks. Treasuries had a pretty good month. The reason is twofold. First, the front end benefited from a Challenger survey that seemed to hint at AI job losses. And also from weaker JOLTS data, more than offsetting the NFP that had seasonality issues. All of this happened in the context of benign inflation.

But secondly, the curve flattened, as the back end benefited from falling fiscal concerns, so this is now potentially being revisited after the Supreme Court IEEPA ruling. But even with IEEPA, the impact on the back end was really quite limited. Furthermore, equity jitters added to the bid for bonds.

Now, we think these general drivers for the equity markets will remain in place, and there are two fat tails. The first one would be that the front-end circle would be supported because the AI bubble may burst. Now, then you would get a negative wealth effect larger than the one in 2000. And 2000, of course, saw a shallow recession on the back of the negative wealth effect. And the Fed would likely cut more than is priced.

Alternatively, AI could do fantastically well, and that would probably lead to a quite weak labor market, and also to Fed cuts.

So those two Fed tails will become closer to the base case over time. But at this stage, it's still more of a tail. But we are encouraged by the fact that the designated Fed chair, Mr. Warsh, is in our corner on that, in that he also thinks AI will be quite deflationary.

This means that bonds will work well again as a portfolio hedge. It won't be like 2022, which was an inflationary problem where both bonds and stocks lost money. But it will be a deflationary story. And then risk parity is back.

Remember, in 2000, 2001, 2002 — the aftermath of the last equity bubble, which is probably the closest analog — even medium-sized duration positions would have been enough to offset equity losses for the year.

So, we have long duration to hedge our equity exposure. While we prefer the front end of the curve, as the curve would likely bull steepen, we also think the back end will work for cash-constrained investors. And we do think there will be episodically fiscal concerns, but we do think that in case of a deflationary scenario with a big labor market, potential recession, there will be enough demand for U.S. bonds. So risk parity is back.

But the harder question is, of course, “When do we need that insurance that these bonds provide?” i.e., “What is the equity market outlook?” Alex, what's your take?

Alex Saunders (02:57)

The first thing to note is our Citi Equities Tactical Polls Indicator triggered at the end of last month. So, we probably will see some turbulence. We're actually already lower than where we were in that initial trigger. So it's probably more of a range trade from here.

On the positive side, the generals framework — which looks at the seven-largest market-cap names vs. their 200-day moving average — has not triggered. And the macro's in more of a Goldilocks-type environment where we've had increasing leading indicators of growth and inflation readings that have been quite benign.

Given that Tech and AI has been at the center of the jitters recently, what's your take on that, Dirk?

Dirk Willer (04:14)

Yeah, thanks Alex. I mean, there are two stories, right? One is the excessive capex story, and one is the AI disrupting many industries (including software) story.

On the first one, yeah, we do share those concerns, I would say. The market, of course, punished the stocks in the last earnings season that really increased capex. And there is a fear we get negative free cash flow on the back of it, and that the investment will not generate a sufficiently high ROI. And that is certainly possible. Well, I mean, there are a fair number of competitive LLMs in the market, switching costs are not that high.

So we think the very significant use cases for AI will almost certainly be matched by very significant revenues. But how high the margins can be is, of course, very much an open question. And so, for the market to stop worrying about very high capex — and we wouldn't expect capex to be scaled back in the short term, certainly — it would require a clearer path to monetization, preferably in the context of healthy margins. So that is something we are still waiting for, to change the market's mood on that topic.

And then a negative point maybe to make here is also that this increased capex by the hyperscalers increases the pressure on the privately held LLMs because they don't have the huge cash flows of existing businesses or the funding of those investments. And so now the bar is even higher for these privately held LLMs to raise money to stay in the game. If they couldn't raise enough money, then, of course, there would be meaningful impact on the broader AI build-out, given how significant they are. So there are potential positive, potential negative triggers. But overall, those fields will always stay with us.

The second negative story: that AI would disrupt countless industries, and especially the software industry. And there is certainly some truth to that as well. But a lot has happened, a lot has been priced, and the development is maybe somewhat slower in terms of the disruption, and maybe the market can look through that. So overall, I would say, yes, those concerns may persist on the capex side.

But Alex, we can't have a macro podcast today without discussing the IEEPA ruling. What are your thoughts on that front?

Alex Saunders (06:22)

Thanks Dirk. So we have probably more questions than answers at the moment. But in terms of answers, the first thing to note: I would say the decision was expected, if not the timing.

There is a loss of \$250 billion in potential revenue. It's very likely that this will be recovered by reimposing tariffs under alternative authority. Bessent has already said that 2026 revenue won't change that much.

For now, we have Section 122 tariffs that will apply to all goods and countries, with certain carve-outs that are not fully clear as of yet. And then to come, we'll get Section 301, which is country-specific, and Section 232: We already have some, but we'll get more likely product-specific tariffs later in the year.

It's not clear what will happen to the revenue that's already been collected, \$170 billion or so. We would make two points. The first one is the Treasury has enough liquidity — the TGA already has \$925 billion. The second one is that this needs to be litigated, and that will likely take years.

So more questions than answers at the moment. I would say the market reaction has not been overly large. Equities were up a little bit on Friday, back a bit today. Curve is

slightly steeper, depending which part of the curve you look at. Dollar has been slightly weaker, but again it depends. EMFX has strengthened, especially Mexico and Brazil. This was highlighted in some of our work earlier in the year.

Dirk Willer (07:50)

Got it. Thanks Alex.

So in summary, we think risks on the equity side have risen but we stay the course, but with hedges. We think duration can work well, as before you hedge, unlike 2022 as the next bust will likely be deflationary in nature and it's reassuring that Mr. Warsh agrees with us. This will be the Revenge of the Risk Parity trade, and we therefore quite like duration.

Thank you for joining us for today. This episode was recorded on Feb. 23, 2026, 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 Head of Global Equity Strategy.

And be sure to watch also other Research @ Citi podcasts, 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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