Research @ Citi Markets Edition: A Positive Case for U.S. Equities

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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 here at Citi Research. Welcome to Research @ Citi Markets Edition, covering various topics at work within the U.S. equity markets.

I'll be doing this podcast solo as I want to use the opportunity to flesh out our views for U.S. equities as we head into the second half of the year. Along these lines, what you'll note is that over the weekend, we've raised our price target for the S&P 500 along with earnings expectations.

If I were to identify the second-half setup, it would simply be “short-term hurdles relative to long-term opportunities.” Let's focus first on what's driving our target increase: It's the earnings picture. The AI influence is coming through loud and clear here, what we saw with the Q1 reporting period is something that we would identify or characterize as episodic in terms of its strength. The question becomes one of how persistent this is going to be longer-term.

In fact, if you look at where we started the year with our earnings expectation, it has been easily surpassed with the current consensus setup. With our new earnings targets, we are leap-frogging other strategists and setting ourselves up at what we believe are the highest on the Street.

Where this takes us is that the Q1 earnings results we think set up for a persistency of earnings beats, albeit at a lesser rate, as we go into quarters two, three, and four. As this unfolds, in turn, what we think it sets up for is investor confidence in what ‘27 is going to look like.

The combination of the two, we think, provides a backdrop whereby U.S. equities can continue to work higher between now and the end of the year. Keep in mind, we're just getting going in the month of June. We've got seven months still for this storyline to play out.

What I like to point out in this context is the second related element of this: that macro conditions certainly matter. The global geopolitical landscape, along with Iran, oil price, inflation, interest-rate issues, all are significant attributes that we need to contend with. But essentially, what we're looking at here with the S&P 500 is what we characterize as a bifurcated market.

Well, what do I mean by that? That means that we have a new sheriff in town: this AI playbook that essentially is providing a fundamental tailwind for many areas of the tech, communication-services, industrials, energy, and even utility sectors. This tailwind is expected to persist if you look at the capex spending plans out through the end of the decade. That cohort contributes roughly half of the index composition for the S&P 500.

The other half is going to relate to more-traditional macro drivers. This is where you're going to find the bulk of the financial sector, healthcare, consumer discretionary, and so forth. My point here, though, is that when you look at the macro influence on the S&P 500, the impact isn't as much as it is commonly expected to be, leading us to conclude — as we've discussed in the past — don't confuse Wall Street, i.e. the S&P 500, with Main Street, i.e. the broader U.S. economy.

Now, to be clear, there's increasing evidence that the AI investment spend is contributing to the underlying economic conditions here in the U.S., but we'll leave that for a different storyline. But to summarize, this point is that when we look at the fundamental setup for the S&P 500, as we go through the balance of this year and into next, we think the earnings picture is something that you typically only see coming out of recession periods, and not nearly from as high of a starting point as this one is. So: episodic event, and fundamentals, that we think continues to drive the index price action.

Macros matter. Yes, we're all eyes on the next phase of the Iran conflict, as I mentioned, the related oil/interest-rate/inflation connotation that comes from that. But thus far, we've seen limited negative impact of higher oil prices. We think companies have been fairly, fairly muted in the way they've discussed this going forward, such that as we go through the second half of the year, we expect that there probably is still some room both ways: for companies to report a little bit more negative influence, others more positive influence.

So, longer-term perspective: The way we're setting this up is that the earnings drivers for the S&P 500 look good. This drives an increase in our fundamental target for the index.

Now, shorter-term, what are the hurdles? Really, what this comes back to is where sentiment around this AI playbook is taking us. We have, in our own proprietary indicators, moved into what we'll say are euphoric conditions. Often this can mean that when that setup is in place, you can get shorter-term pullbacks and volatility. This is what we're basically suggesting is always going to be an issue on the heels of the type of price action that we've had in the index thus far this year.

There are other issues. Last week we saw an unusually strong jobs report vs. expectations. As I mentioned, ongoing confusion around the ultimate end of the Iran conflict with this implication on energy prices. Some concern about index moves as we have mega-cap IPOs ahead, and then the natural as to-be-expected profit-taking mode in an area like semiconductors.

So, my point here is that the longer-term setup, in our view, continues to be a very constructive one, predicated on the AI spending influence as that infrastructure continues to get built out.

Shorter-term, however, we face hurdles that are mainly sentiment-driven, but real. We have to navigate the interest-rate circumstance, the Fed condition with Chairman Walsh now in place, and as I mentioned, an ongoing bevy of other news that comes into play here. So where this takes us is in aggregate still positive, but allowing for, as I mentioned, some ongoing space of volatility.

I also want to dig in for a moment on this notion around dispersion, because one of the aspects that's at work in the U.S. equity markets is this energy and tech leadership. But as I mentioned, other sectors of the market haven't done so great. This is to be expected, given what I've mentioned in terms of the macro influence. But it also continues to be very clear that AI has been driving the bus.

Now, as we move further into the second half of the year, we potentially get to some point where we're talking about a clearer end of sight for the Iran conflict, continue to see oil prices work themselves lower, and begin to resolve some of the related inflation and interest-rate concerns. The opportunity also exists for a broadening, OK? And this broadening is another element that comes in and, in our view, can help lift the index towards our full-year targets.

Interestingly, though, while most of our focus is on the S&P 500, we'd also say that the broadening playbook can take us down-cap into U.S. small and mid-cap. Side note: If you look at year-to-date index performance, small-cap has actually outperformed large-cap. We highlight that that's mostly a function of a fewer number of AI-influenced companies, but the valuation circumstance as you go down small-cap, the earnings growth opportunity does mean that as we look at this dispersion backdrop, not only is the opportunity solid in our view for large-cap U.S. equities, but also can be played down-cap where we've been constructive more recently on small-cap and in particular small-cap value.

So, to sum all of this up, there's no question in our minds that AI tech leadership is critical in terms of an index driver into the end of the year and likely going forward. But a broadening notion in addition to that should be a contributing factor.

We step back and answer the question that we get frequently on this AI playbook and buildout: What inning are we in? Our answer is that, in our view, we're looking at middle innings. Now, to start the year back in December, when we were putting out early targets for this year, we would have said early innings. So we are acknowledging that as time passes, as the stock price tells us that there's a lot of good news being priced into the securities, we're moving later into the game. But we still think that there are several innings to play on this.

And so, to summarize our setup going into the second half: Yes, we've got short term hurdles to be navigated, but the longer-term opportunities that we see unfolding here continue to derive from the ongoing expansion of the AI opportunity into many areas of the AI-enabler buildout, and then ultimately the AI-user cohort.

Hopefully this has been of some interest to you. I want to summarize by just saying that this podcast was recorded on June 8, 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 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 (10:03)