

Research @ Citi Markets Edition: Tech Trade at a Crossroad

Recorded: July 6, 2026

Published: July 7, 2026

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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.

Today, I'm going to discuss our positioning views for Q3 with a focus on tech and the broadening trade. [In our last podcast](#), we talked about a constructive outlook for the S&P 500 going into the back half of the year. This was premised on what we characterized as earnings-growth exceptionalism, which is essentially referring to the AI influence dynamic that has caused S&P level earnings to grow at a significantly faster rate thus far this year relative to most other periods in time, other than coming out of recessions.

That earnings tailwind continues in place as we go into the second half and into the Q2 reporting period, which will consume a lot of the Q3 timeframe. However, this is where it gets interesting. In our views going into the quarter, we've actually gotten a bit more cautionary on the tech trade and have focused more on the broadening opportunity as we go into Q3.

Let me explain. If you look at the S&P 500 and some of its derivative price-action components more recently, it's quite fascinating. As an example, the S&P 500 is up roughly 9% year to date, but probably 15% for Q2. Surprisingly, though, off 1% to 2% from its early June highs.

Compare that to the Nasdaq, which is up 16% year to date, but a whopping 27% during Q2. And compare that to the semiconductor sector within the S&P 500, which is up 33% year to date and about that much during the Q2 timeframe. Interestingly, that semi component has also sold off 10% to 11% since early June. So my point here being that we've had a very strong influence on this AI trade and related earnings tailwind coming specifically from the semiconductor component.

However, as you begin to look at the backdrop for the semiconductor driver within the AI complex, what you run into is a little bit of what we'll call a game of chicken. The stronger the capex spend by the hyperscalers, the stronger the setup is for the semiconductor component of that capex influence.

You do, however, run into a point where we have to be wary that you can see higher memory costs and higher costs for other inputs begin to become part of that capex playbook. And on the other side of the semiconductor strength, it begins to set up for concerns about the return on investment for the hyperscalers and other AI capex spenders. This is the game of chicken that we're talking about.

Essentially, the better the earnings are for the semiconductor component, at some level, the read-through by the marketplace has put more pressure on the hyperscalers, again, to justify ROI. Fascinatingly, for the strength that I mentioned in the S&P 500, the semiconductor component ... the NASDAQ 100, if you think about that old Mag 7 cohort (and we recently have been talking more about the Mag 8), they're roughly flat year to date.

So what's happened for this part of the index, which comprises literally 40% or so of the index, we've seen idiosyncratic behavior among these players. Some up, some down, some sideways. When I say some down, as an example, the software sector within the S&P is actually down 17% year to date.

Again, this bifurcation in performance is something that we've been talking about for some time, but it's also something that we think is going to continue to be with us from this dynamic where, OK, are we entering a phase where these mega-cap growers can't all perform equally, against a backdrop that still favors the AI spending growth that is expected to persist after the balance of this decade?

So what we're doing specifically as we go into the Q3 timeframe is, as I mentioned, we've stepped back in terms of our positioning on the tech component specifically, which is an area that we've been quite constructive on, particularly via semiconductors for the better part of two to three years. And we've allowed this to digest as we go into the Q2 reporting period.

We think we'll get much more spin from the companies, whether they're the semi manufacturers, the hyperscalers, some of the other related players in this cohort of companies, that's going to speak to, OK, I get it, the spending strength is there. It's good for fundamentals now. But how long can it really persist? And that questioning is what we think will keep some edge on the tech trade as we go into the summer months.

Now, let's pivot and talk about what else is going on in the market. In the past, we've said that, hey, the AI component of the S&P 500 is probably approximately 50% of the aggregate index. This means that everything else is the other 50%.

That everything else is going to align more closely with more traditional ... let's call it fundamental, but more importantly, *macro* metrics. What we've got going into Q3 now

is a line of sight towards a tail-off on the Iran conflict, which you see in oil prices breaking the \$70 level over the past week or two. We've got a new Fed chair in place, and we're starting to get the messaging that the market will have to take some time to, I think, interpret as we go forward.

But the high-level perspective on this is what we suggest can happen during the Q3 timeframe is a broadening dynamic. And this broadening means that the markets don't rely as much specifically on the AI trade and can actually broaden into other sectors. So what we've done going into Q3 is get a bit more constructive in a couple of them: consumer discretionary for one, industrials for another. And what this does is align with a view that we think the cyclical component of the market can do better than it has, relatively speaking, during Q3.

Now, coming back to the Iran conflict, the point here is that so much of the concern regarding the Fed and regarding interest-rate pricing has related to the inflation condition. And clearly on the heels of Chair Warsh's first and probably second presentations to the public, the concern has been that he's remained fairly adamant on managing the inflation component in a way where the market is now pricing in a higher probability of a Fed hike in the upcoming Fed meetings.

Our take on this is a little bit different. Again, the AI-related action has been the big driver of U.S. equity markets through the first half. What we think happens now with oil prices fading is that as Q3 unfolds, we'll begin to take some pressure off of that inflation concern. And what should begin to unfold is, again, lower oil prices lead to lower inflation metrics, leads to lower or let's call it more muted expectations for a more aggressive Fed on the hawkish side.

In turn, coming back to the price action of those parts of the markets, we see room for recovery. So that broadening down a cyclical path is what you would expect intuitively when you come off of a period where the market's been pricing in a Fed concern related to the inflation dynamic. And again, we think what this sets up for is a relative performance shift in the months to come.

Now, to summarize, this is not to say the AI trade is dead. The fundamental attributes here continue very much in place and are part of our ongoing constructive U.S. equity call for this year. But we do, however, have to acknowledge that what's been good for the semis potentially runs into a dynamic where it's perceived as a bit more of a headwind for other areas within the AI cohort, particularly the hyperscalers.

We would also note, though, that if you were to get any signs of, let's call it a deceleration in the rate of AI capex spending — which is not in the line of sight, but certainly something that could come up in discussions — the software sector could potentially be a beneficiary of that as well, which is why we've gotten incrementally less negative on that part of the market.

So all told, we think the Q3 setup here is one for tech trade at a crossroads, a broadening dynamic at work. And this is all in the context, again, to emphasize an ongoing, fairly constructive view on the S&P 500 led by very, very exceptional earnings-growth dynamics into the second half.

That'll wrap it up for this podcast. We've recorded this on July 6, 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 this same channel. Thanks, and have a great day.

Disclaimer (09:26)

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