

Research @ Citi Markets Edition: Q4 — It's Not How You Start, It's How You Finish

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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 colleague, Pat Galvin, who runs U.S. Equity Strategy with me here at Citi. I've invited Pat here today to talk about the path to year end from a variety of perspectives.

There are three main areas that we want to focus on in terms of how to position in this very unusual tape for the run-in to year end. I'd remind our view has been for some time now, that in looking at the S&P 500, we really have to have perspectives on two aspects of it.

First is the half that is directly affected by the AI-infrastructure buildout and its implications. The other is the half that's more traditionally influenced by ongoing macro drivers. And there, we've been referring to the Jackson Hole pivot as an important dynamic here, where since the Jackson Hole timeframe at the end of August, we lost the broadening call, if you will, but it was made up for by improved performance on some of the AI components. But essentially, what that's done is open the door for a number of different macro interpretations.

Three topics that we want to address, as I mentioned, first on AI. The way we're looking at this is that the underlying tailwinds, probably facing some scrutiny but still in very good shape. Heading into the end of the year, generally speaking, we favor the semiconductor component over the hardware component. And software continues to do just fine from a performance perspective. But here, we're looking for a bit more conviction in positive revision dynamics to fundamentals, as valuations have improved over the past quarter.

Away from that, we've also gotten more constructive at the margin on the media component, which is where you catch some of the internet names that are involved in the AI-related spending. Here, revenue growth trends that we saw in Q2 reports look pretty solid, and I think they allayed some of the concern regarding the ongoing AI capex playbook.

Now, there are some flies in the ointment, to be sure. We're seeing some evidence of societal pushback in terms of data center buildout, and that will be vetted, I think over time. But for now, we're fairly comfortable that at least for the balance of Q4, fundamentals are in pretty good shape.

Now, as we go into Q4, midterms continue to come up as a critical topic of conversation. And let's turn it over to Pat here to get some perspective on how we're thinking about that. Pat?

Patrick Galvin (02:34)

Hey, thanks Scott. Yeah, the midterms have been coming up quite a bit in client conversations. And I would say for us, our view has been the midterms, it's not really a significant market-moving event overall.

I think that higher likelihood of a divided government, which we can see in the polls, we can see in the prediction markets, is more or less the likely outcome. The potential policy implications and read-throughs to equity fundamentals, very limited in scope in those outcomes.

Historically, midterms, it's not really a significant market-moving event. And if you look back the last 60 years or so, on average, we see a bit of equity-market underperformance the weeks leading up to the midterms, relative to non-election years. But this typically reverses course quite quickly. As soon as that event vol passes, equities return back to the normal trend of non-election years right after the midterms.

So it's not a big deal for us, but I would say this year specifically, the prediction markets, the polls, telegraphing that strong momentum for the Dems over the last few weeks limits the surprise factor for equities should we see at least the House flip to the Dems, or even a full-on Dem sweep outcome.

Scott Chronert (03:42)

So we've got the midterms coming up. Again, just to emphasize, historically, the pattern is, you get a selloff into the midterms themselves, on the uncertainty component of it. But then history would say, post that, you tend to regroup some of that and plays to a bit more constructive end-of-the-year setup, which I'm going to come back to again.

OK, so we've got AI, we've got midterms. But again, the big elephant in the room is how to handicap oil prices, the Iran circumstance, and then obviously what's happened in recent weeks with Fed rate expectations, which have turned quite notably hawkish. You want to opine on that for a bit, Pat?

Patrick Galvin (04:15)

Yeah, sure thing. The equity markets have been very resilient in the face of some of the headwinds you mentioned. But if we just take a look back at the price action, since the middle of the summer we've had oil prices go from mid-70s to close to 100 on WTI. Ten-year yields have backed up about 60 bps from 4.6% to 5.2%.

And rates markets, I mean, we priced in four additional rate hikes from the Fed. So earlier in the year, we were talking about Fed cuts into the end of the year, and now we're looking at four additional hikes after the latest move from the Fed.

So if we take that context and look at the S&P down 70 bps from all-time highs, the market's been very resilient overall. But if we look under the surface, there's been a fair bit of carnage, mainly the consumer cyclicals and the rate-sensitive defensives portion of the market experienced pretty significant drawdowns in the neighborhood of high single digits, low double digits from that midsummer period.

So the market's priced in some of those energy price shock rates, inflation headwinds. It's just only visible in a portion of the market. There, we'd say the risk-reward gets a little bit more attractive for this portion that we've corrected.

If we were to see some progress or line of sight towards a resolution on Iran, I think that takes some pressure off the Fed and sets up for somewhat of a relief rally in rate-sensitive consumer and defensive. The poll momentum, the prediction-market momentum swinging in the favor of the Dems, it puts a bit more pressure on the current administration to cool things down in Iran, and find some pathway to a resolution ahead of the midterms.

Scott Chronert (05:51)

Great.

OK, so to wrap this up, as we mentioned, three big topics as we think about the Q4 setup. We're emphasizing a couple of things. Number one, it's not how you start the quarter, it's how you finish.

So, the current backup in oil prices, yields, the Fed hawkish narrative is pretty well known. We're presuming that mitigates as we go through the quarter — you see some pricing potentially come out of the Fed dynamic.

And what that would do, obviously, is set up for some contrarian positioning here. Those sectors that have been most under pressure as a function of higher rate concerns, potentially give you some snapback opportunity. The AI trade continues fairly persistent, but noisy. No surprise there.

And so, what we're essentially suggesting is a more eclectic approach to positioning going into Q4. In our view, there's still an upside opportunity to the S&P. We suspect it's probably a bit more back-half-of-the-quarter-loaded, if not year-end-rally-like, if

you will. But we also have to acknowledge that there are ongoing risks in front of us should this hawkish Fed narrative really be supported by underlying economic conditions — which, again, we think has oil prices as a linchpin.

Bottom line here, we're going to wade down the constructive path. We're going to play somewhat contrarian in terms of how we think about some of the sector response heretofore. The AI trade continues underway. But again, as I've mentioned a couple of times, we think it continues quite nuanced and with lots of trading dynamics that work under the surface.

All in, I hope you found this of some value. This podcast was recorded on Sept. 28, 2026. Thanks for joining today. 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 (07:44)

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