

Research @ Citi Markets Edition: Winds of Stagflation

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Transcript:

Opening Teaser: (00:00)

Research @ Citi Markets Edition

Alex Saunders (00:03)

Welcome to Research @ Citi Markets Edition, where we break down global macro in 10 minutes or less.

I am your host today, Alex Saunders, Head of Quant Macro Research, and I'm joined by Giammarco Miani of our Global Macro Strategy Team. Welcome to the show, Giammarco.

Giammarco Miani (00:19)

Thanks, Alex. Great to be here.

Alex Saunders (00:21)

We're recording this podcast at 9 a.m. on Monday, March 23, 2026.

Much to discuss as always, not least the continued conflict in the Middle East. Friday and over the weekend brought new headlines of potential escalation and de-escalation. We discuss the potentially stagflationary impulse from an extended oil supply concern, how central banks and rate markets are reacting, and — as if that wasn't enough — private-credit concerns.

Starting with stagflation, the duration and severity of the conflict and the targeting of energy infrastructure last week adds another layer of complexity to the energy picture. Our commodity team adjusts their base case higher, and also assigns a 30% probability to a dire extended closure of the Strait, with Brent crude over \$150 per barrel. This higher-for-longer energy regime brings stagflation worries.

We broadly agree with Fed Chair Powell when he was asked about stagflation during the recent press conference: We're not at the levels of growth or inflation to bring to mind the stagflationary 70s, but we are seeing potentially a large stagflationary impulse.

Borrowing from our global-economist scenarios and my quant team's regime modelling, we look at how such a shock might feed through into asset classes. As you might

expect, such an environment is negative for equities and bonds, but credit typically fares worst on a risk-adjusted basis. Given where the economy was prior to the conflict, scenario analysis suggests negative returns for equities and credit with little differentiation across regions, but low, slightly positive short ratios for bonds, with the winner being inflation-protected bonds delivering positive returns.

This is more of a stagflation-like impulse. Full stagflation would mean much more negative returns across asset classes, with the havens potentially being the dollar (historically at least), price-based strategies such as trend-following, or Quality and Defensive equities.

There are some nuances, according to our analysis, depending on the central-bank reaction. In stagflationary times, without financial conditions tightening, bonds perform meaningfully worse, equities a little better, and gold can act as an inflation hedge.

Last week gave us a window into how central banks are thinking about the energy shock. Giammarco, what did we learn?

Giammarco Miani (02:44)

Yeah, Alex, what a week for G10 central banks! The big question coming into last week was if, and also how much, central banks would respond to the current oil price shock and the prospects of higher inflation. Not so much in terms of imminent hikes, but more in terms of guidance for the rest of 2026.

You could say there are many analogies one could draw with the 2022 shock, for example. Obviously, at the time, COVID restrictions easing, inflation was already running higher. On top of that, we had big fiscal coming. Well, this time around, it's mostly an exogenous supply shock. So many were wondering whether central banks would see through the shock, at least for now.

And I think many hoping for that outcome were really left disappointed within ... let's call it the G3: U.S., UK, Europe. The case for the UK and the BOE was striking. I think that was the biggest shift in rhetoric that we saw. The BOE was expected to deliver another two cuts this year up until a few weeks ago pre-conflict. Instead, at the last meeting, we got a 9-to-0 vote split to hold vs. expectation for 7-to-2. But more importantly, we saw some of the dovish members shifting from pushing for cuts to discussing hikes.

For the euro area, the ECB struck a bit more of a balanced tone, you could say. But the scenario analysis on higher oil, at least later, was strikingly hawkish. And also, the headlines post-meeting sort of suggested that June is live as a meeting.

The Fed, on the other hand, was the only G10 central bank where cuts were still expected up to last week. That changed in part, obviously, because oil continued to rally, but also due to a more hawkish-than-expected FOMC. I mean, the presser was

focused much more on inflation rather than labor markets, with the particular emphasis on goods inflation.

So you could say generally the tone was quite hawkish relative to expectations. Outside of G3, the central banks that relatively — and I would really stress here “relatively” — looked more likely to see through the shock were perhaps the BOC and the SNB. The BOC highlighted risks due to the weaker local economic fundamentals. With respect to the SNB, they cited downside growth implications from the conflict as the main risk to the economic outlook.

And moreover to us, they appeared to prefer the effects channel as a monetary-policy tool. So overall, there was a good amount of divergence among central banks' reaction. And while oil for now, in our view, will likely continue to dictate the directionality of rates and yields, we think different central banks' rhetoric can probably dictate the magnitude of these moves and how much of this pricing eventually gets realized. Obviously, bigger for those places where the rhetoric has already shifted hawkish.

Alex Saunders (05:31)

And how does all this feed through into FX, Giammarco?

Giammarco Miani (05:34)

It's an interesting question, because in many countries right now you have opposing drivers at play, right? You have obviously a commodities terms-of-trade shock, which is negative effects for the importers. But then you have yields moving higher in a lot of these countries, which without a commodities of trade shock are generally good for FX.

So far, we've showed that commodities have been the main driver for FX. And we also showed that in 2022, commodities continue to be the main driver, for example, for euro-dollar for a good part of the year, regardless of what rates is. So, we expect commodities to remain in the driver's seat for FX for now.

But one thing to note on commodities terms of trade and specifically for commodities effects against the dollar, so the likes of Aussie, Nokkie is that historically we find the cross-sectional correlation between moves and commodities FX against the dollar and changes in commodities terms-of-trade tend to be equities regime-dependent.

And what do I mean by that? As equities remain well-behaved, measured in our analysis as the level of VIX is at, the cross-sectional correlation between commodities effects and commodities in terms-of-trade changes remains quite high. So let's say, as energy commodities continue to rally, the exporters see their currency appreciate even against the dollar.

But as the VIX moves higher, that correlation tends to weaken and can even turn negative, right? So that's a warning sign for the high beta commodities effects. If VIX spikes, you could see these currencies behave more in line with the risk-off in equities rather than the rally in commodities.

Alex Saunders (07:09)

Thanks, Giammarco.

And as if that wasn't enough to absorb, private credit has also been in the spotlight. Our high-yield strategists make the point that private markets have absorbed software-company exposures at a higher rate than either public loan or high-yield markets. Our recent report shows that the higher software-exposed investments have underperformed.

But what does that mean for broader financial conditions? We would see three transmission channels:

Via loan ETFs, which are a small part of the overall market. But given their daily liquidity, they can have an asymmetric effect on risk appetite and price discovery.

CLO formation. CLOs are a large buyer of leveraged loans. Therefore, a slowdown in issuance could portend a tightening in financing conditions in those markets.

And then finally, by bank lending. If such lending to the non-depository financial institutions was to moderate, it could also tighten financial conditions.

These transmissions are not necessarily in our base case. However, the investment-grade credit market has not reflected those potential spillovers in our view and remains the most attractive downside hedge.

So overall, we see a potentially stagflationary impulse rather than a stagflation regime. Functionally, this means slightly weaker equities and credit with real rates performing better than nominals in bonds.

Much will depend on their central-bank reaction functions. A hawkish repricing is already underway with inflation risks rising. But there's been some relative changes in rhetoric already. Private-credit worries are centered on the large weight in software companies. We're monitoring transition channels for potential spillovers into broader financial conditions.

In such an environment, we think credit tends to offer a downside asymmetric hedge.

Thank you for joining us today. This episode was recorded March 23, 2026, and I'm your host, Alex Saunders, standing in for Dirk Willer. For more details, Citi clients can check 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 our Research @ Citi podcasts, which you can view on the same channel.

The macro-strategy team will be back in two weeks. Stay sharp!

Disclaimer (09:27)

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