Research @ Citi Podcast, Markets Edition: The Bubble Playbook

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Opening Teaser: (00:00)

Research @ Citi, Markets Edition

Dirk Willer (00:04)

Welcome to Research @ Citi, Markets Edition, where we break down global macro in 10 minutes. I'm your host, Dirk Willer, Citi's Global Head of Macro, and with me today is Adam Pickett, our London macro head. Welcome to the show, Adam.

Adam Pickett (00:16)

Thank you, Dirk. It's great to be back.

Dirk Willer (00:19)

We are recording this podcast at 9 a.m. on Monday, Oct. 6, 2025.

Global equity markets have done well in the seasonally challenged month of September and are setting up for the typical year-end rally. Many investors are asking whether the equity market is in a bubble. We think it is, and we will discuss what to do about it.

To discuss a bubble, we need to start out with the definition of a bubble. We use the following: If something goes up by more than two standard deviations against the long-term trend in real terms, we call it a bubble. We use prices for that, not valuation. The main reason is that earnings can be in a bubble, too. But if you do use valuation, you get actually very similar results.

We also reset the bubble after large sell-offs. The reason is that for bubble top, sentiment needs to be quite extreme. And it just never is after these large sell-offs.

Using this methodology, we found nine bubbles starting in 1929. And we entered the last time in June of 2023, and then re-entered in June of 2025.

But there are two main takeaways.

The first is, when you enter bubble territory, you buy the market. Only in 1929 did the market go straight down. In the other eight cases, it went straight up. The bad news is it's not that easy to tell how long it lasts. It's really quite variable. But one important point is that it typically ends badly in the sense that most of the gains that the market makes during the bubble period get unbound when the market is exiting the bubble.

Adam Pickett (01:50)

Dirk, how would you think about this? Are we closer to the beginning or closer to the end?

Dirk Willer (01:55)

We don't think we're close to the end. And that's really for two reasons. One is that sentiment usually is much more bullish at the peak of a bubble than we currently seem to be. And for that you can, for example, look at the survey of Large Asset Allocators that we track. You can look at the Individual Investor Survey. And it's really not the typical pattern that you see.

The second point is a bit more fundamental. The gap between the peak in equity markets and the peak in the capex cycle as proxied by semiconductor sales, for example, is really not that long. So, in 1999, for example, it only took a bit more than six months between the peak in Nasdaq and the peak in the capex cycle. And so therefore, if you call the top in the market now, you have to believe that the capex story is over within half a year plus, which seems really extremely short.

Now, there are, of course, already some bubble-like aspects really showing up. I mean, vendor financing has become a big topic. But the point is that this is quite normal. I mean, yes, it's part of the virtuous cycle while the market is going up, and vendor financing will be part of the vicious cycle when the market is turned. But we think we're really not yet close to the end of this rally.

But one important point is that if you're in a bubble, you have to really risk-manage it, maybe more aggressively than you typically do. So how would you risk-manage the bubble?

Adam Pickett (03:13)

That's exactly right. It's tough, Dirk, but we've got two methods or indicators that we really find valuable in situations like this. The first? You alluded to Citi Indices, the Polls Indicator that Citi produces. Positioning optimism, liquidity, leverage, and stress is a nice scorecard of various factors across positioning, volatility, economic data, and other market-based models, designed to try to capture when the market is perhaps a little bit complacent.

And effectively what we find is that when this indicator goes above 17, that's a line in the sand to get out of risk. And when we run a simple strategy of testing the S&P unconditionally, buy and hold vs. cutting out when polls is above 17, you reduce your max drawdown by about a third, you improve your active information ratio from about 0.85 to 1.3. So big, sharp improvement there. And you overall get better absolute returns with lower volatility.

Now, that's good for general equity-market periods. But what about a bubble? Now, in a bubble, typically you have quite narrow leadership. So, in theory, the leadership matters even more than usual. We test this. We call it “when the generals fail.”

Now what we find is that if you take the biggest seven stocks in the index — leadership group, the generals — and you look at when three out of those seven are trading below their 200-day moving average, it leads the overall index lower.

It was early in the dot-com, it was early in ‘22, it was early this year as well. Neither of those two signals has triggered, which when we combine with some of the more discretionary dynamics that you mentioned, Dirk — a lot of this spending is done out of capex, rather than the debt as well — we think it's too early.

But one factor we haven't mentioned is the Fed. What do you think there, Dirk?

Dirk Willer (05:04)

That's a very important point because usually the Fed hikes during these bubbles when they're building. Obviously ’99, about 175 basis points but also in other cycles. And the cut is pretty much unheard of into a bubble. It's a little bit unclear just how important the Fed was in ’99, because presumably the bubble would eventually have ended regardless, because it's not about rates, it's about misallocation of capital essentially in the end. But it probably did speed things up. Bubbles do need liquidity.

In ‘99, in the last quarter, there was a big liquidity infusion because of the Y2K bug or the fears of the Y2K bug. And that liquidity was then taken away in early 2000. And this almost certainly was important for timing the precise peak of the bubble.

So this is very bullish, the Fed function here. It is a bit of a virtuous cycle. So the capex boom maybe contributes actually to less hiring and a weaker labor market. And that, again, leads to a more dovish Fed and lower rates, and leads to more capex. And so it goes.

Inflation, of course, becomes a bit of a risk during these bubbles. But for now, the Fed is, of course very, very far away from hiking. And so from that point of view, we really think it's another very bullish factor.

But Adam, how do other asset classes behave during these equity bubbles? And what could be different in our Fed discussion?

Adam Pickett (06:16)
So when we run other asset classes and other assets through these bubble periods, we get a few stylized facts. Firstly, bond yields go up, Treasury space. Secondly, the curve, Treasury curve 530s, tends to flatten but again I think that's mostly because the Fed typically are hiking, so the jury is a bit further out on this one.

Bond yields underperforming probably still makes sense in a world where maybe there's U.S. economy rebound risk out to the second half of next year. And certainly when we look at the cuts priced into the second half of next year or the beginning of ’27, we think those may be overblown.

But lastly and most contentiously on the dollar, the dollar tends to go up in a U.S. equity bubble. This makes sense from a pure capital-flows perspective. But obviously, if the Fed are going to be leaning into this and cutting perhaps more than they should be, financial conditions are already super loose, then maybe that also complicates things for the dollar.

We still think the euro trends towards 120 for the end of the year, and there's risk of a reversal after that. Some work we did this week looking at how hedge ratios have changed amongst foreign owners of U.S. assets this year does a very good job of explaining the gap between euro-dollar performance against models using relative rates and relative equities.

So until we've got more clarity on that sort of excessive Fed dovishness story, as well as the hedging story, we find it a little bit harder to buy into a dollar rally story just yet.

Dirk Willer (07:45)

Thank you, Adam. So, of all, on our definition, the U.S. equity market is in a bubble, but that makes us bullish, not bearish. Risk management is key, though, and we will propose two ways how to go about this important topic. Lastly, rates usually go up during bubbles, but the current Fed is more dovish than usual, which could prolong the bubble.

Thank you for joining us today. This episode was recorded on Oct. 6, 2025, and I'm your host, Dirk Willer. For more details, Citi clients can check out our reports on the Citi Velocity portal. If you enjoyed the podcast, please leave us a review on your favorite podcast platform.

Next week's Research @ Citi Markets Edition will be hosted by Beata Manthey, Citi's Head of Global Equity Strategy. The Macro Strategy team will be back in two weeks' time. Stay sharp!

Disclaimer (08:33)