

Research @ Citi Markets Edition: The AI Impact on U.S. Equities

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Opening Teaser: (00:00)

Research @ Citi, Markets Edition

Scott Chronert (00:04)

Hi, I'm Scott Chronert, Head of U.S. Equity Strategy at Citi Research. Welcome to Research @ Citi, Markets Edition. This is our second, which will be an ongoing series, of podcasts, focusing on topics of worth within the equity markets here in the U.S.

With me today is Drew Pettit, my 10-year colleague in building out all things related to our U.S. Equity Strategy and ETF Research platforms. In particular, Drew also has lead on Thematic Strategy, which we're going to work into our focus today.

In our opening podcast, we focused on the structural bull case for U.S. equities as we see it. Today, we dive into this a bit deeper, and take a look at the AI impact on U.S. equities. Generally, you'll hear us talk about this in three components: the stock market vs. the economy, AI in the market, and then AI's impact on the market.

To kick things off, I think there's a basic view in financial markets that as goes the economy, so goes U.S. equities. Our view is that this is not really the case as a function of the way the markets have unfolded over the past 30 years. We like to think of U.S. equities according to three clusters: Growth, Cyclical and Defensive.

Back in the 90s, the Growth cluster was roughly 12% or so of the aggregate index. As of this podcast, we're looking at a Growth weight within equities of closer to 40%. Essentially, what happens here is that as this has broadened out in terms of the Growth influence on U.S. equities, the related influence of traditional macro metrics has lessened. So, when we look at the world from here, this index change has, in essence, created a divide between the economy and broader U.S. equity market actions.

Drew Pettit (01:52)

Yeah, and it's funny, boss, like when we look at the data and all the work we've done over this past decade, we see that the earnings drivers are changing. So, it used to be as goes GDP, you see earnings growth directionally follow that. Well, the earnings

drivers are different right now. You actually see inflation matter more in the difference between top-line inflation and cost inflation. And then the other piece we're seeing, labor productivity, might actually play a bigger role than real GDP growth.

So, when we tie this all together, you're actually looking at a connection where GDP probably explained more than 50, 60, almost 70% of earnings growth in the 70s and 80s. What we're looking at today, it's probably less than a quarter.

So, as you were saying, this isn't a new development. This is a trend that's really been in place for I would say most of the financial-crisis timeframe. And really, it's about tech finding its way into everything, not just the tech sector.

Scott Chronert (02:53)

Right. So, the way we go about this is that when we look at our U.S. equity strategy views, we tend to lead with a fundamental perspective that incorporates many of these aspects. We don't completely ignore the macros. They certainly are an important influence, but perhaps not to the degree that's often recognized in a lot of the financial media, if you will.

Now, when you turn to this next driver in terms of AI, and we think about AI in the markets, the way we talk about this is that over the past two to three years, the influence of AI has begun to kick in in a way where it's manifesting in strong capex trends. It's manifesting, though, in the index construction component where it's having a very clear impact on the underlying fundamental trends for the index as this part of the market becomes more and more important.

This also has triggered our work that has enabled a push into the Thematic Equity Strategy component of this as a way of teasing out some of these influences. And this is where Drew's taken the lead over the past couple of years for us.

Drew Pettit (03:56)

Yeah, you definitely beat me to this, boss. It's that the thematics seem to matter almost more than the basic old sector constructs that we looked at. So, AI, for example ... well, I'll call it topic *du jour*, but it's really been the topic for two-plus years at this point.

When you think about what's really tied to AI, it's not just the Mag 7. We think probably half the market cap in the S&P is tied to AI in some sense. You have to think about the whole supply chain from power generation and transmission to chips, server racks to the end devices where you might be using AI tools, the networks that get you there in the software app platforms that are there. So, it transcends the typical sector classification.

So back to, "How big is AI in the market?" It's probably at least half the S&P 500. So, it's funny right now: The focus on AI in the market and the tradeable ideas is really

around the most obvious build-out in application levels. But when we dive into the value chain and think thematically beyond the obvious, there is a lot more to come. It's not just tech, and tech disrupting tech. This is tech influencing everything across the supply chain.

Scott Chronert (05:17)

OK, so let's hold this thought. So basically, what we're suggesting here is that the AI impact on U.S. equities in terms of the percentage of the index that's influenced by AI may be as much as 50%. What this means is that we're looking at essentially two markets when navigating the U.S. stock market. You've got the AI influence; you have everything else that probably is going to have a little bit more of an economic-sensitive dynamic to it.

But what really gets interesting here is that this is beginning to influence the AI impact on the market in a way where we're now starting to look at underlying employment levels vs. sales. For example, the S&P 500 hasn't shown much employment growth over the past year. In fact, it's close to zero. But in the meantime, the sales per employee has been ramping very nicely up and to the right.

What this means is that we're seeing more and more operating leverage as you're seeing corporates begin to incorporate AI-related productivity enhancements and leverage essentially human capital. So, they're fine-tuning businesses. They're reducing cyclicalities, if you will. And this, we think, actually translates into a longer-term valuation tailwind for U.S. equities.

Now, going forward, what we think we're going to see is ongoing new product development that ties in AI-related technologies. And essentially, longer-term, what this should begin to do is translate into lesser earnings volatility over time, higher productivity growth, and in turn, again, comes back to our first podcast on setting up for a more structural S&P 500 outlook from here.

Drew Pettit (06:51)

Yeah, the beauty of this is how it builds on itself. It's almost like internet and e-commerce. You couldn't have the latter until the former was really established. So, AI starts to create new business opportunities and evolve businesses.

It was interesting, at our tech conference at the beginning of September, companies were talking about AI. We get that. It wasn't just C-suites saying "AI, AI, AI" until investors paid attention, but they were looking for ways to better define and measure its impact on their business, both internally when thinking about how they can get more out of their people, but even talking about new products and how quickly product cycles would evolve.

And again, they're not just sitting on the sidelines hoping this happens and hoping it shows up. They're looking for the financial impact. Is it the number of calls we can receive without adding new headcount? Is the product cycle shorter so it should show up in better sales and retention? Is it maybe not adding more coders to get those new products out?

So, it was funny. They were talking about it, but much more concretely now than they probably have in the past year. And they were looking for both productivity impacts on their businesses and business-changing type of impact and shift and evolution that would affect their customers.

So, it was amazing. It's tech changing how tech is thinking about itself and how businesses are evolving. And it's all over. And now we're finally starting to see areas where we can quantify it.

Scott Chronert (08:23)

OK, so let's pull us back to a higher-level view on this. I get asked the question a lot in terms of, "Doesn't this look and feel like the tech bubble back in the late 90s going into 2000?" I got a little bit more gray hair than does Drew, but I can tell you that what we're looking at right now is markedly different from the situation back then.

Now, we get it. Companies can't spend on new technology forever without delivering some expectation for returns around this. What we think in terms of the differences here vs. the tech-bubble timeframe is the nature of the companies doing the spending. For the most part, the spending on capital equipment and related infrastructure really is coming from general cash-flow generation, as opposed to specifically tapping into the broader U.S. equity and debt market. So, we think now that probably won't persist forever, but it's certainly a key differentiator.

So, the underlying fundamental premise for what's being spent on AI is different in our view from what unfolded during the tech bubble. But as we play this through in terms of the influence, we want to just be sensitive to, yes, at some point corporates are going to need to demonstrate that they're earning a return. And it may be very direct, it may be indirect, but we have to be open to that this is going to unfold down paths we haven't necessarily seen to this magnitude historically.

So, at the end of the day here, we look back on the three big takeaways of what we're talking about today. The first is that, again, for people looking at the broader U.S. equity markets, keep in mind our view that Wall Street is not directly tied to Main Street, as one might think. The market is not as reflective of the general economy in aggregate at this point, courtesy of these big growth tailwinds. And, essentially, we're looking at changes in underlying corporate behavior as a function of technology.

At the same time, this is influencing how we think about the AI impact in the marketplace in terms of weighting shifts within the Growth, Cyclical, and Defensive

components of U.S. equities. But then longer-term, the playbook here is going to be how AI is influencing the market via productivity enhancements. And this is going to take, I think, the opportunity set well beyond just the tech sector and much more into the broader market environment.

So, with that, we'll wrap things up for this section. Hope you found it a good and interesting lead. And we'll look to catch you in our next in the ongoing series.

This podcast was recorded on Sept. 29, 2025. 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 Strategy. And be sure to watch for our Research @ Citi podcast, which you can view on the same channel. Thanks, and have a great day.

Disclaimer (11:08)

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