

Research @ Citi Podcast Markets Edition: Geopolitics in the Driver's Seat

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Transcript:

Beata Manthey (0:00)

Welcome to Research @ Citi Markets Edition, where we break down global macro in 10 minutes. I'm your host, Beata Mantey, Citi's Head of European Equity Strategy. Joining me today is our Senior Equity Strategist, David Groman. Welcome to the show, David.

David Groman (0:19)

Thanks, Beata. Great to be here as always.

Beata Manthey (0:21)

It's been only four weeks since our last episode and once again, markets are in a very different place. On the one hand, we are still seeing sizable disruptions to commodity supplies with the Strait of Hormuz remaining closed. But on the other side, risk sentiment has staged an impressive recovery and equity markets are back to all-time highs. So David, how do you explain this tension between the macro backdrop and the markets?

David Groman (0:48)

Yeah, that's a really good question. It's also a tricky one to answer, obviously. But based on many of the conversations we're having, I would chalk up the optimism we've seen in equity markets really to three key things.

So first, just on the geopolitical front, it looks like some of the most severe downside risk scenarios — which would include more destruction of energy infrastructure, for example — are now off the table. So even if it takes a few more weeks before a deal is reached between the U.S. and Iran, oil prices should therefore still be on a downward trajectory throughout the rest of this year.

Second is just on equity market positioning, which has had a significant reset just over the past month or so. So earlier this year, investors were heavily net long across many major markets. Positioning then swung into net short territory with a big buildup in short positions. And now, as sentiment has recovered, positioning is back to neutral territory. But there's still a lot of the short positions that could potentially close from here, squeezing the market higher going forward.

And finally, we have investors refocusing on fundamentals again as we head into the earning season globally. And especially when it comes to the tech space, revision trends have been really strong just over the past month or so.

So when you put these things together, markets are at all-time highs, but it's of course worth emphasizing that there are still plenty of downside risks to be thinking about that are still on the horizon as well.

Beata Manthey (2:06)

All makes sense, David. And I think we should return to those downside risks later on. But you also mentioned investors are refocusing on fundamentals again. Can you give us a bit of an update on how earnings forecasts have been changing, given all the geopolitical volatility we've seen?

David Groman (2:23)

So just for context, one of the key themes we were focused on coming into this year was a broadening of earnings outcomes. By that I mean expectations for a Goldilocks macro backdrop, which was going to be characterized by solid global growth and also Fed rate cuts, but ultimately support stronger earnings growth among a wide set of sectors with the focus really being on higher beta and maybe more value-diluted parts of the market. But what this geopolitical shock has done is led us back down a narrowing path.

So if we look at global earnings revisions, we're now seeing earnings upgrades in only two places: commodity sectors and the technology sector. And meanwhile we've seen earnings downgrades elsewhere, especially in consumer-facing sectors. So, there's really a gap opening up between leaders and laggards, at least on the earnings revision side of things.

Beata Manthey (3:10)

Are valuations reflecting this dynamic?

David Groman (3:13)

Well, that's the really interesting part. To that question, I would say not yet. Things are obviously changing pretty quickly, but the valuation backdrop still looks much more attractive for growth than value.

So what we're seeing now is like global growth, which is obviously heavily tilted towards tech, is trading at something like an 80th percentile multiple valuation vs. its history. But at the same time global value — which in theory should be more vulnerable to earnings pressures stemming from this war in Iran — is still looking relatively expensive. Global value is actually trading near its highest valuation ever over the past 25 years.

So if we put the EPS and valuation picture together, it's still reasonable that investors have been more aggressively buying the dip in tech over the past few weeks.

But with that, let me let me turn back to you. I've recently adjusted all of our global equity allocations to incorporate what we've talked about thus far. Can you explain some of the changes that we've made there?

Beata Manthey (4:07)

We came out with our Global Equity Quarterly outlook, where we rerun all of our models, refresh our views for the months ahead. It is a particularly difficult exercise right now, given how much volatility there is in terms of the news flow. But if I was to summarize our views to year end, we still see markets grinding higher from here. But we also think that the path to those gains is going to look different and probably narrower. And given that macro risks are still skewed to the downside from here, we think investors should adopt more of a quality and defensive tilt in their portfolios going forward.

So with that in mind, we've recently upgraded the U.S. to overweight in our global allocation, swapping with the broader EM. We've also kept the UK market as an overweight. And meanwhile, we are sticking to our underweight on Australia and Japan. We are currently neutral on continental Europe.

David Groman (5:08)

So can you walk us through your thinking on the U.S.? And obviously, in the past, we've talked a lot about the improving outlook for international equities relative to the U.S. as well. So is that story over? Or how are you thinking about it?

Beata Manthey (5:19)

So there are a few reasons why the U.S. is looking better on our allocation models right now. The first one is that valuations have reset quite a bit and the U.S. is actually now trading at a pretty average premium to other developed-market peers.

And based on our proprietary What's Priced In for EPS model, the market is discounting much more reasonable EPS outcome for the U.S., especially compared to Europe and Japan. As we were mentioning before, we've seen continued strength in tech earnings. And given the uncertain backdrop we are coming up against, that should benefit a growth- and quality-tilted U.S. market.

But does that mean that diversification is done? Not necessarily. Instead, it could be just more of a pause. And that's because there are still these big structural shifts benefiting the European markets via the fiscal spend that should push European GDP and European EPS higher over meaningful periods of time.

And you can tell a similar story in Japan, given the reflation dynamics, as well as emerging markets, where market composition and underlying growth drivers are changing incredibly quickly.

David Groman (6:40)

Yeah, that all makes sense. So to summarize in a few sentences, how should equity investors be navigating the next few weeks? And what should we be looking out for from here?

Beata Manthey (6:48)

Growth and defensive tilt. We do prefer the U.S. to the rest of the world for now. Still constructive on equity markets. And really, as we've been saying throughout this podcast, all eyes are back to fundamentals. And what's a better time to look at that than during the reporting season? So this is the dynamic we are watching very, very carefully.

Plenty to keep looking out for, but let's wrap up here, David. Thanks for being here.

David Groman (7:16)

My pleasure.

Beata Manthey (7:17)

Thanks for joining us today. This episode was recorded on the 27th of April, and I'm your host, Beata Manthey. Our next Research @ Citi Markets Edition will be hosted by Dirk Willer, City's Global Head of Macro. Thanks for tuning in. Goodbye for now.

Disclaimer (7:34)

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