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Citi Wealth

CIO Strategy *Bulletin*

October 10, 2025

Political winds lift Japan, rattle U.S. markets

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- **Political risk is back on the radar.** Markets are now contending with renewed uncertainty – geopolitical realignments that affect supply chains, elections that could reshape fiscal priorities, and domestic tensions that threaten reform momentum. The U.S. and China are once again exchanging tariff and trade threats, Japan's ruling party elected a new leader biased towards looser fiscal and monetary policy, and France remains in search of a durable political equilibrium. While domestic politics remain messy, surprises abroad are driving a new wave of "global reflation risk;" political shifts overseas pushed global yields higher as investors priced in those concerns. (see **Figure 1**).

  In Japan, the ruling LDP party chose Sanae Takaichi as its new leader, placing her one parliamentary vote away from becoming Japan's first female Prime Minister. Her platform of "responsible expansionary fiscal policy" signals additional stimulus ahead - not tighter money - while suggesting the Japanese economy has little need for higher interest rates right now.

  Markets took the cue: long-end Japanese bonds sold off, the yen weakened, and equities jumped.

  Bottom Line: We remain underweight Japanese duration, anticipating larger issuance to finance fiscal expansion amidst weaker long-end demand from insurers and pensions. The key question now is whether the LDP can assemble a stable coalition to push through that spending – and which Japanese equity sectors stand to benefit most.

- **Despite the forceful rally since the April lows in Tech (+Tech-adjacent) stocks, we don't see a classic bubble, even as we remain cautious of lower quality exposures.**

  S&P 500 valuations (measured by price to forward earnings) remain in the top 5% of observations over the last 15 years – nearly two standard deviations above average – but profitability and compositional profile strength support much of that move. Net margins are also near record highs, showing a 0.74 correlation with P/E expansion over that period. Simply put, companies are more profitable than ever, and market pricing reflects today's strong fundamentals.

We do not believe today's capital expenditures (capex) boom is a tech bubble 2.0. In the late 90s / early 00s, rising capex was fueled by debt and a sharp increase in leverage. Today, companies are reinvesting profits and cash flows into innovation and technology – making this cycle more sustainable (see **Figure 2**).

Rate cuts will lower borrowing costs – potentially unlocking a fresh wave of AI infrastructure spending, especially from firms beyond the "Big 4"[1] (AMZN, META, MSFT, GOOG)[1].

Technology now represents 35.4% of the index, up from 19.9% in 2010 – the most profitable sector by far. That said, not all Tech is equal. We remain cautious on unprofitable growth names where stretched multiples rest on hope, not cash flow. Valuations are 1.25 standard deviations above their 15-year mean for this group – leaving them vulnerable if rates rise or growth stalls like we saw in 2022.

Bottom line: AI-driven capital expenditure isn't just alive – we believe it's poised to broaden and accelerate in the quarters ahead.

- The next big catalyst? Earnings season. **More than half of US market cap reports this month, making earnings the next key driver of equity sentiment. With roughly 60% of YTD gains driven by earnings growth, earnings need to continue to deliver for new index highs.**

  Here are three themes we are focused on during reporting season:

  1) Guidance on productivity gains and expectations for a real return on AI-oriented spending. How do companies discuss the criticism of the circular spending in AI infrastructure?

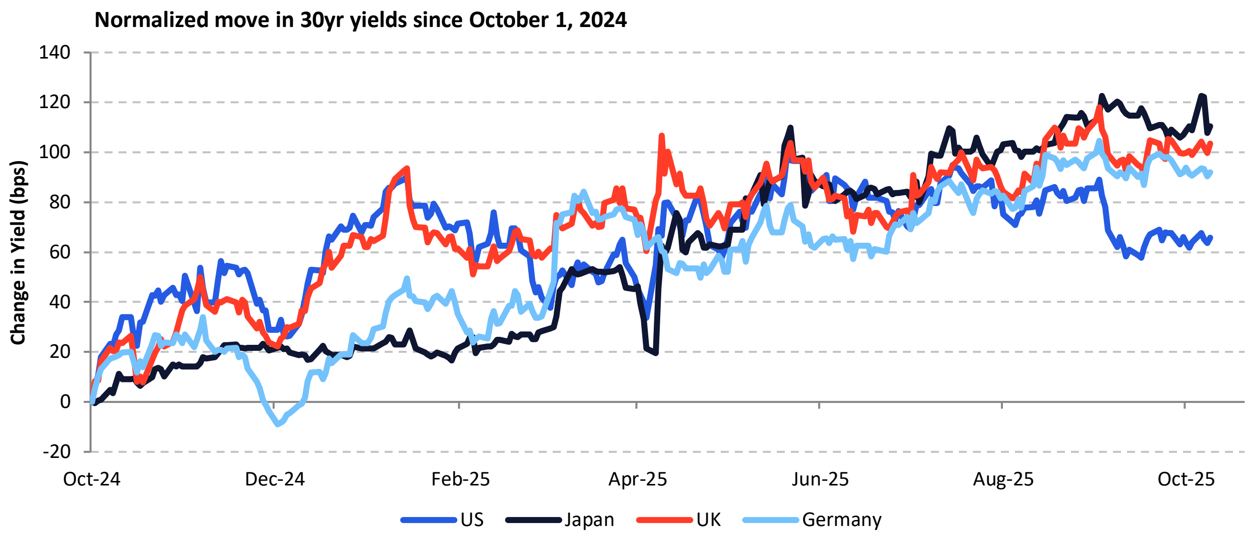
  2) Management commentary on the state of demand and growth. In the absence of government economic data due to the shutdown, corporate insight into the state of the economy will offer invaluable, real-time insights.

  3) The state of global trade. While tariffs have faded from recent conversations, insight into trade flows from global multi-nationals and the presence (or absence) of tariff-related inflation will underpin margin and revenue revisions for future quarters.

  Bottom line: Earnings will matter more than normal given the government shutdown, melt-up in stocks, and growing concern about the sustainability of AI spend. We expect earnings can support a move higher for US large-cap stocks into year end.

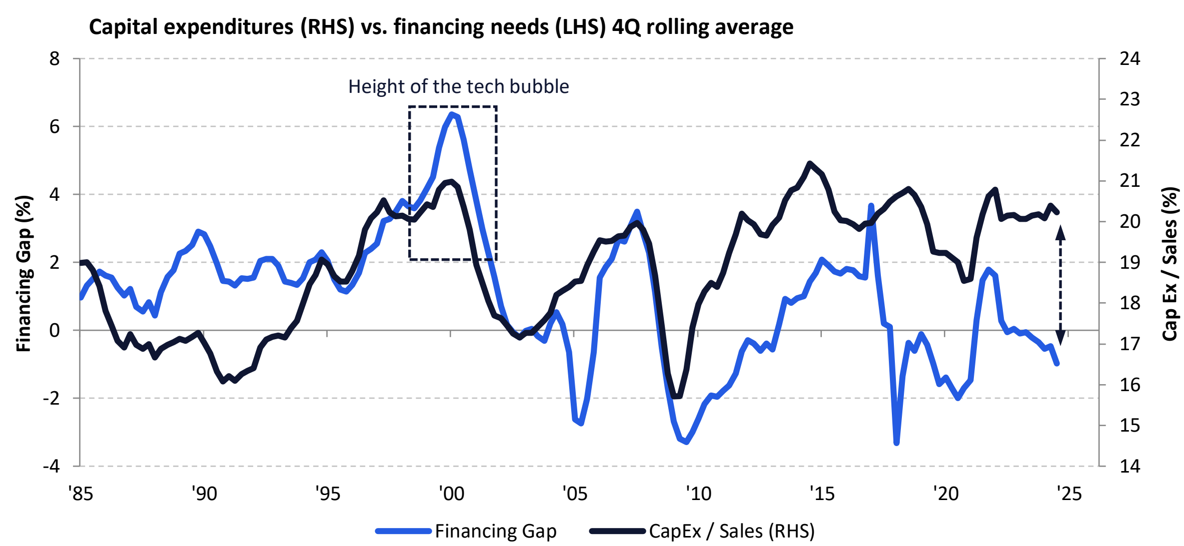
[1] Individual companies mentioned do not constitute a recommendation and are stated for illustrative purposes only.

FIGURE 1: Political, fiscal, and inflationary pressures driving global yields higher



Source: Bloomberg as of October 9, 2025.

FIGURE 2: In this cycle, capex spending can be funded by firms' own operations



Source: Haver Analytics as of October 1, 2025. The rectangle in the graph highlights the large financing gap of the late 1990s Tech bubble and the black arrow indicates the contrast in today's capex spending which is funded by firms' own profits.

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Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
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