THE SHORT AND LONG

Weekly Bulletin

AI Policy Tightens as Central Banks Lean Hawkish

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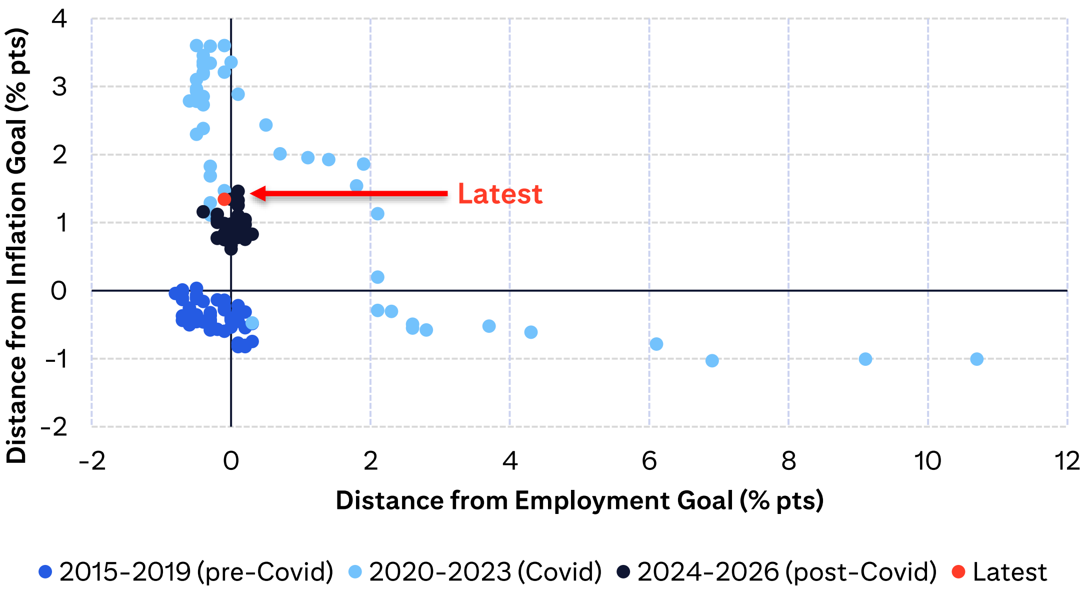
Inflation runs hotter than target across most major central banks, and policy should stay biased toward higher rates. We would not treat a round number on policy rates or Treasury yields as a reason to shift duration positioning.

A volatile fall in a midterm election year presents a historically challenging stretch that has often rewarded investors who add rather than retreat. We would use weakness, particularly on a fear reading, to put cash to work in equities while staying short duration in fixed income.

THIS WEEK IN CHARTS

FIGURE 1: Federal Reserve Dual Mandate Misses



Source: Haver Analytics as of September 15, 2026.

LOOKING CLOSER

The Fed is only missing its inflation objective, not its maximum employment goal, and the miss is at the high end of the recent range. Maintaining credibility on inflation requires a rate hike.

THE AI SAFETY DEBATE SHIFTS FROM WHETHER TO REGULATE TO HOW

Debate around AI safety, governance, and the pace of frontier development intensified over the weekend. Several leading AI executives argued that model capabilities are advancing faster than the safety and oversight frameworks built to govern them. Policymakers and industry leaders have started to converge on a narrower question, which is how governance standards should work in practice rather than whether they should exist at all.

Regulatory risk is rising, and the timing matters as we move into U.S. midterm election season. Proposals under discussion include independent model evaluations, expanded disclosure requirements, and common industry safety standards. Measures along these lines may delay or restrict frontier model releases, raise compliance costs, and place new limits on how firms develop and deploy their most advanced systems.

We have seen this pattern before in other technology advancement cycles, and regulation of this kind may favor the largest incumbents. Established firms want a seat at the table as rules take shape, and they can absorb compliance costs that smaller companies cannot. In our view, that dynamic may raise barriers to entry even as it slows the leading edge.

We also believe the fundamental investment thesis has not changed. Compute demand, power, and networking remains intact, and a large share of enterprise AI adoption does not necessarily depend on frontier models at all. Competition between the U.S. and China may further limit the scope for restrictive policy since policymakers need to weigh safety against global technological leadership. Within this environment, we expect cybersecurity providers and AI governance solutions to gain importance as adoption scales and observability needs to expand.

We are watching these key signposts: whether frontier model releases slip or face restrictions, whether earnings forecasts and expected returns on AI investment move lower, whether the IPO calendar for the frontier labs gets delayed, whether the industry adopts common safety standards, whether meaningful global coordination emerges, and whether capital spending plans change. We have not seen the confluence of those signals yet, though OpenAI did indicate a potential later IPO date. Overall, while near-term market volatility may persist around this news flow, a modest speed limit on frontier development may even smooth and extend the investment cycle.

Bottom line: The AI debate has become a question of implementation, not existence, and regulatory risk deserves closer attention. We view these developments as a reason for closer monitoring, not a reason to immediately change equity positioning.

CENTRAL BANKS LEAN HAWKISH, AND WE REMAIN UNDERWEIGHT DURATION

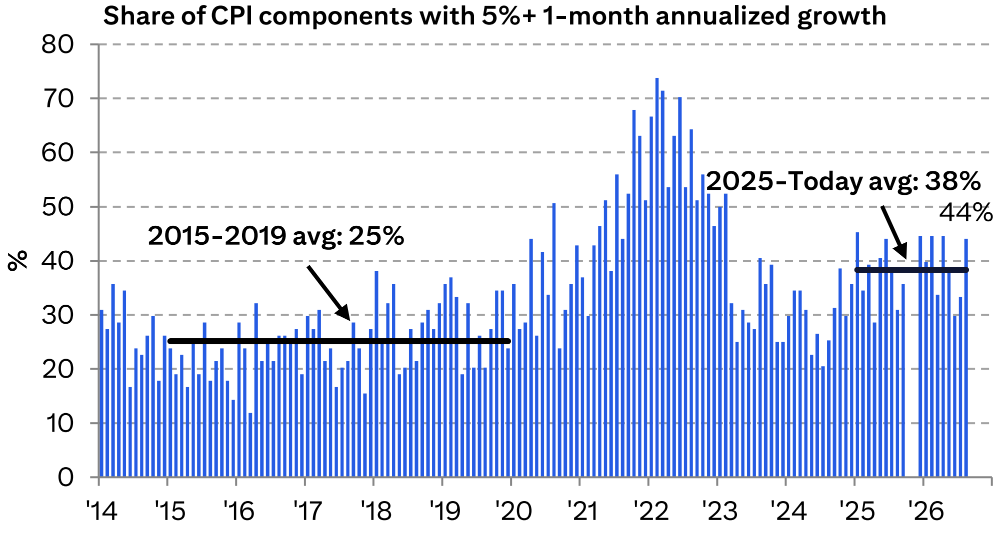
Central banks dominate the calendar this week, with the U.S. Federal Reserve (Fed), the Bank of England (BoE), and the Bank of Japan (BoJ) all meeting. The European Central Bank (ECB) set the tone last week by raising rates by 25 basis points and with notably hawkish guidance. Markets now price another hike at the next meeting and three hikes in total by spring 2027.

Growth supports that stance. Outside of France, Purchasing Managers' Indexes (PMIs), which measures economic activity, point to solid expansion across Spain, Germany, and Italy, which allows the ECB to focus on its price stability mandate. Staff forecasts revised core inflation higher for next year, and they now show inflation still running above the 2% target in 2028. The BoE looks likely to hold this week, though we would watch the dissents closely after three at the last meeting, and markets lean toward a November hike. We expect the BoJ to hike this week as well, with five-year household inflation expectations near 10.8%, nominal wage growth at the strongest pace in three decades, and corporate profit margins at wide levels. Even so, the BoJ remains behind the curve.

We have argued for some time that the Fed's next move will be a hike rather than a cut, and last week's Consumer Price Index (CPI) report strengthened that case. The Fed sits close to its employment goal, so its dual mandate miss now falls almost entirely on inflation.

Breadth tells the same story. The share of CPI components growing at 5% or more on a one-month annualized basis has averaged 38% since the start of 2025 and sits at 44% today, against a 25% average in the years before the Covid pandemic (Figure 2). In our view, maintaining credibility on price stability requires a hike.

FIGURE 2: Inflation breadth rose this past month and remains elevated



Source: Haver Analytics as of September 15, 2026. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

That view carries directly into bonds. Ten-year inflation compensation priced into Treasuries has held steady near 2.3%, while the realized headline CPI has averaged 3.3% over the past decade and continues to trend higher. Upside risks to inflation keep appearing, most recently through energy and transportation costs. If inflation does not return to target, we believe inflation compensation in Treasuries looks badly mispriced.

We are often asked when we would add back to duration and the question usually relates to the level of yields. We would frame it differently. The 10-year yield tracks the Fed funds rate, deficits, and Fed holdings of Treasuries very closely, and the funds rate is the most important driver. This means yields usually fall in a sustained way only when the policy rate declines significantly. That outcome typically requires a recession, and our probit recession metric, which draws on jobless claims, Institute for Supply Management (ISM) surveys, and the unemployment rate, puts the current odds of recession at only 2%. The business cycle matters more than the level of yields, so we remain underweight duration and favor short maturity, high-quality bonds.

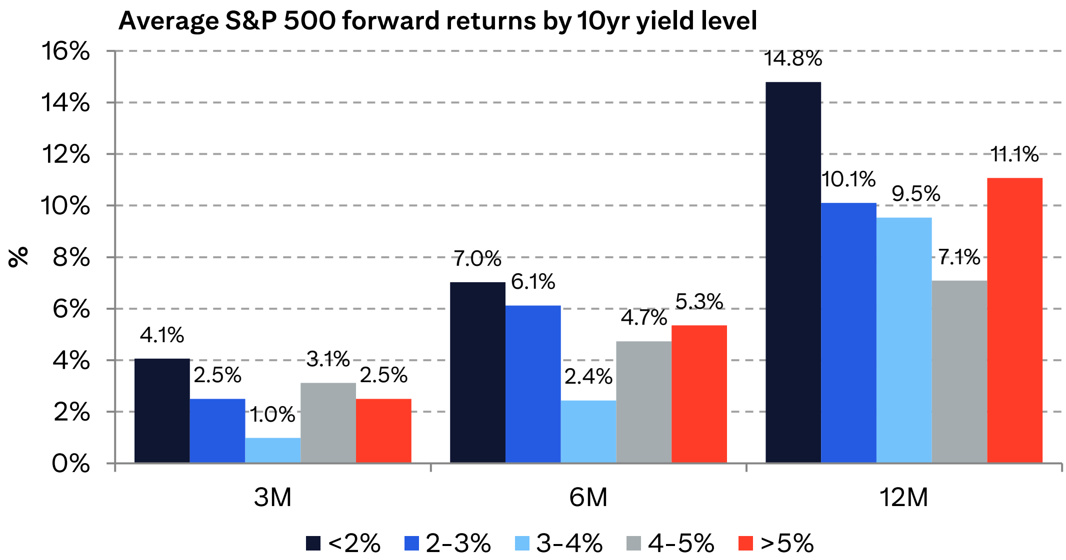
Bottom line: Inflation runs hotter than target across most major central banks, and policy should stay biased toward higher rates. We would not treat a round number on policy rates or Treasury yields as a reason to shift duration positioning.

SEASONAL VOLATILITY MAY CREATE OPPORTUNITY FOR UNDERINVESTED INVESTORS

As mentioned in our Bulletin last week, September and October historically rank as two of the most volatile months of the year for markets, particularly when combined with midterm election cycles. Past patterns do not always repeat, and we would not position on seasonality alone. Yet if the headline volatility from the weekend persists while fundamentals remain robust, we believe this kind of volatility creates potential opportunity rather than risk.

Higher Treasury yields should not stand in the way. Investors often ask whether a move toward 5% on the 10-year Treasury would threaten equities, and history suggests otherwise. Since 1990, average forward S&P 500 returns when yields sat above 5% reached over 11% in a year, above the 7.1% recorded when yields ran between 4% and 5%. It was also higher than the 9.5% recorded between when yields were between 3-4% (Figure 3). Equity markets have tended to perform well in higher-yield regimes, not despite them.

FIGURE 3: Higher yields don't always translate to lower equity returns



Source: Factset as of September 10, 2026. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Sentiment gives us a useful guide for timing. A S&P 500 sentiment and positioning indicator we reference has moved away from complacency, which earlier this year correctly signaled stocks would chop around current levels. We would treat a further move toward our fear threshold as a potential opportunity to add to equity risk.

For investors who remain underinvested in equities or are holding excess cash, we believe it will be prudent to monitor a pullback during this seasonally volatile period, as we are inclined to add to risk in that event.

Bottom line: A volatile fall in a midterm year presents a historically challenging stretch that has often rewarded investors who add rather than retreat. We would use weakness, particularly on a fear reading, to put cash to work in equities while staying short duration in fixed income.

	WHAT HAPPENED	WHAT'S AHEAD
ECONOMIC DATA	**U.S.** CPI in August rose 3.4% Y/Y for headline, 2.4% Y/Y for core as expected. The core monthly reading was a bit hotter than expected while gasoline made up 1/3 of the total increase. NFIB small business optimism dipped to 98.7 in August from 99.8 with weaker sales, supply disruptions, and inflation worries dampening sentiment.	**U.S.** Retail sales for August Import/export prices for August
	Global China's exports rose by 25% in August and is on track to match last year's record trade surplus as AI and EV demand surges.	**Global** Japan CPI for August
POLICY	**U.S.** Treasury conducts smaller than expected UST buyback and kneejerk reaction was long-bonds under pressure. President Trump declined Saudi request to strike Houthis.	**U.S.** FOMC September meeting with rate hike odds at ~90%
	Global ECB hike rates by 25 bps and signaled additional policy tightening in the months ahead due to closer proximity to energy price spikes.	**Global** Meeting postponed for GCC foreign ministers and their Iranian counterparts in Oman to reach a deal on managing SoH flow and defuse tensions BoJ expected to hike rates this week BoE expected to keep rates steady this week
MARKETS	**U.S.**	**U.S.** More earnings signal substantial cost headwinds from Iran conflict that will be mitigated via price hikes, cost cutting
	Global Yields rise around the globe but some pockets of pushback from the 10 and 30 year UST auction with lower yield than when-issued. Oil prices remain above $100/bbl level with refineries already running at capacity.	**Global** September is historically the weakest month for equities with an average return of –0.8% for the S&P 500; positive returns are a coin toss.

Source: Bloomberg as of September 15, 2026. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

RELATED READING

September 9, 2026 | Strong Payrolls Support Rate Hike Expectations Amid AI-Earnings Boom

In last week's Bulletin, we looked at why the U.S. labor market remains strong. We also looked at why September historically represents a challenging month for equities, and midterm election years amplify that volatility.

July 20, 2026 | The Short and Long Podcast

In the third episode, "AI, Quantum, and Cybersecurity; From Breach to Resilience," host and Chief Investment Officer of Citi Wealth Kate Moore speaks with Fatima Boolani, Co-Head of U.S. Software Equity Research, Citi Research, and Anneka Gupta, Chief Product Officer at Rubrik, on how today's cybersecurity threats require continuous adaptation in prevention and resilience and covers questions every investors should be asking right now around cybersecurity in the age of AI. Watch on **YouTube**, **Apple,** or **Spotify** and subscribe for future episodes.

July 14, 2026 | The Short and Long: Q3 Macro Investment View

Citi Wealth's quarterly report is designed to offer global, data-driven guidance to help investors navigate increasingly complex markets with confidence and clarity. The latest report delivers a breakdown of forces shaping global markets, how they impact potential investment opportunities, and provide guidance across asset classes.

April 2, 2026 | Global Investment Council

The Citi Wealth Global Investment Council met April 2, 2026, and reallocated equity exposure from Europe to the U.S. The move maintains equity allocation while shifting risk toward more resilient markets. European fundamentals were already weakening prior to the Middle East conflict, and the U.S. offers more durable earnings with less geopolitical vulnerability.

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Bond credit quality ratings		**Rating agencies**	
Credit risk	**Moody's** [1]	**Standard and Poor's**[2]	**Fitch Rating**[2]
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
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

1 The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3, to show relative standing within the category.
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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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