THE SHORT AND LONG

Weekly Bulletin

HIGHER RATES ARE HERE TO STAY, AND EARNINGS KEEP PACE

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TAKEAWAYS

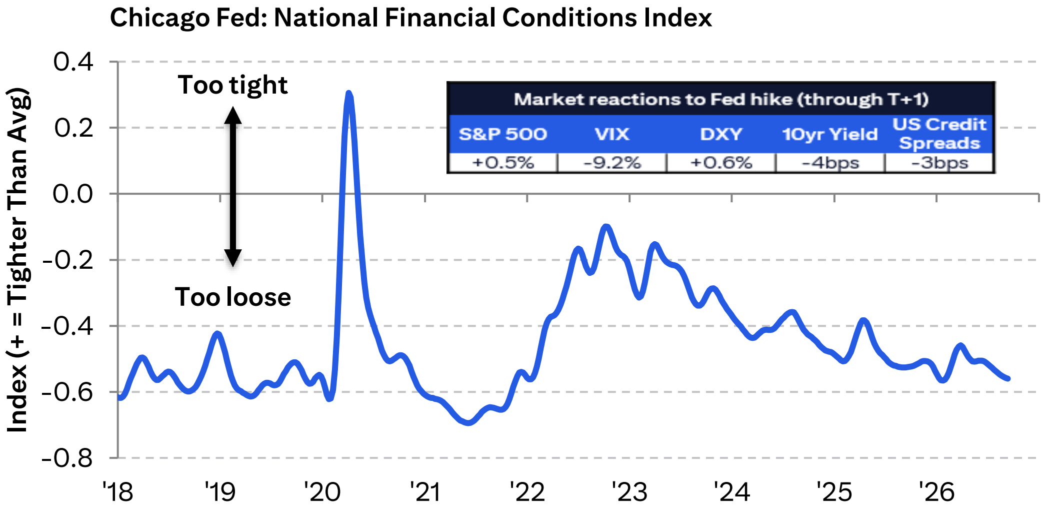
The U.S. Federal Reserve (Fed) and Bank of Japan (BoJ) joined the European Central Bank (ECB) in raising rates last week. In our view, strong global growth gives central banks room to lean against inflation with higher policy rates at a time where economies can absorb them.

Credit markets continue to send a positive signal despite higher rates. Banks appear more willing to lend, credit creation is improving, and hyperscaler leverage remains low even amid heavy issuance. We remain focused on staying up in quality and short in duration in fixed income.

Higher rates have yet to dent corporate fundamentals, and earnings growth is broad across sectors. Rising real yields have compressed valuations, which we see as a rational de-rating rather than fear. Our equity stance remains constructive and unchanged for now.

THIS WEEK IN CHARTS

FIGURE 1: Fed had room to hike, and markets approved of the move



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LOOKING CLOSER

Loose financial conditions gave the Fed room to act. Chairman Kevin Warsh said the committee removed a "dose of accommodation," and risk asset price movement signaled the market approved of the hike and signals of further tightening.

CENTRAL BANKS LEAN AGAINST INFLATION FROM A POSITION OF STRENGTH

The Fed and the BoJ joined the ECB in raising rates last week, which continues the global shift toward tighter monetary policy. The Fed raised its policy rate by 25 basis points. The BoJ also hiked by 25 basis points to 1.25%, its highest policy rate in over three decades. The onset of a hiking cycle is not a historically attractive time to buy duration, which supports our underweight stance in the near-term.

Markets read BoJ Governor Ueda's guidance as more dovish than he likely intended, and the yen has declined in the days since. In our view, a weaker yen may support Japanese equities in the near term, because it has historically coincided with stronger earnings for Japanese companies. Analysts have revised earnings sharply higher across most Japanese sectors this year. We continue to watch this balance closely, particularly if the BoJ turns more hawkish and the yen durably strengthens.

The Fed's decision fits the framework we laid out in January. At the time, we argued that strong real growth and sticky inflation would create a nominal growth environment that supports higher policy rates, not lower ones. Many strategists expected multiple cuts this year, and markets have since priced those cuts out. In our view, the unanimous decision sends two messages: first, the Fed sees broad-based inflationary pressure and remains committed to its 2% target. Second, it continues to act independently despite political pressure.

Loose financial conditions gave the Fed room to act (Figure 1). The Chicago Fed's National Financial Conditions Index has stayed on the loose side, and that backdrop has driven equities to all-time highs, kept credit spreads near historic tights, and kept volatility relatively contained. Markets judged the hike as prudent for now: through the day after the decision, the S&P 500 rose 0.5%, the VIX fell 9.2%, the U.S. dollar index gained 0.6%, the ten-year Treasury yield declined 4 basis points, and U.S. credit spreads tightened 3 basis points.

Some critics argue that higher rates hurt rate-sensitive areas such as housing, and that this weakness weighs on the broader economy. We see it differently. Residential investment is weak due to structural supply issues, including local zoning and regulatory limits on new building, which drive that weakness more than a 25-basis-point hike does. Meanwhile, nonresidential investment grew 9.5%, with AI spending driving much of that gain, while goods and services consumption remains robust. We would focus on the majority of economic sectors that support higher policy rates rather than highlighting the few that are weak.

Bottom line: Central banks are leaning against inflation at a time when, in our view, economic growth remains resilient enough to absorb higher rates. By reducing the risk that inflation expectations become entrenched, tighter policy should help preserve price stability and support a constructive backdrop for risk assets. Against this backdrop, we maintain a risk-on bias and an underweight duration as policy rates move higher.

DEBT MARKETS ADJUST TO HIGHER RATES WITHOUT FLASHING WARNING SIGNS

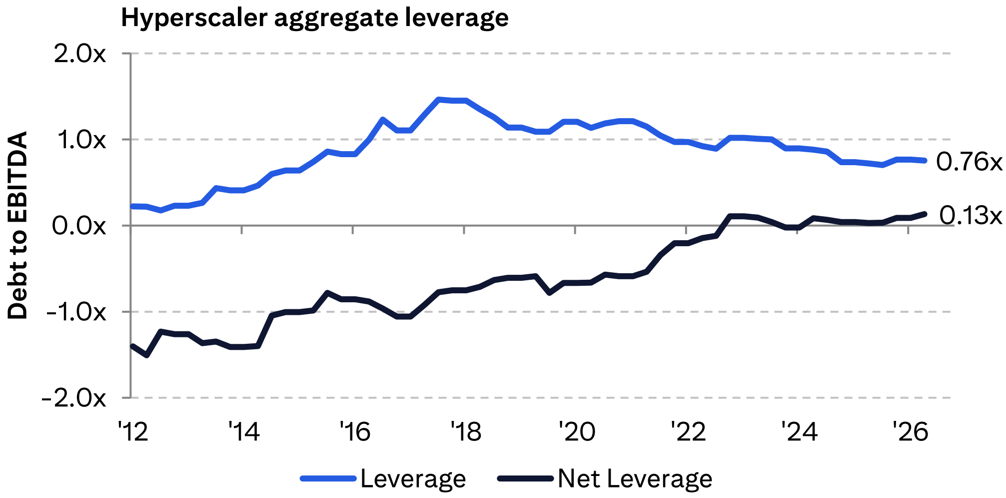
In our view, higher rates are here to stay, both at the policy level and further out on the yield curve. On the lending side, the credit tailwind we flagged in December is subtly playing out. The Fed's Senior Loan Officer Opinion Survey shows that banks are no longer tightening lending standards, and the composite has moved back to neutral. Loan demand has also strengthened, particularly among large- and medium-sized firms.

Hard data support the survey. The ratio of bank loans and leases to deposits keeps climbing, which points to more lending activity. We would not call this a credit boom, but with banks more willing to lend, credit creation has improved at the margin despite higher rates.

The bigger story sits on the borrowing side. Hyperscalers have issued upwards of $250 billion of debt this year, over twice their total for all of last year. We acknowledge that this new supply has put some upward pressure on technology, media, and telecom (TMT) spreads. However, we distinguish between heavy debt supply and problematic leverage. Problematic leverage develops when debt builds up relative to earnings, rates rise, and something breaks. In our view, hyperscaler debt does not fit that description today.

Strong profitability also supports these borrowers. Among the ten largest companies in the S&P 500, gross margins have risen from 47% in 1995 to 58% today, and EBITDA margins have climbed from 21% to nearly 40%. We believe these companies can service debt at higher rates, particularly because revenue from the AI buildout appears to have only just begun.

FIGURE 2: Despite massive issuance this year, hyperscaler leverage remains low



Source: Factset as of September 21, 2026.

Investment grade and high yield spreads remain tight despite the new supply. That keeps our fixed income positioning relatively simple. We favor staying up in quality, keeping duration short at the front end of the curve, and taking risk in equities instead of reaching for spread. Ultimately, we believe higher rates pose a greater challenge for sovereign financing than for corporate solvency. In our view, weak fiscal discipline and rising public sector leverage are a bigger concern for markets today than private sector debt.

Bottom line: Economies are adjusting to higher rates, but credit markets continue to reflect healthy fundamentals despite headline-grabbing issuance numbers. Within fixed income, we favor staying up in quality and at the front end of the curve to help manage duration and supply risks.

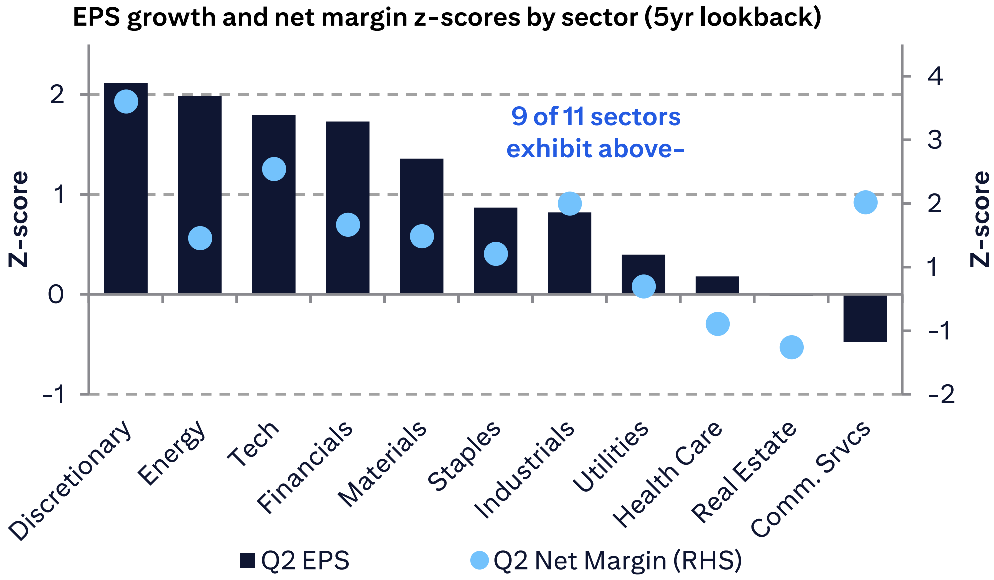
EARNINGS STRENGTH OFFSETS VALUATION PRESSURE AS REAL YIELDS RISE

Clients often ask at what level higher rates begin to hurt equities. Many strategists cite a specific 10-year yield threshold, then move it as yields rise past it. We find fixed thresholds difficult to apply in today's environment. In our view, higher rates would need to hurt fundamentals to meaningfully hurt equities, and fundamentals remain strong. We also believe the pace and volatility of rate moves matter more for earnings revisions than the level itself, and both have stayed relatively orderly.

Analysts continue to revise earnings higher around the world, particularly in the U.S. and Japan. U.S. macro data that typically lead realized earnings growth also points to robust levels in the near-term. Realized earnings growth has recently beaten even what the lofty macro data implied.

Earnings breadth is also stronger than many investors appreciate. Many investors describe this as an AI-only market, yet nine of 11 sectors show above-trend earnings growth on a five-year z-score basis, and nearly half show top-quintile growth (Figure 3). Net margins also remain extremely elevated across most sectors. Small caps are the one area where we see greater rate sensitivity. Our call for small-cap underperformance has not played out this year, but we believe any further tightening in financial conditions would weigh more on small caps than on large caps.

FIGURE 3: Earnings breadth continues to impress



Source: Factset as of September 21, 2026. Sectors are using their respective S&P indices as proxy. 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.

Higher rates show up in valuations instead. Rising real yields raise the discount rate applied to future cash flows and pressure price-to-earnings multiples. Over the past year, the S&P 500 forward P/E has declined as the U.S. five-year real yield has risen. Forward multiples have fallen across major regions since their post-Covid peaks, yet global equities have still delivered strong performance because earnings have grown rapidly. In our view, this is a rational de-rating driven by strong growth and higher real yields, not a signal of fear.

We continue to monitor several risks to the bull market thesis. First, a disorderly rise in yields could constrict economic and corporate growth, so we track the pace and makeup of any move for signs that multiples have found a floor. Second, another spike in geopolitical tension that drives oil near $125 per barrel for an extended period could pressure margins and consumption. Third, we also watch whether consumers can withstand another round of inflation pressure, and we'll get a read on this as third quarter earnings begin to roll out in coming weeks. Finally, AI capital spending underpins much of the market story. We see no evidence yet that this investment cycle is failing to produce adequate returns, and we believe it can continue for years. We continue to monitor circular financing and regulatory discourse, but insatiable demand gives us no reason to change our stance as of yet.

Bottom line: Higher rates have yet to derail the fundamental story, and strong, broad earnings growth continues to offset valuation pressure from rising real yields. We are watching yields, oil, the consumer, and AI investment closely, but none of these risks change our constructive equity stance at this point.

	WHAT HAPPENED	WHAT'S AHEAD
ECONOMIC DATA	**U.S.** Retail sales rose 1.2% in August, the most in five months, as 12 of 13 retail categories reported increases. The control group sales (which feed into GDP) increased the most in nearly two years.	**U.S.** Flash PMIs for September set to release this week
	Global China retail sales grew 0.4% in August, missing estimates for 0.8%, while industrial output accelerated more than estimates as the economy divides between domestic slowdown and export growth Japan CPI rose 1.7% in August, cooler than consensus, but BoJ-adjusted core remains above 2% since 2024.	**Global** Eurozone flash PMIs for September set to release this week Germany IFO survey for September set to release this week
POLICY	**U.S.** The Fed voted unanimously to hike rates 25bps to 3.75-4% range and dot plots signaled one more hike is expected this year. With policy viewed as no longer restrictive, growth and inflation forecasts were raised.	**U.S.** Chair Warsh framed the hike as "removing a dose of accommodation," which suggests there is more work to do, neutral rate is materially higher than previously thought. President Trump and Xi expected to meet over trade, AI, geopolitics, and more.
	Global The BoJ hiked rates 25bps to 1.25% as expected. This marks the highest policy rate since 1995, but the yen sold off as takeaways leaned less hawkish with many believing BoJ remains tilted toward growth over inflation. The BoE held rates steady at 3.75% but signaled it will hike if the Iran war continues and warned of 4% inflation in 2027.	**Global** World leaders gather this week for the UN General Assembly Meeting postponed for GCC foreign ministers and their Iranian counterparts in Oman to reach a deal on managing Strait of Hormuz flow and defuse tensions.
MARKETS	**U.S.** AI leaders called for caution on frontier model development, implementing independent audit, testing, and evaluation. This won't affect current model usage and undersupplied compute.	**U.S.** Early Q3 reporters beating on top and bottom lines more than average. There is a strong relationship between early reporters and full quarter results, suggesting we may see further upside surprises in coming weeks. More earnings signal substantial cost headwinds from Iran war that could be mitigated via price hikes, cost cutting.
	Global The yen weakened after dissents to hike and signals that the tone didn't fit with follow-up hikes. Oil cooled slightly with calm in geopolitical headlines, but refined product flow continues to be hampered by supply chain disruptions.	**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; Oct/Nov historically see reverse rally

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RELATED READING

September 18, 2026 | Fed Hikes in Response to High Inflation

In our latest CIO Update, we look at the U.S. Federal Reserve's decision to raise its benchmark rate by 25 basis points, its first increase since 2023. We review what this means for investors and look at why persistent inflation raises the bar every portfolio, even as higher policy rates lift nominal yields on cash.

September 15, 2026 | AI Policy Tightens as Central Banks Lean Hawkish

In last week's Bulletin, we looked at how the AI debate moved from whether to regulate to how. We also looked at why inflation runs hotter than target across major central banks, and policy should stay toward higher rates.

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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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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- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
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