Tomorrow's Affairs
Analysis of today
Assessment of tomorrow

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Are we witnessing the beginning of the end of the AI bubble?



Tolstoy famously wrote that "Happy families are all alike; every unhappy family is unhappy in its own way." Something similar could be said about punctured asset-price bubbles.

While such occurrences generally lead to economic recessions, the resulting pain and unhappiness vary widely, depending on the circumstances.

With the tech-heavy Nasdaq and now the S&P 500 falling into correction territory (a decline of more than 10%), we now seem to be witnessing the beginning of the end of the AI bubble.

No single factor seems to have triggered it. Concerns about debt financing of huge capital investments were already mounting when the US midterm elections revealed strong, widespread opposition to the construction of data centers and equally strong demand for greater regulation.

Moreover, the spy scandal that brought down Nvidia's founder and CEO, Jensen Huang, has jeopardized the company's role as the "central bank" of the AI ecosystem.

Will the chip giant continue financing its own customers to keep the party going?

Investors seem to have their doubts, judging by the steep decline in AI-related stock prices.

Economic fallout

With tech stocks showing continued weakness even as Anthropic set a record with its initial public offering, this is a good moment to compare the AI bubble with earlier ones, particularly the dot-com boom and bust of the late 1990s.

There are three reasons to fear that the economic fallout from the AI bubble will be more severe than the mild recession that followed the 2001 dot-com bust.

The first is the unprecedented scale of the AI investment boom, as measured by corporate capital expenditures.

The second is the much larger size of the accompanying stock-market boom, which already dwarfs that of the dot-com bubble. And the third is the unsustainable trajectory of public debt.

According to a recent Brookings Institution study, planned AI investment for 2025–32 will amount to as much as 3.6% of GDP.

That is more than three times as much as the 1.1% of GDP that was invested in the internet between 1996 and 2003, and around 50% higher than the 2.2% of GDP invested in railroads between 1870 and 1890.

Worse, a recent JPMorgan study estimates that AI investment could be adding around 0.5 percentage points to GDP growth over the past year, which means that an abrupt slowdown in the sector would deal a serious blow to the overall US economy.

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As stock-market valuations fall back to more normal levels, everyone looking at their portfolios or pension savings will feel poorer and cut back accordingly. Given the degree to which the market's overvaluation is concentrated in a single technology, the shock and pullback could be severe.

Recall that just before the dot-com bubble burst, total market capitalization as a share of GDP—Warren Buffett's preferred measure of stock-market overvaluation—stood at around 150%.

Today, even after the Nasdaq and S&P 500's recent correction, it stands at around 275%.

The problem of concentration

Then there is the problem of concentration: as few as seven AI-related companies account for around one-third of the S&P 500's overall valuation, implying that the recent price correction has already wiped out a substantial amount of household wealth.

Heightening the risk of a major market meltdown is the rapid increase in margin debt for stock purchases, which has surged by around one-third over the past year, to a record-high $1.5 trillion.

All this leverage will amplify any sustained downturn in stock prices, because many investors may be forced to sell their holdings to meet their lenders' margin requirements.

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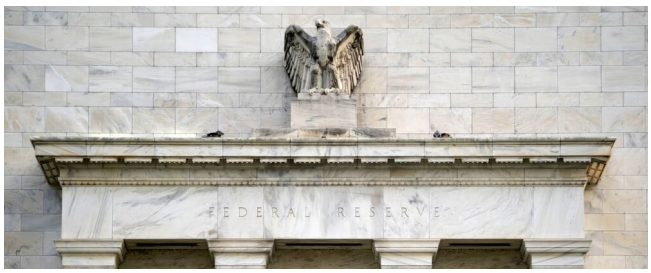
Yet another source of fear is the challenging global economic environment in which today's AI bubble would burst.

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And rarely has there been so little political will to address the problem.

A bond-market crisis

This lack of fiscal discipline will become a big problem in any AI-induced recession, because governments will have only limited means to provide fiscal stimulus.



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Worse, today's debt levels and high interest rates could precipitate a bond-market crisis if heavily leveraged investors are forced to liquidate their large bond holdings to cover their stock-market losses.

In 2008, the US Federal Reserve was caught flat-footed by the collapse of Lehman Brothers, which exacerbated the 2007–09 Great Recession.

With ominous signs that the AI bubble could be starting to burst, one hopes that the Fed is not asleep at the wheel again.

Its new chair, Kevin Warsh, has promised to pay close attention to the AI sector and to recent market signals, which do give some comfort that he will support a change of course in monetary policy if circumstances demand it. But whether he will do so in time remains to be seen.

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