Markets and US economy increasingly dependent on AI boom

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Last week Wall Street feverishly anticipated the quarterly revenue and profit results from Nvidia, the chipmaker at the center of the artificial intelligence (AI) boom. Would the results exceed expectations and quell the growing fears that the AI boom is a bubble which may soon burst with major consequences?

They were published after Wall Street had closed on Wednesday and were above forecasts with a 62 percent increase in revenues to $57 billion in the three months to the end of October and forecasts of even more to come in the current quarter—$65 billion, some $3 billion more than expectations.

When trading opened on Thursday Nvidia's shares jumped by 5 percent with the tech-heavy NASDAQ index and the S&P 500 recording significant rises. But it was a different story by the end of the day. Nvidia's share price was down 3.2 percent and the gains in the rest of the market had turned into losses.

The S&P 500 rose by 1.4 percent in the morning only to end the day 1.6 percent lower in its biggest intraday reversal since the turbulence set off by President Trump's announcement on "reciprocal tariffs" at the beginning of April. Wall Street then bounced back yesterday on expectations that the Federal Reserve will make a rate cut at its meeting next month.

The volatility in the market is the expression of concerns about the viability of AI as a series of unanswered questions continue to mount.

These include: whether the massive amounts of electricity needed to power AI centers will be available; will the companies setting them up generate enough revenue for a sufficient rate of return on the billions, even trillions invested; how viable are the circular deals through which Nvidia in particular has invested in companies which then use the money provided to buy its chips; and whether the current models for AI development will be superseded, turning the data centers now under construction into so-called "stranded assets."

Apart from the gyrations on the stock market—the shares of Meta are down by 21 percent since it reported earnings at the end of October with Microsoft down by 13 percent—there is the issue of the broader economy.

Noting that the AI boom is driving the economy, a report in the *New York Times* posed the question: "What happens if it falters?"

"The US economy in 2025 is split in two: Everything tied to artificial intelligence is booming. Just about everything else is not," the article said.

There is a boom in areas where massive data centers, the size of theme parks, are being constructed but in the rest of the economy it is different.

"Unemployment has been rising, hiring has slowed and industries including manufacturing and home building are cutting jobs. Consumer sentiment has slumped amid high prices. The public sector has been weighed down by budget cuts and federal layoffs. Tariffs and the uncertainty surrounding them have been a drag on international trade and led to slower investment by many companies."

According to the article, by one measure investment in computer equipment and software accounted for more than 90 percent of the growth in GDP in the first half of the year.

It cited comments by Anirban Basu, the chief economist at a building trades group, who noted that data center construction was "the only real driver of nonresidential construction spending growth in America."

While the construction of these centers creates a boom in the limited areas in which they are established, that will be short-lived because once they become operational they will employ at most only a few hundred people.

"Some places have gotten confused by a lot of messaging from the hyperscalers that this is the beginning of a regional technology," Mark Muro, an economist at the Brookings Institution told the *Times*.

He said the data centers "become just massive buildings with a couple of hundred jobs, which aren't terrible, but aren't really going to move the dial."

The AI stock market boom and the concerns that it could bust were featured in a lecture delivered by Federal Reserve governor Lisa Cook last week. Cook, who has responsibility for financial stability, began by reminding her audience of the effects of a financial crisis, recalling that in the aftermath of the 2008 crisis, unemployment in her home state of Michigan rose to 14 percent with the national jobless rate hitting 10 percent.

As with all Fed officials, Cook began with assurances that the financial system was "resilient." The same thing was said prior to the 2008 crash as well, and no central bank official is ever going to say that the conditions for a crisis are developing lest that acts as a trigger to set it off.

But in the course of her remarks, she did point to a number of potential sources of major turbulence.

She said the Fed had assessed that asset valuations "on the whole were elevated relative to historical benchmarks in a number of markets, including equity markets, corporate bond markets, leveraged loan markets, and housing markets."

The areas named cover a significant slab of the financial system. She said her "impressions" were that there was an "increased likelihood of outsized asset price declines," before adding the almost obligatory reassurance because of the system's "overall resilience" there were not the weaknesses that played out in the 2008 crisis.

But asset valuations were not the only source of potential instability to which she pointed.

The growth of private credit, which according to Fed estimates has doubled in size over the last five years, was another area of "potential vulnerability."

"The increasing complexity and interconnections with leveraged financial entities create more channels through which unexpected losses in private credit could spread to the broader financial system."

The increased involvement of hedge funds in the Treasury market, the basis of the US and global financial system and which played a significant role in the market freeze amid the "dash for cash" at the start of the pandemic in March 2020, was also "another vulnerability" Cook said she was following.

Hedge fund holdings of Treasury cash securities had increased from 4.6 percent of the total in the first quarter of 2021 to 10.3 percent in the first quarter of this year.

"This represents significant growth in the scale of liquidations that could result if hedge funds were to sharply reduce their Treasury positions because of changing market conditions," she said, as was witnessed in 2020.

The overall situation confronting the US economy is that far from entering a new "golden age" as proclaimed by Trump, it contains any number of triggers that could set in motion a major crisis.