

Sooner or later investors will demand returns, and there will be losers.

The Market's Rude Reminder on AI

REVIEW & OUTLOOK

It's too soon to call what happened this week to artificial intelligence stocks a correction. Call it instead a reminder: Hype about new technologies is an inevitable human temptation, and sometimes it pays off, but eventually investors demand returns on capital.

That's the way to think about the disconcerting market swings of recent days. Many tech shares have taken a dive, sometimes by large percentages. That has dragged down the NASDAQ and the S&P 500 index, which has come to be dominated by those companies. Our advice is to go for a relaxing walk this weekend instead of checking your 401(k) balance.

This seems counterintuitive in the face of encouraging earnings reports from some big AI-related companies, and in some cases the good earnings news arrested the decline in the company's stock price. But stock prices are forward rather than backward looking, and investors still are grappling with big questions about the AI future.

AI will have a profound effect on the global economy. It remains impossible to say what those effects might be or who will profit from them, and how. Estimates of global AI-related investments regularly top \$1 trillion per year and probably are undercounts after including other forms of investment such as the companies that adopt AI in their own businesses.

This implies that AI would need to boost to substantially boost business productivity and generate unprecedented returns eventually. One recent academic study calculated that American data-center hyperscalers alone would need to earn revenue equal to roughly 9% of gross domestic product per year by 2032 to break even on their investments.

America's ability to raise and allocate this private capital—the institutional investors and entrepreneurs, the legal system and market structure—is the envy of the world. But unforgiving market discipline on the way down is a not-so-secret ingredient in the special sauce.

As AI continues to evolve, the challenge will be to reevaluate the risks and do so relative to other bets. It's a continuous process that plays out every second markets are open. Investors this week didn't abandon equities entirely, even if they did pour some capital back into the bond market. Instead, they pivoted into recently overlooked industries such as consumer goods. The Dow Jones Industrial Average had a decent week.

None of this is to downplay the potential dangers. The sheer quantity of capital that has flowed into tech suggests that if and when investors decide a large-scale reappraisal is required, it is likely to be bloody. All the more so since much of this investment has been financed with debt, especially via opaque private-credit markets. Credit can turn a technological reappraisal into a financial panic or worse.

All of this poses challenges for politicians and policy makers, even as they enjoy the equity ride up. One is monetary: Loose money tends to encourage the kind of credit mania that's especially dangerous when it coincides with a technological revolution. On this score, it's a welcome development if tech investors are acting in part on a growing conviction that Federal Reserve Chairman Kevin Warsh intends to pour less rum into the punchbowl.

Another is regulatory, as officials must stay alert to the corners of the financial system where potential risks may lurk. The goal here isn't to shield everyone everywhere from any loss. It is rather to ensure that markets will be able to operate effectively even in a correction and without recourse to public bailouts. Hey, we can dream.

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AI as a technology is a winner and so far has been a boon to the economy without the feared job losses. Whether all the companies currently developing AI will be winners is a different question. Now, time for that walk.

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