

The AI Investment Cycle Is Rewriting the Market Playbook

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Investors often associate interest rate cycles with economic cycles. Historically, central banks have used monetary policy to either stimulate or slow economic activity in pursuit of stable growth and inflation. Today, however, the relationship has become less straightforward. The emergence of artificial intelligence (AI) as a powerful investment and productivity theme is reshaping the economic landscape, with some estimates suggesting that AI-related investment and adoption could add meaningfully to U.S. economic growth over the coming decade.

As a result, the economy's sensitivity to interest rates may be less pronounced than in previous cycles. Traditional indicators such as inflation, interest rates and unemployment remain important, but their ability to explain short-term equity market performance has become increasingly challenged.

Recent market action provides a good example. The yield on the 10-year U.S. Treasury rose sharply from 4.75% at the end of August to 5.29% by September 30. Under traditional market thinking, higher borrowing costs and a higher discount rate for future earnings would be expected to weigh on equity valuations. Yet over the same period, the S&P 500 Index declined only 0.4%, while the technology-heavy Nasdaq-100 Index gained 3.3%.
Source: Bloomberg Finance L.P.

The reason is that today's equity market, particularly the largest companies within the S&P 500, is increasingly driven by the AI investment cycle rather than the interest rate cycle. For now, this has been a tailwind for investors. However, the AI cycle is inherently more difficult to forecast than traditional economic cycles.

Economic variables typically evolve gradually and are published on predictable schedules. Central bank decisions, for example, occur at regular meetings (generally monthly) and are extensively analyzed beforehand. AI innovation, by contrast, can advance rapidly and unexpectedly. New breakthroughs, applications or productivity enhancements can emerge without warning, just as challenges related to regulation, cybersecurity, infrastructure constraints or competitive disruption can surface suddenly.

Investors have benefited significantly from the positive developments associated with AI. Nevertheless, the very factors that have driven strong returns also introduce a higher degree of uncertainty. While the opportunities remain compelling, maintaining diversification and preparing portfolios for a wider range of outcomes will be increasingly important as markets continue to navigate this evolving investment landscape.



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