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The U.S. Economy is Starting to Feel Like it's 1999

A pair of new developments has raised our concerns that recent AI investment may result in a financial bubble that poses significant risks to the real economy. First, an analysis of productivity growth from the San Francico Fed (which we discuss in more detail later) hints that while AI investment has boosted labor productivity, it has done so by less than other forms of investment such as traditional business equipment. Second, the Atlanta Fed continues to predict that investment in business equipment in 3Q2026, fueled by AI, will grow at a 17.8% annual rate, outperforming even the first two quarters. Accelerating growth, despite high yields, hints at a lack of scrutiny behind the ongoing cap-ex boom.

To be clear, we do not claim that AI will fail to eventually deliver major productivity gains. Instead, we share growing concerns that AI revenues will miss expectations, resulting in a correction along the line of 2000. **For several reasons, were a similarly sized correction to occur today *(e.g.* with a similar decline in equity price, lending conditions, etc.), the macroeconomic impact would be worse.**

In 2000, real personal consumption expenditures growth fell by 2.5% (from 5.0% in 1999 to 2.5% in 2000). The exceptional growth prior to 2000 was fueled by rapid productivity growth that does not exist today. Currently, consumption is in a much more precarious condition. It has held up well since 2022 solely due to wealthy households. This is a concern because stock ownership is heavily concentrated among these households, increasing the risk of a sharp pullback. Second, consumers entered 2000 with sentiment near record highs, sentiment is near record lows. **We estimate that a 2000-like correction would slow consumption growth by 4%.**

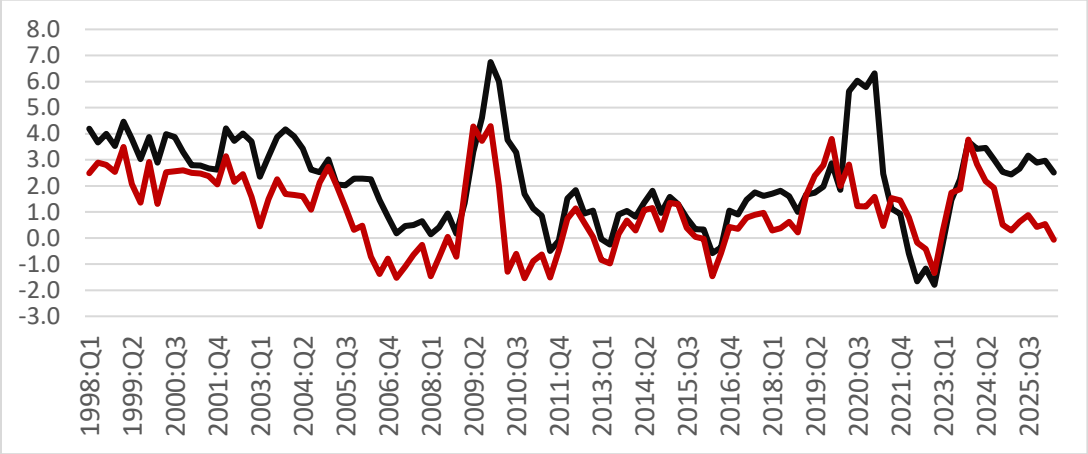
In 2000, non-residential investment growth fell by about 12% (from 6.7% to -5.6%). With AI yet to pass through to strong productivity gains, we would expect a larger decline of about 15% today. Finally, lingering, albeit misguided, inflation concerns would probably cause the Fed to act too slowly in cutting rates. **If the economy experiences a correction of similar magnitude to 2000, the real economy will slow by about 5% leading to an unemployment rate around 6.5%.** This would constitute a moderate recession.

While we see strong parallels between the current U.S. economy and 2000, we see few with the economy in the run up to 2008. Although the housing outlook is terrible (more on this below), the risk is limited to weak construction along with a long period of stagnant price growth. Better mortgage quality will keep delinquency rate from a major increase and homeowners locked into low rate mortgages will also prevent widespread forced selling, preventing a major price decline.

Other Developments in Macroeconomics:

1. While non-residential investment has ignored higher yields so far, housing, as we expected, is being hit very hard. The Atlanta Fed's 3Q2026 GDP growth forecast remains very strong at 3.6%, but it now expects residential investment to fall at a 2.7% annual rate. This follows housing's first positive quarter since 2024. The housing outlook remains poor. September housing starts were an awful 1.22 million, well below expectations, which were already low at 1.31 million. **Housing remains highly interest rate sensitive with little hope of recovery until mid-2027, when we expect the Fed to pivot**.

Figure 1: Labor Productivity (red) and Growth from Technology (black), y/y



2. Some of our concerns about a possible AI financial bubble come from a breakdown of productivity data from the San Francico Federal Reserve. In the first half of 2026, labor productivity grew at a respectable 1.9% annual rate. Labor productivity, however, is simply GDP per hours worked. The more interesting question is why labor productivity grew? The Fed's analysis finds that it is entirely because of strong recent investment that has created a larger stock of physical capital. It is not because this investment has led to technological improvements that make labor more productive. **Investment in AI, so far, has been less productivity enhancing than, for example, traditional business**

equipment. Historically, technology has led to about 1.2% growth per year. Over the past year, however, it has been near zero.

3. Over the past week, CME Fed Funds futures have shifted from a 33% chance of a 25 bps rate hike to a 8% chance today. Over the past few years, when CME futures have moved like this during the Fed's blackout period, the movement has almost always been correct. A rate hike is thus, fortunately, very unlikely. The oddity is that the same futures now predict an even higher peak of the Fed's tightening cycle, with October 2027 futures suggesting a Federal Funds rate of 475-500 bps. **We simply reiterate that core-inflation measures of inflation that remove shelter are already at or near 2% and falling**. The Fed's pivot will instead happen in mid-2027.

-Paul Shea

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