

# In Focus

## AI economic scenarios:

Revolutionary growth, or recessionary bubble?



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As 2025 draws to an end, investors' focus is turning increasingly to AI-related risk: is it a stock market bubble that is about burst and tip the US into recession?

Economists are not best placed to decide if we are in a stock market bubble. We find it hard enough to forecast macro indicators. Much will depend on whether the current market-leaders will be able to deliver on earnings expectations, which in turn will depend to a large degree on the pace of AI adoption and its monetisation. This is one for the stock pickers.

### Bubble trouble?

There are three factors that suggest, even if the ultimate outcome is a bubble, we are not there yet.



#### First,

Investor surveys highlight that the biggest current concern for asset allocators is an AI bubble. Bubbles rarely form where everyone expects them, and the heightened concern suggests that the irrational exuberance that typically precedes a stock market bubble is unlikely in the very near future.



#### Second,

and more fundamentally, there is little sign of a global recession that might be the prompt for a major correction in the stock market. Very few leading indicators of recession are flashing. Indeed, we think that growth expectations are generally too pessimistic.



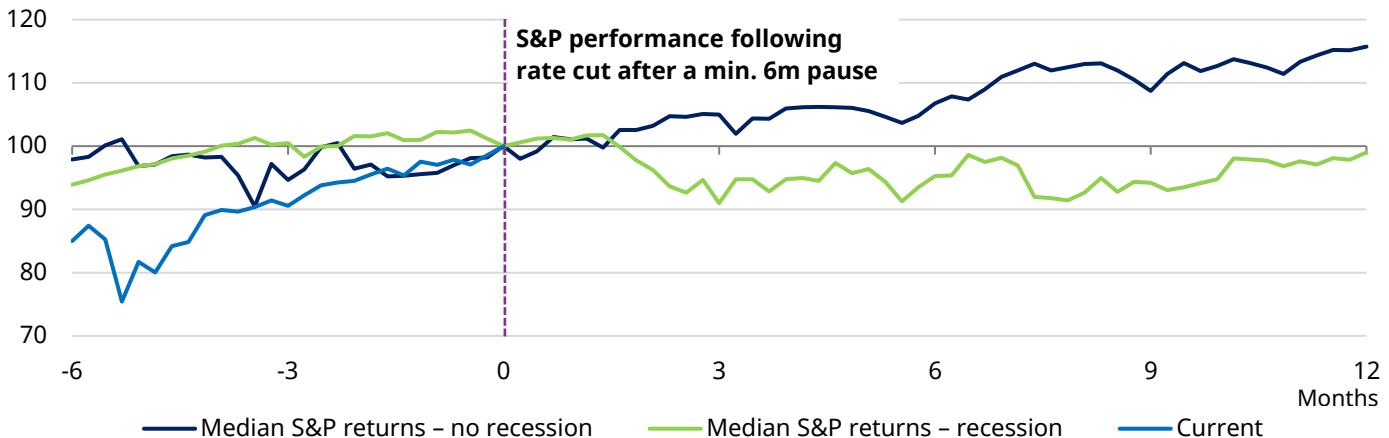
#### Third

– and the biggest risk in our view – is that politicisation of the Federal Reserve may result in deeper interest rate cuts into a strong economy and fuel higher inflation. In this environment, higher nominal growth would support corporate earnings and, in the small sample of episodes when the Fed has cut into strong growth, equities have performed well. Indeed, it is such expansionary monetary policy that could sow the seeds of a 'melt-up' in equities that eventually inflates the bubble. But it doesn't feel imminent.

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## Fed cuts into a strong US economy risk a 'melt up' in equities

Index (Base =100 to date of the first rate cut)



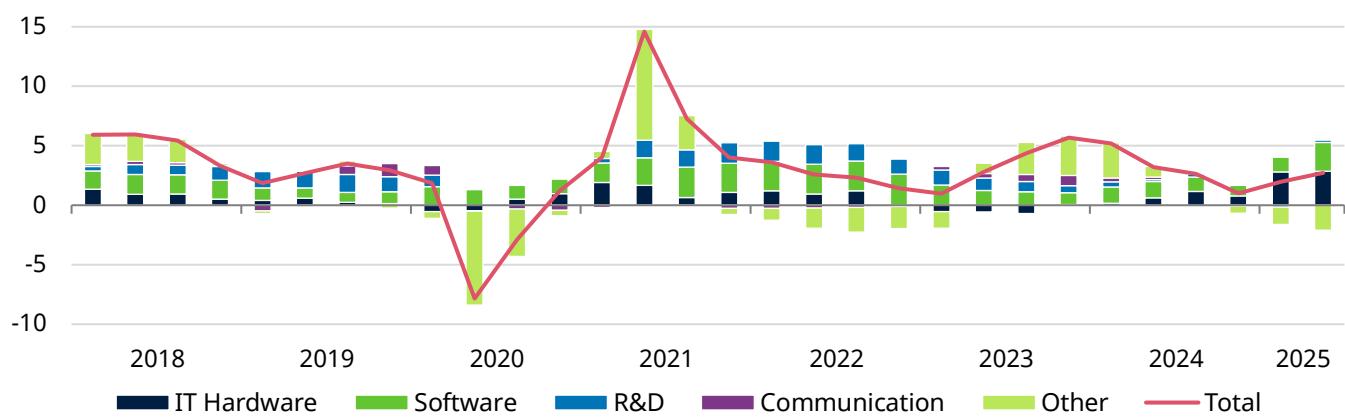
## Two scenarios, one beginning

In designing our two scenarios, the solid macro backdrop, coupled with the lofty investment plans of hyperscalers for 2026, mean that in both cases we have assumed strong capex spending and booming equity market performance

through the year ahead. Capex, largely geared towards AI, has begun to make an increasing contribution to US GDP growth in recent quarters and we assume this strengthens further.

## AI-related sectors are increasingly driving US investment

Contributions to US private investment growth (%-pt, real)



We then assume that a day of reckoning comes in late 2026 when markets begin to question the ability of tech companies to deliver on the hype. At this fork in the road, our scenarios begin to diverge. In the AI Bust scenario the stock market bubble bursts and tech companies pull back from rapid investment, which has a negative impact on the broader economy.

By contrast, in the AI Boom, proof emerges from the market wobble that AI technologies – not only large language models (LLMs), but also autonomous robotics, vehicles and more – are shown to be transformative. This is then assumed to spur rapid adoption of the technology that could even see new market leaders emerge. In this respect, the AI Boom and AI Bust scenarios are not necessarily mutually exclusive.

## Overview: how the two scenarios might play out

<b>2026</b> AI hype cycle continues with stronger Capex spending vs. 2025. Stock prices rise further. Lower interest rates and looser fiscal policy support further growth and consumption.	'Trough of disillusionment' – end of 2026 Equities come under pressure as initial wave of AI investment slows and the market becomes sceptical of ROI.	<b>AI Bust scenario</b> Investors start to conclude that AI is not as commercially viable as hoped, with fewer readily achievable or valuable use cases.	<b>2027-2029</b> Stock prices tumble. Capex slumps and corporate defaults rise, with some negative effects on wider consumption. A mild recession is triggered, and the Fed cuts rates below neutral. Two years of broad stagnation follow before cyclical recovery begins.
		<b>AI Boom scenario</b> Market volatility is ongoing but remains a side-show. AI and its multiple use cases e.g. robotics and autonomous vehicles gain traction. Efficiencies resulting from mass displacement of labour become clearer.	<b>2027-2029</b> Stock prices recover with new leadership. AI and energy infrastructure Capex continues to boom. Productivity increases significantly, but unemployment rises. This weighs on consumption and tax receipts. Energy inflation increases, although core inflation is subdued. Fed rate cuts do not generate cyclical upturn.

### AI Bust

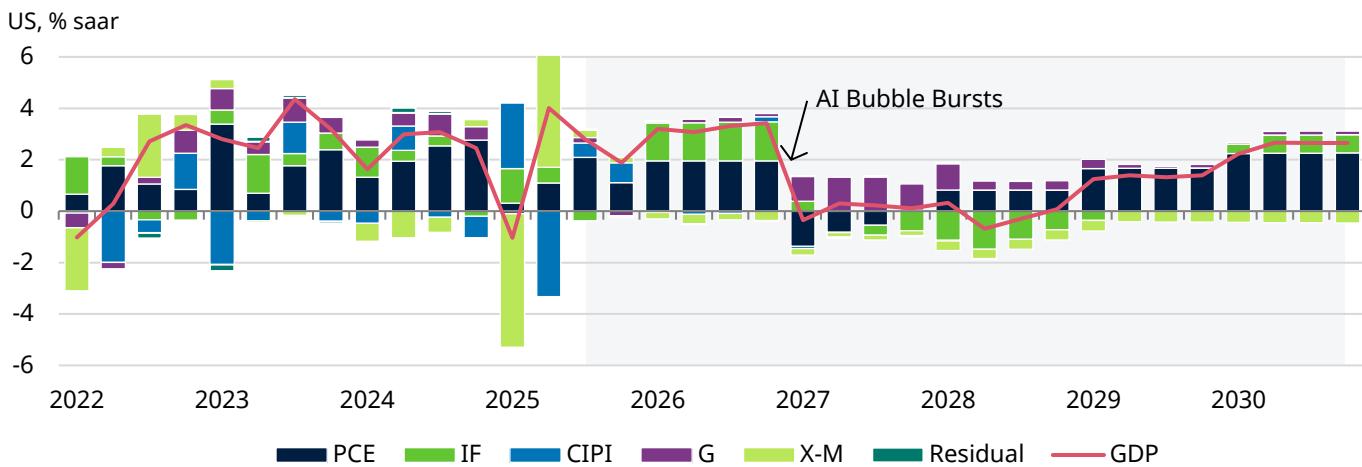
In many respects, the Bust scenario is more straightforward, and perhaps more palatable, than the outright AI Boom. That's not to say the bursting of a stock market bubble would be painless: it would mean investors suffering steep declines in asset prices. But the many past instances of historic market bubbles mean we can be more confident about the macroeconomic implications.

As shown in our stylised US GDP profile, we assume that the bursting of the stock market bubble has an immediate, negative effect on private sector activity. As it becomes clear that tech companies will not be able to monetise

AI investment, spending is shelved. We then assume a two-year investment recession like that seen in the aftermath of the dot.com bubble.

We also assume there would be some negative impact on private consumption. We are sceptical of the narrative that wealth effects have been the key driver of US consumption in recent years – there is little evidence of consumers either selling assets or leveraging up against them to fund purchases. However, falling stock prices and rising unemployment would still have some negative impact on sentiment and spending. This is enough to tip the US into a mild recession.

### AI Bust – Capex drops, with negative impacts on sentiment and spending

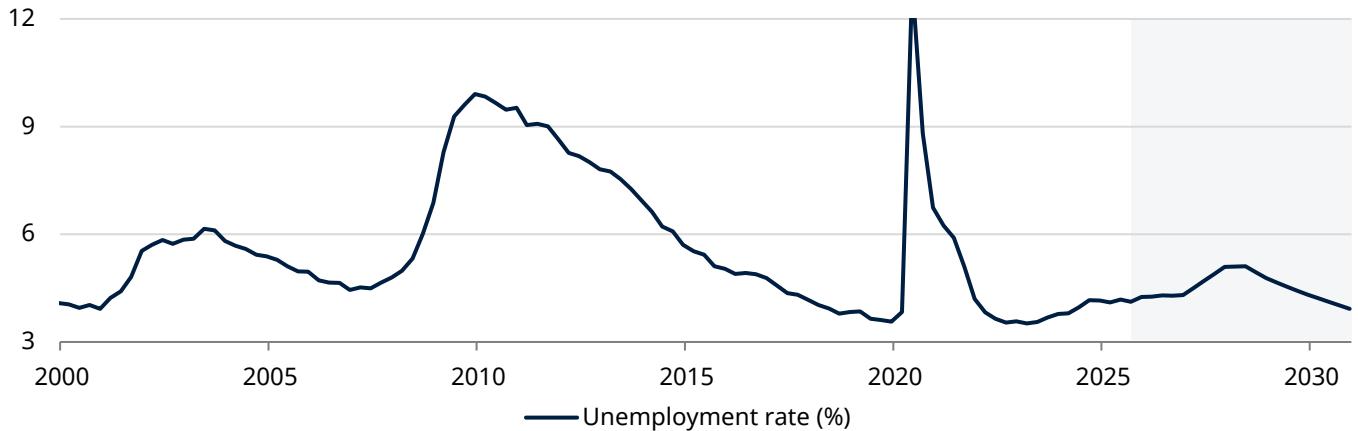


Source: Schroders Economics Group.

Rising unemployment and softer demand would relieve capacity constraints in the US economy. This would allow the Fed to cut interest rates to below neutral. And this, coupled with automatic stabilisers and some fiscal

stimulus, are assumed to set the scene for a cyclical, consumer-led recovery through late-2028 onwards. In this environment, equities would begin to perform well again, but with more breadth and different market leaders.

## Employment and inflation allow the Fed to cut below neutral



Source: Schroders Economics Group.

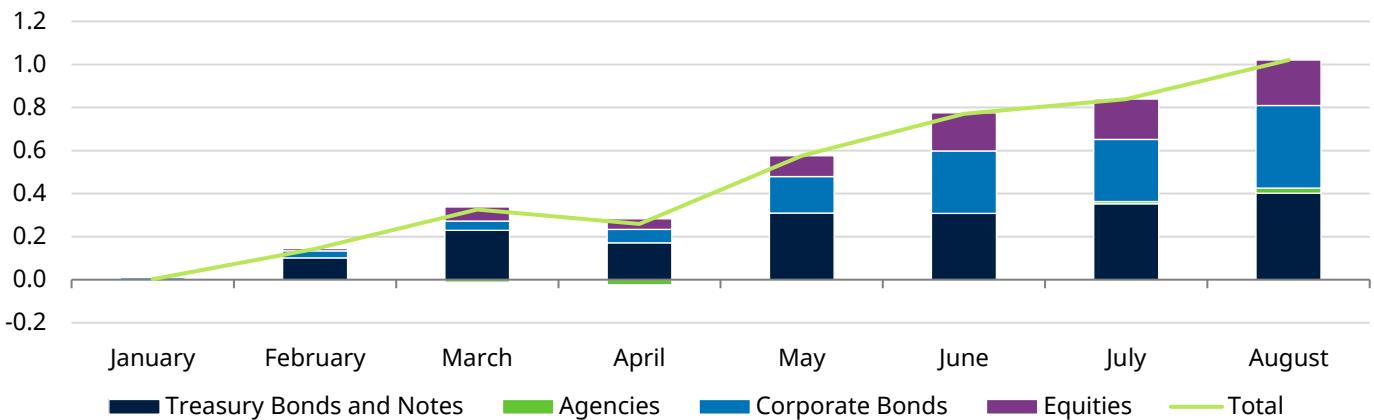
Finally, we assume that the Bust scenario would be negative for the US dollar. This stands in contrast to the aftermath of the bursting of the dot.com bubble, when in the first instance the dollar strengthened on safe-haven bids.

However, [as we have previously argued](#), the erosion of trust in US institutions has probably weakened the safe haven properties of the dollar and left it liable to significant depreciation over the next decade.

Evidence of these weakening foundations can be seen in recent Treasury market flows, leaving the US external deficit increasingly funded by hotter capital inflows to equity and credit markets. In the near term this is likely to ensure the dollar is more volatile in line with risk appetite fluctuations. A reversal of these flows would be likely to drive outright depreciation.

## Fed rate cuts and reversal of equity inflows could weigh on the dollar

2025 US Cumulative Inflows (\$ trillion)



Source: Macrobond, Schroders, US Department of Treasury, 28 November 2025.

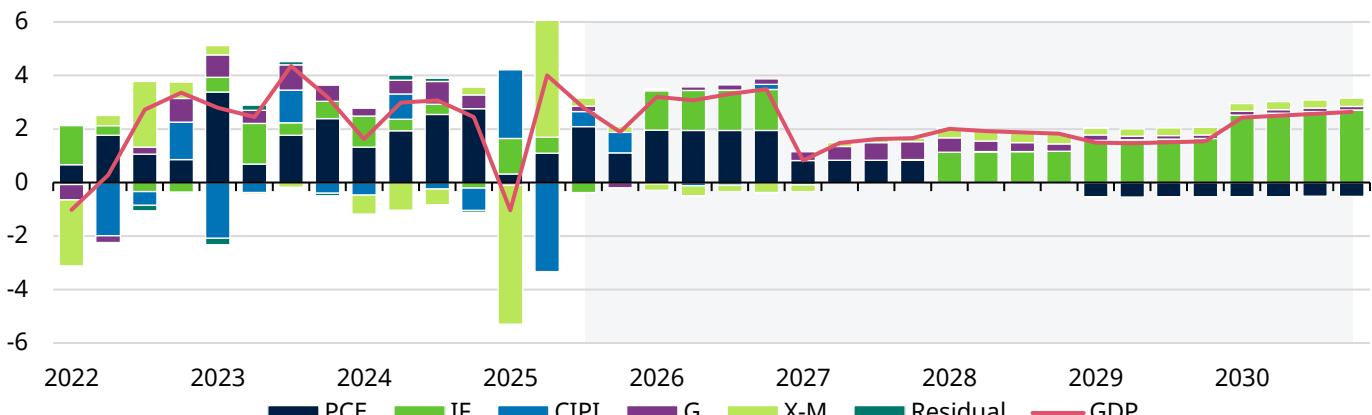
## AI Boom

If the Bust scenario is relatively straightforward to model, the uncharted waters of the AI Boom is not. This scenario is purposefully assumed to be quite extreme in order to tease out the long-term implications of a rapid, 'third industrial revolution' which unfolds over a matter of months rather than years or decades.

For the sake of the scenario, we have assumed that after a market wobble in late-2026 there is some pause in tech capex as the winners and losers of the AI arms race are thrashed out. After that, our key assumption is of an exponential ramp-up of capex as firms rush to roll out AI infrastructure and services as it becomes clear that AI is deeply transformative. This is assumed to support robust US GDP growth.

## AI Boom – rapid adoption leads to capex growth, but with labour displacement

US, % saar

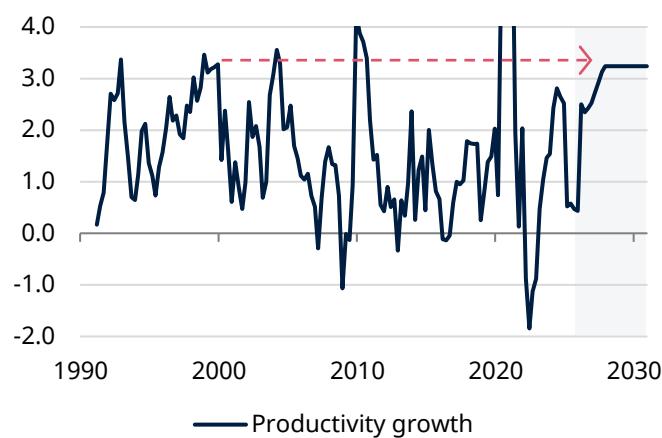


Source: J.P. Morgan, Schroders Economics Group, 6 November 2025.

However, in such a scenario where robotics and autonomous vehicles, amongst other technologies, begin to displace workers, the outlook for consumption is far less clear cut. In our scenario, we have assumed that the AI Boom sees US productivity growth climb to the rates seen prior to the dot.com bubble and stay

there – around 3.5% per year. By assuming that both population growth and participation rates remain the same, such strong productivity would imply an increase in the unemployment rate towards 10%. Such jobless growth would have at the very least a slightly negative impact on consumer spending.

## US productivity boom results in rising unemployment

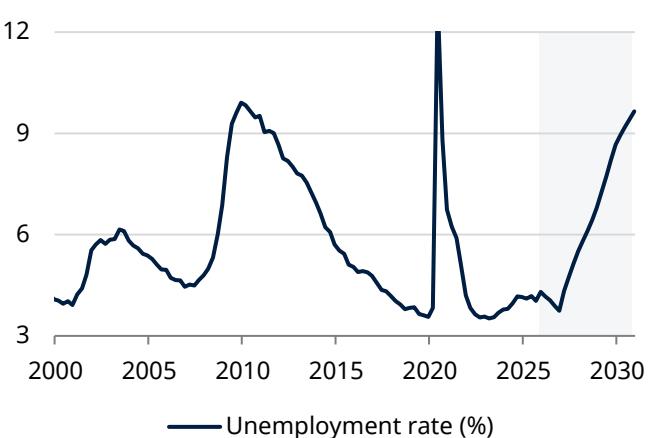


Source: Schroders Economics Group. 6 November 2025.

## Twin-speed growth and inflation

It is also easy to construct a twin-speed story for US inflation in such a scenario. Rising unemployment, pressure on incomes and softer consumer spending all sound deflationary – certainly for important buckets of the US CPI basket such as housing and core services. Moreover, the displacement of workers with machines ought to also bring down the cost of providing services over time.

However, the scramble to rapidly adopt transformative AI would be likely to cause strains on other areas of the economy. If tech firms struggled to keep up with rampant demand it is fair to assume there would be an inflationary impact in the goods sector. There is already a lot of focus on the enormous energy demands that AI is likely to bring using data centres.



In isolation, it would be wrong to assume that rising energy services inflation would change the overall outlook for US inflation. At about 3% of the CPI basket it is just too small. However, these strains could clearly spread if AI companies passed on higher energy prices. And it is possible that rampant demand for electricity could start to move the needle on commodity prices. Around half of US electricity is generated using natural gas and rising demand could see prices climb. And given the importance of natural gas to fertiliser production, it is feasible that this could also begin to put upward pressure on food prices.

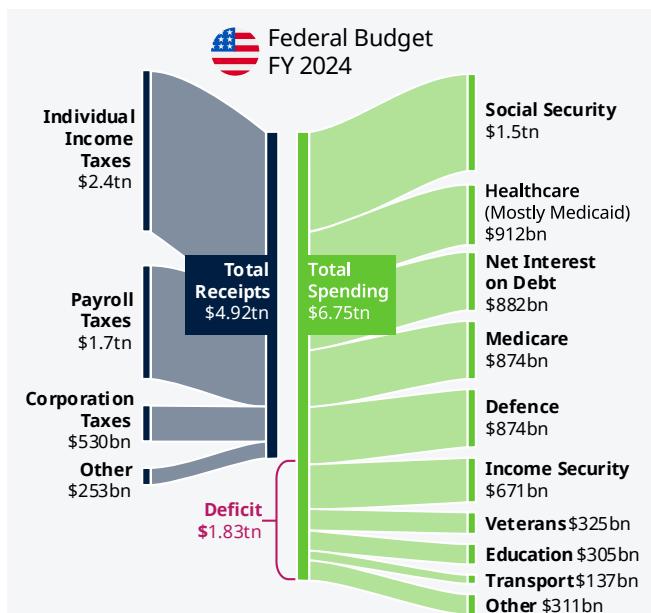
## Tricky environment for policymakers

The Fed's dual mandate means that such a scenario would present a challenge for rate-setters. Twin-speed growth and inflation may cause policymakers to hesitate in cutting rates, fearful of a strong overall economy fuelling inflation in some sectors. Ultimately, rising lay-offs and falling inflation would pave the way for much lower interest rates.

The fiscal implications of the AI Boom scenario might also motivate the Fed to get on with delivering rate cuts. After all, the prospect of jobless growth could have profound implications for the US public finances. As things stand, around three-quarters of Federal revenues come from the taxation of labour whereas only about one-quarter comes from corporations. On the other side of the ledger,

## AI boom would bring major fiscal challenges for the US

The US deficit was \$1.8 trillion last year<sup>1</sup>



Source: Schroders Economics Group. 6 November 2025. <sup>1</sup>Source: Monthly Treasury Statement.

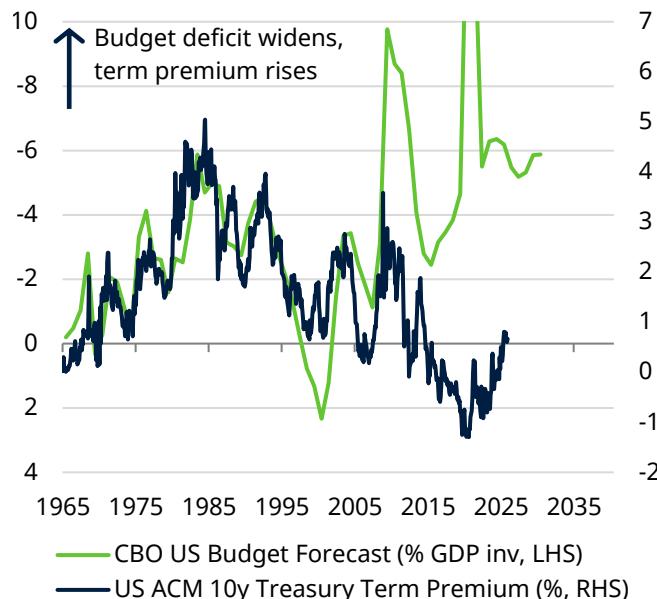
## Conclusion

Perhaps the most obvious question to come out of this dystopian scenario is whether governments would allow such unfettered adoption of AI. There are advantages to the development of AI. Indeed, we have argued for many years that the adoption of technology will be a necessary response to long-term structural headwinds such as a shrinking population and rising old age dependency ratios. The use-case is obvious in economies such as Japan, and soon China, where these demographic trends are most pronounced.

But what about the interaction between technological advancement and populism? We have in the past argued

a large portion of Federal spending is on welfare. There is an obvious tension here. The displacement of workers would result in a (permanent?) reduction in income tax revenues and put upward pressure on welfare spending.

The implication is that the US – and other governments around the world – would need to raise more tax from corporations and perhaps even carry out a total overhaul of tax and spending frameworks. Unless or until that happened, the path of least resistance would surely be towards higher long-term bond yields as investors would demand larger risk premiums.



that the deindustrialisation of Europe due to rampant competition from China could fuel more populist support. Presumably an even more acute threat from technology would only add to those populist tendencies. And what about the emerging markets that would not be able to afford rapid adoption of the new technology?

From an investor's point of view monitoring these developments is critical. Where potential AI scenarios are as divergent as igniting a boom or triggering a bust, complacency has to be among the bigger risks.

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