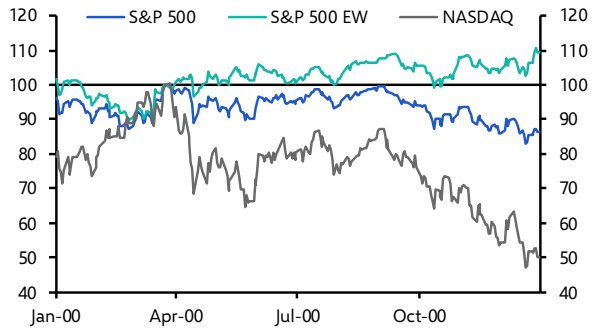
Lessons from the dot.com bust



Neil Shearing *is the Group Chief Economist at Capital Economics. He has overall responsibility for managing our global team of 70+ economists and leading our research, as well as developing the firm's products and its relationship with clients. Neil is a leading voice within the investment community and his views are regularly sought by global media outlets, including the Financial Times, the Wall Street Journal and Bloomberg. He is also an associate fellow at Chatham House.*

The slump in technology stocks over the past few weeks has drawn comparisons with the bursting of the dot.com bubble in the early 2000s. Of course, no comparison is exact. In particular, while valuations have become very stretched over the past couple of years, they never hit the levels reached at the peak of the dot.com bubble. The rally in technology stocks over the past four years has instead been driven by exceptionally strong earnings growth, and the expectation that this would continue.

Chart 1: US Equity Indices (23rd March 2000 = 100)



Sources: LSEG, Capital Economics

Echoes of 2000

Nonetheless, the parallels with the dot.com era are striking. Both episodes have been characterised by exuberance surrounding a transformative technology: the internet back then, AI today. There are also other echoes. Today's stock market is extraordinarily concentrated. Several mega-cap companies have come to dominate equity indices, and leverage is building in parts of the system, including among companies at the forefront of the AI boom.

So what lessons can be drawn from the early 2000s? A key one is that it took time for the collapse in tech stocks to spread to the wider equity market. Indeed, in the nine months following the bursting of the dot.com bubble in March 2000, the average stock in the S&P 500 rose. As Chart 1 shows, there were two phases to the tech sell-off in 2000 – an initial drop in the spring followed by a more sustained sell-off in the autumn, the combined effects of which meant that the Nasdaq had fallen by around 50% from its March peak by the end of that year. Yet the S&P 500 Equal Weight (EW) Index increased by around 10% over that period.

It's the economy, stupid

This gets to perhaps the most important lesson from that episode, which is that the performance of the wider economy, and the response of the Federal Reserve, will play a crucial role in determining whether a correction in technology stocks morphs into a broader equity slump.

In the immediate aftermath of the bursting of the dot.com bubble, the US economy continued to perform relatively well. GDP grew by around 4.5% in the first half of 2000. Meanwhile, inflationary pressures were showing signs of picking up and the Fed was tightening policy, raising interest rates from 5.75% at the start of the year to 6.50% in May.

The minutes of FOMC meetings at the time make for interesting reading. Alan Greenspan and his colleagues consistently pointed to the underlying strength of the economy, seeing little reason to expect weakness in equity markets, or problems in the technology sector, to translate into a broader economic downturn. In fact, the minutes to the May FOMC meeting at which interest rates were hiked for a final time – by a larger 50bp – noted that "The members saw little risk in a relatively aggressive

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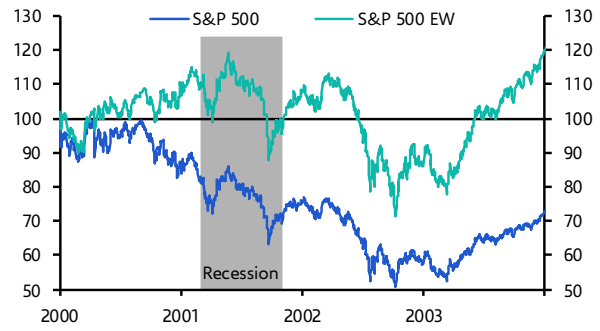
policy move, given the strong momentum of the [economic] expansion".

Ultimately, however, the economy did turn down, in part due to the Fed's tightening. The US entered a recession in March 2001, albeit a relatively mild one. Growth subsequently recovered, but unemployment continued to rise, peaking at 6.3% in June 2003. The broader stock market then rolled over. The S&P 500 did not bottom out until October 2002, by which time it had recorded a peak-to-trough fall of around 50%. (See Chart 2.)

Chart 2: S&P 500 (23rd March 2000 = 100)



Sources: LSEG, Capital Economics

Watch the AI capex cycle

There are some important parallels with today. The economy is holding up well despite the weakness in technology stocks. GDP grew by 3.4% q/q annualised in Q3, and our GDP tracker is pointing to a near-3% pace of growth again in Q4. Meanwhile, underlying inflationary pressures remain relatively strong. We expect core PCE inflation to remain above the Fed's 2% target throughout next year. Accordingly, we expect the Fed to raise interest rates further. Our forecast is for a hike in December and at least one more after that.

The key question, therefore, is whether this combination of weaker equity markets and tighter monetary policy precipitates a broader downturn in the US economy, triggering an equity market sell-off on a scale comparable with that of the early 2000s.

Much will depend on what happens to the AI cycle, which has played a key role in supporting US economic growth over the past couple of years. Although identifying turning points in capex cycles is notoriously difficult, there are reasons to be concerned, as we have set out here.

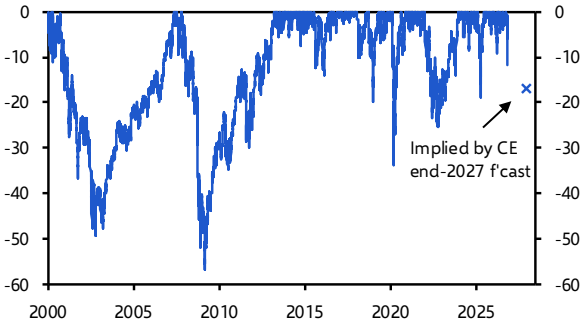
According to our estimates, the AI investment boom may have accounted for as much as one-third of US GDP growth over the past year. It follows that without this prop to growth, GDP growth would slow from its current pace of around 3% to 2% or so.

The more important question is whether AI investment stops providing such a powerful tailwind and actually becomes a drag on growth, with business investment falling outright, as it did in 2001 and 2002. The resilience of the US consumer and by extension the labour market will also matter.

On this front, we are somewhat more optimistic. For a start, we do not expect the Fed to tighten monetary policy by quite as much as markets are currently pricing in. Moreover, while AI could move from being an economic tailwind to a headwind, the economy should receive support from other sources in 2027, including lower global energy prices.

Our central case, therefore, is that US quarterly growth rates slow over the course of next year but that the economy avoids recession. That would mark an important contrast with the early 2000s and should help limit the damage to equity markets. Having been bullish on US stocks since mid-2023, our forecast is for a drop in the S&P 500 to 6,500 at the end of 2027. That would amount to a 17% fall from its peak last month, although the actual peak-to-trough fall is likely to be larger since the market is unlikely to trough on the last day of the year. Either way, this would be a smaller drop than in the early 2000s. (See Chart 3.)

Chart 3: S&P 500 Drawdowns From Previous Peak (%)



Sources: LSEG, Capital Economics

A narrow path

There are considerable uncertainties around this outlook. These include the possibility of policy mistakes, most notably the Fed tightening too much, as well as fresh economic shocks. One risk is that

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developments in the Middle East prevent global oil and natural gas prices from falling next year, as we currently expect.

The US economy is therefore treading an increasingly narrow path. A correction in technology stocks may not necessarily become a repeat of the dot.com bust. But the extent to which it does will depend less on what happens in the tech sector itself than on whether the wider economy can absorb the unwinding of the AI investment boom.

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In case you missed it

James Reilly broke down the S&P 500's exposure to an AI bust.

Vicky Redwood unpacked the interplay between the AI revolution, technological risks and economic resilience.

Our Asia team released a deep-dive on the impact that AI is having on the region.

Contact

Email sales@capitaleconomics.com
Visit www.capitaleconomics.com

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Neil Shearing, Group Chief Economist