Global markets face reckoning as triple threat fractures appear



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ANALYSIS

Since the end of 2022, global financial markets have sailed through turbulence, floating on three convictions: artificial intelligence delivers immediate, unquenchable productivity gains; disinflation steadily allows central banks to lower interest rates;, and geopolitical friction, while noisy, remains broadly contained.

Today, however, and despite the relative confidence that comes from near-record equity markets, every one of those pillars is fracturing simultaneously.

From news of accelerating circular tech financing, the emergence of AI commoditisation amid the release of open-source models, a US debt refinancing spiral and volatile geopolitical bottlenecks, investors are either ignoring the risks or hoping they go away.

But the clouds aren't breaking up. Warren Buffett's $US400bn ($570bn) in cash reserves tells me he thinks the sky is darkening.

The tech divide

Nowhere is market concentration and exuberance still more evident than in the technology sector, where the Magnificent Seven have long driven broad market gains. However, signs of a thematic breakdown are emerging, as the group no longer trades cohesively. Divergences in performance are growing between companies that generate immediate cash flow and those investing billions in capital expenditure.

More investors are beginning to ask: Can this unprecedented capital expenditure continue without seriously diluting returns on invested capital?

As tech giants pour hundreds of billions into data centres, chips and energy infrastructure, evidence suggests that increasingly efficient AI models may actually require less computing power per task. That threatens future margin expectations, creates massive white elephants (abandoned data centres), and commoditises the AI models themselves.

More troubling are reports that Nvidia is exploring a $US250bn backstop for an OpenAI data centre, alongside hundreds of billions in chip financing arrangements. It seems the dangerous circular dealmaking is alive and well.

Fixed-income tremors

While this logic doesn't seem to have created many waves among equity investors, it's already causing tremors in fixed-income markets. Credit default swap prices on major tech debt have surged to active-trading highs, signalling institutional credit markets are pricing in systemic counterparty risk.

Add to this the explosive public debut of mainland Chinese memory-chip makers such as CXMT and the rapid rise of open-weight AI models, and top-tier tech labs look increasingly vulnerable to margin compression.

US balance sheet woe

While tech balance sheets display circular risk, the US federal balance sheet is becoming a structural crisis. The US Treasury's debt management has fundamentally shifted towards the short end of the yield curve. By issuing short-term Treasury bills rather than locking in long-term rates by issuing bonds, the government has effectively turned its $US39 trillion ($55.6 trillion) debt pile into an adjustable-rate mortgage.

The problem is that US interest expenses are now hypersensitive to overnight interest rate movements, and a budget deficit of about $US2.5 trillion is continuing to grow due to mandatory spending for defence, Medicare and social security.

Consequently, annualised interest payments on the national debt have breached $US1.4 trillion, and so the US Treasury finds itself trapped in a classic doom loop: it must issue vast amounts of new debt simply to service the interest on existing obligations.

As well, foreign central banks and institutional investors are paring back purchases of US sovereign debt due to geopolitical tensions and fiscal concerns, and are instead accumulating gold.

This imbalance between huge supply and shrinking demand is driving long-term benchmark yields upward, pushing 10-year and 30-year Treasuries to multi-year highs – not good for stocks.

Ultimately, the Federal Reserve will face a grim dilemma: permit bond yields to spike until they trigger a credit freeze, or intervene to monetise the debt, sacrificing the long-term purchasing power of the US dollar.

Race for hard assets

It's little wonder institutional smart money is quietly rotating into hard assets such as gold to hedge against future currency debasement. Heaping burning coals on the fiscal and technological risks is the sudden return of commodity volatility.

The intensification of the conflict in the Middle East is further testing the fragility of global supply chains. With significant portions of maritime oil transiting vulnerable regional chokepoints such as the Strait of Hormuz, any escalation brings immediate supply shocks because strategic reserves are near depleted.

Inflation

When Brent crude spikes towards $US100 a barrel, the immediate transmission mechanism is felt across transport, aviation, manufacturing and consumer spending. Even during temporary pauses in hostilities, the conflict premium remains stubbornly high.

Furthermore, the threat of another tariff war and protectionist trade policies threatens to entrench structural inflation, putting additional pressure on bond yields.

Meanwhile, in the US, shortages of labour, oil and imported components are interrupting the wishful disinflation narrative that markets relied on throughout early policy-easing cycles.

Central banks

This convergence of sticky inflation, massive sovereign debt supply and erratic energy markets boxes central banks into a corner.

The past decade's cheap capital, predictable supply chains and unconstrained tech earnings growth is slowly, but ever so surely, giving way to a new regime marked by debt overhangs, geopolitical fragmentation and margin pressure.

And that's not going to be great for those "all in" on equities.

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