

# Is AI Inflationary or Deflationary? The Fed May Soon Have to Decide

The AI boom goes from strength to strength. Big technology companies are pouring hundreds of billions of dollars into chips, data centers, and power-hungry infrastructure. One estimate puts annual AI infrastructure investment above \$650bn in 2025 and potentially over \$800bn in 2026. Meanwhile, SpaceX's record initial public offering (IPO) — raising about \$75bn and valuing the company near \$1.75tn at issue — is a useful reminder that capital markets remain wide open for anything with a plausible claim on the AI future.

That creates an awkward problem for the Federal Reserve (Fed). AI may be a long-run productivity miracle. But the short-run impulse looks less like disinflation and more like a classic investment boom colliding with limited supply. Semiconductors are scarce and used in almost all industrial goods. Electric grids are constrained. Construction costs are rising. Land, labor, copper, turbines and transformers are not infinitely elastic. Data centers may be digital assets in the long run, but they require very physical inputs.

Some Fed officials have already expressed concern that these pressures could complicate the inflation outlook. The concern is not simply that Nvidia chips cost more. It is that the AI build-out touches several sticky categories at once: equipment, electricity, commercial construction, skilled labor and financial conditions. Add buoyant equity markets and robust IPO demand, and the Fed must also consider whether asset-price inflation is loosening conditions even as policy rates remain restrictive.

This is where the new Fed chair, Kevin Warsh, matters.

Having chaired his first Federal Open Market Committee (FOMC) meeting this week, Warsh has already signaled that the central bank's inflation framework needs updating, including greater attention to trimmed or underlying inflation measures rather than simply relying on core personal consumption expenditures (PCE). At his Senate hearing, Warsh said he wants to understand "the underlying inflation rate" and whether shocks are creating second-round effects. After several years of overshooting the 2 percent target, the Federal Reserve's institutional credibility is no longer free.

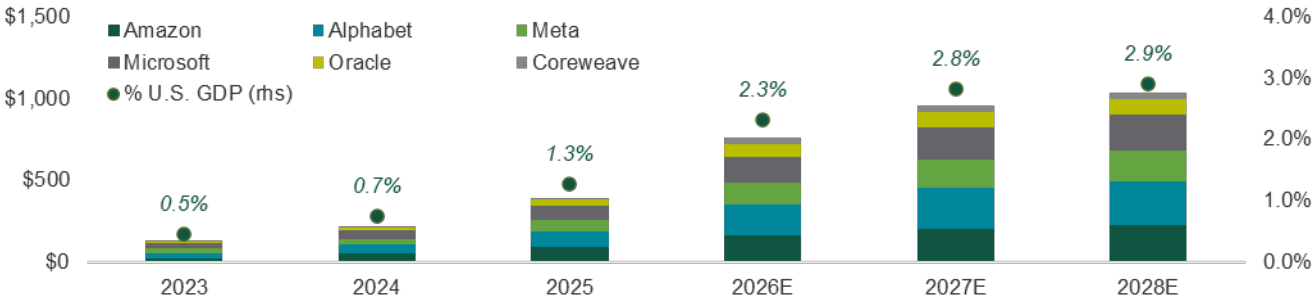
The numbers could force the issue. If AI-related demand adds as much as 0.5 percentage points to core inflation over the coming year, policymakers cannot easily look through it. A credible central bank may need to lean against the boom by keeping rates higher, slowing credit growth, and tightening financial conditions enough to cool the most speculative parts of the cycle.

The complication is that AI may still be deflationary in the end. If it replaces labor, compresses wages and raises productivity, today's inflationary capital expenditure (capex) surge may be tomorrow's disinflationary supply shock. The Fed's task is therefore not to decide whether AI is good or bad. It is to decide which horizon matters.

With inflation data firming and Warsh promising to restore credibility, the debate is likely to intensify. AI may yet lower prices. But first it must work through the inflationary cost of building itself.

## THE HYPERSCALER CAPEX BOOM – NOW VISIBLE IN NATIONAL ACCOUNTS

Capex (in billions) relative to U.S. nominal GDP



Source: Northern Trust Asset Management, Bloomberg. Capital expenditure reflects reported actuals for 2023–2025 and Bloomberg consensus estimates for 2026–2028. Amazon represented by AWS only. Coreweave reflects available reported and estimated data from IPO onwards. Historical trends are not predictive of future results.

# POSITIONING SCENARIOS

## Fiscal and Productivity Boost (30% probability)

Tax cuts, deregulation and AI adoption more than offset supply restraints. Strong productivity gains continue, allowing for robust economic growth without sparking higher inflation.

## Two-Speed Expansion (40% probability)

Soft labor force dynamics and a bifurcated economy govern what would otherwise be a stronger growth environment, resulting in a trend-like expansion and disinflation.

## Economic Fault Lines Broaden (30% probability)

The economic expansion is cut short by persistent supply-side restraints, energy headwinds, or AI-related disruption that weakens activity and/or tightens financial conditions.

Note: Probabilities are assumed from proprietary research and are subject to change.

### Additional Index Definitions:

**Bloomberg Treasury Bills 1-3 Months:** The Bloomberg U.S. Treasury Bills: 1-3 Months Index tracks the market for treasury bills issued by the U.S. government with time to maturity between 1 and 3 months. US Treasury bills are issued in fixed maturity terms of 4, 8, 13, 17, 26 and 52 weeks.

**Bloomberg U.S. Treasury:** The Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index. STRIPS are excluded from the index because their inclusion would result in double-counting. The US Treasury Index is a component of the US Aggregate, US Universal, Global Aggregate and Global Treasury Indices. The index includes securities with remaining maturity of at least one year.

**Bloomberg Global Treasury:** The Bloomberg Global Treasury Index tracks fixed-rate, local currency government debt of investment grade countries, including both developed and emerging markets. The index represents the treasury sector of the Global Aggregate Index.

**Bloomberg Municipal:** The Bloomberg Municipal Bond Index is a flagship measure of the US municipal tax-exempt investment grade bond market. Included in the index are securities from all 50 US States and four other qualifying regions (Washington DC, Puerto Rico, Guam, and the Virgin Islands). The index includes state and local general obligation bonds and revenue bonds. All bonds in the Municipal Bond Index are tax exempt and hence are not eligible for other indices that include taxable bonds, such as the Bloomberg U.S. Aggregate.

**Bloomberg U.S. TIPS:** The Bloomberg US Treasury Inflation-Linked Bond Index (Series-L) measures the performance of the US Treasury Inflation Protected Securities (TIPS) market. Federal Reserve holdings of US TIPS are not index eligible and are excluded from the face amount outstanding of each bond in the index.

**Bloomberg Global Inflation-Linked:** The Bloomberg Global Inflation Linked Index (Series-L) measures the investment-grade, government inflation-linked debt from 12 different developed market countries. Investability is a key criterion for inclusion of markets in this index, and it is designed to include only those markets in which a global government linker fund is likely and able to invest.

**Bloomberg U.S. Aggregate:** The Bloomberg US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, fixed-rate agency MBS, ABS and CMBS (agency and non-agency). Provided the necessary inclusion rules are met, US Aggregate-eligible securities also contribute to the multi-currency Global Aggregate Index and the US Universal Index.

**Bloomberg Global Aggregate:** The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-seven local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

**JP Morgan GBI – EM Global Diversified Composite Index:** The J.P. Morgan Emerging Markets Bond Index Global Diversified tracks total returns for U.S. dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities.

**Bloomberg U.S. High Yield:** The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on the indices' EM country definition, are excluded. The US Corporate High Yield Index is a component of the US Universal and Global High Yield Indices.

**Bloomberg Global High Yield:** The Bloomberg Global High Yield Index is a multi-currency flagship measure of the global high yield debt market. The index represents the union of the US High Yield, the Pan-European High Yield, and Emerging Markets (EM) Hard Currency High Yield Indices. The high yield and emerging markets sub-components are mutually exclusive.

**MSCI AC World:** The MSCI ACWI captures large and mid cap representation across 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries.

**MSCI USA:** The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market.

**S&P 500:** The index, a gauge of the large-cap U.S. equity market, includes 500 companies that represent approximately 80% of the market capitalization of publicly traded U.S. equities.

**Russell 2000:** The Russell 2000® Index measures the performance of the small-cap segment of the US equity universe.

**Russell 1000 Growth:** The Russell 1000® Growth Index measures the performance of the largecap growth segment of the US equity universe. It includes those Russell 1000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium term (2 year) growth and higher sales per share historical growth (5 years). The Russell 1000® Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

**Russell 1000 Value:** The Russell 1000® Value Index measures the performance of the largecap value segment of the US equity universe. It includes those Russell 1000 companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium term (2 year) growth and lower sales per share historical growth (5 years). The Russell 1000® Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics.

**MSCI World:** The MSCI World Index captures large and mid cap representation across Developed Markets countries.

**MSCI World ex US:** The MSCI World ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries\*--excluding the United States. With 778 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

**MSCI Europe:** The MSCI Europe Index captures large and mid cap representation across Developed Markets (DM) countries in Europe. The index covers approximately 85% of the free float-adjusted market capitalization across the European Developed Markets equity universe.

**MSCI Japan:** The MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market. The index covers approximately 85% of the free float-adjusted market capitalization in Japan.

**MSCI Emerging Markets:** The MSCI EM (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

**MSCI China:** The MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). The index covers about 85% of this China equity universe. Currently, the index includes Large Cap A and Mid Cap A shares represented at 20% of their free float adjusted market capitalization.

**S&P Global Natural Resources:** The index includes 90 of the largest publicly-traded companies in natural resources and commodities businesses that meet specific investability requirements, offering investors diversified and investable equity exposure across 3 primary commodity-related sectors: agribusiness, energy, and metals & mining.

**S&P Global Infrastructure:** The S&P Global Infrastructure Index is designed to track 75 companies from around the world chosen to represent the listed infrastructure industry while maintaining liquidity and tradability. To create diversified exposure, the index includes three distinct infrastructure clusters: energy, transportation, and utilities.

**MSCI ACWI IMI Core Real Estate:** The MSCI ACWI IMI Core Real Estate Index is a free float-adjusted market capitalization index that consists of large, mid and small-cap stocks across 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries\* engaged in the ownership, development and management of specific core property type real estate. The index excludes companies, such as real estate services and real estate financing companies, that do not own properties.

**CBOE Volatility Index:** The Cboe Volatility Index (VIX Index) is a leading measure of market expectations of near-term volatility conveyed by S&P 500 Index option prices.

**CBOE Crude Oil Volatility Index:** The Cboe Crude Oil ETF Volatility Index (OVX) is an estimate of the expected 30-day volatility of crude oil as priced by the United States Oil Fund (USO).

**Philadelphia Stock Exchange Semiconductor Index:** The Philadelphia Semiconductor Index is a modified capitalization-weighted index comprised of companies that are involved in the design, distribution, manufacturing, and sale of semiconductors.

**NASDAQ-100 Index:** The NASDAQ-100 Index is a modified capitalization-weighted index of the 100 largest and most active non-financial domestic and international issues listed on the NASDAQ. No security can have more than a 24% weighting.

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