Are AI Stocks Running Out of Steam?

The emergence of DeepSeek, a Chinese AI startup, has challenged the U.S. AI industry's dominance, raising concerns about the sustainability of AI-driven market valuations, particularly impacting Nvidia. While broader economic concerns, including U.S. policy shifts, have compounded the downturn in Nvidia's share price, the correction may also be a sign of deeper shifts in AI valuations. Are AI stocks running out of steam?

One of the most repeated mistakes equities investors make is the assumption that an industry leader will always remain so. Nobody ever seems to assume that competitors will emerge and take a significant share from the first mover. That failure often leads to unrealistic pricing.

The recent emergence of DeepSeek, a small but innovative Chinese artificial intelligence (AI) startup, has just shaken the U.S. AI leadership narrative. DeepSeek's revolutionary reasoning model is reported to have stunned the industry with its comparatively excellent performance over leading American AI models.

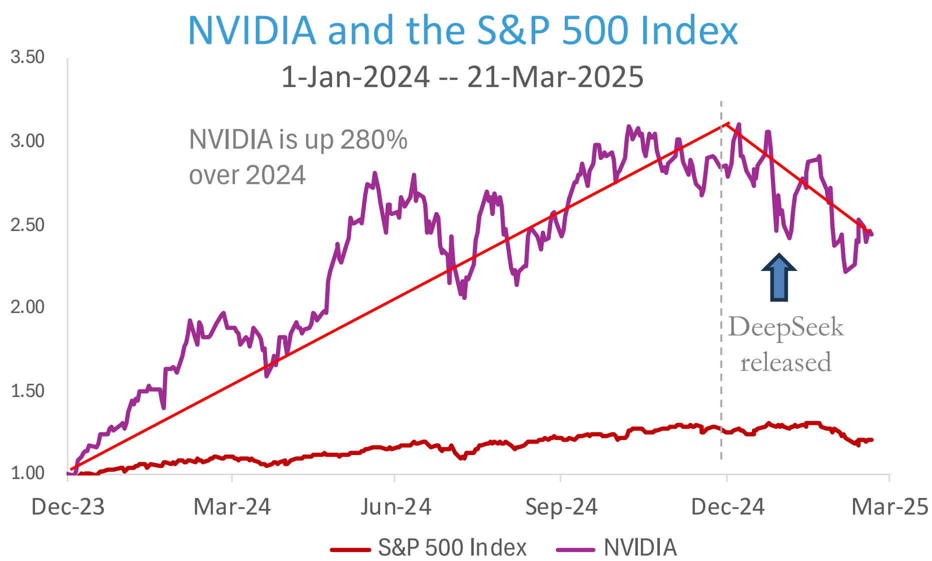
If the Chinese demonstration is to be taken at face value, the development raises serious questions about the sustainability of the U.S.-dominated AI boom, particularly for companies like Nvidia, whose fortunes are deeply intertwined with the sector's growth.

Whenever financial market performance and valuations hinge on a handful of high-performing stocks, even a minor disturbance to the narrative can lead to dramatic consequences. When DeepSeek was released in early February Nvidia saw its valuation plummet by nearly 17%. Such volatility is seen as good reason to reassess the assumptions about the AI market's future.

DeepSeek's model has drawn attention not just for its performance but for its cost-effectiveness. Unlike U.S.-based companies that have poured billions into building proprietary AI models, DeepSeek reportedly achieved groundbreaking results with a much smaller investment. Moreover, the startup's decision to release its model as an open-source platform threatens to democratize AI in a way that could destabilase the current market dynamics upon which the current lofty valuations are based.

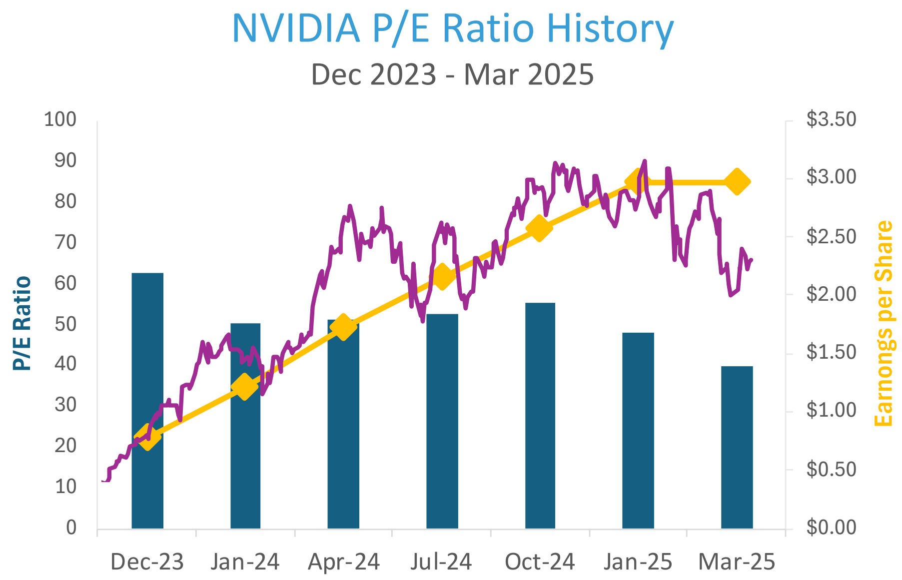
The U.S. stock market gains over the last few years have been concentrated in a handful of tech companies. Any reappraisal of their prospects leaves the market vulnerable to rapid downturns, as demonstrated by Nvidia's sharp sell-off following concerns about its long-term growth prospects. Some analysts argue that the market may simply be adjusting to more rational valuations after a period of exuberance. Others, however, warn that this could mark the beginning of a more significant shift in the AI industry's trajectory.

The chart below shows the impact of DeepSeek on Nvidia's share price back in early February, but also tracks the decline in the share price since its peak at the start of the year. The continuing decline in the Nvidia share price and the overall market has been impacted by the aggressive economic policies of the new US Administration, but the fact that that AI stocks are falling harder and faster than other stocks does indicate that there is a re-evaluation of the benefits of AI taking place.



Nvidia and other AI-related stocks are not necessarily in a "bubble", where market participants drive stock prices above their value in relation to some system of stock valuation[1]. Some commentators have been raising an alarm over the sky-high share prices of Nvidia, Apple and Microsoft (as well as the perceived overvaluation of US stocks more generally), but it should be noted that this has come with a corresponding rise in earnings.

The chart below shows the rise in earnings per share (EPS) for Nvidia, which has largely kept pace with the rise in the share price. However, the lower share price has brought down the price to earnings ratio (P/E ratio), one of the ratios that defines whether a stock is a "growth" stock or a "value" stock. Value stocks have low P/E ratios, while growth sticks have high P/E ratios.



Rather than suggesting that Nvidia and other AI stocks are in a "bubble" that will burst, it seems more appropriate to think that investor enthusiasm for these stocks – as in all fads – is waning. In other words, it maybe that AI stocks are running out of steam.

Predicting winners in technology is impossible. While one bad month – or bad quarter - in the markets doesn't spell the end of the AI boom, it highlights the vulnerabilities of a highly concentrated market.

Dr Steve Garth
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[1] Behavioral finance theory attributes stock market bubbles to cognitive biases that lead to groupthink and herd behavior.