

DeepSeek threat sends tech stocks tumbling and the Fed will be watching

The Nasdaq 100 could be set for its largest one-day fall since 2022 if this DeepSeek correction extends much further this Monday. Potentially, this technology could be a game-changer, and questions are being asked about the huge amounts of money the traditional tech players, the so-called Magnificent 7, have been ploughing into AI development. We look at the implications for FX and Treasury yields should these falls be sustained



Tech stocks are leading the NASDAQ and Dow Jones lower this Monday

The real and perceived DeepSeek threat

Nasdaq futures have briefly been off by more than 4% this Monday. Should the index close down by that magnitude today, it would mark the largest one-day sell-off since September 2022. We have not seen that kind of a sell-off in tech stocks since then, which reflects the conviction held by most investors for nearly two years that the 'Magnificent 7', the likes of Microsoft, Alphabet and Meta, would deliver. Some buy-side investor surveys point to being long 'Magnificent 7' as being the most crowded financial market trade for that period.

At the heart of this is the Chinese artificial intelligence company DeepSeek. Its app soared in

popularity after releasing a free-to-air model last week. It's said to use less data at a fraction of the cost of its more traditional rivals. It's potentially a major challenge to the incumbents, and questions are being raised about the billions of dollars they've pumped into developing their own AI models.

The breakthrough could be that DeepSeek can achieve a state-of-the-art model without state-of-the-art equipment. The current notion is that for larger models, one needs more computing power - if you want more context, you need more calculations. The often dreamed-about shortcut could be the use of smart algorithms.

DeepSeek now seems to show that we can do more with existing computing power than previously thought. Moreover, DeepSeek is offering its model for free right now. The market, therefore, needs to price in a slower adoption rate of high-performance computing and revenues of companies selling AI models. And this is at a time when traditional company valuations are already highly sensitive to small changes in expectations. The valuation of the companies depends on their discounted earnings which can be approximated by a multiple. ASML, for instance, trades at a current share price over earnings per share multiple of 33.6x, Nvidia at a multiple of 48.5x.

So, perhaps we don't need these enormous amounts of calculations in AI text, video, audio and graphics and we can do more with existing equipment. And that has repercussions for the revenue expectations of the operators of those models (Microsoft, Meta, Grok), and especially the hardware vendors on which these models run, such as semiconductors designed and sold by Nvidia and SK Hynix, often produced by TSMC on equipment from ASML.

But here's a word of warning. Although the alarm bells are ringing for the 'Magnificent 7' today, things could turn quickly. There is still uncertainty about exactly how DeepSeek works, whether it is safe, and how robust it is.

The Fed will be watching closely

The Fed is worried about the stock market insofar as how it feeds back into the real economy. Primarily, this is via the wealth effect - will a stock market fall lead to consumers feeling less wealthy and therefore inclined to pull back on spending? This is incredibly important given consumer spending is 70% of the economy. Other effects can come through the corporate sector. Will it impact financing (less able to raise money via equity offerings or through venture capital funds), or will it also make businesses more cautious about hiring and investment?

At this stage, we are talking about a relatively modest move for equity markets. At the time of writing, NASDAQ futures are down around 4%, wiping out around \$1.2tn of market capitalisation. But this is in an environment where household net worth has increased by more than \$50tn since the pandemic. Investors may not be particularly happy, but we are not going to see broader consumer spending trends shift on the back of this.

That said, the Fed will remain watchful. If this leads to a broader correction, then the Fed will be much more inclined to cut rates and will come under intense pressure to do so from President Trump! After all, the US consumer has been the key driver of US exceptionalism, and it is primarily higher-income households, which typically have larger equity portfolios, who have been leading that growth story.

The top 20% of households by income spend the same dollar amount as the bottom 60% of

households by income. For the top 20% - who make more than \$250k per year - inflation has been an irritation but not a constraint on spending, while they have disproportionately benefited from the surge in financial and real estate wealth. They have also benefited from higher interest rates - locked in at low mortgage rates but investing money in higher interest-paying money market funds.

If a sense of worry starts to hit these free-spending households, they may well start to pull back on some of their consumption, and the Fed will be much more inclined to respond with lower interest rates.

Nasdaq sell-off sparks broader unwind

The initial reaction in the FX space today was familiarly defensive. The Japanese yen and the Swiss franc are the clear outperformers and those high beta currencies that trade on higher volatilities, such as the Norwegian krone, Swedish krona plus Australian and New Zealand dollars are all under-performing.

Probably the biggest question for the FX market from today's Nasdaq developments is whether the correction proves significant enough to substantially shift market pricing of the Fed's easing cycle. Recall that on Friday the market was pricing 42bp of Fed easing this year and now prices 54bp. Were the Nasdaq correction large enough to see those Fed easing expectations move out to 75bp this year, that would probably be worth another 2% drop in USD/JPY towards 152 - a clear vehicle for a story such as this.

Treasuries can show a meaningful reaction lower in yields from here should there be a multi-week reaction to the downside for stocks or at least a 10% fall in broad indices. So far, we're on a one-day move, so that's still to be seen. As it is, the 10yr Treasury at 4.5% is what we'd call a relatively neutral valuation. It coincides with 10yr SOFR at around 4%. The forward market discount for the funds rate is now in the 3.75% area. That would need to dip much deeper to inspire rationale for further large falls in the 10yr yield from here.

We'd been tactically bullish in the past week looking for a reaction lower in US yields in any case, partly on core inflation optimism and benchmark revisions to payrolls data likely coming next week. Today's move pushes in that direction. Significant dips below 4.5% on the 10yr will need more than a one-day dip in tech stocks. Note that we remain structurally bearish for Treasuries through 2025, meaning that we'd need something more seismic to shift that longer-term view.

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