

How to spot an AI bubble before it pops

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If technology stock valuations plummet, the fallout could have severe impact on Canada's already fragile economy.

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Market pundits have been predicting a dramatic drop in artificial intelligence (AI) stocks for many months now and with SpaceX and other big-name technology companies going public, the concerns – and possible financial fallout – are increasingly top of mind for investors.

But while some Canadian economists and financial experts see a bubble set to pop, others view AI as a revolutionary, money-making technology that's worth its expensive stock market valuations for the long term.

“A bubble is definitely in the works,” says George Athanassakos, a professor of finance who holds the Ben Graham Chair in Value Investing at Western University's Ivey Business School. “To get the timing right, however, is not easy. Markets can stay irrational longer than you can remain solvent, as John Maynard Keynes used to say.”

How Canada could be affected

If technology stock valuations do plummet, as they did during the dot-com bust at the turn of the century, it's not just U.S. technology investors who may be affected, says Dr. Athanassakos. The fallout could spread across other sectors, including Canada's already fragile economy.

“The U.S. market may be affected more severely than the Canadian market, as it is more technology-driven. But because the Canadian economy is heavily tied to the U.S. market, Canada will be hit both directly and indirectly,” says Dr. Athanassakos.

A drop in U.S. and global demand could hit Canadian exports, he adds, with the most severe impact on Ontario's manufacturing sector. Falling global demand could also cause a collapse in commodity prices, including oil and other Canadian resource exports.

While the Bank of Canada could intervene by cutting interest rates to stabilize the markets and access to credit, Dr. Athanassakos says a concern is what will happen to private credit and private equity markets that are already under pressure.

Ing-Haw Cheng, the Maple Financial Group Chair in Derivatives and Risk Management and a professor of finance at the University of Toronto's Rotman School of Management, is more bullish on AI, given that many big-name AI companies such as Nvidia, Amazon, Alphabet and Meta Platforms are making money – a lot of money in some cases. That's unlike the dot-com crash, driven by the dawn of the Internet age in the early 2000s, when unproven, unprofitable companies traded at sky-high valuations.

“I think most people agree that valuation ratios are pretty stretched; whether or not it's a bubble, that's less certain. I could go either way on that,” he says. “We need to separate this idea of this possible financial bubble from whether or not AI is actually a revolutionary technology.”

If there was a drop in AI valuations, Nikola Gradojevic, a professor and Fidelity Chair in Finance at the University of Guelph, says companies that aren't speculative – including some of the major technology giants driving the technology – are likely to survive and thrive.

“Those that survive are those that capture some kind of long-term economic value,” he says. “I can only see AI developing further and becoming more widespread, so I don't anticipate a huge panic. A lot of companies will fail, but those that survive will be hugely valuable.”

How investors can prepare for a possible pop

A technology-driven downturn is hard to predict, especially with so many other factors affecting markets, including the conflict in Iran and the pending U.S. midterm elections in the fall, Dr. Athanassakos says.

But for active investors looking to monitor the markets, he suggests following fundamental investment metrics, such as the price to earnings per share ratio, among others, to get a sense of expected returns.

Dr. Athanassakos notes that the most popular valuation ratio for forecasting the long-run performance of stocks, especially regarding the direction of the stock market, is the cyclically adjusted price-to-earnings (CAPE) ratio, used to

determine whether a stock market or index is overvalued or undervalued. Developed by prominent U.S. economists Robert J. Shiller and John Y. Campbell, the CAPE ratio compares a market's current price to its average, inflation-adjusted earnings over the past 10 years. Extremely elevated CAPE ratios have historically preceded major market downturns, such as the 1929 Great Depression, the dot-com crash in 2000, and the 2008 global financial crisis.

According to data from Dr. Shiller's website, the CAPE ratio is at 41.02 as of June, the highest it's been since the dot-com boom in late 1999 when it touched 44.2. The current level is also nearly 50 per cent higher than the recent 20-year average of around 28 and more than double the long-term historic average of about 17.

Dr. Athanassakos adds that in recent times, however, the CAPE ratio "seems to have lost some of its lustre" with stock market watchers and it shouldn't be used as a standalone metric for investors looking to predict market direction.

"Every cycle looks different until it does not," he says. "There is little doubt in my mind that reckoning is nigh. It is unavoidable and the result of investors, markets and governments believing that 'this time is different.'"

Beyond growth metrics, Dr. Gradojevic says investors should pay attention to negative market sentiment towards AI, especially growing concerns about how the technology is taking jobs from humans.

"If for some reason we all become negative towards AI ... and the movement becomes widespread, that's another indicator that doesn't bode well for AI growth," he says, pointing to the 19th century when a radical movement of English textile workers, known as Luddites, protested against automated machinery that threatened their livelihoods.

Instead of trying to time a market drop, experts suggest that investors should focus on protecting themselves against a downturn through old-fashioned diversification.

“Use less debt, get out of highly speculative technology stocks and keep more cash than before,” Dr. Athanassakos says.

Alongside diversification, Dr. Gradojevic recommends that investors be patient and selective with their investments.

“Try to focus on value, or which company may deliver long-term economic value,” he says. “Don’t go for the hype just because it’s AI.”

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