

Strategy

AI supports bullish trend, but profit-taking is advised after strong rally

Key message

1. AI is the core driver of the current Taiex bull market, and its strength will be sustained provided AI stocks remain resilient.
2. AI is poised for a strong second half; non-AI sectors face a muted peak season due to tariffs.
3. We recommend taking profits at current high levels and adding to core AI stocks with solid fundamentals after a price correction.

Event

The Taiex is undergoing a bull run driven by technological innovation, in particular AI. However, we believe investors should carefully assess risks and opportunities after a strong rally and adjust their stock holdings in anticipation of changes in the market.

Analysis

AI is the core driver of the current Taiex bull market; its strength will be sustained provided AI stocks remain resilient. Historically, each major market rally is led by a dominant sector. In 1990-2000, PC and internet-related stocks took the lead, while in 2004-07, real estate and financial stocks were the primary rally drivers. In the present era, AI-related tech stocks have emerged as the core driver of global stock market gains, with the Magnificent Seven in the US stock market and associated cloud and semiconductor sectors serving as bellwethers. Following a spike in AI investment enthusiasm sparked by ChatGPT in 2023, 2024-25 have seen commercial deployment and widespread AI adoption by enterprises. Increasingly, large firms are integrating AI into virtual assistants, customer service, medical imaging analysis, and robotic process automation. These applications are enhancing operational efficiency and optimizing costs, fueling a new wave of productivity growth. As long as these leading sectors do not show clear signs of weakening, the bull market is likely to continue. Moreover, unlike previous bull markets that were often curtailed by aggressive rate hikes by the US Fed, the current rally is benefiting from an environment of more accommodative monetary policies.

Magnificent Seven posted stellar earnings; CSPs to raise capex. The Magnificent Seven have delivered better-than-expected financial results in the current earnings season and maintain an optimistic outlook, which has driven strong rallies across global stock markets. Among them, the four major CSPs, namely Microsoft, Amazon, Alphabet, and Meta, have significantly revised up 2025-26F capex in light of surging demand for AI computing power. With AI demand far exceeding supply, these firms must keep expanding their data center capacity and acquiring high-performance computing equipment to meet growing enterprise demand for AI services. Specifically, the combined 2025F capex of the four CSPs will likely amount to US\$342bn, up 50% YoY, versus the previous growth estimate of 38% YoY.

This substantial increase in capex will directly translate to robust demand for AI-related hardware, including high-end GPUs, servers, networking equipment, and thermal solutions, benefitting the entire AI supply chain. For suppliers in Taiwan, this means orders from global tech giants will remain strong, allowing them to deliver substantial sales growth moving forward.

AI supply chain remains heated, but non-AI sectors struggle to recover. The nearly two-year AI boom has led to a pronounced structural divergence in global stock markets. On one hand, the AI supply chain continues to see strong order volume, with companies posting impressive sales and earnings growth. On the other hand, non-AI sectors are undergoing a sluggish recovery, creating a stark contrast.

In the US, every constituent of the S&P 500, except the Magnificent Seven, reported mediocre 2Q25 earnings and generally provided neutral or conservative 3Q25 guidance. These non-tech firms are grappling with weak consumer demand and rising costs, making it difficult to follow the growth trajectory of AI-related firms.

The Taiex faces similar challenges. Non-AI supply chains are suffering from limited order visibility amid a sluggish global economic recovery and anemic end-market demand. Their operating results also trail behind those of their AI-focused counterparts. This divergence underscores the uneven nature of the current global economic recovery and highlights the profound, structural impact of AI on industries.

US consumption losing steam; outlook for non-AI sectors overshadowed by tariffs.

Looking ahead, we expect continued capex growth from major global CSPs to keep the operations of Taiwan's AI supply chain afloat in the traditional 2H25 peak season, which could potentially surpass their historic 2H levels. Following the mass production of next-generation AI chips and launch of more AI applications, in addition to accelerating digital transformation among businesses, we expect orders for the AI supply chain to remain strong.

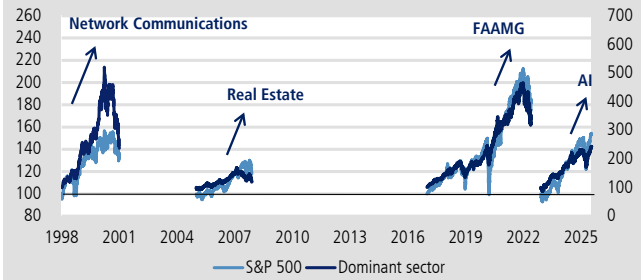
However, non-AI sectors will continue to face multiple headwinds. The first is poor market demand due to global tariff policy, especially amid the ongoing US-China trade conflict, which in turn has created uncertainty for export-oriented industries. Second, the recovery of the global consumer market has been weak, leading to soft end-market demand and lackluster orders for upstream supply chains. A key indicator worth noting is US core GDP, which is based on private domestic final sales and measures domestic demand in a more effective manner. In 2Q25, the indicator only edged up 1.2% YoY, which was the weakest uptick since 4Q22. This metric excludes government spending and trade impact, and thus provides a more accurate gauge of underlying consumer demand. Muted readings of the indicator may continue to weigh on the outlook for non-AI stocks. As a result, the current sectoral divergence is unlikely to ease anytime soon.

Conclusion & top picks

With US tariffs on semiconductors being finalized and AI-related demand remaining robust, we are optimistic about the medium to long-term prospects for the Taiex. However, following a robust rally, the index now faces correction risk as its PE has risen significantly and the economic impact of reciprocal tariffs is sinking in. Additionally, the Taiex tends to suffer seasonal pullbacks in August and September, and thus we recommend that investors gradually reduce holdings of AI stocks that have seen excessive gains as a means of managing downside risk. Nonetheless, from a long-term perspective, any market correction would likely present a buying opportunity, with AI sectors remaining the top investment target. Currently, Taiex PE is around 17x, above its long-term average of 15x. Over the past 15 years, the average monthly performance of the Taiex has been a 1.1% decline in August and a 0.9% drop in September. These are the two months that the Taiex becomes most prone to declines within a calendar year.

Figure 1: Historically, each major market rally is led by a dominant sector; as long as dominant sector remains afloat, bull run continues

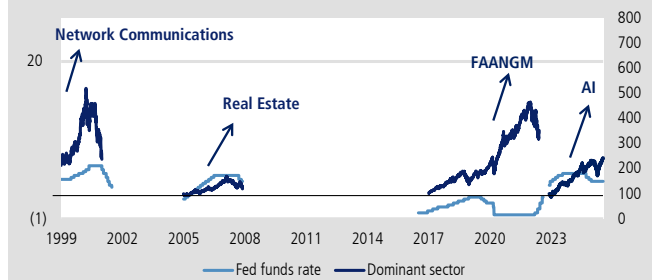
S&P 500, point (LHS); performance of dominant sector in each major rally, point (RHS)



Source: Bloomberg; KGI Research compiled

Figure 2: Previous stock market bull runs were often curtailed by aggressive Fed rate hikes, but current rally is benefiting from accommodative monetary policies

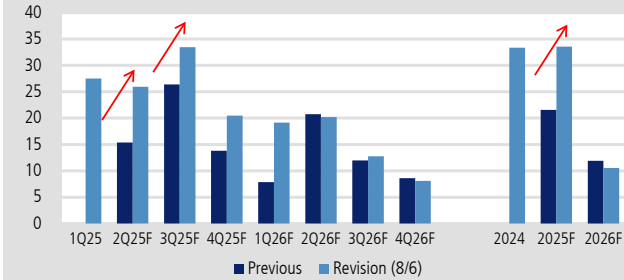
Fed funds rate, percent (LHS); performance of dominant sector in each major rally, point (RHS)



Source: Bloomberg; KGI Research compiled

Figure 3: Magnificent Seven delivered better-than-expected financial results in current earnings season, & firms maintain an optimistic outlook

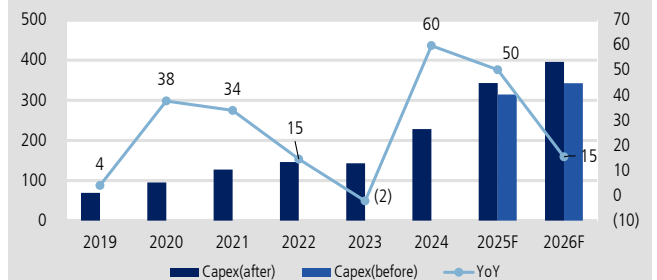
Projected quarterly and annual EPS YoY for Magnificent Seven, percent



Source: Bloomberg; KGI Research compiled

Figure 4: Combined 2025F capex of 4 major CSPs of Magnificent Seven will likely total US\$342bn, up 50% YoY, versus previous estimate of 38% YoY

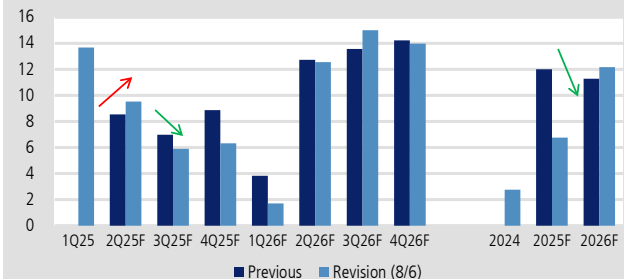
Capex by large CSP, US\$bn (LHS); Capex YoY growth, percent (RHS)



Source: Bloomberg; KGI Research compiled

Figure 5: Every constituent of S&P 500, except the Magnificent Seven, reported mediocre 2Q25 earnings & generally have provided neutral or conservative 3Q25 guidance

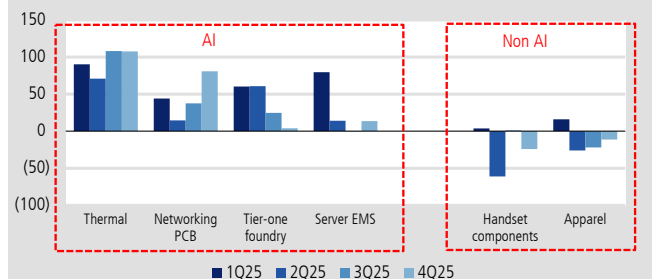
Projected quarterly and annual EPS YoY for S&P 500, excluding Magnificent Seven, percent



Source: Bloomberg; KGI Research compiled

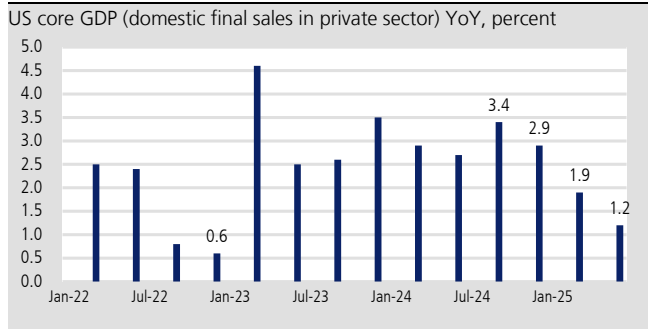
Figure 6: Taichung AI supply chain poised for a strong peak season in 2H25F, while non-AI firms should see muted 2H25 due to tariffs

Taiex sector quarterly EPS YoY, percent



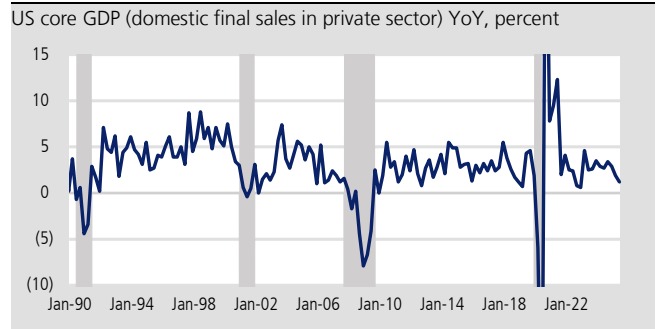
Source: KGI Research estimates

Figure 7: US core GDP, which measures domestic demand effectively, only rose 1.2% YoY in 2Q25, weakest since 4Q22



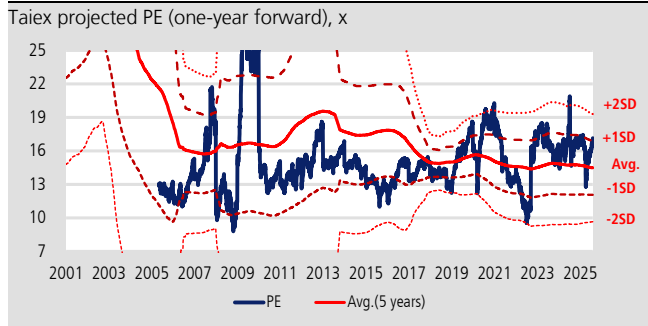
Source: Bloomberg; KGI Research compiled

Figure 8: Anemic readings of US core GDP may continue to weigh on non-AI stock outlooks, & current sector divergence is unlikely to ease soon



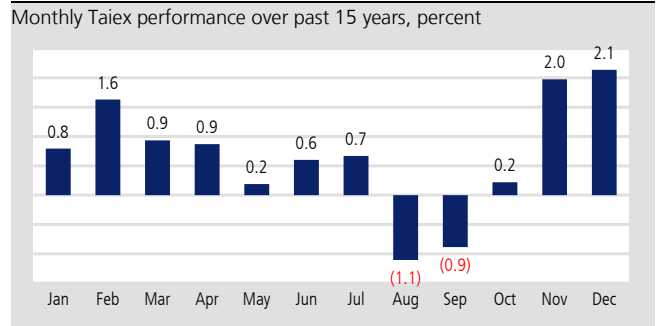
Source: Bloomberg; KGI Research compiled

Figure 9: Taiex PE is around 17x, above long-term average of 15x



Source: TEJ; KGI Research compiled

Figure 10: Taiex tends to see seasonal pullbacks in August-September



Source: Bloomberg; KGI Research compiled

Figure 11: Projected earnings & valuations of Taiex constituents

Earning (NT\$bn)	2021	2022	2023	2024	2025F	2026F
Taiex	3,917	3,771	2,682	3,769	4,402	4,851
Taiex excl. TSMC	3,320	2,755	1,844	2,595	2,847	3,098
Tech	1,914	2,147	1,698	2,249	2,768	3,247
Tech excl. TSMC	1,317	1,130	860	1,075	1,213	1,494
TSMC	597	1,017	838	1,173	1,555	1,753
EPS growth (%)						
Taiex	78.1	(3.7)	(28.9)	40.5	16.8	10.2
Taiex excl. TSMC	97.4	(17.0)	(33.1)	40.8	9.7	8.8
Tech	51.7	12.2	(20.9)	32.4	23.1	17.3
Tech excl. TSMC	77.1	(14.2)	(23.9)	25.1	12.8	23.1
TSMC	15.2	70.4	(17.5)	39.9	32.5	12.8
PE (x)						
Taiex	19.7	20.5	28.8	20.5	17.5	15.9
Taiex excl. TSMC	14.0	16.9	25.3	17.9	16.3	15.0
Tech	29.3	26.1	33.0	24.9	20.3	17.3
Tech excl. TSMC	19.3	22.5	29.6	23.7	21.0	17.0
TSMC	51.3	30.1	36.5	26.1	19.7	17.5

Source: KGI Research

Figure 12: Our top picks

Sector/ theme	Company	Code	Investment rating	Target price (NT\$)	Mkt cap (US\$mn)	Share price (NT\$)	Change +/- (%)	EPS (NT\$)		PE (x)		P/B (x)		ROE (%)		Cash yield (%)	
								2025F	2026F	2025F	2026F	2025F	2026F	2025F	2026F	2025F	2026F
AI supply chain	Alchip	3661 TT	Outperform	4020.0	10,431	3840.0	4.7	75.82	129.66	50.6	29.6	7.1	6.1	14.5	21.7	1.0	1.7
	DELTA	2308 TT	Outperform	686.0	55,506	637.0	7.7	20.43	24.51	31.2	26.0	6.9	6.0	22.5	24.6	1.6	2.0
	QCI	2382 TT	Outperform	325.0	37,641	290.5	11.9	16.52	19.62	17.6	14.8	4.8	4.5	27.9	31.2	4.5	5.4
	Wistron	3231 TT	Outperform	145.0	13,132	124.5	16.5	8.46	11.08	14.7	11.2	2.0	1.8	16.0	17.3	4.1	5.4
	AVC	3017 TT	Outperform	1220.0	14,275	1090.0	11.9	42.77	55.41	25.5	19.7	11.4	8.8	50.3	50.5	2.0	2.5
	EMC	2383 TT	Outperform	1140.0	13,702	1150.0	(0.9)	45.28	58.33	25.4	19.7	9.0	7.2	39.5	40.4	2.4	3.0
	TSMC	2330 TT	Outperform	1350.0	1,022,168	1175.0	14.9	59.96	67.61	19.6	17.4	5.7	4.6	32.3	29.4	1.7	1.7
	Accton	2345 TT	Outperform	1180.0	18,616	989.0	19.3	44.13	47.17	22.4	21.0	11.8	9.8	59.3	51.0	2.5	3.0
High-yield and undervalued stocks	Fositek	6805 TT	Outperform	1170.0	2,357	1025.0	14.1	28.29	45.00	36.2	22.8	10.8	8.7	32.2	42.3	1.4	2.2
	MediaTek	2454 TT	Outperform	1700.0	72,534	1350.0	25.9	68.64	83.54	19.7	16.2	5.6	5.1	27.9	32.8	5.0	5.1
	PCSC	2912 TT	Outperform	303.0	9,015	258.5	17.2	11.88	13.36	21.8	19.3	5.9	5.4	28.2	29.2	3.5	3.5
	CTBC Holding	2891 TT	Outperform	45.0	28,345	43.0	4.7	3.32	3.95	12.9	10.9	1.7	1.4	13.5	13.8	4.9	5.6
	E.S.F.H	2884 TT	Outperform	34.0	18,040	33.3	2.3	1.84	1.94	18.0	17.1	1.9	1.7	11.0	10.3	4.1	4.2
	Gigabyte	2376 TT	Outperform	348.0	6,427	286.0	21.7	20.29	23.16	14.1	12.3	3.4	3.2	24.7	26.8	5.7	6.5
	Alltop	3526 TT	Outperform	325.0	561	256.5	26.7	17.48	21.78	14.7	11.8	4.3	4.3	29.8	37.1	6.9	8.6

Source: KGI Research

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