KGI

Strategy

Gradual rate hikes bode well for stock markets; AI-driven earnings growth provides core support for bull market

Key message

1. Historically, the S&P 500 gains 9% on average in the year following the start of a gradual rate hike cycle, versus only 2% following an aggressive tightening cycle. The current market environment resembles a gradual tightening cycle amid normalization of monetary policy.
2. The stock market typically experiences higher volatility in the first one or two months following an initial rate hike. However, continued earnings revisions driven by agentic AI are expected to provide support for the ongoing bull market.
3. We stand by our forecast that the Taiex will reach 50,000 by end-2026 and 55,000 over the next 12 months. Our preferred investment themes are Rubin Ultra, AI ASIC, and beneficiaries of the agentic AI trend.

Event

History shows that in the 12 months following the start of a gradual rate hike cycle, the S&P 500 tends to deliver an average of 9% gains, versus only 2% after aggressive tightening. Market concerns are therefore driven less by rate hikes and more by the risk of a rapid tightening cycle. In our view, the current market environment resembles a gradual tightening cycle amid normalization of monetary policy.

Analysis

Historically, the S&P 500 gains 9% on average in the year following the start of a gradual rate hike cycle, versus only 2% after an aggressive tightening cycle; what stock markets fear is not rate hikes, but excessively aggressive rate hikes. The Fed has recently terminated its easing cycle and raised the fed funds rate target range to 3.75-4.00% in September, reflecting policymakers' ongoing vigilance over inflation risk.

However, a review of previous US tightening cycles suggests that the key difference lies not in whether the Fed raises interest rates, but in the speed and magnitude of those hikes. When the Fed opts for a gradual tightening approach, it generally reflects resilient economic growth and inflation that is relatively manageable. Under such circumstances, monetary policy is primarily intended to prevent the economy from overheating rather than to suppress economic activity. By contrast, when the Fed is forced to impose a barrage of aggressive rate hikes, it often reflects worsening inflationary pressure or broader economic imbalances, which in turn add to the risk of liquidity contraction and economic slowdown.

According to historical data, since the 1970s, rate hike cycles with relatively low tightening frequency during the first year following the initial hike, such as those seen in 1977 and 2015, generated average gains of 9% in the S&P 500 over the subsequent 12 months. By contrast, tightening cycles characterized by more frequent and larger rate increases, including 1973, 1980, 1984, 1988, 1994, 1999, 2004 and 2022, generated average gains of only 2% in the following year. This suggests that what stock markets fear is not rate hikes, but the valuation pressure and economic slowdown risks associated with rapid tightening. Therefore, for investors, the key question is not whether the Fed continues to raise interest rates, but whether the current cycle represents precautionary monetary normalization or aggressive tightening aimed at containing inflation.

Current rate hike cycle is a gradual process of monetary normalization, rather than aggressive tightening. Looking ahead, although the Fed's latest rate projections indicate the possibility of further rate hikes, the overall magnitude of tightening is still expected to remain well below the aggressive cycle seen in 2022. While inflation remains above the Fed's long-term target of 2%, it is still within a relatively manageable range and has not reached a level that would require aggressive tightening to restore stability.

From the perspective of inflation, supply-side factors, including tariff pass-through, AI infrastructure investment, and energy price volatility have created solid support for core inflation. Among them, AI investment has led to rising demand for electricity, equipment, and labor, creating upward pressure on related product and service prices. However, we believe the impact of these supply-side factors on inflation could begin to ease in 2H26-2027, capping the risk of further deterioration in inflation. In other words, although core inflation could remain above the pre-pandemic average level, there is currently no evidence of inflation getting of control. As a result, the Fed may not need to rely on aggressive rate hikes to suppress demand. Instead, monetary policy is more likely to follow a path toward the neutral rate, rather than entering a prolonged and severe tightening cycle.

Initial rate-hike typically triggers one to two months of market volatility , but agentic AI adoption-driven earnings upgrades should continue to shape the long-term trend. Historical experience suggests that the one to two months following the Fed's first rate hike are typically the most sensitive period for financial markets. Investors tend to reassess interest rate levels, funding costs, and the future path of monetary policy, often leading to valuation adjustments and heightened market volatility. However, as markets gradually absorb policy changes, equity performance ultimately reverts to underlying fundamentals, namely corporate earnings and economic activity. Past tightening cycles indicate that if the economy avoids recession and corporate earnings continue to expand, equities tend to deliver positive medium- to long-term returns.

In the current cycle, we believe the scope for further rate hikes remains relatively limited, implying that valuation pressure from higher interest rates should remain manageable. Meanwhile, sustained AI demand has driven continuous upward revisions to Taiex earnings forecasts since 2023, with earnings expectations repeatedly reaching new highs. This earnings momentum has been the key driver of the current bull market, which has now continued for more than three years. Looking ahead, ongoing AI capex expansion by major global CSPs, together with the rapid adoption of agentic AI, following the emergence of Meta's (US) agentic AI platform Muse, we expect the next five years AI computing demand to gradually shift from model training toward inference workloads, providing an additional catalyst for corporate investment and earnings growth. We forecast Taiex earnings growth of 53% YoY this year, followed by a further 24% YoY increase next year. Sustained upward earnings revisions should help offset valuation headwinds associated with rising interest rates.

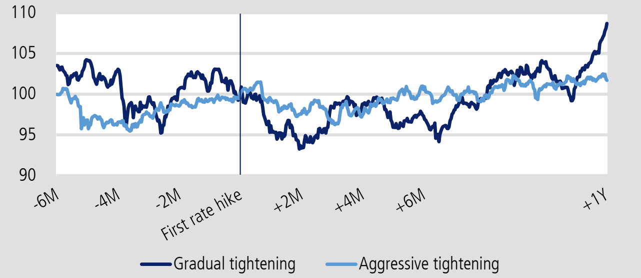
Conclusion & top picks

Historical data suggests that equity markets generally perform better during gradual tightening cycles than during aggressive rate hike periods. Based on our analysis, the S&P 500 has historically generated an average return of roughly 9% in the 12 months following the onset of gradual tightening cycles, compared with only 2% during rapid hike cycles. This suggests that investors are typically less concerned about rate hikes themselves than about the risks of liquidity contraction and economic slowdown associated with overly aggressive policy tightening. We believe the current cycle more closely resembles a gradual normalization of monetary policy rather than the aggressive and consecutive rate hikes in 2022. While the one to two months following the initial hike could be a period of elevated volatility, continued growth of AI demand should support further earnings upgrades for Taiex-listed firms, helping offset valuation pressure from rising rates. Accordingly, we do not believe near-term market volatility alters the long-term bull market outlook. We recommend accumulating positions on pullbacks rather than chasing short-term rallies. We maintain our Taiex forecast of 50,000 by year-end and 55,000 over the next 12 months, based on expectations of continued earnings upgrades and market valuations remaining above historical averages.

In terms of investment themes, beyond hardware upgrade opportunities associated with Nvidia's (US) Rubin Ultra platform, including thermal, power supplies, CCL, ABF substrates, rail kits, and optical communications, we expect continued expansion of AI ASIC programs by major CSPs to drive demand for IC design services, advanced packaging, high-speed interconnect solutions, and testing interface suppliers. Furthermore, as agentic AI gains broader adoption, the growth engine of the AI ecosystem is likely to shift progressively from training to inference. In addition to sustained demand growth for GPUs and AI servers, we see increasing opportunities in server CPUs, high-speed networking, optical communications, cybersecurity, data management, and enterprise software, all of which are well positioned to benefit from the next wave of AI investment.

Figure 1: Historically, S&P 500 has risen by an average of 9% in year following start of gradual rate hike cycles, versus 2% after aggressive cycles, suggesting markets fear rapid hikes rather than rate hikes themselves

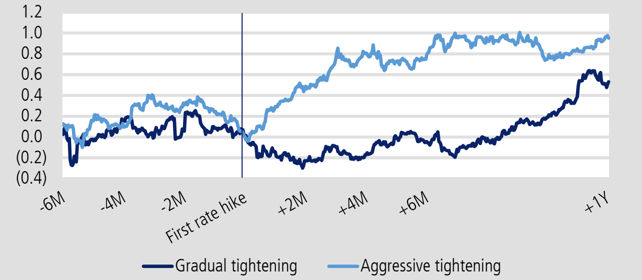
S&P 500 performance after Fed's first rate hike (indexed to 100 on day prior to first hike), points



Source: Bloomberg; KGI Research
Note: Gradual tightening cycles refer to periods in which Fed skips at least one meeting, on average, between rate hikes; aggressive tightening cycles refer to periods in which Fed raises rates at most or nearly every meeting.

Figure 2: Gradual tightening cycles typically see moderate Treasury yield increases & limited valuation pressure on equities; aggressive tightening drives sharper yield increases, PE compression, & higher market volatility

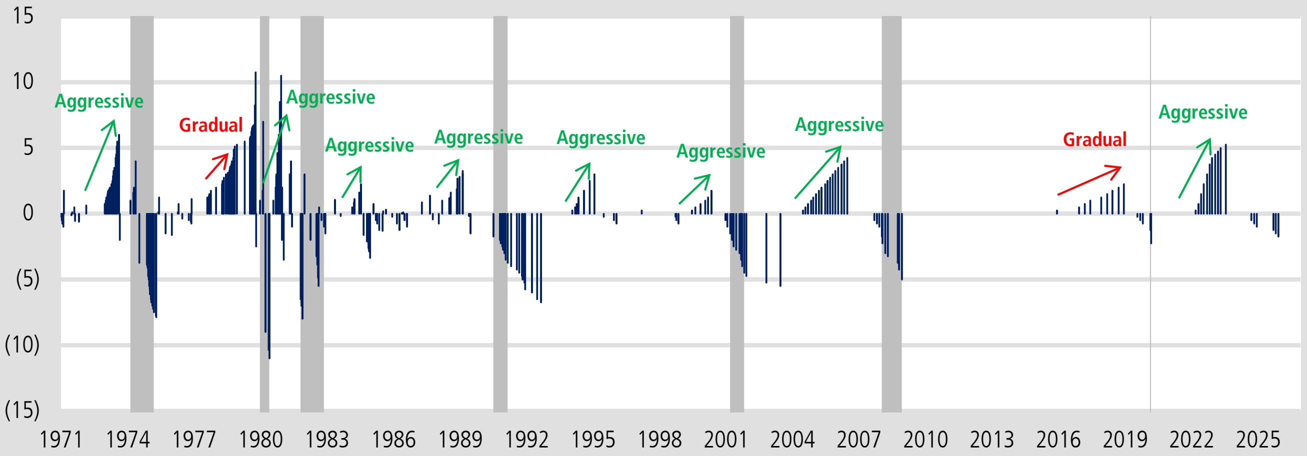
US 10-year Treasury yield performance after Fed's first rate hike (indexed to 0bps on day prior to first hike), bps



Source: Bloomberg; KGI Research
Note: Gradual tightening cycles refer to periods in which Fed skips at least one meeting, on average, between rate hikes; aggressive tightening cycles refer to periods in which Fed raises rates at most or nearly every meeting.

Figure 3: Since the 1970s, we have classified Fed tightening cycles into two gradual cycles (1977 & 2015) & eight aggressive cycles (1973-2022)

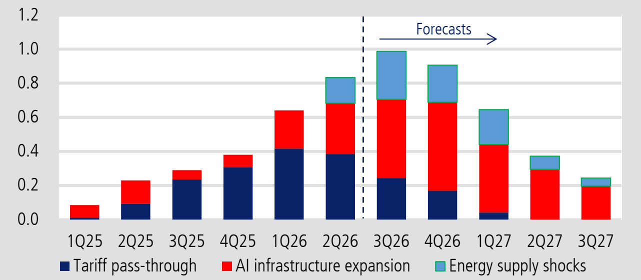
Cumulative Fed rate hikes/cuts, percent



Source: Bloomberg; KGI Research
Note: Shaded areas indicate US economic recessions.

Figure 4: Supply side inflation pressures expected to ease gradually from 2H26 through 2027, reducing need for aggressive Fed tightening

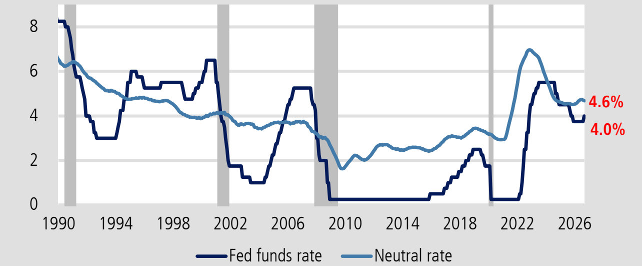
Contributions of three key supply side factors to US core PCE inflation, percent



Source: Oxford Economics; KGI Research
Note: Data from 3Q26 onward are forecasts.

Figure 5: Fed funds rate has risen to 4%, approaching market's estimated nominal neutral rate of 4-5%, suggesting limited room for further aggressive tightening

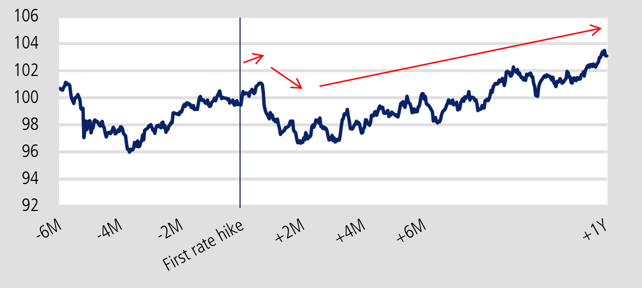
US benchmark & neutral interest rates, percent



Source: Bloomberg; KGI Research
Note: Shaded areas indicate US economic recessions.

Figure 6: History suggests impact of first rate hike fades over time; while short-term volatility is common, medium- to long-term outlook remains bullish

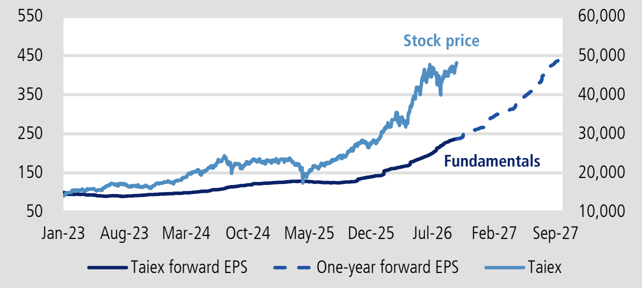
S&P 500 performance after Fed's first rate hike (indexed to 100 on day prior to first hike), points



Source: Bloomberg; KGI Research

Figure 7: AI-driven earnings upgrades have repeatedly pushed Taiex earnings estimates to new highs, providing support for bull market that has lasted for over three years

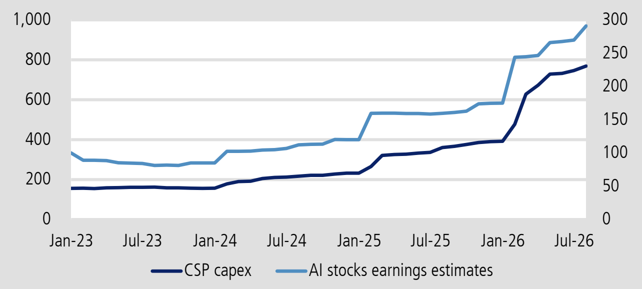
Taiex forward EPS, points (LHS); Taiex, points (RHS)



Source: FactSet; KGI Research

Figure 8: Major CSPs still raising capex, boding well for earnings outlook for AI supply chain, allowing Taiex earnings to be revised up

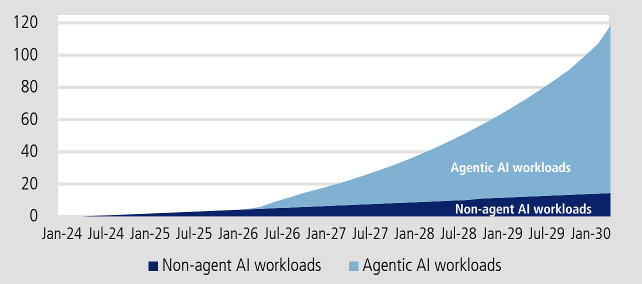
Projected capex by large US CSPs, US$bn (LHS); Taiex AI earnings estimates, points (RHS)



Source: TEJ; Bloomberg; KGI Research
Note: We use earnings forecasts as of end-2022 as base of 100.

Figure 9: Rapid rise of Meta's agentic AI platform Muse could accelerate agentic AI adoption, shifting AI compute demand from training to inference over next five years

Monthly AI token consumption, tn tokens



Source: Ticker Trends; KGI Research

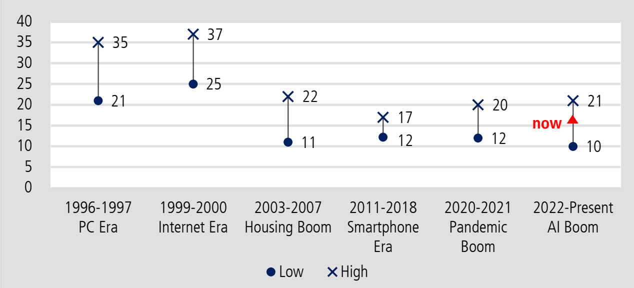
Figure 10: Earnings & valuations of Taiex constituents

Earning (NT$bn)	2021	2022	2023	2024	2025	2026F	2027F
Taiex	3,917	3,771	2,682	3,780	4,344	6,659	8,240
Taiex excl. TSMC	3,320	2,755	1,844	2,607	2,626	3,852	4,630
Tech	1,914	2,147	1,698	2,249	3,101	4,891	6,412
Tech excl. TSMC	1,317	1,130	860	1,075	1,383	2,083	2,801
TSMC	597	1,017	838	1,173	1,718	2,807	3,610
EPS growth (%)							
Taiex	78.1	(3.7)	(28.9)	40.9	14.9	53.3	23.7
Taiex excl. TSMC	97.4	(17.0)	(33.1)	41.4	0.7	46.7	20.2
Tech	51.7	12.2	(20.9)	32.4	37.9	57.7	31.1
Tech excl. TSMC	77.1	(14.2)	(23.9)	25.1	28.6	50.6	34.5
TSMC	15.2	70.4	(17.5)	39.9	46.4	63.4	28.6
P/E (x)							
Taiex	40.2	41.8	58.7	41.7	36.3	23.7	19.1
Taiex excl. TSMC	27.9	33.7	50.3	35.6	35.3	24.1	20.0
Tech	66.8	59.5	75.2	56.8	41.2	26.1	19.9
Tech excl. TSMC	47.8	55.7	73.2	58.5	45.5	30.2	22.5
TSMC	108.7	63.8	77.3	55.3	37.7	23.1	18.0

Source: KGI Research

Figure 11: AI boom lifted Taiex forward PE to peak of 21x; despite easing to 19x, PE remains within historical bull market range

Historical Taiex bull-market PE range (one-year forward), x



Source: TEJ; KGI Research estimates

Figure 12: Taiex valuations & corresponding index levels

2026F PE (x)	Equivalent index level (points)	2027F PE (x)	Equivalent index level	26-27F Avg.PE (x)	Equivalent index level (points)
15	30,533	15	37,780	15	34,157
16	32,569	16	40,299	16	36,434
18	36,640	18	45,336	18	40,988
20	40,711	20	50,373	20	45,542
21	42,746	21	52,892	21	47,819
22	44,782	22	55,411	22	50,096
23	46,817	23	57,930	23	52,373

Source: TEJ; KGI Research

Figure 13: Our top picks

Sector/ theme	Company	Code	Investment rating	Target price (NT$)	Mkt cap (US$mn)	Share price (NT$)	Change +/- (%)	EPS (NT$) 2026F	EPS (NT$) 2027F	EPS YoY (%) 2026F	EPS YoY (%) 2027F	PE (x) 2026F	PE (x) 2027F	PEG (x) 2026F	PEG (x) 2027F	P/B (x) 2026F	P/B (x) 2027F	ROE (%) 2026F	ROE (%) 2027F	Cash yield (%) 2026F	Cash yield (%) 2027F
Semiconductor	TSMC	2330 TT	Outperform	3,200	2,017,053	2,475.0	29.3	108.25	139.22	63.4	28.6	22.9	17.8	0.4	0.6	8.4	6.1	43.0	39.9	1.2	1.3
	MediaTek	2454 TT	Outperform	6,600	266,567	5,285.0	24.9	71.34	123.26	7.9	72.8	74.1	42.9	9.4	0.6	21.7	18.5	28.7	46.3	1.3	1.4
	Alchip	3661 TT	Outperform	6,180	10,225	3,770.0	63.9	130.60	171.62	89.8	31.4	28.9	22.0	0.3	0.7	6.2	5.3	23.5	25.9	1.7	2.3
	GUC	3443 TT	Outperform	5,870	35,904	8,525.0	(31.1)	50.99	130.40	81.3	155.7	167.2	65.4	2.1	0.4	57.8	35.3	41.8	67.0	0.4	1.1
	Chipbond	6147 TT	Outperform	280	4,996	213.5	31.1	5.30	7.45	41.6	40.8	40.3	28.6	1.0	0.7	3.0	2.8	8.2	11.2	1.9	2.6
	HON	7769 TT	Outperform	9,000	32,062	5,670.0	58.7	129.97	226.71	89.2	74.4	43.6	25.0	0.5	0.3	14.6	10.8	36.6	49.7	1.6	2.8
	MPI	6223 TT	Outperform	10,000	16,674	5,415.0	84.7	76.08	137.53	134.7	80.8	71.2	39.4	0.5	0.5	31.3	24.8	47.3	70.3	0.8	1.5
AI server	AVC	3017 TT	Outperform	4,340	44,064	3,555.0	22.1	107.68	173.61	119.9	61.4	33.0	20.5	0.3	0.3	20.6	13.2	74.5	77.3	1.3	2.1
	Jentech	3653 TT	Outperform	7,365	32,013	6,920.0	6.4	70.19	146.88	95.2	109.3	98.6	47.1	1.0	0.4	37.7	28.6	41.4	69.1	0.6	1.3
	DELTA	2308 TT	Outperform	2,505	155,918	1,910.0	31.2	40.57	66.29	75.3	63.4	47.1	28.8	0.6	0.5	14.0	10.5	33.9	41.7	1.1	1.7
	Fositek	6805 TT	Outperform	2,685	5,451	2,530.0	6.1	63.66	103.26	105.3	62.2	39.7	24.5	0.4	0.4	18.1	12.9	52.0	61.3	1.1	1.8
	EMC	2383 TT	Outperform	7,625	56,867	5,050.0	51.0	108.84	190.64	166.2	75.2	46.4	26.5	0.3	0.4	24.7	15.3	63.1	71.4	1.3	2.3
	Unimicron	3037 TT	Outperform	1,175	61,207	1,185.0	(0.8)	16.10	32.71	283.4	103.1	73.6	36.2	0.3	0.4	14.4	11.0	22.6	35.8	0.6	1.2
	ZDT	4958 TT	Outperform	685	16,700	475.5	44.1	15.61	26.33	155.0	68.6	30.5	18.1	0.2	0.3	3.1	2.8	12.1	17.0	1.6	2.8
	Chenbro	8210 TT	Outperform	1,440	3,541	897.0	60.5	48.10	67.10	68.4	39.5	18.6	13.4	0.3	0.3	8.1	6.2	48.4	52.3	2.7	3.7
	King Slide	2059 TT	Outperform	15,000	36,987	12,350.0	21.5	336.97	500.02	226.4	48.4	36.7	24.7	0.2	0.5	26.6	17.3	88.8	84.7	1.4	2.1
	Wiwynn	6669 TT	Outperform	7,750	37,281	2,115.0	266.4	370.69	566.42	34.8	52.8	5.7	3.7	0.2	0.1	2.5	1.9	49.2	58.7	9.6	14.7
	Wistron	3231 TT	Outperform	300	19,887	184.5	62.6	17.65	26.40	101.4	50.3	10.5	7.0	0.1	0.1	2.7	2.2	28.2	34.8	5.6	8.5
Others	NTC	2408 TT	Outperform	720	54,540	503.0	43.1	75.16	130.67	3775.8	75.9	6.7	3.8	0.0	0.1	3.7	2.0	86.9	74.3	4.5	7.8
	Holy Stone	3026 TT	Outperform	1,000	4,223	810.0	23.5	14.85	39.73	125.6	167.6	54.6	20.4	0.4	0.1	11.5	8.2	22.6	46.9	1.4	2.5
	GWC	6488 TT	Outperform	1,500	14,244	948.0	58.2	16.69	59.99	9.2	259.4	56.8	15.8	6.2	0.1	4.8	4.0	8.5	27.5	0.9	3.2

Source: KGI Research

KGI Locations

China Shanghai	Room 1507, Park Place, 1601 Nanjing West Road, Jingan District, Shanghai, PRC 200040
Taiwan Taipei	700 Mingshui Road, Taipei, Taiwan Telephone 886.2.2181.8888 · Facsimile 886.2.8501.1691
Hong Kong	41/F Central Plaza, 18 Harbour Road, Wanchai, Hong Kong Telephone 852.2878.6888 Facsimile 852.2878.6800
Thailand Bangkok	8th - 11th floors, Asia Centre Building 173 South Sathorn Road, Bangkok 10120, Thailand Telephone 66.2658.8888 Facsimile 66.2658.8014
Singapore	4 Shenton Way #13-01 SGX Centre 2 Singapore 068807 Telephone 65.6202.1188 Facsimile 65.6534.4826
Indonesia	Sona Topas Tower Fl.11 Jl. Jend. Sudirman kav.26 JakartaSelatan 12920 Indonesia Telephone 62 21 250 6337

KGI's Ratings

Rating	**Definition**
Outperform (OP)	We take a positive view on the stock. The stock is expected to outperform the expected total return* of the KGI coverage universe in the related market over a 12-month investment horizon.
Neutral (N)	We take a neutral view on the stock. The stock is expected to perform in line with the expected total return* of the KGI coverage universe in the related market over a 12-month investment horizon.
Under perform (U)	We take a negative view on the stock. The stock is expected to underperform the expected total return* of the KGI coverage universe in the related market over a 12-month investment horizon.
Not Rated (NR)	The stock is not rated by KGI.
Restricted (R)	KGI policy and/or applicable law regulations preclude certain types of communications, including an investment recommendation, during the course of KGI's engagement in an investment banking transaction and in certain other circumstances.

Total return = (12M target price - current price) / current price