Strategy

AI-led bull run holds, but valuation & policy risks loom

Key message

1. The AI boom continues to support a medium- to long-term bullish outlook for the Taiex, with earnings from the AI supply chain to grow by a respective 55% and 77% YoY in 2025-26F compared to 2022 (pre-AI boom).
2. Short-term valuation pressure is emerging on the Taiex, as FOMO-driven sentiment increases market risk.
3. AI stocks remain our top picks, but investors should wait for valuation correction before entering. For non-AI stocks, sectors such as defense/aerospace, financials, catering, and convenience stores are worth watching.

Event

AI will continue to support the Taiex over the medium- to long-term, but the FOMO effect has driven AI stock valuations to historical highs, sparking a catch-up rally, and even signs of overvaluation in non-AI sectors.

Analysis

AI boom to sustain Taiex medium- to long-term bullish outlook. Since the onset of the AI wave in 2023, the structural foundation of the Taiex uptrend has remained intact. AI is not merely a speculative theme, it is driven by real demand. The ongoing expansion of computing power, accelerated data center construction, and sustained capex by cloud service providers has propelled Taiwan's supply chain, solidifying its role as a key hub for AI, allowing it to repeatedly achieve record-high earnings.

Using 2022 as the baseline before the AI boom, we estimate that earnings across Taiwan's AI supply chain will increase by 56% in 2025 and 77% YoY in 2026. This suggests that AI-driven structural demand remains in the early stages of an upcycle and continues to provide strong support for Taiwan's tech industry and equity market valuations.

It's worth noting that the nature of the AI boom differs from the hollow expectations seen during the dot-com bubble in 2000. Back then, internet firms lacked viable profit models, whereas AI is directly tied to corporate capex and tangible revenue generation. However, from a capital market perspective, the current AI boom mirrors the kind of imaginative growth story seen during that era, where investors are willing to pay a premium for projected growth over the next decade. Drawing from historical parallels, the current AI frenzy appears to be roughly one-third to halfway through the equivalent stage of the dot-com bubble. This suggests further upside potential, though interim volatility and market corrections are likely unavoidable.

Short-term valuation pressure is emerging as FOMO amplifies risks. While AI continues to support the medium- to long-term bullish structure of the Taiex, signs of overheating have begun to surface in the near-term. From an industry perspective, beyond major players like foundries and server assemblers, subsectors such as thermal modules, power supplies, copper-clad laminates (CCL), and networking PCBs have all seen their PE ratios climb to five-year highs.

While part of the valuation surge is supported by structural demand, a larger portion reflects fear of missing out (FOMO) sentiment. Market capital has not only chased AI-related stocks, but has also driven rallies and even overvaluation in sectors with limited direct ties to AI.

From a fundamental standpoint, AI-related sectors have consistently seen upward revisions to earnings forecasts. In contrast, earnings in non-AI sectors continue to weaken, adding downgrade pressure to overall market earnings. In other words, the recent 7,245-point rally (42%) in the Taiex has been driven not only by strong AI demand, but also by valuation recovery. This rebound has been supported by three key factors: (1) easing of trade tensions, which has reduced corporate uncertainty; (2) expectations of Fed rate cuts, boosting market liquidity; and (3) strong global investor preference for AI themes, leading to rerating of the Taiex.

Sustainability & evolution of three key drivers behind valuation recovery warrant close attention. While investors are enjoying the current market rally, it is crucial to monitor the three core factors underpinning this rebound, as their durability and potential shifts will shape the future trajectory of the Taiex: (1) demand driven by the AI arms race; (2) tariff policy under President Trump; and (3) expectations of Fed rate cuts.

AI arms race demand. There is no doubt that global CSPs continue to ramp-up capex. In the near-term, market attention will center on Nvidia's (US) upcoming earnings report and whether it can once again deliver results that exceed expectations. If Nvidia maintains its leadership in the AI chip market, it will directly benefit Taiwan's supply chain. Conversely, if its guidance disappoints, the market's optimistic outlook on the AI industry chain could undergo swift correction.

US tariff policy under President Trump. Over the past three months, the effective average tariff on US imports stood at approximately 10%. However, as of August 7, it has risen to nearly 20%. According to estimates from the Peterson Institute for International Economics (PIIE), a 10% tariff could reduce GDP by 0.44ppt, while a 20% tariff would double the impact to 0.89ppt. In other words, if tariffs continue to rise, the broader economy and overall demand will inevitably be weighed down, adversely affecting corporate earnings and market valuations.

Expectations of US Fed rate cuts. Liquidity support in the market is largely driven by expectations of interest rate cuts. However, it typically takes 2-3 months for tariff-related costs to fully pass through to end-user prices, suggesting that real inflationary pressure may begin to surface toward the end of 3Q25. If price increases exceed expectations, the US Fed may delay rate cuts, introducing uncertainty to the liquidity backdrop that underpins the valuation recovery.

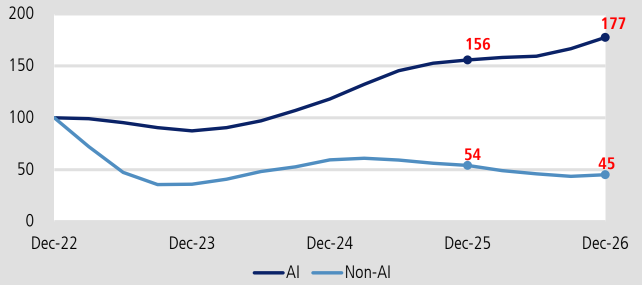
In summary, while AI demand remains solid, shifts in policy and the macroeconomic environment will be key in determining whether the market enters a period of consolidation at elevated levels in the near-term

Conclusion & top picks

Over the long-term, AI demand will remain a key driver for the Taiex. However, in the short-term, it may be prudent to wait for a reasonable valuation correction before re-entering the market. We recommend investors focus on subsectors with notable spec upgrades, such as thermal management, networking PCBs, power supply units, and CCLs, and consider a staggered entry during the correction phase. Additionally, given the relatively weak fundamentals of non-AI stocks, stock selection should be approached with caution. Sectors supported by policy or offering defensive characteristics, such as defense/aerospace, financials, catering, and convenience stores, may present more resilient opportunities.

Figure 1: AI boom driving Taiwan's AI supply chain earnings to new highs; respective earnings growth of 56% & 77% YoY in 2025-26F vs. 2022 (pre-AI boom)

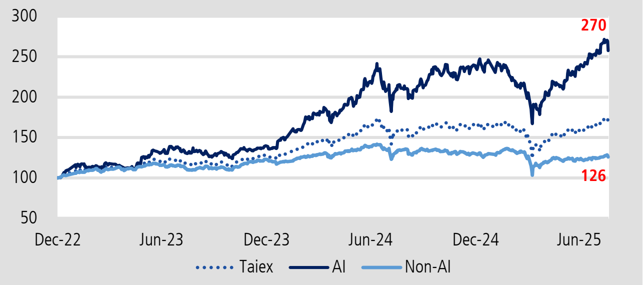
Earnings of Taiwan AI vs. non-AI stocks (trailing 12 months), points



Source: TEJ; KGI Research compiled
Note: Earnings estimates indexed to a base value of 100 in 2022.

Figure 2: AI rally has lifted Taiwan AI stocks 170% since 2023; non-AI stocks up just 26%

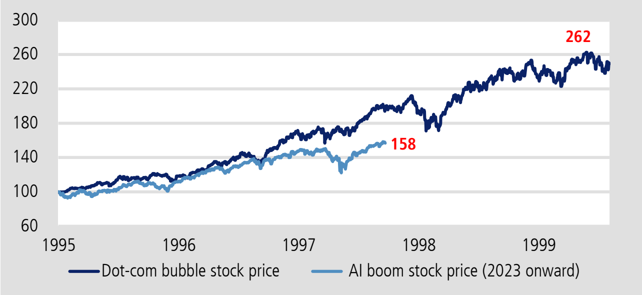
Taiex stock price performance: AI vs. non-AI, points



Source: TEJ; KGI Research compiled
Note: Stock prices indexed to a base value of 100 at end-2022.

Figure 3: Current AI frenzy roughly one-third to halfway through dot-com bubble equivalent stage

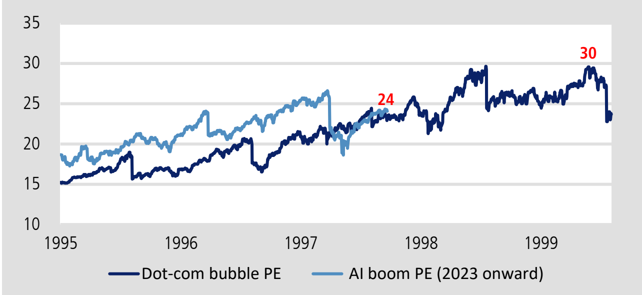
S&P 500, points



Source: Bloomberg; KGI Research compiled

Figure 4: Current AI valuations beyond midpoint of dot-com bubble levels

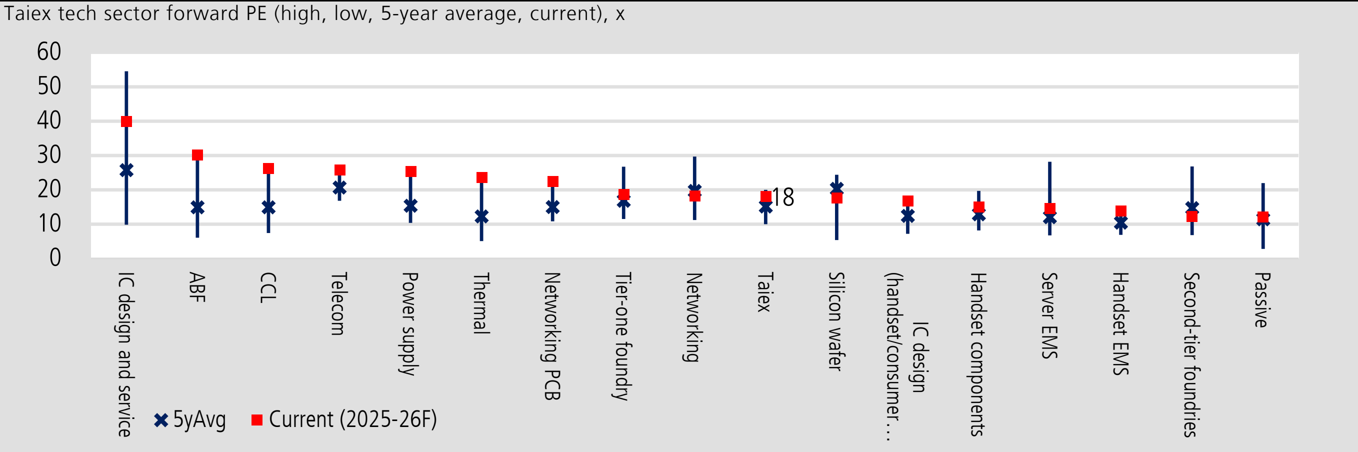
S&P 500 projected PE, x



Source: Bloomberg; KGI Research compiled

Figure 5: Beyond foundries & server assemblers, AI subsectors like thermal modules, power supplies, CCL, & networking PCBs hit five-year PE peaks

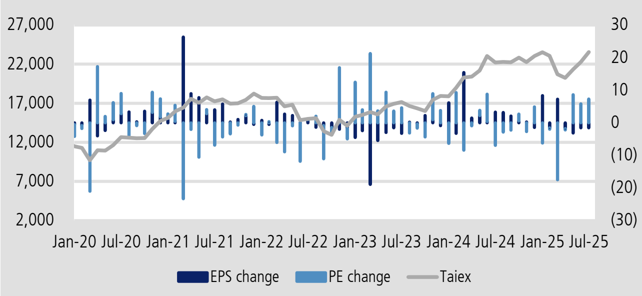
Taiex tech sector forward PE (high, low, 5-year average, current), x



Source: TEJ; KGI Research compiled

Figure 6: Taiex rally of over 7,000 points fueled primarily by valuation recovery & strong AI

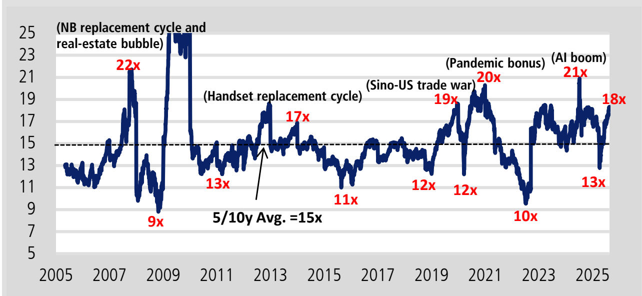
Taiex, points (LHS); EPS & PE change, percent (RHS)



Source: Bloomberg; KGI Research compiled

Figure 7: Taiex rally of over 7,000 points has elevated PE from 13x to cycle high of 18x

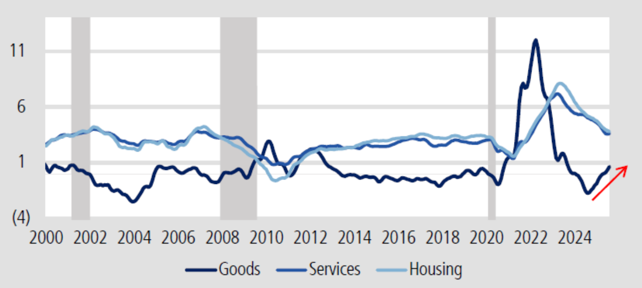
Taiex projected PE, x



Source: TEJ; KGI Research compiled

Figure 8: Rise in US goods inflation over past three months reflects only impact of 10% effective tariff

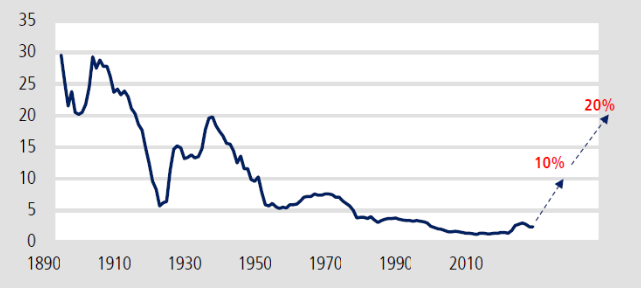
US inflation YoY (3-month moving average), percent



Source: Bloomberg; KGI Research compiled

Figure 9: US tariffs rose from 10% to nearly 20% on August 7, with economic & inflationary pressure after end-3Q25F

US effective tariff rate, percent



Source: Bloomberg; KGI Research compiled

Figure 10: Projected earnings & valuations of Taiex constituents

Earning (billion)	2021	2022	2023	2024	2025F	2026F
Taiex	3,917	3,771	2,682	3,780	4,151	4,579
Taiex excl. TSMC	3,320	2,755	1,844	2,607	2,596	2,826
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)	40.9	9.8	10.3
Taiex excl. TSMC	97.4	(17.0)	(33.1)	41.4	(0.4)	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
P/E (x)						
Taiex	19.9	20.7	29.1	20.6	18.8	17.0
Taiex excl. TSMC	14.4	17.3	25.9	18.3	18.4	16.9
Tech	29.6	26.3	33.3	25.1	20.4	17.4
Tech excl. TSMC	19.9	23.2	30.5	24.4	21.6	17.5
TSMC	50.9	29.8	36.2	25.9	19.5	17.3

Source: KGI Research estimates

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