



## Strategy

### Bulls returning on lower Treasury yields & positive earnings outlook

#### Key message

The Israel-Hamas war will weigh on market sentiment in the near term. Nonetheless, falling US Treasury yields and the positive corporate earnings outlook will bring back TaieX bulls by the end of the year. We recommend companies with the potential for earnings to surprise on the upside.

#### TaieX showed signs of bulls returning in early October after falling for two months

The TaieX fell in both August and September, down a total of 4.6%, due to increased returns on US sovereign bonds, higher energy prices and a strong dollar. However, the index has seen bulls coming back since the start of October on Taiwan-bound global funds, as the aforementioned returns began falling from the 16-year peak and the dollar started weakening.

#### TaieX returns often positive within 1-3 months of yield declines, supporting a rally

The surprise Israel-Hamas war has sparked off a flight-to-safety trend among investors, such as the buying of US sovereign bonds, which has pulled down returns. In addition, Fed officials have frequently stated of late that yield increases over the past few days reflect to a certain extent the effect of the rate hike of 25bps, lowering market bets on further rate hikes in November and December. According to Chicago Mercantile Exchange's (CME) FedWatch, investors see just an 8% and 28% probability that the Fed will raise rates in November and December, respectively. Given the clear indication of falling US sovereign bond returns, we predict the TaieX will rally toward the end of the year and early next year. Our prediction is backed by historical patterns, namely that since 1990 the TaieX has yielded returns of 3.9%, 1.2% and 3.8% for one, two and three months, respectively, following a decline in US sovereign bond returns. Tech sector returns for the same periods were a respective 3.8%, 4.2% and 11.3%, suggesting shares more sensitive to interest rates are more favored by investors when yields fall.

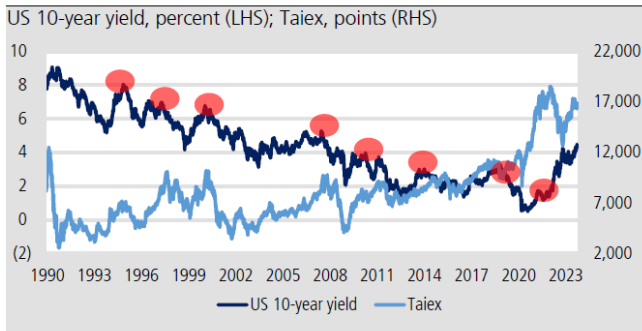
#### Likely new earnings upcycle to support TaieX rally over medium-to-long term

We predict Taiwan's 3Q23 earnings season will surprise to the upside thanks to forex gains. Meanwhile, smooth destocking and replacement by AI server and AI PC in 2024-25F, coupled with a decent macro-economic environment, will usher in a new wave of upward revisions to projected earnings, enabling the TaieX to rally over the medium-to-long term. The NT dollar depreciated 3.5% against the US dollar in 3Q23, bringing significant forex gains to export-oriented sectors such as tech, automobile parts, industrial automation and garment processing. Based on a regression analysis of quarterly appreciation/ depreciation of the NT dollar against the greenback and TWSE-listed firms' share of forex gains in operating profit, we estimate forex gains will boost operating profit by 7% for related firms in 3Q23F. Our survey of inventories shows that PC/ NB inventory turnover has quickened from last year's peak of 82 days to 65 days, of server from 77 days to 62 days, and of GaAs semiconductor from 191 days to 150 days. As AI spurs a replacement cycle, we forecast global server shipments will shift from a decline of 17% in 2023F to growth of 15% next year, and PC shipments from a decline of 11% this year to growth of 3-5% in 2024F, supporting consensus TaieX earnings growth of over 20% for 2024F and 2025F. TaieX forward PE will be a respective 20x and 16x in 2023F and 2024F, versus a five-year average of 15x.

#### Valuation & Action

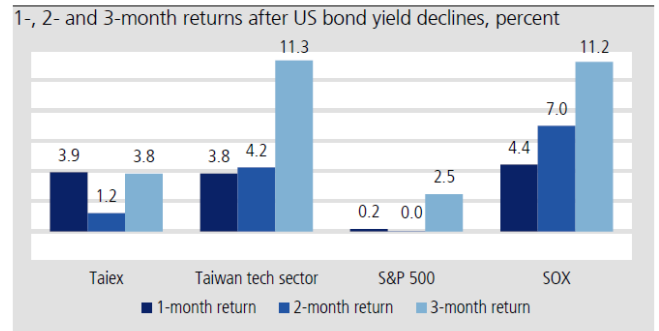
The Israel-Hamas war will weigh on market sentiment in the near term. Nonetheless, falling US Treasury yields and the positive corporate earnings outlook will bring back TaieX bulls by the end of the year. We recommend companies with the potential for earnings to surprise on the upside. Our top picks are Gigabyte (2376 TT, NT\$261.5, OP), Auras (3324 TT, NT\$310.5, OP), EMC (2383 TT, NT\$418, OP), UMC (2303 TT, NT\$48.2, OP), LuxNet (4979 TT, NT\$152.5, OP), Mediatek (2454 TT, NT\$825, OP), Novatek (3034 TT, NT\$430, OP), Nanya Tech (2408 TT, NT\$154, OP), Hu Lane (6279 TT, NT\$154, OP) and Airtac (1590 TT, NT\$1050, OP).

Figure 1: Falling US yields good for Taixex near term



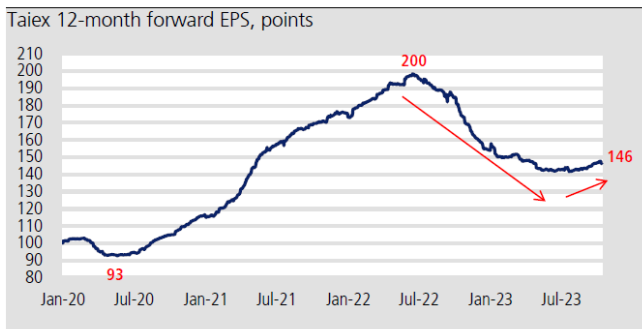
Source: Bloomberg; KGI Research

Figure 2: Taixex returns usually positive within 1-3 months of yield declines



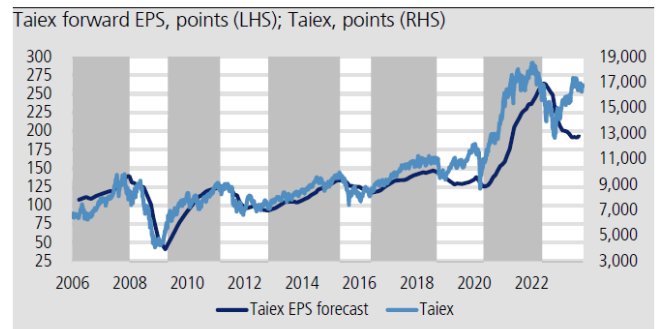
Source: Bloomberg; KGI Research

Figure 3: Upward revisions to Taixex earnings likely



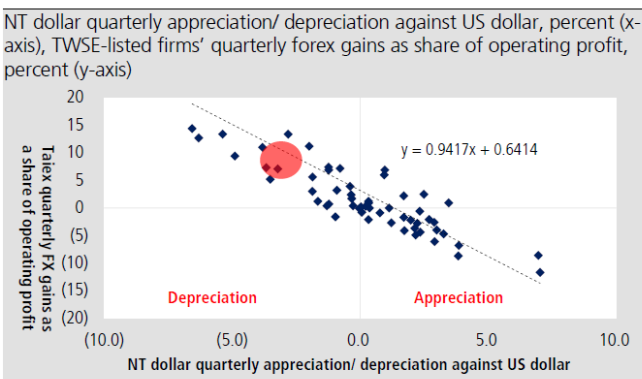
Note: January 2, 2020 = 100  
Source: Bloomberg; KGI Research

Figure 4: Corporate earnings upward revision periods coincide with Taixex bull runs



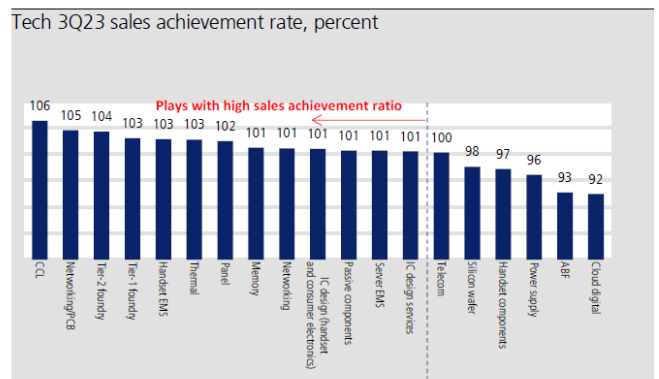
Note (1): January 2006 = 100  
(2): Shaded areas are corporate earnings upward revision periods  
Source: Bloomberg; KGI Research

Figure 5: Forex gains to add 7% to 3Q23F operating profit



Source: TEJ; KGI Research

Figure 6: Firms with high sales achievement rates likely to show positive financials in 3Q23F



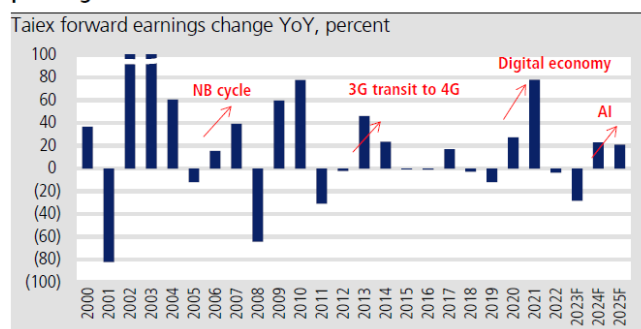
Note: 3Q23 sales achievement ratio refers to 3Q23A sales vs. 3Q23F sales  
Source: TEJ; KGI Research

Figure 7: Tech inventory down significantly from 2022 peak

Sector	Inventory turnover (days, unless otherwise specified)			
	Highest since 2022	Normal level	2Q23	3Q23F
PC/NB	82	50	70	65
Server	77	48	63	62
Large-size panel	66	47	61	55
GaAs	191	135	167	150
Memory	112	42	119	91
Industrial automation	3-4 months	2 months	2-3 months	2-3 months
Petrochemicals	53	44	50	52
Bicycle	5-6 months	2-3 months	5-6 months	5 months
Garment/ footwear	6-8 months	3-4 months	5-6 months	5 months

Source: KGI Research

Figure 8: Taix earnings always surge for two years on tech paradigm shifts



Source: TEJ; KGI Research

Figure 9: Taix &amp; subsector earnings growth projections

Earnings growth, percent	2022	2023F		2024F		Earnings growth, percent	2022	2023F		2024F	
		KGI forecast	Consensus	KGI forecast	Consensus			KGI forecast	Consensus		
Optical communication	Turned profitable	91.3	91.3	197.9	197.9	Petrochemicals	(63.1)	(63.6)	(47.3)	173.5	83.7
ABF	102.5	(59.9)	(64.5)	73.9	73.8	Steel	(75.4)	(33.6)	(69.5)	168.8	140.8
Networking PCB	56.1	(23.2)	(21.3)	70.4	70.3	Shoe-making	100.0	(50.0)	(41.4)	65.9	51.2
IC design and service	94.8	8.3	5.5	51.8	47.5	Auto parts	52.8	(14.1)	(14.3)	53.4	43.3
Networking	239.5	25.3	38.5	51.4	66.2	Heavy electrical	(1.9)	30.3	45.8	33.3	32.7
CCL	(7.7)	(0.7)	(2.1)	47.0	49.5	Industrial automation	5.2	(12.6)	(11.6)	27.8	25.6
Server EMS	(9.3)	(1.5)	2.3	44.3	46.7	Tourism	(46.5)	170.5	174.5	26.6	24.5
Passive components	(0.8)	(27.2)	(25.8)	34.6	31.4	Bicycle	(12.7)	(25.0)	(29.5)	21.9	26.7
Thermal	50.6	10.0	15.4	32.6	20.1	Food	(2.9)	116.9	121.6	20.6	15.4
Handset EMS	(2.1)	(15.7)	(11.7)	27.0	23.3	Aerospace	135.4	39.0	29.9	17.7	18.1
Cloud digital	16.3	15.4	(14.2)	25.9	21.6	Apparel	32.1	(12.0)	(15.2)	12.0	18.4
First-line foundry	70.4	(25.5)	(23.2)	25.2	22.1	Cement	(50.7)	47.0	39.2	7.5	8.6
Power supply	15.1	6.9	7.7	23.8	21.4	Finance	(49.9)	55.8	48.7	6.4	8.8
iPhone components	28.4	(35.8)	(35.8)	23.8	22.9	Food	(13.6)	28.2	39.6	5.9	(4.3)
IC design (handset/consumer electronics)	(2.9)	(36.9)	(38.6)	18.9	22.1	Airlines	(37.8)	253.9	230.5	(51.2)	(49.5)
Second-tier foundries	51.6	(38.6)	(38.2)	5.3	5.9	Container shipping	19.7	(95.4)	(95.5)	Turned unprofitable	(74.1)
Telecom	2.6	6.1	8.3	4.2	4.0						
Silicon wafer	29.5	20.5	14.9	2.6	3.0						
Memory	(36.0)	Turned unprofitable	Turned unprofitable	Turned profitable	Turned profitable						
TFT	Turned unprofitable	Remained unprofitable	Remained unprofitable	Remained unprofitable	Remained unprofitable						
Technology	17.8	(26.5)	(23.1)	31.9	28.0						
Non-tech	(12.0)	(69.2)	(68.0)	22.8	15.9						
Taix	(2.4)	(28.2)	(30.0)	22.8	21.9						

Note: In order of KGI projected 2024 earnings change YoY

Source: Bloomberg; KGI Research

Figure 10: Comparison – Taix valuations

	Forward PB (x)									Forward PE (x)							
	Forward 1-year	2023F	2024F	5-year average	10-year average	20-year average	2007 peak	2008 bottom	Forward 1-year	2023F	2024F	5-year average	10-year average	20-year average	2007 peak	2008 bottom	
Taix	1.70	1.85	1.65	1.70	1.60	1.61	2.28	0.95	16.78	19.75	16.09	14.85	14.81	17.12	21.73	8.80	
Taix excl. TSMC	1.40	1.52	1.36	1.39	1.38	1.46	2.22	0.89	17.03	20.19	16.59	14.39	14.73	15.96	22.71	8.06	

Source: KGI Research

**Figure 11: Our top picks**

Company	Code	Investment rating	Target price (NT\$)	Mkt cap (US\$m)	Share price (NT\$)	Change +/- (%)	EPS (NT\$)		PE (x)		P/B (x)		ROE (%)		Cash yield (%)	
							2023F	2024F	2023F	2024F	2023F	2024F	2023F	2024F	2023F	2024F
Gigabyte	2376 TT	Outperform	360.0	5,155	261.5	37.7	9.42	14.25	27.8	18.4	4.3	4.0	16.1	22.6	2.2	3.3
AURAS	3324 TT	Outperform	400.0	851	310.5	28.8	13.61	18.42	22.8	16.9	4.4	3.9	19.9	23.8	1.9	2.6
WNC	6285 TT	Restricted	N.A.	1,743	130.0	N.A.	8.01	9.33	16.2	13.9	2.5	2.3	16.1	19.0	4.2	4.6
EMC	2383 TT	Outperform	545.0	4,428	418.0	30.4	15.13	22.24	27.6	18.8	5.7	5.0	21.7	28.5	2.0	3.1
UMC	2303 TT	Outperform	56.0	18,687	48.2	16.2	4.59	4.82	10.5	10.0	1.7	1.5	16.5	16.1	3.5	4.1
LuxNet	4979 TT	Outperform	210.0	626	152.5	37.7	3.51	10.47	43.4	14.6	11.6	6.5	30.9	57.0	0.3	0.3
MTK	2454 TT	Outperform	956.0	40,922	825.0	15.9	45.15	56.26	18.3	14.7	3.3	3.2	17.0	22.0	6.4	7.4
Novatek	3034 TT	Outperform	510.0	8,113	430.0	18.6	37.45	39.26	11.5	11.0	3.9	3.6	34.5	34.5	7.0	7.4
NTC	2408 TT	Outperform	85.0	6,811	70.9	19.9	(2.10)	2.83	(33.7)	25.1	1.3	1.2	(3.7)	5.1	0.4	1.8
Hu Lane	6279 TT	Outperform	175.0	476	154.0	13.6	8.42	11.34	18.3	13.6	2.6	2.4	14.7	18.5	3.2	4.5
Airtac	1590 TT	Outperform	1230.0	6,512	1050.0	17.1	34.46	41.01	30.5	25.6	4.9	4.4	16.9	18.2	1.5	1.8

Source: KGI Research

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