Strategy

Correction not yet over, avoid bottom fishing

Key message

1. We don't recommend buying the dip in anticipation of AI-driven rallies ahead as market funds, corporate earnings and economic conditions have changed in the face of mounting concerns about an economic recession, carry trade investors being forced to unwind positions due to a rate hike in Japan and a gloomy outlook for the tech industry.
2. We recommend investors with sizable stock positions offload shares on any rebound, while those with small positions are advised to await signs of bottoming.

Substantial correction calls for change of investment strategy

The Taiex has retreated 4,633 points, or 19%, since July 12. While a rebound could happen at any time, we don't recommend buying the dip in anticipation of AI-driven rallies ahead, a much-touted strategy of bullish investors in the past year or so, as market funds, corporate earnings and economic conditions have changed in the face of mounting concerns about an economic recession, carry trade investors being forced to unwind positions due to a rate hike in Japan and a gloomy outlook for the tech industry. We believe the best investment strategy now is to be defensive.

Changes in macro environment - Looming concerns about economic recession

While debates circulate about whether the economy is heading into a recession and when it will happen, bond markets suggest recession risks are growing. The inversion and rapid narrowing of US Treasury yield spreads, especially of 2-year and 10-year notes, over the past month, with the 2-year yield falling more sharply than the 10-year yield, causing the inversion of spreads to close from 50bps a month ago to less than 10bps now, reflects market expectations for swift rate cuts by the US Fed in response to a significant economic slowdown. Historically, an inversion and rapid narrowing of US Treasury yield spreads often entails a bear run in stock markets, with drawdown ranging from around 20% to over 50%. Bond markets always move ahead of stock markets, so it's better for investors to prepare for the worst in advance.

Changes in market fund movements - Yen carry trade positions forced to unwind

To the market's surprise, the Bank of Japan (BOJ) raised its benchmark interest rate by 15bps on July 31, pushing up the yen-US dollar exchange rate to almost 140:1 from 153:1. The rate hike is a manifestation of the BOJ's determination to normalize its monetary policy, and indicates appreciation of the yen could persist for an extended period of time. Historically, rate hikes driven by appreciation of the yen raise funding costs for carry traders, leading to an unwinding of positions and creating sell-off pressure on financial markets. While some investors are upbeat about liquidity support for stock markets after Fed rate cuts, we note that stock markets tend to retreat in the face of rate cuts alongside an economic hard landing. Rate cuts can only boost stock performance when the economy is making a soft landing, and we need to factor in the fact that the global economy has started to lose steam.

Changes in industrial environment - Weak outlook for tech industry

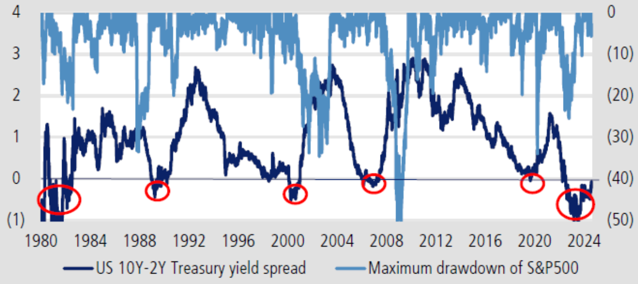
Based on 2Q24 Taiex earnings results so far, we conclude that: (1) 2Q24 corporate earnings have been mostly decent, but many companies have revised down earnings guidance for 3Q-4Q24F, suggesting operations in 2H24F could be lukewarm despite favorable seasonality; (2) recovery in demand for non-AI applications, such as handset, PC, consumer electronics and automotive, has been muted; and (3) although AI companies are involved in an arms race, some investors are starting to question the viability and commercialization of AI business models.

Valuation & Action

We don't recommend buying the dip in anticipation of AI-driven rallies ahead as market funds, corporate earnings and economic conditions have changed in the face of mounting concerns about an economic recession, carry trade investors being forced to unwind positions due to a BOJ rate hike, and a gloomy outlook for the tech industry. We believe the best strategy is to be defensive, and suggest investors with sizable stock positions offload on rebounds, while those with small positions are advised to wait for signs of bottoming.

Figure 1: Inversion & rapid narrowing of yield curve often entail a bear run of stock markets

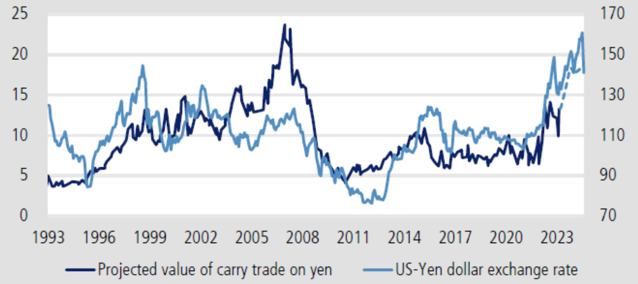
US 10Y-2Y Treasury yield spread, percent (LHS); maximum drawdown of S&P 500, percent (RHS)



Source: Bloomberg; KGI Research

Figure 2: Sharp appreciation of the Japanese yen will force carry traders to unwind positions

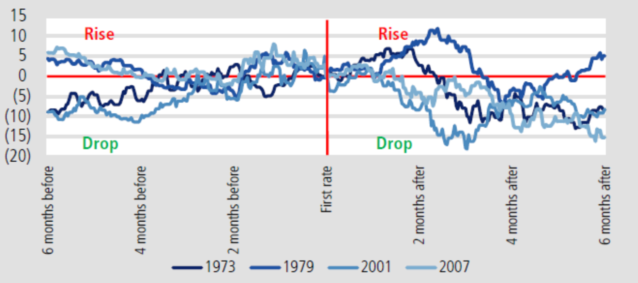
Projected value of carry trade on yen, ¥tn (LHS); US dollar-yen exchange rate (RHS)



Source: Bloomberg; KGI Research

Figure 3: Rate cuts during an economic hard landing are actually detrimental to stock markets

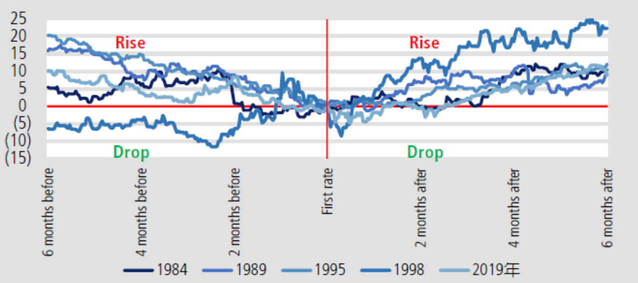
Performance of S&P 500 before & after first rate cut announcement by the Fed, percent



Source: Bloomberg; KGI Research

Figure 4: Rate cuts can boost stock markets only when the economy is making a soft landing

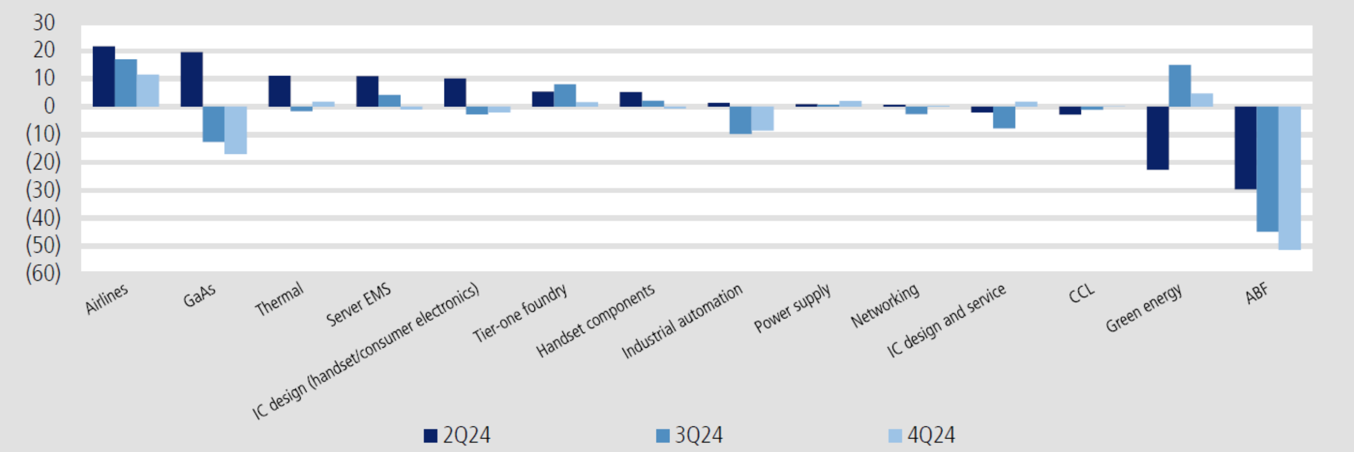
Performance of S&P 500 before & after first rate cut announcement by the Fed, percent



Source: Bloomberg; KGI Research

Figure 5: Taiwan 2Q24 corporate earnings mostly decent, but many firms have revised down earnings guidance for 3Q-4Q24F

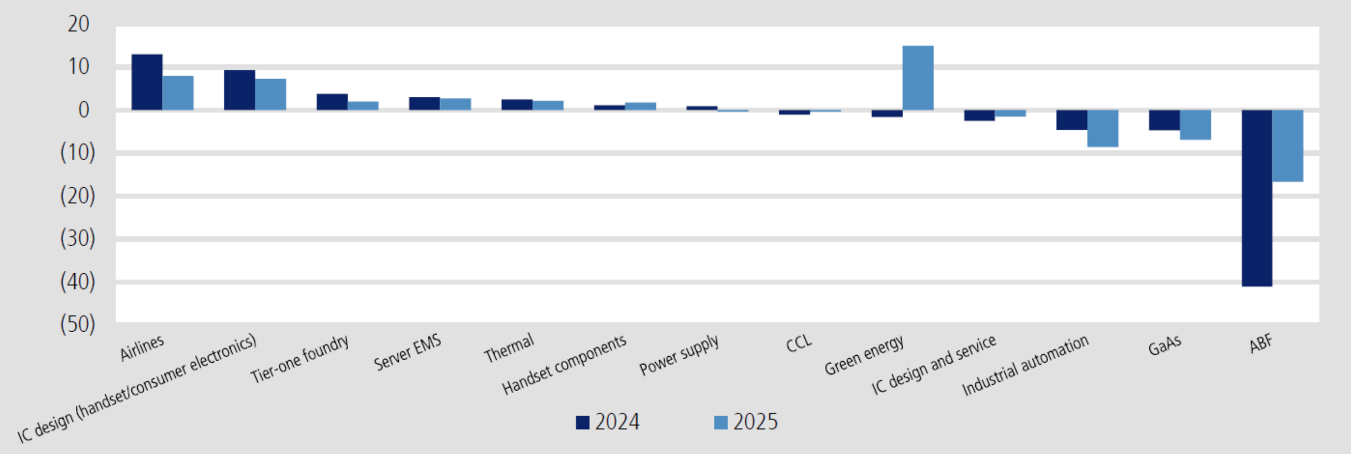
Quarterly earnings revisions by Taiex subsector, percent (based on companies that have released earnings results or recently revised forecasts)



Source: KGI Research compiled and estimates

Figure 6: 2024-25F earnings of individual Taiex subsectors are a mixed bag

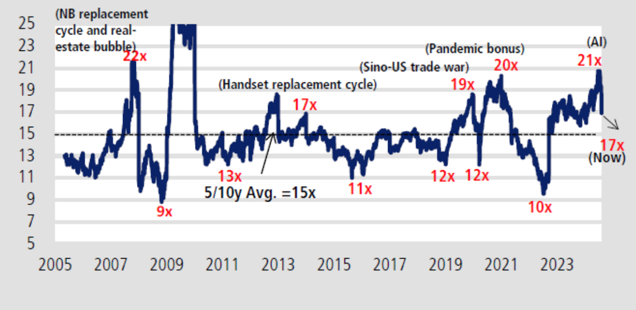
Full-year earnings revisions by Taiex subsector, percent (based on companies that have released earnings results or recently revised forecasts)



Source: KGI Research compiled and estimates

Figure 7: Taiex PE valuation has declined to 17x from 21x

Taiex projected PE (one-year forward), x



Source: TEJ; KGI Research compiled and estimates

Figure 8: Taiex now valued at 17x PE, above long-term average of 15x

Taiex PE and equivalent index level	2024-25F average PE (x)	Equivalent index level (point)
Current	17.0	19,831
Projected	15.0	17,521
Projected	16.0	18,689
Projected	17.0	19,857
Projected	18.0	21,025
Projected	19.0	22,193
Projected	20.0	23,361
Projected	21.0	24,529

Source: TEJ; KGI Research compiled and estimates

Figure 9: Taiex valuation comparison

	Forward PB(X)								Forward PE(X)							
	Forward 1-year	2024	2025	5-year average	10-year average	20-year average	2007 peak	2008 bottom	Forward 1-year	2024	2025	5-year average	10-year average	20-year average	2007 peak	2008 bottom
Taiex	1.85	1.95	1.81	1.72	1.62	1.62	2.28	0.95	16.91	18.62	15.60	15.19	15.00	17.13	21.73	8.80
Taiex excl. TSMC	1.40	1.48	1.37	1.40	1.38	1.46	2.22	0.89	16.49	18.17	15.50	14.91	14.99	16.05	22.71	8.06

Source: KGI Research compiled and estimates

Figure 10: Our top picks

Company	Code	Investment rating	Target price (NT$)	Mkt cap (US$mn)	Share price (NT$)	Change +/- (%)	EPS (NT$) 2024F	EPS (NT$) 2025F	PE (x) 2024F	PE (x) 2025F	P/B (x) 2024F	P/B (x) 2025F	ROE (%) 2024F	ROE (%) 2025F	Cash yield (%) 2023	Cash yield (%) 2024F	Cash yield (%) 2025F
Uni-President	1216 TT	Outperform	86.0	13,456	77.2	11.4	3.85	4.31	20.0	17.9	3.4	3.3	17.3	18.8	3.9	4.2	4.7
ACC	1102 TT	Neutral	40.0	4,390	40.4	(0.9)	3.06	3.40	13.2	11.9	0.9	0.8	6.1	6.7	6.0	5.0	5.5
CTBC Holding	2891 TT	Outperform	39.0	19,410	32.3	20.9	3.29	3.39	9.8	9.5	1.3	1.1	14.3	12.6	5.6	5.9	6.2
E.S.F.H	2884 TT	Outperform	32.0	12,438	25.4	26.2	1.52	1.64	16.7	15.5	1.5	1.4	9.5	9.2	4.7	4.3	4.7
TWM	3045 TT	Neutral	103.0	12,106	106.0	(2.8)	3.80	4.23	27.9	25.1	6.3	6.3	18.0	20.3	4.1	4.1	4.1
CHT	2412 TT	Neutral	119.0	28,912	121.5	(2.1)	4.94	5.11	24.6	23.8	2.5	2.5	10.0	10.4	3.9	4.0	4.0
PCSC	2912 TT	Outperform	319.0	8,690	272.5	17.1	11.49	12.77	23.7	21.3	7.2	6.9	31.0	33.1	3.3	3.7	4.1

Source: KGI Research compiled and estimates

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