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Taiwan, Supply Chain and AI:
Powering the Next Phase of Growth

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A frequent topic in recent meetings has been whether the AI narrative, and the stocks linked to it, are showing signs of a bubble.

Many AI-related companies climbed a wall of worry through the second half of 2025, accompanied by a growing chorus of commentators asking variations of the same underlying question: when, and how, will these multi-billion-dollar investments translate into economic returns?

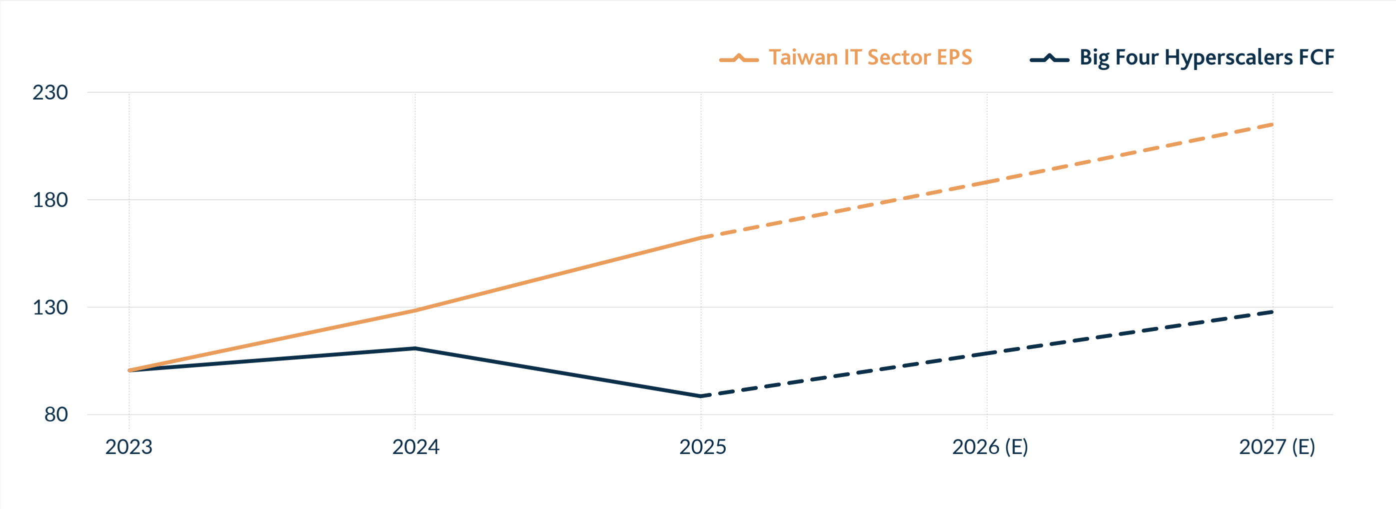
In our view, it is far too early in the AI build-out to draw firm conclusions based on near-term revenues. A large proportion of capital deployed so far has yet to be fully implemented in data centres, while enterprise adoption remains at very low levels. This is despite the fact that almost every management team we speak to recognizes AI as a strategic priority over the coming years. Ultimately, we believe the answer will hinge on how effectively companies use AI to drive revenue growth and improve efficiency.

The Supply Chain Is Where Earnings Are Emerging

From an emerging markets perspective, we see many companies positioned at the cutting edge of AI applications. However, the earliest and most visible benefits have accrued to a different part of the ecosystem: the supply chain. This is where our portfolio has been positioned and where we have seen the strongest gains to date. As emerging market investors, our task today is not to identify the specific winners among hyperscalers and LLM developers, but to be confident that overall spending continues. As illustrated in the chart below, as the four largest U.S. hyperscalers have ramped up AI investment, their free cash flow generation plateaued, while this spending has supported rising earnings across the Taiwan information technology (IT) sector. Although new players continue to emerge to support ongoing investment, it is encouraging that the incumbent players have not experienced a collapse in cash flows despite historically high levels of capital expenditure.

Chart 1

Taiwanese Information Technology Sector vs U.S. Big Four Hyperscalers



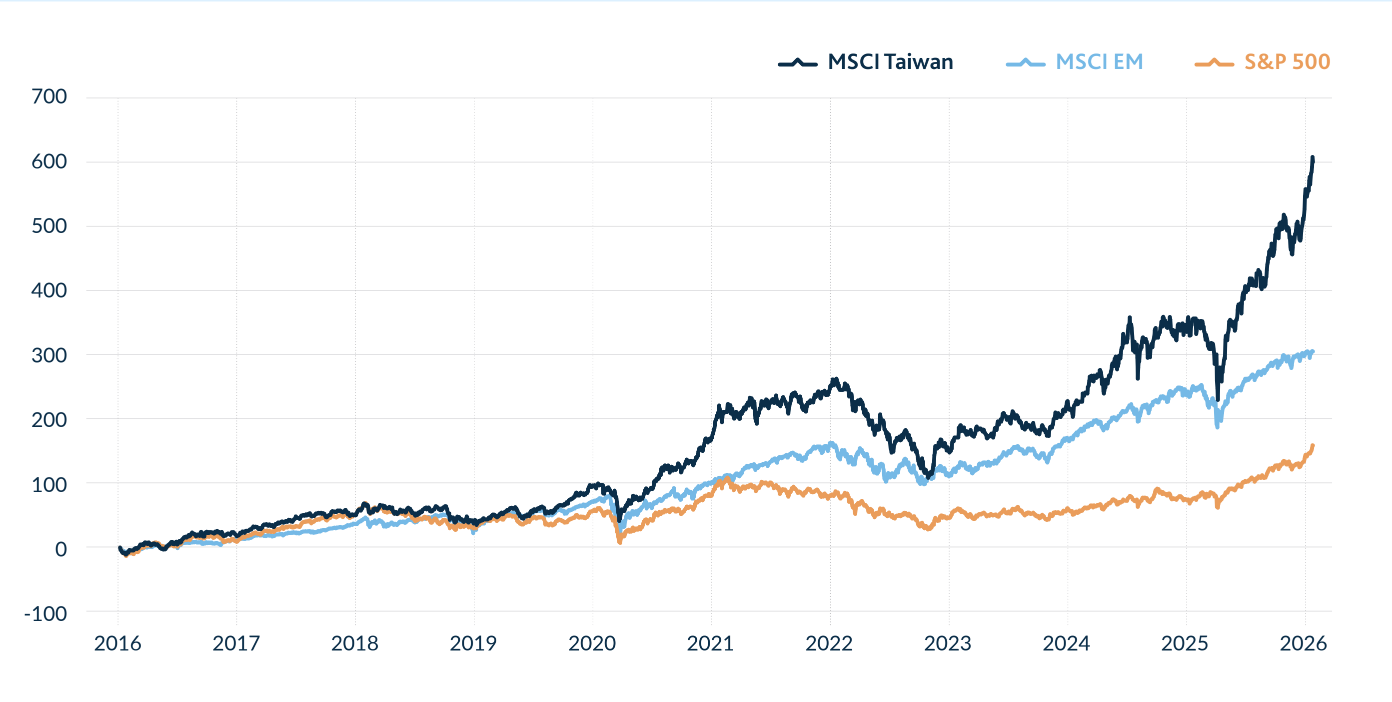
Source: FactSet. Rebased to 100 at 2023.

Taiwan's Unique Exposure to AI

With the IT sector accounting for around 35% of the S&P 500 and 28% of the MSCI Emerging Markets Index, this is an important topic for all equity investors. Taiwan represents approximately 20% of the MSCI Emerging Markets Index and is uniquely exposed, with IT alone comprising close to 85% of its benchmark. As a result, the AI bubble risk is more pertinent in Taiwan than in any other emerging market.

Chart 2

MSCI Taiwan vs MSCI EM vs S&P 500



Source: FactSet. Past performance is not a reliable indicator of future results.

Given Taiwan's crucial role in the global technology supply chain, AI-related companies have unsurprisingly driven both absolute and relative performance over the past two years. Indeed, the overall market now trades at around 18x price-to-earnings, a 10-year high. In the short term, however, an interesting divergence has emerged. While the Nasdaq plateaued in the final quarter of 2025 amid growing debate about bubble-like dynamics in AI, the Taiwanese market continued to rise and finished the year at new highs. This divergence underlines the need for a more nuanced approach to such a broad theme.

Fundamentals Are Catching Up with Prices

Are these new highs justified? At an aggregate level, the answer increasingly appears to be yes. This latest secular growth driver is being reflected in improving fundamentals. Index-level earnings growth is expected to exceed 20% over the next two years and return on equity stands roughly 25% above its 10-year average, with companies enjoying rising net cash positions.

That said, there are warning signs in the U.S. that warrant investor caution. These include evidence of circular investments, increased reliance on debt issuance and ambitious expansion plans from pre-IPO businesses with opaque long-term funding. Even so, we believe there are sufficient counterarguments to justify selective exposure to the AI theme, particularly in Taiwan and other emerging markets.

Spending Momentum and Visibility Remain Strong

Firstly, despite ongoing concerns about the timing of returns on investment, the major publicly-listed hyperscalers have consistently revised their AI spending guidance upwards through 2025. While a number of second-tier players have entered the market and some face questionable funding dynamics, there is little indication of a slowdown in demand. Indeed, with the recent round of guidance out of the U.S., the four major players alone have dramatically increased their spend for 2026 to $650 billion, 50-100% higher than last year – well above expectations and another incremental positive for their emerging market supply chains. In addition, with China's AI spending so far running at just 10% of that seen elsewhere globally, there is significant catch-up potential for those companies serving Chinese demand.

Secondly, our ongoing dialogue with supply-chain participants also reinforces our confidence in growth visibility, with scope for positive surprise over at least the next two years. TSMC, a company not known for exaggeration, has just reported another strong quarter and, more importantly, raised its growth expectations for its AI-related business to over 50% annually over the next five years. It has also increased capital expenditure to provide new capacity for a broad range of customers. We have clear visibility on Nvidia's next two GPU generations, while hyperscalers continue to develop proprietary ASIC chips to address both internal requirements and customer-specific needs.

Managing Cycles and Bottlenecks

Naturally, there is a risk of over-investment in any cyclical upturn. However, our focus on experienced management teams with a track record of prudent capital allocation mitigates this risk. Capacity expansion is being approached cautiously, with permanent capital commitments typically made only once demand is well established. Nonetheless, these expansions are happening gradually and will support earnings growth in the coming years.

Thirdly, rapid advances in computing power are also creating bottlenecks across the supply chain and in the surrounding ecosystem, alongside opportunities for companies able to respond quickly to solve these constraints. In doing so, businesses can benefit from earnings catalysts and are seeing re-ratings as earnings growth accelerates. Taiwan is home to many well-run companies operating in oligopolistic niche market segments, often competing effectively with leading U.S. or Japanese peers and generating attractive returns. We favour companies with strong competitive positions and high barriers to entry, while maintaining diversified customer bases to dilute concentration risk in an industry where the ultimate customer use case is still uncertain.

While TSMC is rightly recognized globally for its near-monopoly in leading-edge chip fabrication and its impressive pricing power, the Taiwanese market extends well beyond a single company. Our exposure spans the value chain, from chip-level components to data-centre infrastructure. This includes high-specification chip materials such as PCB and CCL, networking equipment, liquid-cooling solutions, chip testing, advanced packaging, memory and server assembly. A number of mid-cap companies that were largely uncovered at the start of the AI cycle have since delivered outstanding returns, highlighting the value of active stock selection.

Valuations Remain Supportive

Finally, valuations also tell a different story to the U.S.-related names. On average, emerging market AI-related stocks trade at a discount of around 35% to their U.S. counterparts. While upwards earnings revisions are clear over the last two years, investors appear careful not to overpay or extrapolate high growth rates. The fact that AI valuations are scrutinized in almost every investor discussion suggests a market that is alert to bubble risks rather than complacent. Beneath the averages, there remain clear mispricings and underappreciated catalysts, where active management can capture opportunities while avoiding valuation excess. In a fast-moving space, our turnover in Taiwan has been relatively low as we have held through short-term disappointments where we have confidence in a company's key position that will benefit from structural changes.

Even after the rally, our Taiwanese portfolio trades below 20x earnings while offering around 30% earnings growth and 30% return on equity. We continue to view this as an attractive aggregate valuation, supported by high-quality fundamentals and Taiwan's outsized role in driving long-term earnings growth. Having outperformed the U.S. market over the past decade, Taiwan remains one of the most compelling equity markets globally and continues to deserve close attention.

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