NUS INVESTMENT SOCIETY

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Global Macro Department – China (Overweight)

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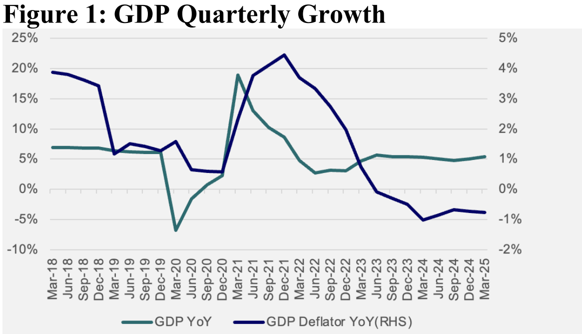
Basic Information (As of 2024)	
GDP	18.7 Trillion USD
M2	313.5 Trillion CNY
CPI	0.2%
PPI	-2.2%
Con. Confidence	86.40
Unemployment	4.3%
Debt-to-GDP	88.30%
Policy Rate (Latest)	1.40%
Stock Index	SSE (A), HSCEI (H)
Currency	Renminbi (CNY/CNH)

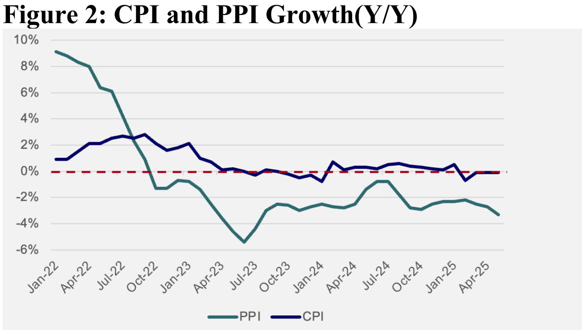
Source: IMF, NBS, PBoC

Figure 1: GDP Quarterly Growth



Source: CEIC

Figure 2: CPI and PPI Growth(Y/Y)



Source: CEIC

Figure 3: USD/CNY Performance

- China, the second largest economy in the world, uses the Renminbi (CNY onshore, CNH offshore) as its national currency. In 2024, China's GDP reached approximately USD18.7 trillion (17% of world), with a growth rate of 5%. The 5% expansion met the government's target despite the economy faced several structural problems including overcapacity, deleveraging, sluggish demand for consumption and property, and so on.

- China economy is walking through a transition period, during which services become more significant and account for 56.7% of the 2024 GDP. Still, China is the global powerhouse of manufacturing, supplying goods produced in incomparable costs and thus boasting a large current account surplus.

- Exports contribute significantly to China's GDP growth, despite the capacity over global demand has raised concerns over China's dumping (15.1% share in global exports). In 2024, net exports of goods and services contributed 30.3% to China's GDP growth, marking their highest share since 1997. The large trade surpluses aroused discomfort of the US and US administration has imposed additional 30% tariffs on imported China goods as of June 2025.

- As the global status of China is rising, policymakers want to broaden and deepen RMB internationalization. Despite onshore RMB (CNY) is not freely tradable, the offshore RMB (CNH) payment has been larger than cross-border payments with China. Now the CNH money market is mainly based on FX swaps, with USD as the main collateral. The progress of stable-coin legislation in Hong Kong could develop a money market based on more RMB-denominated collaterals, as the digital currency could be pegged to fiat currency HKD and CNH instead of USD. Policymakers are encouraging banks to increase the share of RMB used in cross-border trade settlement to 40%, and their tone has shifted from "RMB internationalization" to "international usage of RMB".

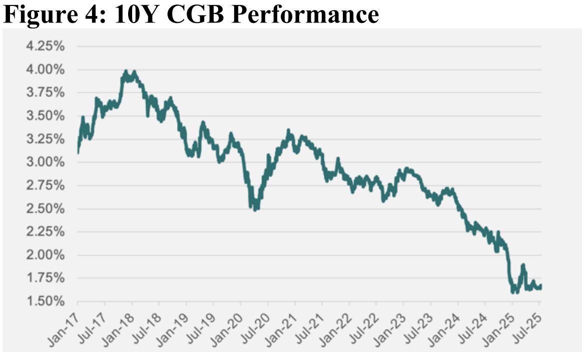
- China AI breakthrough this year (DeepSeek) reflected China's tech and innovation strength. Despite facing access curb to high-end chips, China's DeepSeek-R1 open source large language model provides a high powered, yet cost efficient AI solution. Meanwhile, China's control over rare earth supply is now a significant bargaining chip in trade negotiation with the US, the supply of which is essential for EV, Robotics manufacturing.

Summary of Events in the Past 6 Months

- **Economy:** Retail sales, manufacturing and exports performed strongly in the first half of 2025, supported by front-end trade-in program and front-loading shipments aboard. Deflationary pressures persisted as PPI remained in the negative zone and tariffs exacerbated the pressure as a demand shock. Meanwhile, household deleveraging continued, with higher-tier cities showing

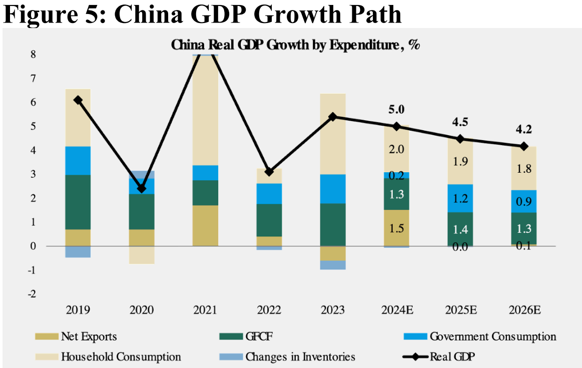
Source: CEIC

Figure 4: 10Y CGB Performance



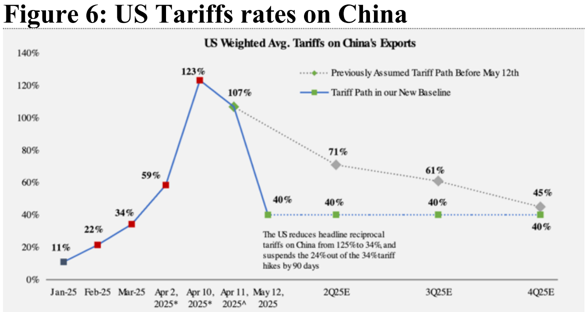
Source: CEIC

Figure 5: China GDP Growth Path



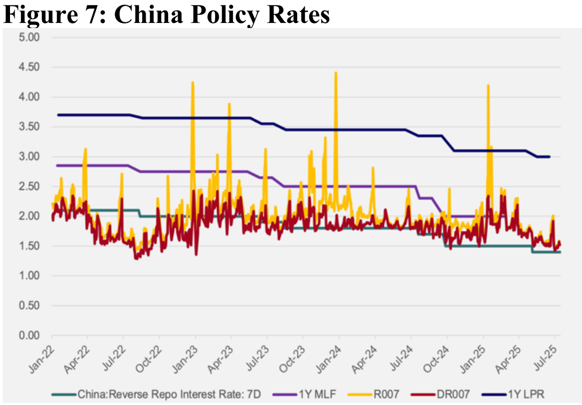
Source: NBS, Morgan Stanley

Figure 6: US Tariffs rates on China



Source: Morgan Stanley

Figure 7: China Policy Rates



Source: Wind

slight rebound in the housing market. Overall, China GDP showed a strong start of the year at 5.4% growth.

- **Policy Rate:** Given the weak economy fundamental, markets expected the PBoC to ease the key rates further. But due to the concerns over currency depreciation, the central bank didn't react until certainty around tariffs became clearer. As such, before the meeting with US officials at Geneva, the PBoC delivered a 10bps cut in 7d reverse repo as well as a 50bps cut in reserve requirement ratio. Interestingly, bonds witnessed a slight sell-off after the rates cut, reflecting markets pared back some expectations of further rate cuts in the year.

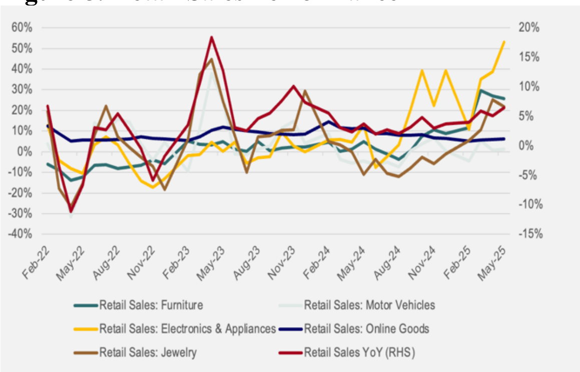
- **Tariffs:** While Trump didn't announce tariffs on China in the first week of his inauguration. He soon imposed two rounds of 10% tariffs on all Chinese imports accusing China's Fentanyl breach. Later, he imposed an extra 34% tariffs on all China goods as part of his sweeping Liberation Day tariffs, triggering China's retaliation. As a response, the US hiked tariffs on China totalling at 145% (125% + 20%), which was a de-facto trade embargo. Consequently, US and China officials held meeting at Geneva and reached a trade truce for 90 days, during which US duties were cut from 145% to 30% and China duties were cut from 125% to 10%. Officials later met at London and reiterated the framework, with China lifting some export controls (e.g, rare-earth). The truce is due 12 August.

- **FX:** As markets priced in the expectation that Trump would impose tariffs on China at a higher level (60%) than that in his first terms, RMB entered into the year with heavy depreciation pressure against USD. Deep Seek was released around Lunar New Year, after which the sentiments on China AI and tech improved materialistically and QFII clients allocated more capital into China equities, showing support for CNY. But the overall consensus for RMB is to go weaker. This was realised after the liberation day announcements, when China

- **Bonds:** After a sharp rally in 2024, PBoC halted the bond purchase in January with the aim to prevent CGBs yields to fall too much. Since then, 10Y CGBs have been traded around 1.60% most of the time. There are news saying that PBoC may resume the bonds purchase in the second half of the year, albeit not confirmed yet.

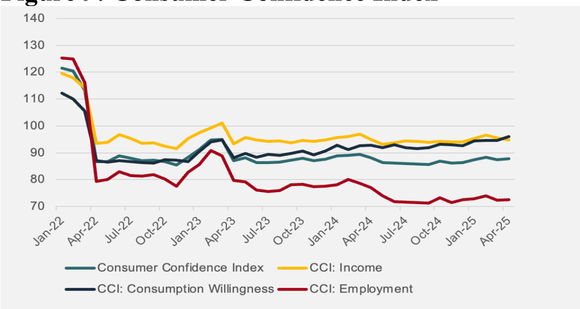
- **Policy Tones:** In the 1Q25 Monetary Policy implementation report, PBoC signalled an evolution in its understanding of the economic imbalances, and admitted that (a) investment worsens over-supply despite it creates current-period demand; (b) credit easing may boost supply more than demand amid supply-centric policy framework, weighing on prices; (c) there needs to be reform coordination across monetary, fiscal, industrial and employment policies, as well as social welfare system to restore the balance in aggregate demand and supply. And the policymakers have put more attention to tackle excessive internal competition.

Figure 8: Retail Sales Performance



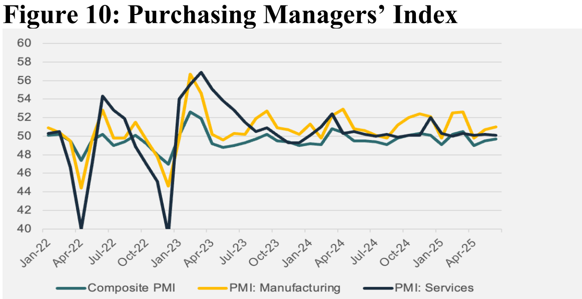
Source: Wind

Figure 9: Consumer Confidence Index



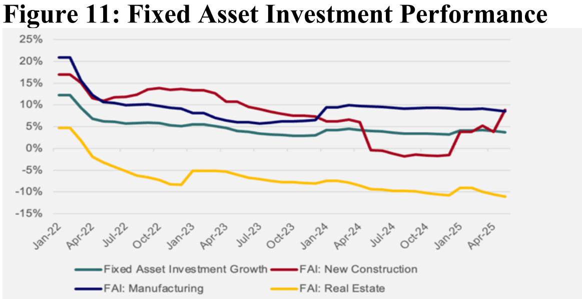
Source: CEIC

Figure 10: Purchasing Managers' Index



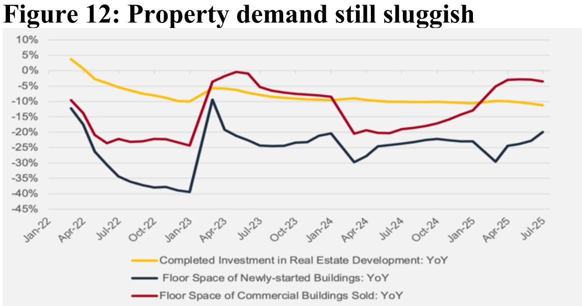
Source: CEIC

Figure 11: Fixed Asset Investment Performance



Source: CEIC

Figure 12: Property demand still sluggish



Source: CEIC

Figure 13: Industrial profit growth gradually improved

Economy: Supported by front-loading activities

Retail Sales, Production Activities: Front-loading boost

Retail sales remained strong in 1H25, driven by government subsidies on electronics and home appliances as part of the RMB300bn trade-in program. Despite online goods, autos, and home appliances sales realized a strong growth, the caveat is that many of the purchase may be one-off to replace their old devices. As such, the demand for durable goods may fade in 2H25 compared to the first half. As of June, 54% of government funding has been deployed, and some cities have been reportedly suspended the program temporarily due to funding shortfalls. Despite China released the third batch of funding in late June, it is likely that retail sales will drift lower due to payback from the consumer trade-in program. The May retail sales recorded a 6.4% growth YoY, which marked the strongest since Dec 2023. Industrial production keeps expanding at around 6% each month in 1H25, supported by front-loading manufacturing activities to meet the exports demand ahead of tariffs. After a +7.7% figure in March, the activities soften as exports growth slow down slightly. The trade-truce between China and US could support the industrial production for a while, while services production require more support from the domestic customer demand. However, industrial profits fell =1.1% in the first 5 months despite rising output, exacerbating deflationary presdures and the need to tackle overcapacity.

Fiscal Spending, Fixed Asset Investment: Driven by public

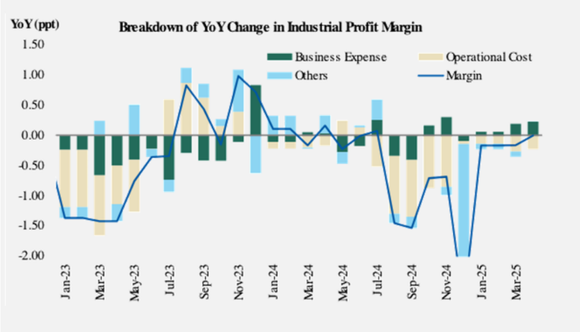
From the data perspective, fixed asset investment shows a steady and strong growth. However, this is imbalanced with infrastructure and property growth being the drag while high-tech sectors spending great expenditure. Downside risk for FAI growth extends as manufacturing capex could slow down after front-loading exports fade, and property sector shows limited sign of rebound. Despite further relaxation on purchase restrictions and fiscal support to housing and land buyback is delivered, the tackle of housing glut would be bumpy amid household deleveraging and sluggish demand.

Amid once three-digit tariffs, markets expected the government to deliver fiscal policy support to offset the growth headwinds from US tariffs. But the government move this time is more responsive rather than pre-emptive, reacting after clearer signals are seen. Modest fiscal package is delivered in the NPC in March, during which Beijing kept the GDP target at around 5% and announced a RMB2tn augmented fiscal expansion for 2025. As such, a 4% of GDP official budget deficit, along with RMB2tn special long-term treasury bonds and ~RMB500bn widening in LGSB quota. But still, the majority of the fiscal spending is used for infrastructure and manufacturing capex rather than consumption related, and local government is reluctant to use LGSB allocation for housing inventory buyback given worsening fiscal status.

1H25 net government bond issuance is RMB7.66tn, up 4.32tn yoy due to a low base in 1H24 amid tight examination of LGSB. As such, the TSF growth is largely contributed by the government bond issuance (~32% in June). After declining in April and May, net RMB loan increased 5% in June, with both household and corporate loans expanding. Overall, as compared to negative TSF print in 2024, it seems that the financial system cycle is bottoming out supported by higher full-year government bonds issuance and increased corporate bonds issuance, especially SOEs amid enhancing industrial profits.

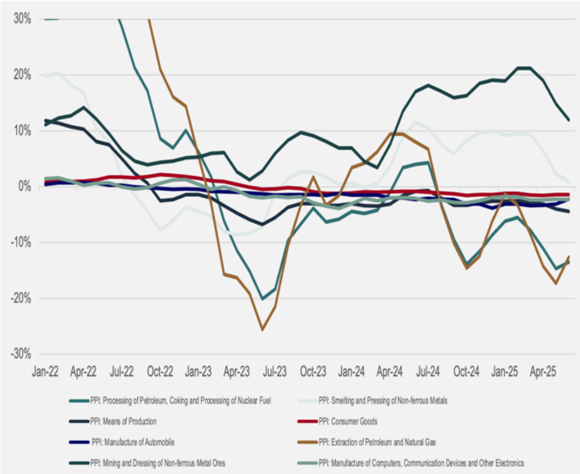
Deflation: Remain sticky

China's PPI has been in the negative for 33 consecutive months, with the June figures posting a 3.6% drop. The cost of production materials fell at a faster pace, with steeper drops seen in mining, raw materials, and processing prices. While the commodity price drop globally is a tailwind for low inflation, the deeper PPI deflation reflects the structural gap between supply and demand. The "involution", which is known as excessive competition for limited resources or opportunities led to price wars, especially in the new three industries (EV, lithium-ion battery, and solar panel). Moreover, amid weakening demand across green sectors, accumulated overinvestment and disorderly price competition have triggered deep PPI deflation. As such, products are sold at loss-making levels.



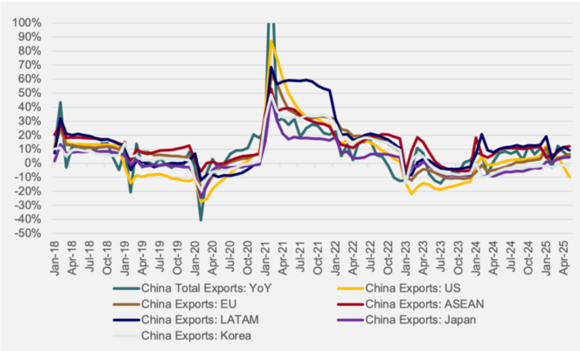
Source: NBS, Morgan Stanley

Figure 14: Supply-Demand imbalance led to deep negative PPI figures in some sectors



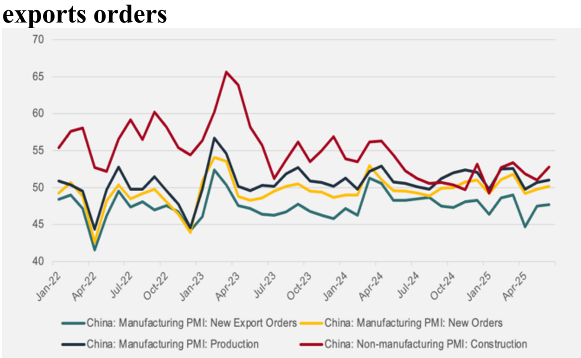
Source: CEIC

Figure 15: Strong Exports Performance despite tariffs turmoil



Source: CEIC

Figure 16: Tariffs brought uncertainties to new exports orders



Source: CEIC

Figure 17: Enterprise profit is improving amidst ongoing inventory de-stocking

Notably, the government seems to realize the deep-rooted supply-demand imbalance that constrain reflation, as the CCFEA reckoned that “efforts must be made to regulate enterprises’ disorderly price competition in accordance with laws and regulations. So far, government’s efforts included slowdown in manufacturing credit, scaling down export tax rebate for a wide range of products. But overall the recovery will be bumpy given the severe level of excess capacity, high investment growth, but only slowly recovery and modest support from domestic consumption.

External Trade: Still resilient despite higher tariffs

Exports contributed largely to the China’s 5% GDP growth in 2024. While the first two months of 2025 showed exports moderating greatly due to holiday and base effects, the following months data indicated that the incomparable supply chain of China is still supporting the exports performance. The March exports showed 12.4% growth ahead of liberation day announcement, and the April exports ticked up 8.1% with shipping to US slowing down but to RoW accelerating. June exports increased by 5.8% from 4.8% in May amid temporary easing of tariff pressures ahead of the August deadline. Notably, rare-earth exports surged 32% mom, reflecting progress from agreements reached in June to ease restrictions and restore global supply. A major headwind for shipment to US is the cancellation of tariffs exemption on de-minis goods, as well as the potential curb for transshipment. But still, exports to ASEAN, EU, and Japan remained strong. Risk of exports performance is tilting to downside given front-loading export activities are likely to fade in 2H25.

Policy: Reactive against tariffs, proactive within domestic

Local Government Debt Swap Program

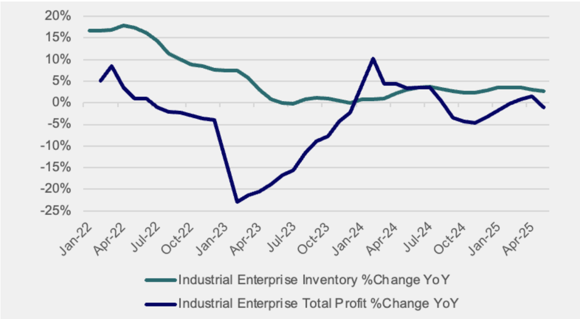
A total size of RMB10tn is provided for swapping local government hidden debt over the course of 5 years, which will help governments save on interest payments and encourage them to borrow more. The 10 trillion quota is made up of a one-off RMB6tn for 3 years and an annual amount of RMB0.8tn for five years. The one-off 6 trillion will lift the ceiling of local government special debt while the annual 0.8 trillion will be taken from the annual LGSB quota. As the debt resolution initiative will swap high-risk LGFB debt with risk-free government bonds, it is estimated that a total of RMB600bn in interest payments will be saved, according to Finance Minister Lan Fo’an. He also pointed out that the scale of local hidden debt would decline to RMB2.3tn from RMB14.3tn by 2028. Despite less interest rates incurred and a RMB2tn repayment of hidden debt from shantytown redevelopment guaranteed, less land sales revenues bring cloudy picture for local government, especially in tier-3,4 cities.

Also, it is worth noting that local governments may accumulate some new hidden debt with the new round of debt swap.

Growing policy consensus to reduce economic imbalance

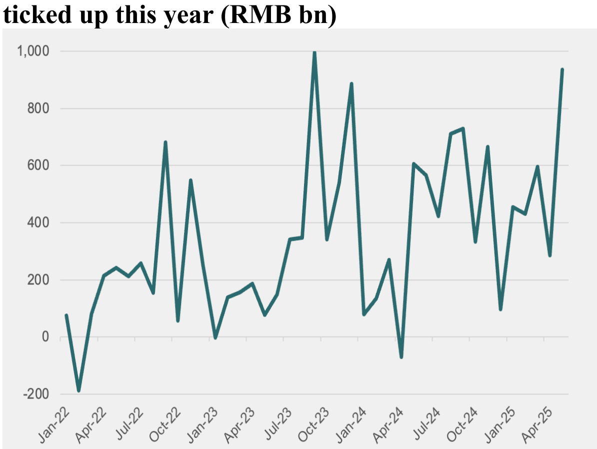
Event	Details
Central Economic Work Conference (Dec 24)	Consumption was ranked first among 9 key tasks for 2025
Annual NPC (Mar 25)	¼ of RMB2tn fiscal package is consumption-related, with RMB300bn allocated to flagship trade-in program
1H25 Steel Production Controls (Mar 25)	NDRC reiterated the continuation of steel output controls this year, with provincial-level controls underway
1Q25 Monetary Policy Report	PBoC admitted for the first time that in a supply-centric policy framework, credit easing may boost supply more than demand, weighing on prices. More policy/reform coordination is needed to rebalance the economy
The Central Commission for Financial and Economic Affairs meeting (Jul 25)	The government emphasised the need for “anti-involution”, and the Party journal provided a theoretical basis for addressing excessive competition in an article published afterwards.

It is a good signal that the government realize the vicious spiral of the involution, as the price competition hurts the producer profits, while the



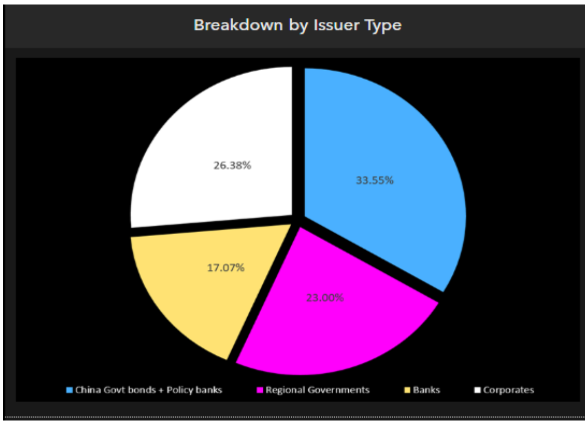
Source: CEIC

Figure 18: Central Government Bonds Financing ticked up this year (RMB bn)



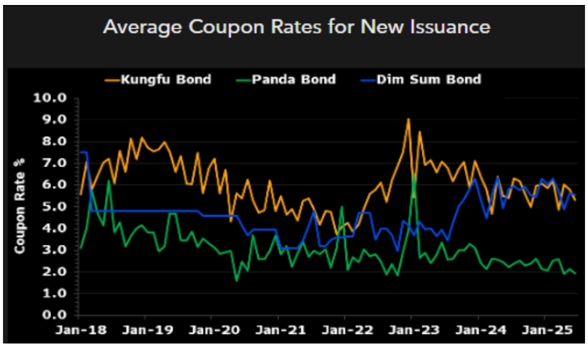
Source: Wind

Figure 19: China Government is the major issuer of the bonds



Source: Bloomberg (As of 2019)

Figure 20: Higher for longer US rates make offshore issuance less attractive



Source: Bloomberg Intelligence

Figure 21: China is buying gold and diversifying its reserves from USD and US Assets

overproduction deepens the deflation with the supply-demand imbalance. However, it would hurt investment in specific areas and may lead to layoff in jobs in the near term. It will take time for the government to balance the long-term benefits and the short-term loss, and for now no concrete measures have been rolled out.

Capital Market: the New "Nine Measures" and dividend payouts

Since 2022, China SSE Index has never come back to 3500. A sluggish consumption demand hurts the companies' earnings and margins, and lack of return on equity investment also hurts the investors' confidence in the domestic market. In 2024, policies to revive the capital market become firmer. On 12 Apr 2024, the State Council unveiled the new "Nine Measures", which emphasized (a) strengthening capital market supervision and governance; (b) raising the quality of listed companies though higher IPO thresholds, more forceful de-listing mechanisms, and better shareholder returns; (c) Enhancing investor protection through more transparent disciplinary mechanisms, better disclosure, and higher representation of long-term, institutional capital in A share.

Following the new "Nine Measures", the following measures are introduced to encourage increased dividend payout.

Authority	Details
CSRC	Encourage companies to pay dividends multiple times a year
	Support companies to use capital reserves to offset losses, and to distribute dividends in the future
	Cash used for share buybacks and cancellations could be considered as dividend payout
SSE & SZSE	Restrictions on shareholding reductions, and/or risk warnings for companies with low dividend pay out

Capital Market: Swap facility

On 24 September, the PBoC, CSRC, and NFRA jointly held a press conference and delivered a package of policy easing measures. Among them, RMB500bn liquidity provision program was announced for non-bank financial institutions to borrow money directly from the PBoC with qualified collateral, and RMB300bn relending program for banks to support listed companies to support listed companies' share buybacks. The Securities Funds and Insurance Companies Swap Facility provided institutions with the funds needed to invest in the stock market and boost market confidence.

On 18 October, the PBoC officially launched the RMB500bn swap facility with NBFIs, with 1 year extendable tenor and eligible collateral including bonds, stock ETFs, REITs and constituents of CSI300. The first round of the program attracted 20 brokers and mutual fund firms to participate with an overall amount applied of >RMB200bn. The funds received via the swap can only be used to buy stocks, stock ETFs, or market making of ETFs.

On 31 December, the PBoC and CSRC announced that the second round of swap facility would be carried out shortly and expanded the number of participants from 20 to 40, including 5 insurers.

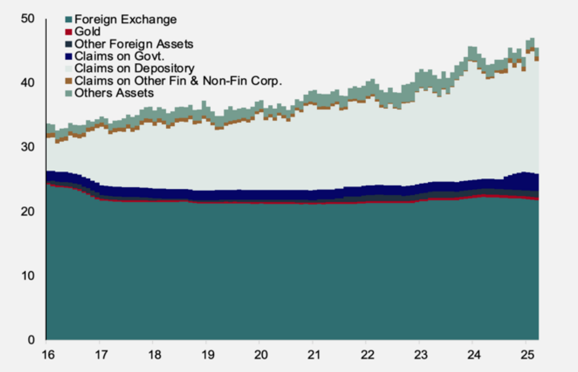
The swap facility boosted new ETF launches as well as attractiveness of high dividend names.

Capital Market: National Team stepped in

Since the Liberation Date, sharp US equities and risk-off environment spilled over to the China stock markets, with SHCOMP plunging to the trough at 3096. To counter the sentiment impact on the equity market, the national team propped up support. Central Huijin, together with a few central SOEs (CRHC, China Chengtong) and national pension fund stabilized the market by committing to stock and ETF buying, with a majority in the CSI300 index ETFs buying (RMB100bn).

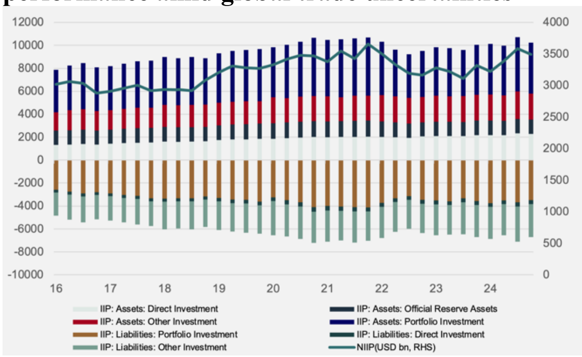
Meanwhile, the PBoC on 8 April vowed to provide liquidity support vi relending to Central Huijin whenever necessary. In addition, CRHC and China Chengtong participated in RMB180bn of PBoC's stock buying relending facility out of RMB300bn quota offered previously. And the SOE banks offered stock repurchase loans for companies listed on the A shares, concurring with multiple listed firms announcing buyback since April.

These measures show that policymakers attach great importance on the stableness of equity market, providing resources and support for a resilient market amid tariff turmoil.



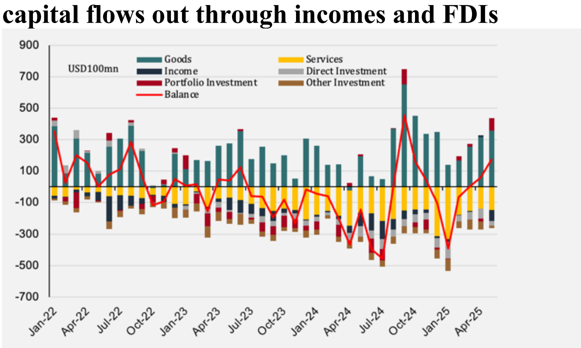
Source: CEIC

Figure 21: Net IIP Position is favorable for RMB performance amid global trade uncertainties



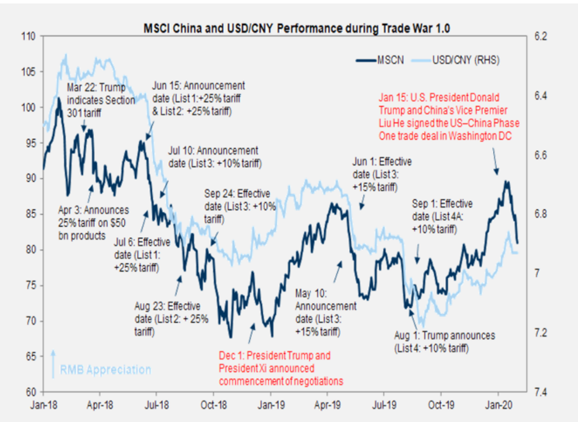
Source: CEIC

Figure 22: China holds goods trade surpluses and capital flows out through incomes and FDIs



Source: Wind

Figure 23: China equities and FX suffered from tariff shocks uncertainties in Trade War 1.0



Source: Goldman Sachs

Figure 24: H-Shares recovered from the low and has outperformed S&P this year

Cross-Border Policies and Channels: Encouraging Facilities

Connect Schemes	Launch Date	Quota (RMB)
Shanghai-Hong Kong Stock Connect	Nov 2014	Southbound Net Buy 42bn Daily Northbound Net Buy 52bn Daily
Mutual Recognition of Funds	Jan 2015	Southbound Aggregate 300bn Northbound Aggregate 300bn
Shenzhen-Hong Kong Stock Connect	Dec 2016	Southbound Net Buy 42bn Daily Northbound Net Buy 52bn Daily
Bond Connect	Sep 2021 (S) Jul 2017 (N)	Southbound Aggregate 500bn (Annual) & Aggregate 20bn (Daily) Northbound no limit
GBA Wealth Management Connect	Sep 2021	Southbound & Northbound: Aggregate 150bn
Swap Connect	May 2023 (N)	Trading 20bn (Daily), Clearing 4bn (Daily)

The new HKMA RMB trade financing liquidity facility offers longer-tenor 1m, 3m and 6m RMB funds with interest rates referencing onshore interest rates plus a spread, expanding the previous short-term offerings, including overnight, 1d, 1w and intraday. The new facility will introduce currency swaps, where banks can swap their HKD funds for RMB funds with the HKMA, which can obtain RMB funds from the PBoC through the RMB800bn currency swap agreement.

As a consequence, the liquidity of Hong Kong's offshore RMB market is likely to enhance, bolstering the hub's position as the offshore RMB business hub. The longer tenors provided could make companies and banks feel more comfortable in using the RMB to settle trade.

Tariffs: A buffer for now

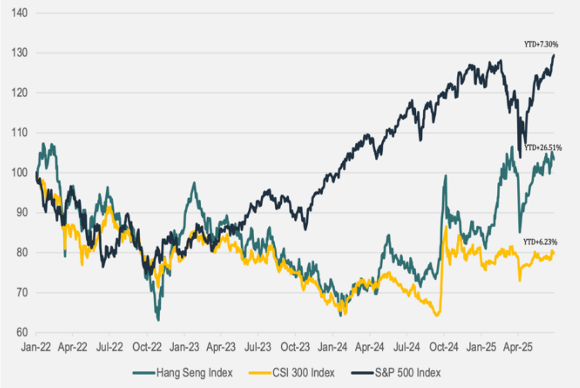
Date	US Action	China Response
Feb 2024	Trump promised in a campaign "at least 60%" tariffs on all China imports if he wins	-
May 14, 2024	Biden administration quadrupled EV duties to ~100% and doubled chip tariffs to 50%, as well as hiked	-
Feb 4, 2025	Effective 10% additional tariffs on all goods imported from China due to fentanyl issues	10%-15% tariffs on some US goods, export controls on critical minerals, entity list additions and antitrust probes
Mar 4, 2025	Effective another 10% additional tariffs on Chinese goods	Additional tarrifs on some US goods,
Apr 2, 2025, Apr 4, 2025	Trump announced liberation day tariffs globally, among which China is imposed an additional 34% of tariffs	2 days later, China announced a retaliatory 34% tariff increase on all US exports to China
Apr 9, 2025	Trump announced a further increase in the tariff rate on China to 125% (+20%=145%), while a 90-day pause on other countries besides the 10% baseline	
May 12, 2025	US and China suspended most tariffs after Geneva talk, cutting tariffs to 10%. As such, US additional tariffs on China is 30% (20% fentanyl) while China on US is 10%, effective for 90 days	
Jun 11, 2025	US-China London talks agreed on a framework to keep the tariff level agreed in Geneva, and US agreed to ease exports control on semiconductors (not highest-end chips) while China approved licenses for rare earth exports.	

Difference between the first trade war

Unlike the trade war 1.0, during which China's administration let RMB depreciate to absorb the tariff shocks, the government this time attached greater importance of the financial system stability, especially FX and equities. Apart from retaliatory tariffs, the government focused more on export controls and additions to the entity list. This time, RMB is resilient and even strengthens slightly against USD.

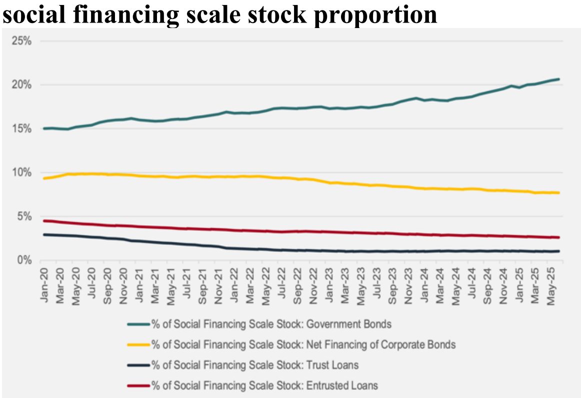
China's card: Rare earth

Unlike the first trade war when China prioritised enitity list as non-tariff retaliation to exports control. This times, however, the authority levered China's irreplaceable strengthen in rare earth supply chain, given the possession of over 85% global rare earth refining and 90% of NdFeB magnet production, critical for robots and EV motors, national defense, and wind turbines.



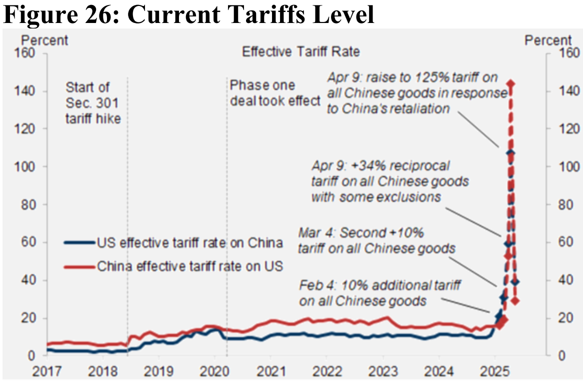
Source: Wind

Figure 25: Government Bonds are taking up more social financing scale stock proportion



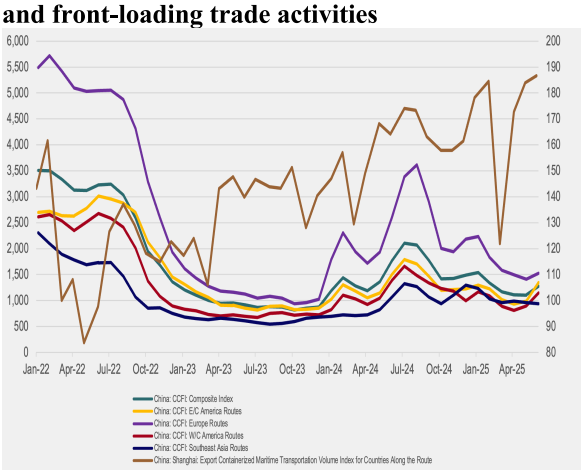
Source: Wind

Figure 26: Current Tariffs Level



Source: Goldman Sachs

Figure 27: Freight Index reflected tariffs shock and front-loading trade activities



source: Wind

Figure 28: China is the largest rare earth producer globally

Beijing is developing a tracking and licensing systems for export controls, and could be reactive in response for US or its allies imposing tech and chip controls on China. Despite Beijing and Washington reached a trade talk in Geneva, China has only been slowly loosening the exports control on critical minerals (especially magnets and alloys), so as to urge US to equally ease the chip controls on China as well as prevent the tariffs from rising too high.

Moving Forward, it is likely that the tariffs level will stay at the current level. If China can comply with the Fentanyl issues, the 20% punitive levies may also be brought down. Given that each side holds key exports elements that are instrumental to the other's tech development (semi chips vs rare earth minerals), more rounds of trade talks can be expected. Meanwhile, China may be required to "fully" open the market access to the US given its running a large trade surplus.

Rates: Bullish momentum calm down, shift to a single rate framework

A shift of mandate focus

In the first two decades of the 21st Century, China is an investment centric economy where both property sector and local government show huge demand for credit. As such, the PBoC targeted M2 and TSF growth rates as intermediate targets for a while. However, as property bubble busted, the interest rates have become more important in borrowing decisions. While the PBoC is more in charge of daily operations and do not hold official scheduled central bank meetings, it has started to refer to DM central banks and put interest-rate policy as the bedrock of its monetary policy framework. According to the Q1 Monetary Policy Report, the PBoC's liquidity toolbox comprises of a) RRR cuts and CGB trading for long-term liquidity; b) MLF, ORR and various structural lending facilities for medium-term liquidity; c) 7d OMO reverse repo, temporary overnight repo and reverse repo for short-term liquidity.

As such, the PBoC is moving away from quantitative objectives, the best measure of which are the outstanding aggregate financing growth representing the credit growth.

Transition of the interest rates corridor

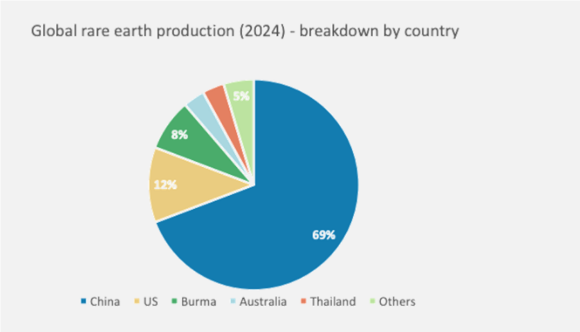
China is undergoing a substantial transition towards a Western-style system that depends on short-term policy rates. The 7d OMO reverse repo rate has gradually become the dominant policy rate in China. And DR001 has become a more dominant short-term interbank rate. As such, the interest rates for temporary overnight repo and reverse repo operations, which are set at 20bp below and 50bp above the 7D OMO reverse repo rate, have formed a new and narrower interest rate corridor. Outright reverse repo (ORR) and CGB trading are new tools for the PBoC to fill part to the gap left by the MLR.

Before, the interest rate corridor is the range between the rates on the excess reserves and the standing lending facility (SLF). The SLF is a tool used by the central bank to provide short-term funds to financial institutions on demand, which is set at the 7-day reverse repo rate plus 100bps. The IOER is the rate at which the central bank makes interest payments on the excess reserves deposited by financial institutions. The issue is that the corridor is too wide, and the PBoC does not explicitly commit unlimited lending at the upper bound despite an effective lower bond. The new corridor is interpreted with the floor at 20bps below the 7d OMO reverse repo rate and the ceiling at 50bps above. And the overnight repo rate for depositary institutions (DR001) is regarded as the new targeted short-term interbank rate.

Diminished role of MLF: benchmark rates to a pure liquidity tool

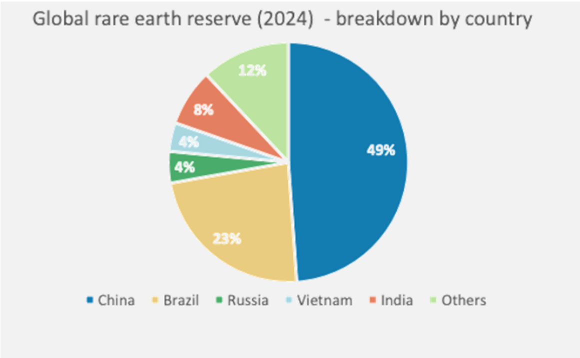
Introduced in 2014, the Medium-term lending facility is a type of PBoC lending to commercial banks that aims to inject mid- to long-term liquidity. It has since become the most used channel for the PBoC to adjust mid-to long-term liquidity, other than RRR. Meanwhile, Loan Prime Rates, which are the lending rates to best-quality clients and benchmarks of mortgage rates, have once linked to MLF. As the PBoC pushed the date of MLF operations to the 25th of each month from previous the 20th, which is the LPR release date, the relationship between these two rates started to de-link.

As a bank draws an MLF loan and pledges CGBs to the PBoC, the MLF operations lock a substantial amount of CGBs at the PBoC, limiting the



Source: Morgan Stanley

Figure 29: China has the largest rare earth reserves in the world



Source: Morgan Stanley

Table 1: Summary of Key Rates Event since 2024

Time	Measure Details
Mar. 2024	Xi's publishment commented "it is necessary to enrich the monetary policy toolbox", and "the PBoC must gradually increase the trading of CGBs in its OMOs". -> Led to a resumption of CGB trading in Aug. 2024.
19 Jun 2024	In the Lujiazui Forum, PBoC Governor Pan delivered a speech stating that the PBoC "will consider refining its official policy rates" and "will define the short-term rate 7d OMO rate as the main policy rate". Also, he mentioned that the PBoC would make efforts to narrow the interest rate corridor as well as the introduced the trading of CGBs by PBoC in the secondary market to become a new method for creating base money.
1 July 2024	The PBoC decided to borrow CGBs from primary dealers of open market operations in coming periods.
8 July 2024	The PBoC announced that it will carry out temporary overnight repo or reverse repo operations. Interest rates for the temporary overnight repo and reverse repo will be set at 20bp below and 50bp above the 7d OMO reverse repo rate respectively. And the operations are conducted through "quantity bidding at a fixed interest rate".
22 Jul 2024	The PBoC announced a 10bp cut to 7d OMO reverse repo rate, alongside 10bp cuts to both 1y and 5y LPR. Notably, the bidding form was revised from "interest rate bidding" to "quantity bidding at a fixed interest rate". Meanwhile, the PBoC announced that banks with the demand for selling medium- to long-term bonds could apply for a temporary reduction or exemption of collateral when obtain MLF funding to increase the supply of tradable bonds.
25 Jul 2024	The 1y MLF rate was reduced by 20bps.
Aug - Dec 2024	The PBoC restarted trading CGBs, with a net purchase of RMB100bn. The PBoC net purchased a total of RMB1tn in CGBs in Aug-Dec 2024, before the purchase was halted in Jan 2025 due to concerns over falling CGB yields. The major way is to sell long-term bonds and buy short-term bonds with an intention to steepen the yield curve.
28 Oct 2024	The PBoC unveiled the outright reverse repo to enrich the monetary policy toolbox. The policy tool is carried out once a month, with a tenor of no more than one year. The operation will be conducted in the form of "fixed-quantity, intereste rate bidding and multi-price bidding".

supply of tradable bonds in the market. This results in banks holding a large share of outstanding CGBs, which are then pledged to the PBoC against borrowing. As such, a sizeable part of CGBs are not traded in markets, leading to a relatively low turnover ratio of CGBs, especially across the long tenors.

On 24 March, the PBoC revised the MLF rate bidding form from "single-price bidding" to "multi-price bidding", downplaying the benchmark role of MLF. This remarked that the 7d OMO reverse repo rate is the policy rate, and it could avoid excessive policy signals and misguiding market expectations.

Increasing significance of overnight reverse repo

Compared with the MLF, the ORR offers greater flexibility, as it transfers ownership of the pledged securities to the PBoC, allowing the PBoC to trade the securities. Unveiled in Oct 2024, the ORR is conducted only in 3m and 6m tenors, which concurs the initial announcement of no more than 1y.

Policy Rates: Easing priced in, not too urgent

Long expected policy easing measures were not delivered until May, including a 10bp cut in 7d OMO reverse repo to 1.4%, a 50bp RRR cut to inject RMB1tn long-term liquidity to the banking system, and a 25bp cut in the relending rate and the PSL rate. Knee-jerk sold off in long-end CGBs reflected that the markets faded some easing expectations.

Moving forward, China is likely to follow the Fed easing decisions. Given that the rates differential between China and the US is still well and the 1H25 economic data performing well, China may deliver 10 or 20bps cut in policy rates and another 50bps RRR cut to protect the bank's net interest margin. Preemptive easing is possible if payback of economic data indicates a weaker economic fundamental in 2H25.

CGBs: Finding a floor

A big drop in CGB yields happened in December 2024 after the December Politburo meeting announced a "appropriately loose" monetary policy. For example, in terms of 10Y CGBs, a continuous rally from ~2.6% in early 2024 to ~2.0% in November was followed by another 40bps plunge, heading to 1.6% at the start of the year.

Even though the PBoC has been warning of the risk of a one-way drop in long-end interest rates since last April, the CGBs are rallying relentlessly with policy easing expected. To prevent rates from overshooting the downside, the PBoC decided to halt the CGBs purchase in January. Given the trade-in program and larger budget deficit planned, the government are issuing more bonds this year, which shows great demand across primary and secondary markets.

As the CGB yields finding a floor, it is said that the PBoC will resume the bonds purchase in 2H25, with agent banks already bidding short-end CGBs. Trading CGBs could help the PBoC maintain more stable interbank rates. Still, CGBs are likely finding a floor, with 10y CGB unlikely to fall below 1.5%. Improved equity performance and the administration encouraging long-term capital entering into the equity market, China bonds could continue to underperform the equities.

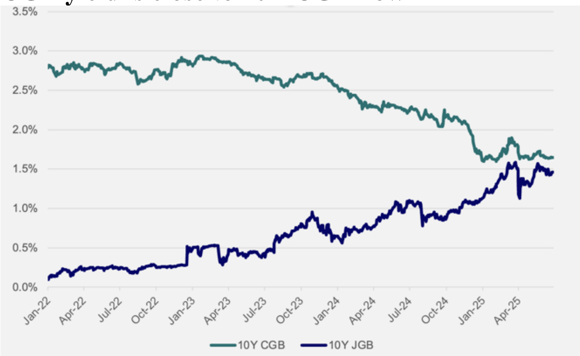
Equities: Investors' appetites improved

Outperformers: High Dividends, Tech, Innovation BD

As government tends to anchor household's expectation on equity and property market other than pre-emptive easing and stimulus, insurers and pension funds are encouraged to step up equity investment allocation and listed companies are encouraged to increase shareholders returns. Amid this regime, banks and brokers are the key beneficiaries given it's a) high dividend– H shares China Financials offer 5% yields which is higher than CGBs yields; b) Asset allocator such as mutual funds rotate their assets to under-owned China bank sector so as to better track the key indices; c) The falling interest rates could benefit the asset side as margin finance & securities lending rates are priced based on supply and demand dynamics in the MFSL market instead of linked to the LPR; and benefit the liability side as NIM could improve with lower funding costs after 50bps RRR cut. Among them, H-share banks and insurers are attractive from the dividend perspective, but may lack room for rally. A-shares brokerage is the relative laggard in the financial sub-sectors and may catch up in 2H25. Meanwhile, companies that get stablecoin/crypto license in Hong Kong franchise may

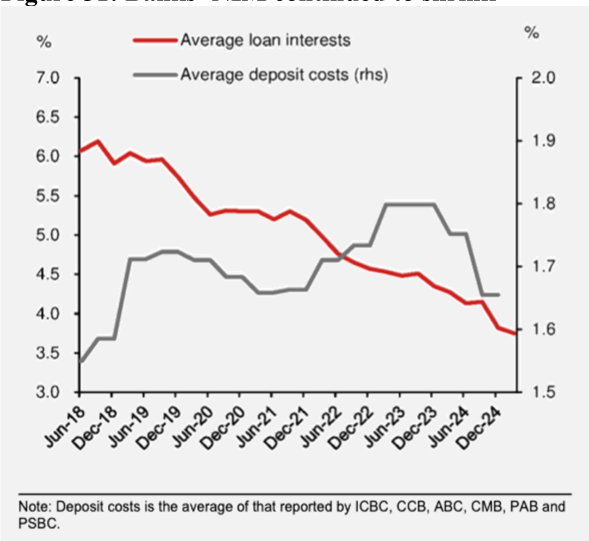
Oct 2024 – May 2025	The balance of outright reverse repo increased by RMB 4.4tn (collateral could be circulated in the secondary market), while the MLF balance dropped by RMB 1.8tn

Figure 30: Japanification concerns arise as 10Y CGB yield is close to 10Y CGB now



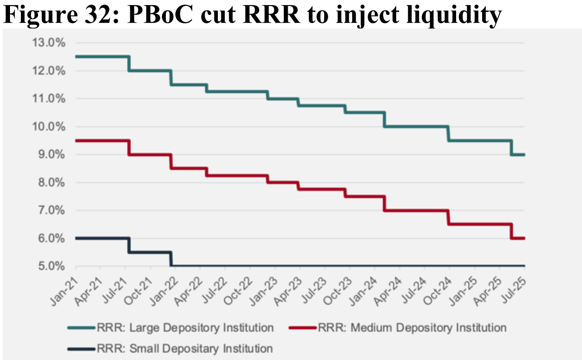
Source: CEIC

Figure 31: Banks' NIM continued to shrink



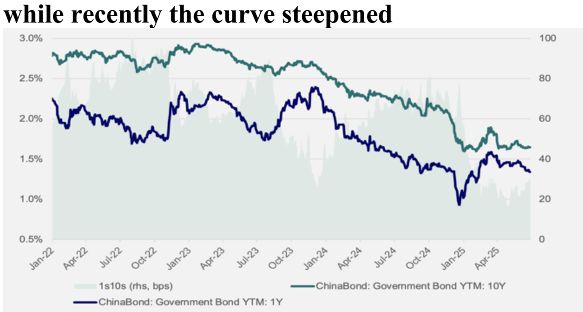
Source: Nomura

Figure 32: PBoC cut RRR to inject liquidity



Source: CEIC

Figure 33: 1s10s Bull Flattener is a trend in 2H24, while recently the curve steepened



Source: Wind

also witness a rally amid sentiments. Last but not least, China insurers have very little exposure to tariffs.

The launch of DeepSeek-R1 underscored China's ability to deliver globally competitive, cost-efficient frontier AI models even with constrained access to top-end chips, flipping the narrative on Chinese tech innovation and helping drive a powerful rebound in China Tech benchmarks (HSTECH +27%, MSCI China +19% over the past month). Plus, the Q424 earnings result mostly exceeded expectations on revenue and profit, as the valuation is well below global peers. However, Q125 earnings result is diverged, and some companies faced pullbacks as the earnings still cannot support the valuation. Moving forward, the launch of tech and innovation ETF and continuous progress in AI innovation could support the tech outperformance, especially the Data & Cloud and Software & Application names, which welcome robust Southbound flows this year. The government support in artificial intelligence and still low valuation of tech companies could buoy the AI frenzy in China tech.

Another attractive sector is pharma given foreigners interest in the sector because of its innovative potential, cost-effectiveness, good clinical data and IP, and clean deal structure. The MNCs favor China Pharma & Biotech as out-licensing trend continues. The healthcare sector also generates great return upon patent approval, and go-global value upon partnership or M&A. Moreover, the healthcare pricing reform in China could lower pricing pressure on innovative drugs in the future. As such, the structural shift could unlock long-term growth for innovation biotech & pharma industry, despite near-term catalysts may have been largely priced in.

Laggards: Anti-involution campaign helped bottom out

China EVs, Lithium Batteries are supported by trade-in programs demand. However, the solar panels industry still experienced overcapacity and management tones remained bearish amid the severe margins pressure. Interestingly, solar glass and poly companies share price surged after the readout from Central Financial and Economic Affairs Commissions, indicating that markets welcome the anti-involution campaign.

Property stocks remained tepid, given the sluggish demand of property especially within lower tier cities. Major developers, such as Vanke, also faced severe debt repayment issues apart from lower contract signed. As such, even the government tried to bottom out the

Convertible Bonds: Appealing to both parties

Notably, the CSI convertible bond index has rallied about 8% in 2025, which beat the stock benchmark CSI300's 2.1% and CGB's 0.9%. Convertible bonds, issued at a lower coupon by listed companies especially small-caps, provide investors with exposure to equity upside with lower volatility and drawdowns. Given the bullish stock momentum, convertible bonds are well bid among buyers and issuers also find it attractive to raise funds at a lower cost. The convertible bonds ETF also received strong inflow.

Moving forward, the supply of convertible bonds may reduce given billions of dollar of issuance are likely enough for companies to repay debt and spend for corporate purpose for a while. As such, the existing bonds may still be attractive in the secondary market, despite some of them carrying a great premium over the share price.

FX: Depreciate against the basket while gain vs Dollar

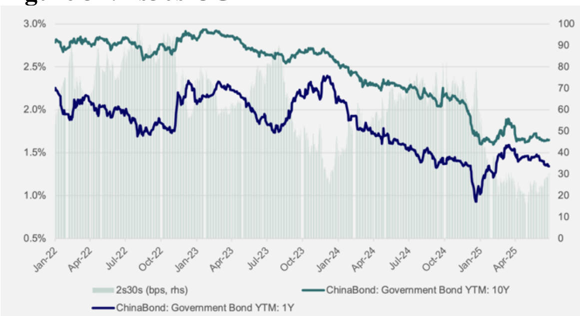
FYI: RMB Circulation

RMB circulation comprises of "onshore-offshore" circulation and "offshore-offshore" circulation. Onshore-offshore refers to the payment of RMB out from China Mainland and back into China Mainland, such as foreigners buying China goods or onshore bonds. As such, when RMB is paid out from China, it forms the CNH liquidity pool while the CNH liquidity is drained when offshore participants send RMB into China. The offshore-offshore circulation does not involve any party in China and is denominated in CNH. While it does not change the pool of CNH liquidity, the demand for CNH liquidity rises when traction volumes go higher so as to settle transactions smoothly.

Before Liberation Day: Efforts to curb sharp depreciation

After Trump is elected, his key agendas - tariffs, tax cuts, and deregulation have further fuelled US exceptionalism. And trade war 1.0 in his first term with China has led to RMB depreciation. As markets expected that Trump

Figure 34: 2s30s CGB



Source: Wind

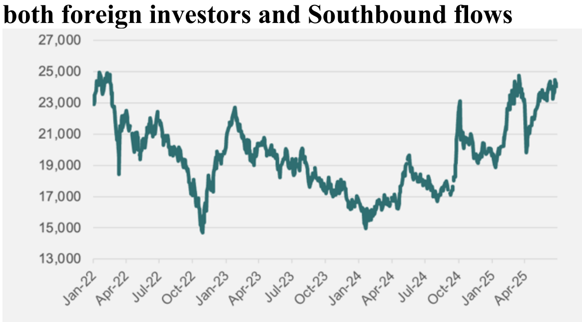
Figure 35: FR007 1Y IRS rate is coming down amid easing cycle

Source: Wind

Figure 36: 2s5s NDIRS has been inverted for a while this year

Source: Bloomberg

Figure 37: HSI performed strongly, attracting both foreign investors and Southbound flows



Source: Wind

would impose another tariffs on China due to larger trade deficits and China not fully committed to the US-China deal, RMB faced significant depreciation pressure so as to absorb the tariff shocks.

Meanwhile, as RMB depreciation typically results in a larger amount of capital outflow, China's administration is wary about rapid depreciation and hence the PBoC guided the markets through a stronger fixing and liquidity withdrawal. USDCNY was closed at 7.2988 at the end of 2024, with PBoC regarded 7.30 as a key psychological level. As such, the central bank keeps fixing largely unchanged in 7.18-7.19 region and spot capped in the range of 7.30-7.35 at the start of the year. The strong fixing also leads to a rise in the CFETSS CNY index, reaching highest level since 3Q 2023. Front-end funding remain tight with T/N traded around -4pips to -5pips. Efforts to withdraw liquidity offshore included issuing RMB60bn central bank bills in Hong Kong.

While strong bid for USD from both corporates and FIs kept CNY above 7.30, the miss of expectation that Trump would announced tariffs on China after his inauguration resulted in USDCNY moving from 7.32+ level down to around 7.24. However, dip buying supported the pair at low and markets were reluctant to chase further CNY strength. As later Trump announced 10% fentanyl tariffs on China, CNY was sold off. But his decision to delay impose on Canada and Mexico shifted the trading patterns of USD to "buy the rumours, sell the news". And hence, CNY CFETS index followed DXY to move lower after first tariff announcement. CNY is traded at around 7.25 per USD ahead of the liberation day.

Liberation day to Geneva Talk: Not really Deja-vu

54% -> 145% levies on China stand out of the other countries. The liberation day tariff sparks debate over US recession and lead to US equities sell-off, USD lower, and later UST yield spikes. While major currencies strengthen against the greenback, RMB is an exception. Post the tariff escalation, USDCNH once moved higher to 7.42, spilling over to onshore at 7.35. However, the PBoC this time did not loosen the grip on dollar fixing, as the punitive level can obviously not be offset by a currency depreciation. As such, the fixing was only released slightly above 7.20, but the central bank never let it deviate much (high: 7.2133 on 16 April).

Sharp USD weakness given foreign investors reducing exposure to US assets and repatriation from positive NIIP countries provided a relief for USDCNY higher. Despite a relatively stable dollar fixing, CFETS basket index moved lower (-4% YTD) so as to boost China's trade competitiveness against trading partners amid trade escalation with the US. Given the rates easing have been expected by the markets for long and the PBoC only delivered rate cuts shortly ahead of the Geneva talk, the RMB reaction is relatively muted. Meanwhile, corporates kept buying USD on dip and the 1Y forward points kept hovering around -2000 points.

Overall, the PBoC maintained financial stability amid volatility particularly in the stock and FX markets, while tightening interbank liquidity to help manage the pace of CNY depreciation against the dollar, as illustrated by tighter interbank liquidity with overnight repo above the OMO target at 35bps.

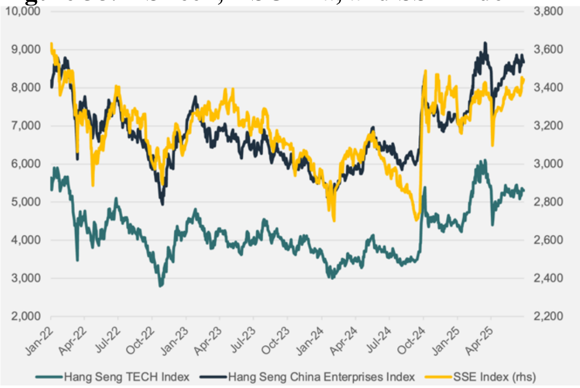
Tariff Truce: Fundamentally strengthen against USD, while weak against the basket

The USD/CNY fixing continuously grinds lower to 7.15, which is a relatively large move with the midpoint down ~300pips in June. This shows that China is willing to show a gradual RMB appreciation amid a weak USD environment. The central bank move is in a vol-dampening behaviour, and agent banks have been accumulating USD to slow RMB appreciation, while corporates have stepped up USD selling albeit the FX conversion rate still modest.

In recent week, China also relaxed outflow channels such as higher QDII quota, onshore-offshore payment connect, and doubled southbound bond connect quota to balance the inflow and promote RMB internationalization. The Q2 dividend payment will also result in FX conversion from CNH to HKD, hence RMB appreciation could only be gradual.

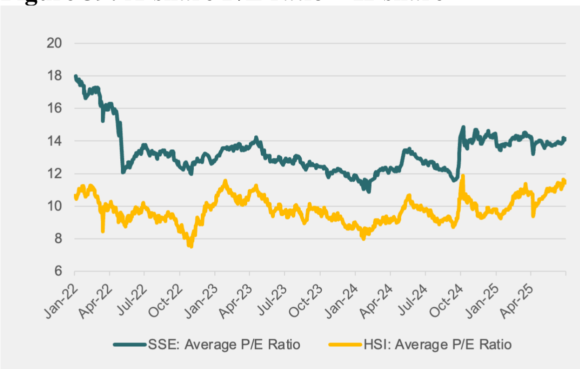
Interestingly, corporates and agent banks behaviour started to change. To hedge the USD-denominated liability, corporates generally long USDCNY forward to lock in a known CNY cost. As such, agent banks take the opposite position as short USD in the future. To hedge, banks generally enter into a S/B USDCNY swap and invest the spot leg CNY cash to generate carry. Given the soft DXY environment, corporates increased

Figure 38: HSTech, HSChina, and SSE Index



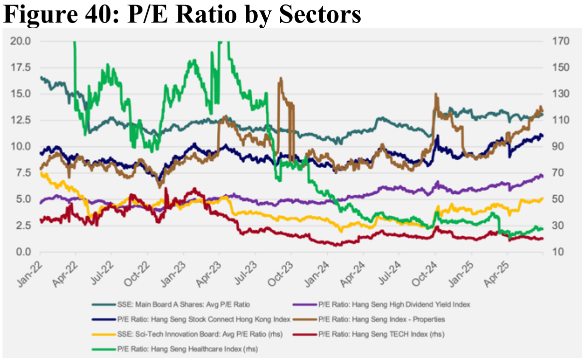
Source: Wind

Figure 39: A-share P/E ratio > H-share



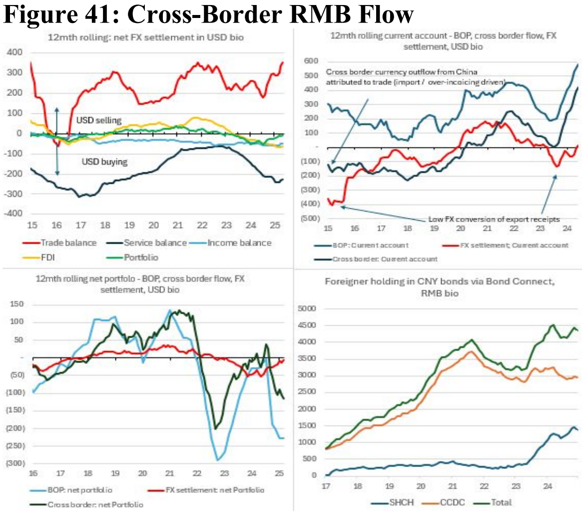
Source: Wind

Figure 40: P/E Ratio by Sectors



Source: Wind

Figure 41: Cross-Border RMB Flow



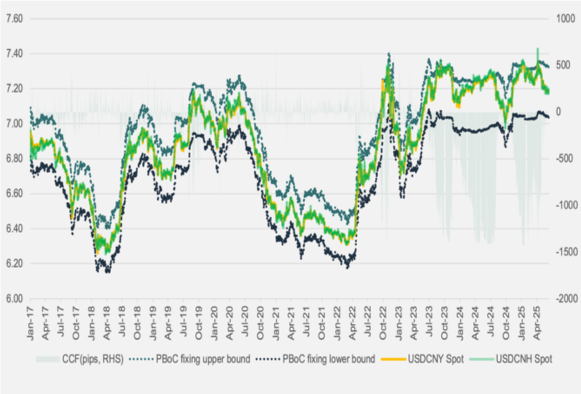
Source: Linkedin

Figure 42: Depreciation pressure challenged RMB ahead of Trump's inauguration and tariffs, but largely eased after Liberation Day

their conversion ratio and unwounded some of their long USDCNY forward position. A less negative forward points reflected the decreasing demand for dollar in the far leg, as well as optimism for the yuan to strengthen on spot. Meanwhile, amid the weak USD performance, China banks and NBFIs started to accumulate their FX reserve, and the FX deposits is now sitting at the highest since 2022.

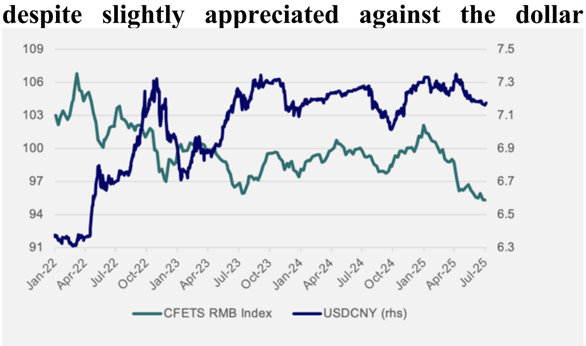
Moving forward, RMB is likely to continue to strengthen against the dollar given (a) The decent economy performance in 1H25 reduces the urgent need for the PBoC to further ease the rates to stimulus the economy, while the Fed may start to cut rates in the 2H25. As such, US-China rates differential may narrow. (b) As US assets holdings from foreigners have come down from the high, China equities have benefited from the capital reallocation supported by the improved outlook for A shares and H shares, especially in the high dividend sectors. (c) Further uptick in exporters FX conversion from their hoarding, as well as reducing dollar buy in the far leg, USDCNY could continue to move lower, with the swap point heading higher.

Still, chance for RMB sharp appreciation or depreciation is limited. Given exports are the powerhouse of China growth and keeping the RMB relatively cheap could increase the export competitiveness. Also, as US Treasury keeps a close eye on China FX manipulation, it is unlikely that the central bank allow the currency to depreciate even though the trade talks break in the second half.



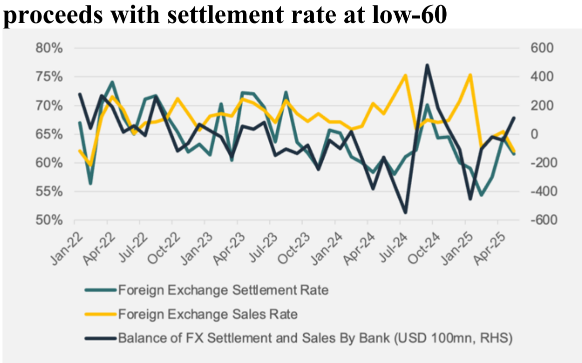
Source: CEIC

Figure 43: RMB depreciated against the basket despite slightly appreciated against the dollar



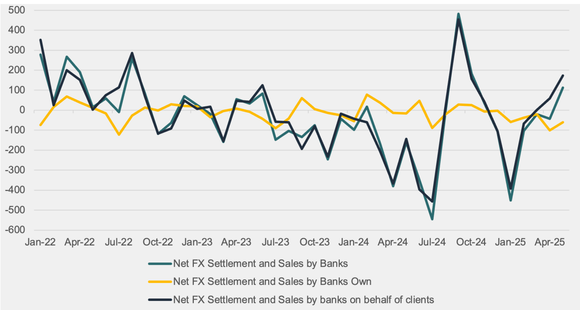
Source: CEIC

Figure 44: China entities prefer to hold FX proceeds with settlement rate at low-60



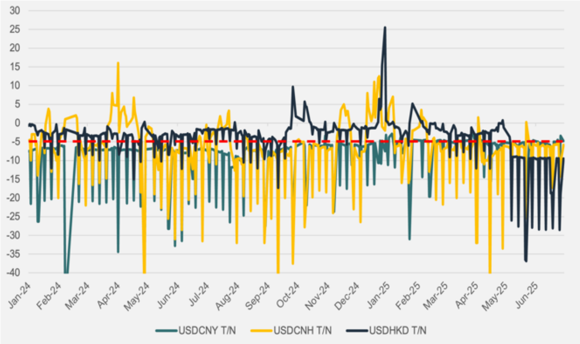
Source: Wind

Figure 45: Banks activities shift upon tariff sentiments and reactions



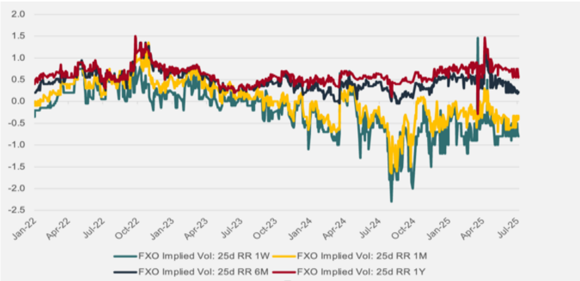
Source: Wind

Figure 46: CNH short-end liquidity is looser than CNY short-end liquidity this year



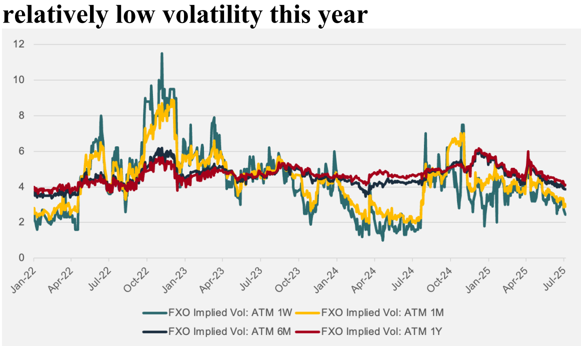
Source: Wind

Figure 47: 25dRR signals a stronger CNY against USD



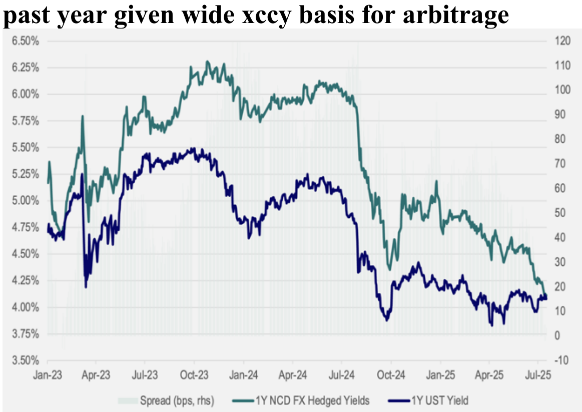
Source: Wind

Figure 48: PBoC guided CNY to trade with relatively low volatility this year



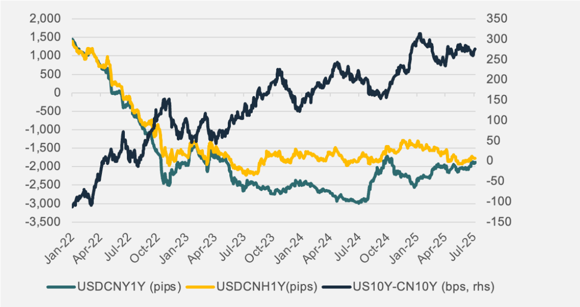
Source: Wind

Figure 49: NCD Hedged Yield is attractive in the past year given wide xccy basis for arbitrage



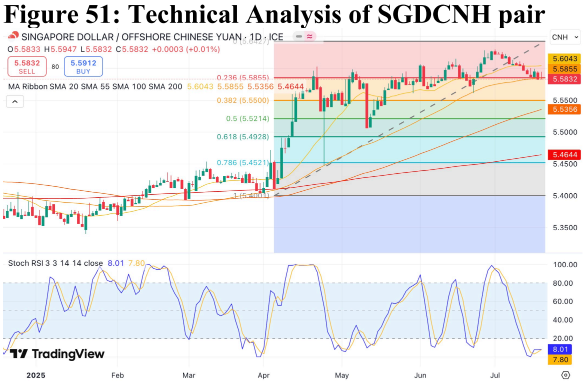
Source: Wind

Figure 50: 1Y USDCNY point is more immune to two countries rates differential



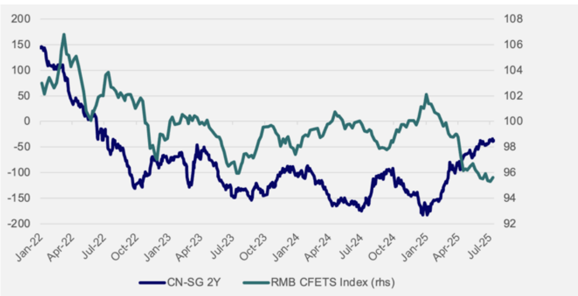
Source: Wind

Figure 51: Technical Analysis of SGDCNH pair



Source: TradingView

Figure 52: CN-SG Rates Differential



Source: CEIC

Trade Idea: Short SGDCNH

SGD has been traded on the upper bound of the policy band this year, buoyed by de-dollarization and local deposits pickup. However, RMB, the onshore trading of which also refers to a NEER model, is depreciating against the basket 5.7% YTD. This reflected that the PBoC tended to anchor CNY against USD at a gradual appreciation path. Given the DXY softness, RMB has slightly strengthened against the greenback but weakened against the basket. CNH, the offshore Yuan, reflected the overall RMB weakness and depreciated against SGD more than 4% this year. Moving forward, the MAS and the PBoC are likely to diverge their NEER management. Hence, we would like to initiate a short SGDCNH trade with a 4 months horizon.

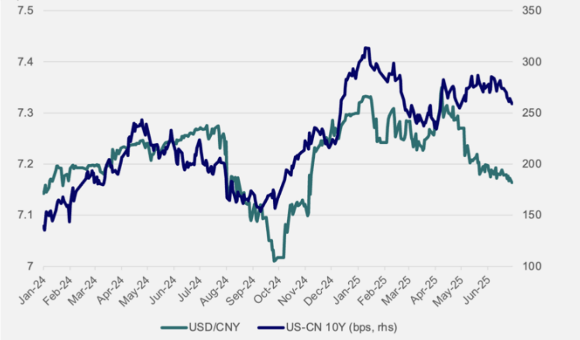
Time Horizon: Till October 2025
Entry: 5.5855
Take Profit: 5.4000
Stop Loss: 5.6427
Carry: -1.08pips/day
Reward Risk Ratio: 3.24

<u>Rationale</u>

The MAS is likely to ease the SGD NEER slope in the monetary policy meeting in 2H25. Given the inflation is cooling down (0.8% YoY in May) and concerns over imported inflation have largely eased, there is less necessity for the MAS to defend the currency with a strong NEER. Even though the MAS has delivered a reduction of the NEER slope earlier this year, capital inflows due to de-dollarization and USD holdings repatriation result in a even stronger SGD. And as such, it is traded on the upper bound of the policy band, which could lead to the MAS further loosen the slope to adjust the currency against the basket. A slightly weaker SGD could also benefit SGD exports, especially a payback of the data could arise in 2H25 after a fading of front-loading activities.

USDCNH once touched 7.40 level after Liberation Day tariff escalations. But since then, as the PBoC continued to release the dollar fixing at around 7.20 amid a broad DXY weakness, RMB has strengthened 3.6% against USD. Moving forward, even though the PBoC prefers vol-damping fixing and allows the RMB to strengthen slightly against USD continuously, there is a risk of large dollar selling given onshore FX deposits and large corporate hoarding. Besides, the RMB CFETS basket has been traded at a multi-year low and may stabilize at the 95 level, while could potentially rebound upon sharp USDCNY lower. CNH could outperform SGD if the basket NEER management differs.

Figure 53: USDCNY & US-CN 10Y Differential



Source: Wind

From a rates differential perspective, the easing expectation of China has faded a bit after a stronger than anticipated performance of the country's 1H economy (GDP +5.3% YoY). As such, NDIRS seems to find a floor and the CGB yields slightly tick up. Meanwhile, SG rates could fall in 2H25 amid domestic easing and following the spill over effect from US rates amid easing decisions by the Fed. I believe that the 2Y CGB and SG Treasury Bond yields could further narrow, making SGD assets less attractive on a relative basis to RMB assets. Plus, CNH could be favoured by a strong Southbound and foreigner appetite for the H-share markets.

Technical

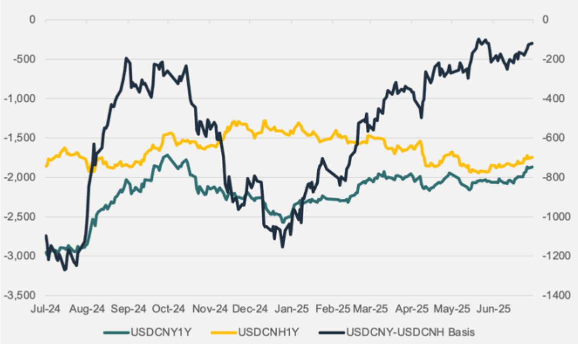
Recently, the pair has crossed the 55dma level, and the RSI at a level < 20 indicates that markets are offering the SGDCNH pair. The next support levels are 100dma and 200dma at 5.5356 and 5.4644 respectively. And the resistance levels are psychological 5.60 and recent SGDCNY fixing high at 5.6287.

Entering at the 55dma at 5.5855 (also the 0.236 level of Fibonacci Retracement) will provide more room to generate positive returns. We will cap our SL at the next Fibonacci threshold of 5.6427 and TP at 5.40. This will provide us with a risk-reward ratio of 1:3.24.

Risk

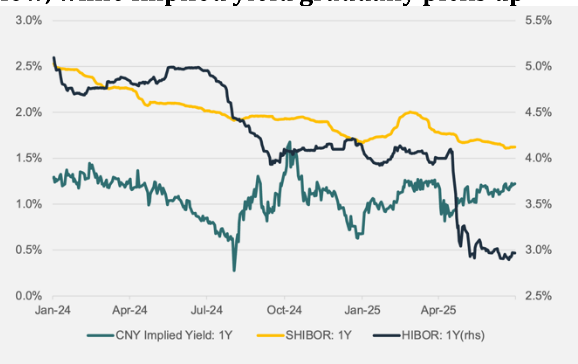
Shorting the SGDCNH pair gives a carry of -1.08pips/day, which is a bit punitive if the pair stabilize at 5.55-5.60 for a long while. Meanwhile, given the strong Q2 performance of Singapore GDP, the MAS may delay another easing of the S$NEER, which could take longer for SGDCNH to move lower.

Figure 54: USDCNY & USDCNH 1Y Swap Point



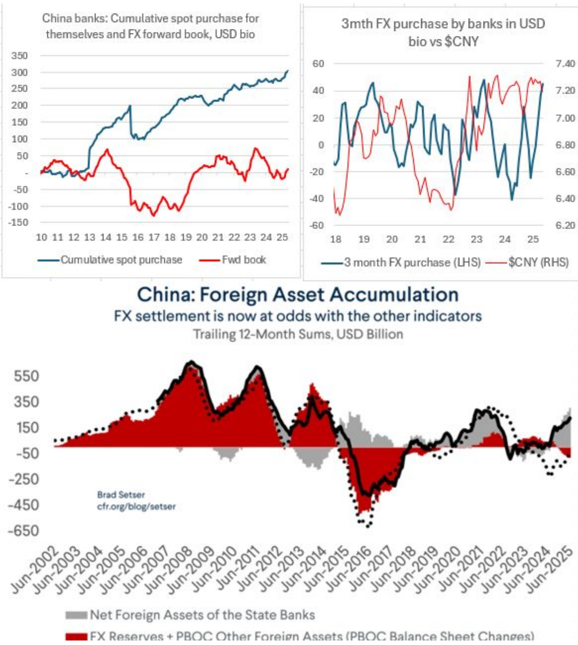
Source: Wind

Figure 55: 1Y HIBOR and HIBOR both at the low, while Implied yield gradually picks up



Source: Wind

Figure 56: State banks are unwinding their short forward book *Source: LinkedIn*



Trade Idea: Long 1Y USDCNY Swap Points

The USDCNY fixing model suggests that the counter cyclical factor plays more role when RMB faces great depreciation pressure, while the PBoC is more comfortable to see CNY gradually appreciate. As such, after the CNY recovered from the low post liberation day, the role of counter cyclical factor has been diminishing. As such, the swap point is driven more by the market dynamics as contrast to central bank/agent banks intervention. A fading seller base for USDCNY forward could result in a less negative point. As such, we would like to initiate a S/B 1Y USDCNY at -1866pips on a 6 months horizon, capturing carry by paying the points and benefiting from Fed easing skew.

Time Horizon: 6 months (till January 2026)
Entry: -1866pips
Take Profit: -1400pips
Stop Loss: -2050pips
Carry: +5.11pips/day
Reward Risk Ratio: 2.53

Rationale

1Y CNY implied yields derived from USD/CNY forwards usually sits at the low versus both on-shore SHIBOR and offshore HIBOR curves amid great CNY depreciation pressure. As the LHS corporate rollover flow, where exporters that repeatedly sell points to extend hedges has been losing carry and slowing, this removed a persistent source of downward pressure. With less fresh supply of points from hedging activities, any marginal demand for USD could push the forward discount greater.

As expectation of USDCNY path shifts to lower, dollar supply from exporters and other market participants increased. As such, agent banks (state banks) started to unwind their short USD forward books. This means that they are becoming net buyers of USD forwards, which likely makes the 12m discount shrink and points move less negative.

As the necessity for PBoC to further cut the rates eases and the Fed faces the pressure from Trump to cut rates urgently, the policy rates decision asymmetry skew to a Fed cut and narrower rates differential. The markets are pricing in at least 2 cuts till January 2026 and the lower front-end USD yields versus relatively floored CNY rates could push the covered-interest differential wider, which could be captured by long 1Y points.

Risk

- Tariff truce ends and trade relationship escalates again
- USD sustains rebound and CNY weakens (greatly) against USD
- Fed hold rates longer due to sticky inflation

Disclaimer

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Basic Information

Real GDP (USD)	838.75 B
M2 (Apr 2025, USD)	2.17 T
CPI (Apr 2025)	109.32
PPI (Apr 2025)	112.70
PMI (Apr 2025)	48.9
Currency	TWD

Chart info

Figure 1: Taiwan GDP Growth Rates, %YoY

Source: EAE, DGBAS (Mar 2025)

Figure 2: Taiwan Money Supply, %YoY

Source: EAE, CBC (Mar 2025)

Taiwan 2H25 Macro Outlook: Navigating Uncertainty Amid Structural Shifts

Executive Summary

Taiwan enters 2025 with a mixed macroeconomic picture of robust growth drivers tempered by emerging risks. The economy rebounded strongly in 2024 – real GDP expanded by 4.59% (Figure 1) on the back of surging tech exports and post-pandemic normalization. Inflation remained moderate (just over 2% last year), allowing the central bank to tighten only modestly.

As 2025 unfolds, Taiwan's story arc centers on transition: a high-tech export engine firing on all cylinders (fueled by AI and semiconductor demand) juxtaposed against external headwinds from trade protectionism and internal political constraints. The key drivers include a booming electronics sector (especially semiconductors for AI), a resilient external surplus, and gradually improving domestic demand.

Offsetting these are significant risks – notably the prospect of new U.S. tariffs ("Trump Tariffs 2.0"), geopolitical tension with China, and structural challenges like an aging population and slowing productivity growth.

Taiwan's policy landscape is also in flux: the central bank holds a cautious stance as inflation edges around 2%, while a newly elected government faces a fractious legislature that has trimmed the 2025 budget, forcing creative fiscal support measures.

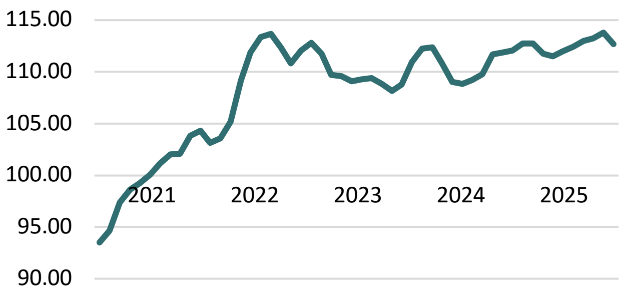
Overall, Taiwan's macro outlook for 2025 is one of cautious optimism amid uncertainty. The baseline scenario sees growth around 3% with contained inflation, underpinned by tech sector momentum and stable policies.

However, investors must remain vigilant to downside scenarios – a reignited trade war, a sharper global slowdown, or political gridlock at home could all undermine Taiwan's prospects. The following report delves into these dynamics in detail, examining how Taiwan is navigating the cross-currents of cyclical recovery and structural change.

Figure 3: Taiwan CPI and Wages, %YoY, 3mma

Source: EAE, DGBAS (Apr 2025)

Figure 4: Taiwan PPI



Source: DGBAS, Trading Economics (Apr 2025)

Figure 5: Taiwan PMI, Prices

Source: EAE, NDC (Apr 2025)

Figure 6: Taiwan Manufacturing PMI

Source: EAE, NDC, S&P Global (Apr 2025)

Policy Landscape

Monetary Policy

Taiwan's central bank (CBC) has adopted a **steady and cautious monetary stance** in the face of lingering inflation and external uncertainties. In March 2025, the CBC left its benchmark **discount rate at 2.00%** – its fourth consecutive hold – after a gradual tightening cycle that brought rates to a 15-year high. Policymakers signaled a desire to **observe the impact of U.S. tariff actions** and other global factors before making further moves. This approach aligns with regional peers: unlike the U.S. Federal Reserve's sharp hikes, Taiwan's hikes were modest and have paused as inflation here is lower and more stable. **Consumer price inflation** was **2.12%** (Figure 3) in Jan–Feb and ticked up to ~2.3% in March – near the central bank's implicit 2% comfort zone.

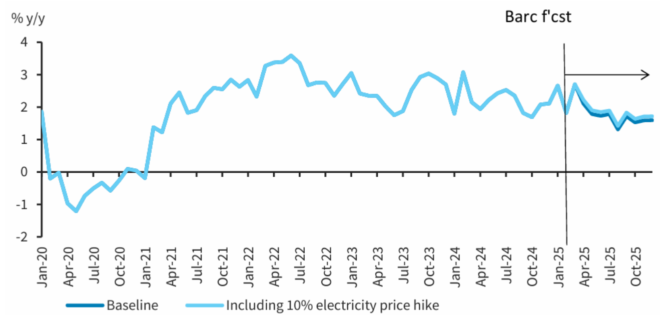
Taiwan's central bank (CBC) has shifted from its 2024 "insurance" hike to a wait-and-see stance. After lifting the benchmark discount rate 12.5 bp to 2.00 % in March 2024—a move explicitly linked to **TaiPower's steep electricity-tariff increase** of **3 % for households** and **15-25 % for large industrial users**—the CBC has held that rate at each of the last four meetings. The rationale changed this year: a second tariff hike was proposed for March 2025, but the **Ministry of Economic Affairs froze electricity prices for H1 2025** to cushion households and industry, while it seeks extra subsidies for loss-making TaiPower. With that inflation risk deferred (Figure 7), the Board on **20 March 2025 kept the discount rate at 2.00 %** (Figure 8), citing still-benign CPI (1.9 % y/y in February) and uncertainty over U.S. tariff policy.

Governor **Yang Chin-long** has emphasized that taming inflation is the "first priority" and that rate cuts won't be considered unless CPI dips below 1.5%. With inflation not yet that low, and in fact slightly above target, the bank stands ready to tighten if needed (especially with a possible **utility rate hike** later in 2025 that could stoke prices). At the March meeting, however, the CBC judged that inflation is **"under control"** and left policy unchanged. Taiwan's monetary authorities are also managing financial stability through macroprudential tools. Notably, they refrained from new **selective credit controls** on real estate in early 2025, pointing to the success of previous rounds (the seventh round in late 2024) in cooling the housing market. In summary, **Taiwan's monetary policy** remains slightly hawkish by its own historical standards but dovish relative to global trends – balancing the need to anchor inflation expectations with support for growth amid global uncertainty.

Fiscal Policy

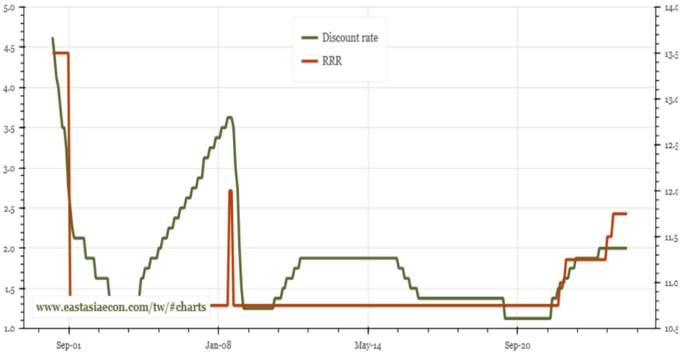
Taiwan's fiscal landscape in 2025 is marked by **political contention and innovative support measures**. The year began with a tug-of-war over the central government budget: the opposition-controlled Legislative Yuan approved the **2025 budget with significant cuts (about 7%)**, reducing operating expenditures and public investment. This paring back, amounting to over **NT$39 billion in cuts**, is estimated to shave **0.15–0.3 percentage points** off GDP growth, prompting warnings that growth could slip below 3% if funds remain frozen. President Lai's government initially sought to reverse these cuts, but by March 2025 the legislature upheld its version of the budget, cementing the spending reductions. This

Figure 7: Electricity Tariff Hike Likely Pose Marginal Upside to the CPI Inflation



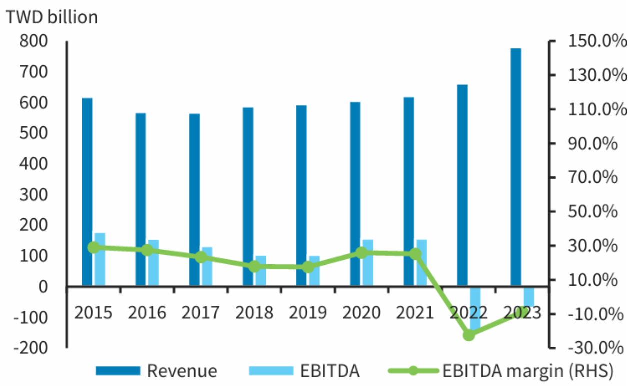
Source: DGBAS, Barclays Research Estimates

Figure 8: Taiwan Policy Rates



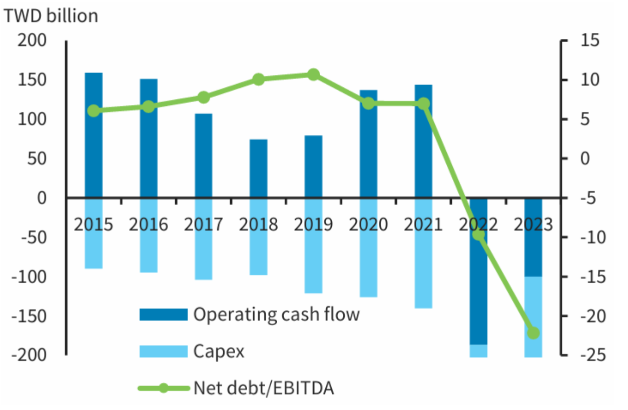
Source: EAE, CBC (May 2025)

Figure 9: Taipower Reported Negative EBITDA Margins Since 2022



Source: Barclays Company Data, Barclays Research

Figure 10: Together with Worsening Cash Flow and Rising Net Debt/ EBITDA Coverage



Source: Barclays Company Data, Barclays Research

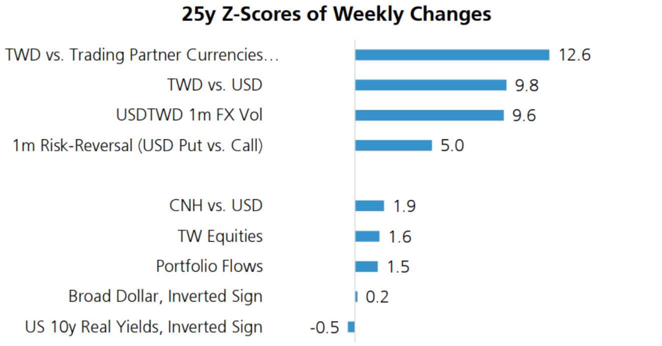
divided government dynamic – with the ruling party lacking a legislative majority – has made fiscal expansion challenging. Nonetheless, the administration has pursued **alternative fiscal tools** to support the economy and address pressing needs. In April 2025, the Executive Yuan approved a **special budget of NT$410 billion (US$12.6 billion)** spread over 2025–2027 to bolster economic and national security resilience. This special package, officially dubbed the *"Strengthening Economic, Social, and National Security Resilience"* act, effectively circumvents the regular budget constraints. Key allocations include **NT$93 billion** in economic support (up from an initial NT$88 bn) aimed at cushioning the impact of U.S. tariff shocks on Taiwanese industries, and **NT$100 billion** to bail out the state-run power utility **Taipower**. Taipower had accumulated massive losses (over NT$420 bn by end-2024) due to soaring fuel costs and a political freeze on electricity rate hikes (Figure 9 and 10). By injecting funds into Taipower, the government hopes to **stabilize consumer prices** and avoid hiking household utility bills – a move that protects consumers from inflation. The special budget also earmarks **NT$150 billion for defense and security**, such as strengthening Coast Guard capabilities, UAV infrastructure, and cybersecurity, reflecting rising geopolitical risks. Importantly, this extra spending will draw on past fiscal surpluses and, if needed, new borrowing, all outside the normal budget cap.

Politically, Taiwan's **fiscal policy in 2025** is a story of constraint and creativity. The KMT opposition, controlling a plurality of legislative seats, has pushed for more funds to local governments and resisted some central spending, even at the cost of delaying civil servant pay raises (a 3% public sector wage hike due in early 2025 was delayed until May). There are even proposals to drastically increase revenue sharing to local counties (from 25% to 40% of revenues), which if enacted could create a **"potential fiscal crisis"** by limiting central resources for defense and social programs. Against this backdrop, the DPP government under Lai is striving to maintain momentum in priority areas (digital infrastructure, defense, social welfare) via special legislation and by lobbying to un-freeze parts of the budget. Taiwan's **public debt**, meanwhile, remains low (around 25% of GDP) and the fiscal balance was near surplus in recent years, giving some buffer. But the current partisan gridlock tests Taiwan's ability to deploy that fiscal space efficiently. The **2025 fiscal stance** thus ends up somewhat mixed: the general budget is contractionary due to cuts, yet the special budget and other one-off measures add a layer of stimulus. How these countervailing forces play out will influence Taiwan's growth path in 2025, especially if external conditions worsen and a stronger fiscal hand is needed.

FX Policy

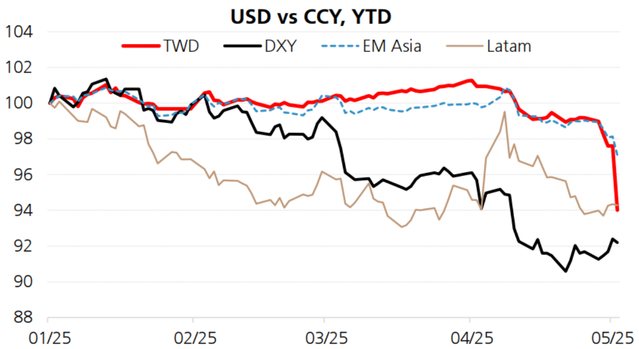
Taiwan's central bank (CBC) appears to be recalibrating its FX policy in light of this structural shift. Historically, the CBC has been an active – if often opaque – participant in the FX market, smoothing excess volatility and leaning against TWD strength. In fact, Taiwan has long been on the U.S. Treasury's FX Monitoring List for its tendencies toward intervention and large reserves accumulation. Much of this intervention has occurred through indirect means or "**shadow FX**" operations: rather than constant spot market selling of TWD, the CBC has provided USD liquidity to banks via swaps, enabling life insurers and others to hedge without driving the spot TWD much higher. This mechanism effectively recycles Taiwan's persistent current account

Figure 11: TWD's 2nd May Move Vis-à-vis Its Conventional Drivers



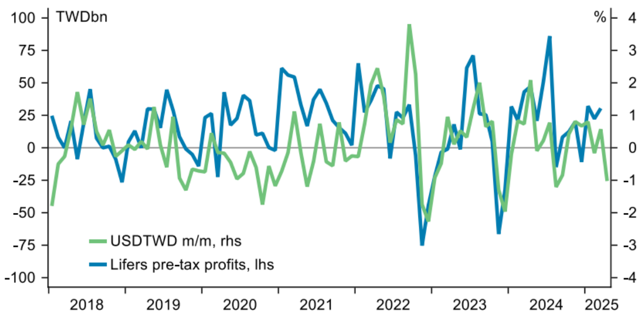
Source: UBS, Bloomberg

Figure 12: TWD's 2nd May Move Vis-à-vis Global FX



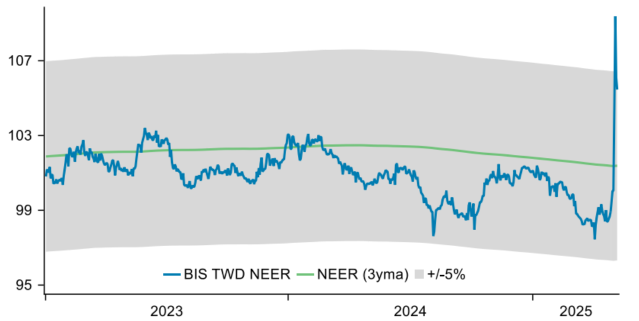
Source: UBS, Bloomberg

Figure 13: Lifers' Earnings are Heavily Affected by FX Movement



Source: Bloomberg, Macrobond, BNP Paribas

Figure 14: TWD NEER Has Reached the Upper Band



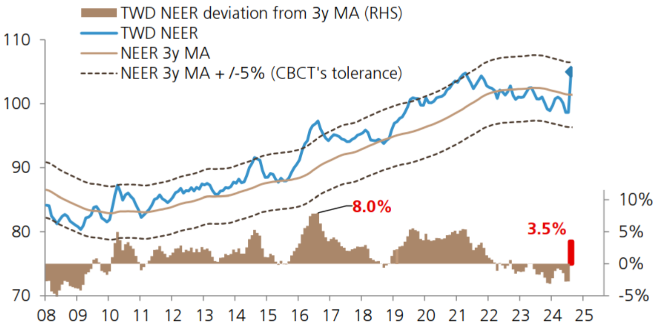
Source: Bloomberg, Macrobond, BNP Paribas

surplus – the CBC absorbs TWD liquidity and supplies USD to the market (often off-balance-sheet), masking the true scale of intervention. It's a strategy that kept the TWD relatively stable in past years despite huge external surpluses. **However, early May's events suggest a subtle but important policy shift.** The CBC did *not* step in with heavy-handed intervention at the first sign of TWD's surge – a break from past form. Only after TWD's rapid 5% jump (and likely once the exchange rate neared the stronger end of policymakers' comfort zone) did the central bank reportedly intervene late in the day to slow the move. By allowing an initial step-change in the currency, the CBC signaled a tolerance for a stronger TWD **equilibrium** than before (Figure 11).

Several factors are guiding this recalibration. **Trade and geopolitical considerations** play a role: with the island's sizeable trade surplus and political pressure from the U.S. (which views Taiwan's currency practices with scrutiny), the CBC may have calculated that a one-off revaluation would ease external pressure. Indeed, speculation swirled that authorities were implicitly permitting TWD strength to bolster goodwill in trade talks. While officials publicly refuted any quid pro quo on FX policy, the optics of Taiwan actively *weakening* its currency in the midst of U.S. negotiations would be poor. Thus, maintaining a **stronger TWD bias** in early 2025 aligns with broader policy diplomacy. Relatedly, Taiwan's leadership has floated structural solutions to manage its surplus: for example, establishing a sovereign wealth fund to invest excess reserves abroad has been discussed. Such a fund would reduce the need for ongoing stealth intervention by channeling inflows into external assets more transparently. In essence, the **policy stance is shifting from short-term cyclical management to long-term structural adjustment** – an acknowledgment that the old playbook (endless intervention and reserve buildup) faces both international political limits and domestic financial risks.

Domestic financial stability is the other key motivator. The CBC and Financial Supervisory Commission (FSC) are acutely aware that unchecked TWD appreciation can stress local institutions – especially the life insurers – but they also recognize that *perpetually suppressing* TWD strength has encouraged those institutions to take on excessive FX risk. Regulators have had to repeatedly loosen rules in recent years to help insurers cope with losses from rising hedging costs and bond yield changes. The early May shock effectively issued a wake-up call (Figure 12). In its aftermath, authorities convened emergency meetings with major insurers to assess FX risk and emphasize prudent hedging strategies. The **official stance now implicitly encourages higher hedge ratios** among institutions to reduce systemic vulnerability – even if that means a stronger TWD in the process. In fact, the CBC's prior willingness to be the ultimate hedge provider at cheap rates gave insurers little incentive to fully hedge. That mindset is now changing: the CBC is likely to be more selective with its swap lines and may price them less generously, nudging lifers to internalize more FX risk management (Figure 13). By the same token, should lifers and banks rush en masse to hedge (and thereby short USD/TWD), the CBC may still step in to prevent a disorderly spiral – but such smoothing will aim to *tame volatility*, not reverse the strengthening trend. We expect **FX volatility to remain elevated** relative to the pre-2025 regime, as the central bank allows the TWD to find a stronger equilibrium and only intervenes to

Figure 15: ON CBCT's Preferred Metric of Overshoots, TWD Still Has 2% Upside – Before the Policy Smoothening Steps-Up Harder



Source: UBS, Bloomberg, UBS Neo T-Pricer

prevent overshooting. Notably, the TWD Nominal Effective Exchange Rate (NEER) is still within ±5% of its 3-year moving average – a range the CBC has informally tolerated (Figure 14). As TWD approaches the **stronger end** of that band (we estimate another ~2% appreciation from current levels), the CBC's smoothing efforts may intensify (Figure 15). But until then, policy is set to accommodate a gently firmer currency. This was echoed by officials emphasizing that April's TWD decline has been fully unwound, and the currency's value is not misaligned from trade fundamentals (a subtle nod that they see no need for panic).

On the interest rate front, the **policy stance remains neutral to slightly dovish** in light of currency strength. With the TWD doing some of the heavy lifting in tightening financial conditions (by making imports cheaper and potentially cooling export growth), the CBC has less urgency to hike rates. Taiwan's inflation has been benign, and a stronger TWD helps keep import prices in check. We anticipate the CBC will keep its policy rate steady near-term, focusing instead on liquidity tools and *targeted measures* to manage capital flows. For example, it can adjust NDF pricing or use moral suasion on banks regarding forward positions, rather than blunt rate changes. Capital flow regulations might also be fine-tuned: authorities could, say, ease rules on capital outflows (to let some steam off TWD pressure via overseas investment) or conversely tighten limits on speculative inflows, depending on conditions. **Capital flow dynamics have indeed shifted:** the post-rally environment has seen continued **repatriation by retail investors** (who are cashing out foreign bond funds amidst U.S. stagflation fears) and likely more onshore USD-to-TWD conversions by firms. This puts upward pressure on the TWD independent of interest differentials. The CBC's challenge is to accommodate these flows without destabilizing expectations. So far, the strategy appears to be: accept a stronger currency as the new baseline, reassure markets that **excess volatility will be managed**, and quietly prepare for a more flexible intervention regime. If needed, the central bank can still tap its enormous reserves (~US$550bn official, plus additional via swaps) to smooth extremes, but the **bias** is now towards **allowing a gradual TWD appreciation** rather than resisting it outright. In summary, Taiwan's policy stance has shifted to **acknowledge the new FX regime** – one of a structurally stronger TWD buttressed by higher domestic hedging – and policy tools are being realigned accordingly, from exploring a sovereign wealth fund to recalibrating intervention tactics and guiding institutional behavior. The era of one-way TWD weakness is over; henceforth, policy will seek a balance between supporting the new equilibrium and curbing excesses, rather than capping the currency at an artificially weak level.

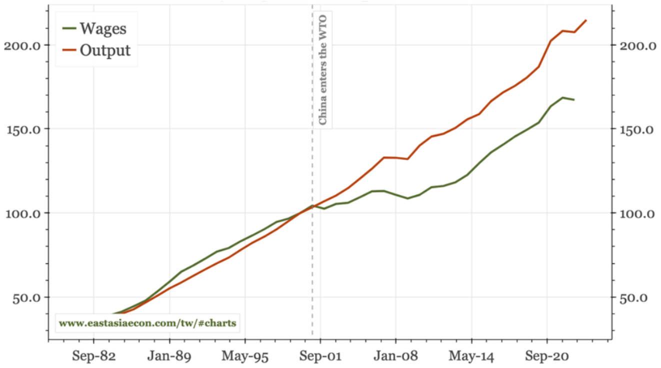
Price Stability and Inflation

Inflation in Taiwan has been relatively well-behaved compared to global highs, but it is navigating a turning point as we move through 2025. In 2024, inflation averaged about **2.2%** – above the historical norm but modest in international comparison. Price pressures last year were driven by supply factors like commodity costs and pandemic-era stimulus, but they began easing by late 2024. Indeed, core inflation (excluding food & energy) decelerated to **1.88%** by year-end 2024. Coming into 2025, Taiwan initially saw a **temporary uptick**: headline CPI rose **2.12% YoY in Jan–Feb** and reached about

2.3% in March 2025, a seven-month high. This bump was largely due to a **spike in food prices** (e.g. pricier imports and weather effects on crops) and expectations of administrative price increases. Even at ~2.3%, inflation slightly exceeded the central bank's 2% alert line, catching policymakers' attention. However, underlying trends suggest inflation will **moderate as 2025 progresses**. The **CBC projects CPI inflation at 1.89% for 2025** (core CPI ~1.79%), down from 2.18% in 2024. Several factors support this outlook: global commodity prices (notably oil) are forecast to soften, and there is a steady (if slow) dissipation of pandemic-era price stickiness in services. Moreover, Taiwan's currency has stabilized, which helps contain import prices.

Domestic cost factors are a wildcard. **Wage dynamics** (Figure 16) and regulated prices are exerting some upward pull on inflation, even as external pressures fade. In 2025, both the minimum wage and public sector salaries saw increases, which boosts household incomes but could also feed into services inflation over time. Additionally, Taiwan introduced *carbon fees* and other green taxes that add a marginal cost to businesses. The government has been cautious with utilities and transport fares – politically sensitive items. It postponed any **electricity rate hike for the first half of 2025**, opting instead to subsidize Taipower to keep power tariffs unchanged. Nonetheless, some adjustments are occurring: for instance, the state railway company will raise train fares in June 2025 (the first hike in 30 years) by an average **26.8%**. While such hikes are one-off, they will nudge headline CPI upward. The central bank estimates that if planned increases in utilities (water, electricity, transport) are factored in, **2025 CPI could end up around 2.0%** – only slightly higher – with core inflation still below last year's level.

Figure 16: Taiwan Output per Hour Compared to Wages per Hour in Real Terms



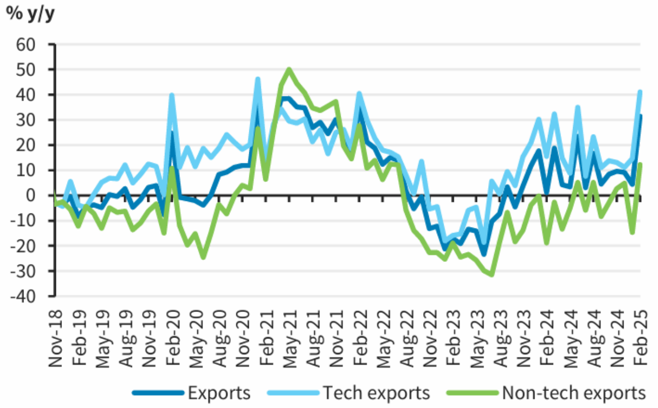
Source: Source EAE, DGBAS (Jan 2023)

Crucially, **inflation expectations remain anchored**. Surveys indicate that the public expects only mild increases in prices, and the central bank has communicated vigilance. Governor Yang has stated there are "no conditions" for monetary easing now given inflation risks. Instead, if inflation were to surprise on the upside (say due to an oil price spike or larger utility adjustments in H2), the CBC could consider a rate hike from 2% to tamp down demand. For now, though, the base case is **gradual disinflation**: core price growth drifting lower as supply chain issues resolve and comparative base effects kick in. By Q4 2025, inflation is expected to be comfortably back in the **1-2%** range, aligning with regional peers (South Korea, Singapore) who are also seeing price pressures ease. Taiwan's ability to maintain **price stability** is a key strength – it supports consumer spending and gives monetary policy flexibility. In summary, while consumers are facing **higher living costs** in certain categories (food, energy, housing), the overall inflation outlook for 2025 is **benign**. Headline CPI will likely hover near 2%, and core inflation even lower, indicating that Taiwan is navigating the global inflation cycle better than many, albeit with an assist from prudent fiscal measures (like energy subsidies) and the strong TWD earlier damping import costs.

External Sector

Taiwan's external sector – encompassing trade and balance of payments – remains a cornerstone of its economy, characterized by persistent surpluses and tech-driven dynamics (Figure 17). Exports staged an impressive rebound in 2024, defying a weak global environment. Export orders rose for ten consecutive months through

Figure 17: Tech Outperformance Drove Exports Surge

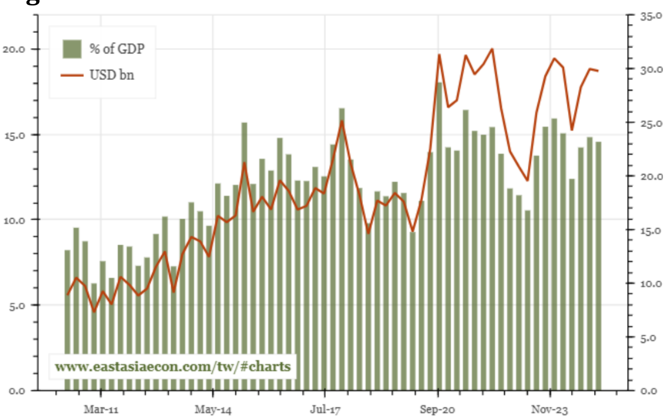


Source: Haver Analytics, Barclays Research Estimates

Figure 18: Taiwan Industrial Production Index

Source: EAE, MOEA (Mar 2025)

Figure 19: Taiwan Current Account Balance



Source: EAE, CBC (Mar 2025)

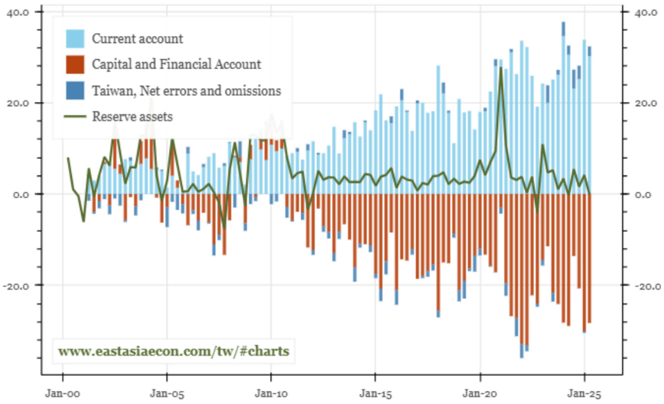
December 2024, and by year-end Taiwan had reversed two years of contraction to post a +5.1% annual increase in export orders (US$589.5 billion). This resurgence was powered by strong demand for semiconductors and electronics. Orders of electronics jumped over 33% YoY in late 2024 amid "emerging technology applications" – essentially the worldwide build-out of AI, 5G, and cloud computing spurring chip and ICT exports. High-performance tech segments like optical equipment and machinery also saw double-digit growth thanks to inventory restocking and capital spending on new tech capacity. Traditional sectors (chemicals, metals) lagged or declined, reflecting cheaper competition abroad, but they form a smaller share of Taiwan's trade.

Entering 2025, Taiwan's export momentum has largely carried forward. In Q1 2025, many tech manufacturers reported better-than-seasonal sales. One interesting factor was a wave of rush orders ahead of anticipated tariffs – foreign customers expedited purchases from Taiwan in Q1 to get ahead of any new U.S. import taxes. This front-loading enabled Taiwan's exports and industrial output to outperform normal seasonal patterns in early 2025. For example, industrial production in April 2025 surged +22.3% YoY to a record high, marking 14 straight months of growth (Figure 18). Officials noted that besides robust AI demand, the U.S. tariff 90-day pause led clients to advance orders, boosting output temporarily. Consequently, Taiwan's trade surplus has remained sizable. Although a flurry of imports for restocking meant import growth outpaced export growth in late 2024 (slightly narrowing the goods trade surplus in Q4), Taiwan still recorded a massive current account surplus of US$113.8 billion in 2024. This surplus is roughly 13–15% of GDP, one of the highest in the world (Figure 19). It is underpinned by the trade surplus in goods and substantial primary income inflows (profits and investment income from abroad), which in Q4 2024 rose by US$3.6 bn YoY as Taiwanese firms earned more on their overseas investments.

On the balance of payments front (Figure 20), a striking feature is how Taiwan recycles (Figure 23) these surpluses via capital outflows:

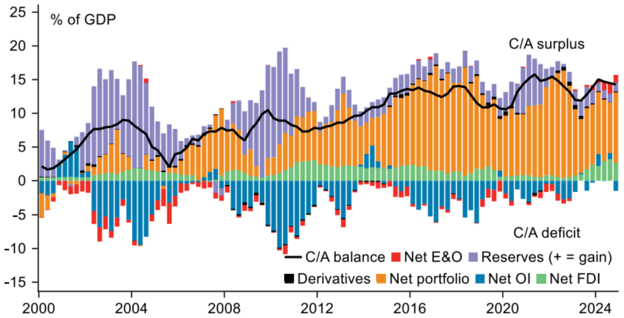
- **Life insurers and public pension funds remain the dominant buyers of foreign assets.** By end-2024 life-insurer overseas portfolios (Figure 21) reached **US $750 bn** (≈140 % of GDP), heavily skewed to USD IG bonds and U.S. agency MBS; the Public Service Pension Fund and Labor Funds together added another **US $215 bn** in offshore mandates. Net of new premium income these institutions channelled roughly **US $17 bn/quarter** into foreign securities through 2024, the single biggest item in the financial account.
- **TSMC's outward direct investment (ODI) set fresh records.** The chipmaker's multi-fab programme (US $40 bn+ in Arizona; ~US $21 bn second plant in Kumamoto; smaller lines in Dresden and Singapore) drove Taiwan's **2024 ODI to an all-time high of US $44.9 bn**, far eclipsing inbound FDI. In Q4 alone net ODI ran **US $7 bn**, dwarfing the <US $1 bn equity inflow from new green-field projects at home.
- **Foreign investors are taking chips off the table.** After a stellar 2024, the TAIEX now trades at **~23× forward**

Figure 20: Taiwan Balance of Payments, USD bn



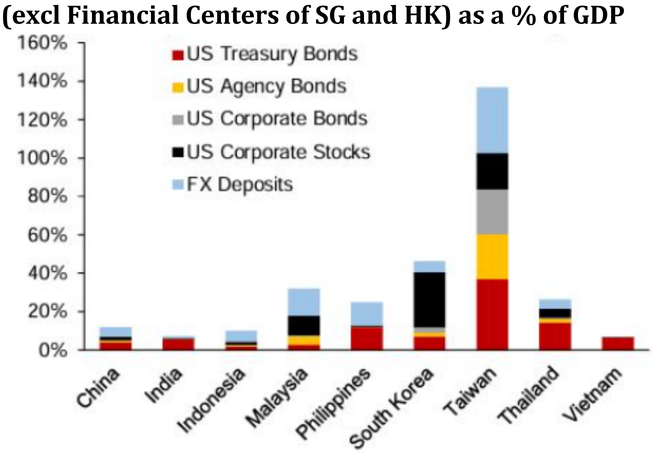
Source: EAE, CBC (Jun 2025)

Figure 21: Taiwan Currently Recycles its C/A Surplus with Outbound Portfolio Investment



Source: Macrobond, BNP Paribas

Figure 22: Asia Holdings of US Assets and FX Deposits (excl Financial Centers of SG and HK) as a % of GDP



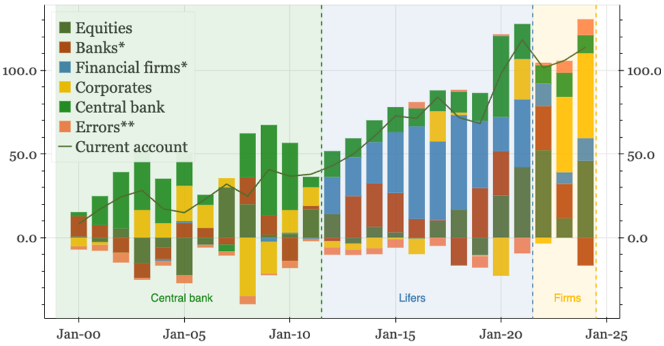
Source: Bloomberg, US TIC, MUFG GMR

earnings versus Korea's KOSPI at ~10× (Figure 24); global funds booked profits, leading to **US $6.6 bn net equity outflow in Q4** and a further ≈US $3 bn in January–February 2025. The selling was concentrated in mega-cap tech where valuations screen rich relative to regional peers. Thus in **Q4 2024** the financial account recorded a **US $30.7 bn net asset acquisition** (capital out-flow). Residents' portfolio out-flows (US $18.5 bn) and ODI (US $7 bn) easily outweighed the modest reserve increase (US $2.4 bn) and more than offset the foreign equity out-flow. The same pattern persisted in Q1 2025. **Net result:** despite a current-account surplus still near **14 % of GDP**, the overall balance of payments stays close to flat. Official reserves rose only **US $10.9 bn in calendar-2024** to **US $573 bn**, and the CBC's swap book even shrank slightly as insurers sourced USD directly in the market.

Taiwan's export sector faces a major headwind from a newly enacted 32% **reciprocal U.S. tariff** on Taiwanese goods, imposed under the Trump administration's trade framework in mid-2025. This steep tariff, justified by Washington as a response to "unbalanced" trade, squarely targets Taiwan given its large surpluses – Taiwan ran a **US$73.9** billion goods trade surplus with the U.S. in 2024 (the **6th-largest** bilateral deficit for America). Crucially, the duties are aimed at **high-value tech exports**: U.S. imports of Taiwanese computers, electronics components and integrated circuits (which together made up roughly half of Taiwan's U.S.-bound exports last year) now face the punitive 32% levy. *(Notably, semiconductors have been exempted from these tariffs to protect U.S. supply chains, but this carve-out offers only limited relief since related ICT products remain affected.)* As a result, Taiwan's export growth to the U.S. is expected to **slow sharply** – economists estimate the tariff could directly subtract anywhere from **1.2 to 2.5 percentage points** from Taiwan's GDP over the coming year. In other words, **2025 GDP growth** could dip closer to ~2% (down from ~3% pre-tariff forecasts) if the full tariffs hit export volumes. On a positive note, analysts believe Taiwan's **advanced tech sector** may prove relatively resilient despite the tariffs, since many rival exporters are also facing U.S. duties and few substitutes exist for Taiwan's high-end chips and ICT products.

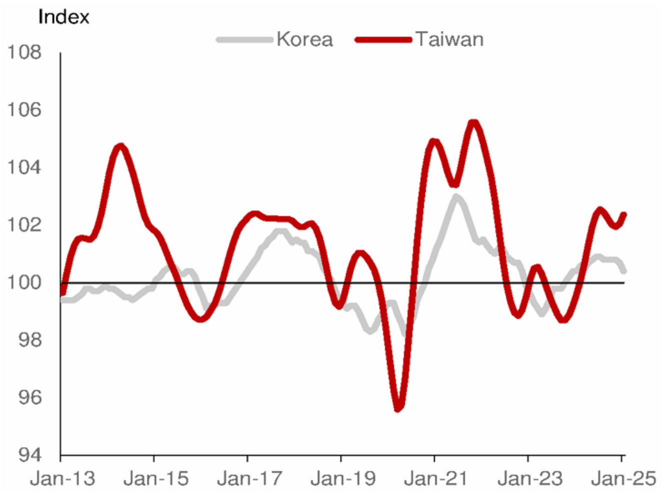
Taiwan is responding to these trade challenges by **adapting and diversifying** its external strategies. Large Taiwanese manufacturers are ramping up **outward direct investment (ODI)** into the U.S. – exemplified by massive new U.S. semiconductor fabs (e.g. TSMC's additional US$100+ billion Arizona investment) and expanded projects in electronics and petrochemicals – in hopes of mitigating friction and securing goodwill. At the same time, firms are accelerating expansion across **Southeast Asia**: roughly **40% of new Taiwanese overseas investment** now flows to ASEAN destinations, as companies seek to develop alternative production bases and markets. Some exporters are even exploring **trade rerouting** options – for instance, shifting final assembly to third countries or using transhipment – to circumvent U.S. tariffs, although authorities are clamping down on illicit country-of-origin loopholes. Despite these adjustments, Taiwan's **external balances remain robust**. The country continues to run a **large current account surplus** (near multi-year highs at ~16% of GDP as of late 2024), reflecting its strong export earnings and global competitiveness. Paradoxically, this very external strength – persistent surpluses and a competitive tech

Figure 23: Taiwan, Recycling of the Current Account, Main Drivers, USD bn



**Net purchases of debt securities and instruments*
***Including derivatives*
Source: EAE, CBC (Jan 2024)

Figure 24: Leading Composite Indexes



Source: CEIC and Nomura Global Economics

Figure 25: Taiwan Semiconductor Production Value, %YoY

Source: EAE, MOEA (Feb 2025)

export base – is what put Taiwan in Washington's crosshairs. While near-term export performance will undoubtedly be dented by the tariff shock, Taiwan's **fundamental resilience** (a diversified manufacturing base, high-tech dominance, and ample external buffers) should help cushion the impact and reassure institutional investors over its longer-term stability.

Sectoral Perspectives

Manufacturing and Electronics

Taiwan's manufacturing sector – particularly electronics and semiconductors – is the powerhouse of its economy, and it is experiencing a renewed boom. Demand stemming from the AI revolution and digital transformation has given Taiwanese tech production a significant lift. As noted, industrial output of electronic components was up 36.5% YoY in April 2025, and semiconductor production jumped +44.4% YoY to record highs (Figure 25). This growth streak extends back into 2024, which saw steady demand for "AI-enabled" devices – smartphones, PCs, data center hardware – and for chips powering AI and cloud services. Taiwan, being home to TSMC and a comprehensive semiconductor supply chain, has capitalized on this trend. TSMC, the world's largest contract chipmaker, projects stellar performance: it expects 2025 revenue to grow in the 20–30% range and has been beating profit estimates (Q1 2025 net profit +60% YoY). A major driver is Nvidia's orders for AI GPUs and other clients' high-performance computing chips – so much so that TSMC's CEO characterized AI demand as "extremely robust" throughout 2024/25. AI-related business now makes up about 15% of TSMC's revenue (2024) and is on track for 20% in 2025, becoming a key growth engine alongside the gradual recovery in smartphone chip orders. This diversification of end-demand (from exclusively consumer electronics toward AI, automotive, etc.) is fortifying Taiwan's manufacturing outlook.

Manufacturers are also investing aggressively to stay ahead. TSMC, for example, is maintaining an enormous capital expenditure budget of $38–42 billion in 2025, same as the prior year. It is pushing into next-generation 2nm process technology, with mass production starting – albeit with high initial costs – and expanding capacity for advanced chip packaging (CoWoS, chiplets) which is crucial for AI chips. Other semiconductor firms (UMC, MediaTek) and electronics assemblers (Hon Hai/Foxconn) are likewise upping investments in new tech and capacity. There is a notable trend of capacity expansion overseas as well. TSMC's high-profile fabs in Arizona are underway, and by the late 2020s about 30% of TSMC's cutting-edge 2nm capacity will be in the U.S. – a remarkable shift for a company that historically kept almost all production in Taiwan. TSMC's total planned U.S. investment has swollen to $165 billion (with an additional $100 bn announced alongside President Trump in early 2025). Similarly, major tech hardware firms are building plants in Japan (TSMC's Kumamoto fab with Sony), in Europe, and across Southeast Asia (discussed further below) to diversify supply chains. While these moves are partly driven by geopolitical strategy (ally-shoring), they also reflect how Taiwanese manufacturing is adapting to structural shifts – moving labor-intensive processes abroad and focusing domestic production on R&D and highest-value stages.

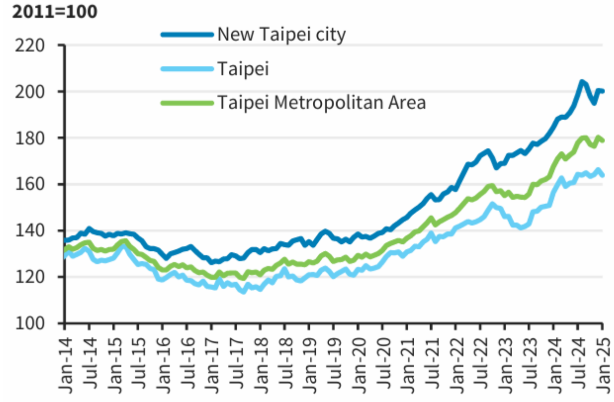
Despite these expansions, Taiwan's manufacturing faces challenges. The global electronics cycle is notoriously volatile; after the strong upswing in 2021, a downturn hit in 2022–early 2023 (with excess inventories in PCs/phones). The current upswing is narrower, led by AI and automotive demand, while some segments like consumer electronics are only in early recovery. For instance, Foxconn (Hon Hai), the big contract electronics assembler, saw profits miss forecasts in 2024 as smartphone demand remained soft. There's also intensifying competition: Samsung and Intel are vying in advanced logic chips (though still behind TSMC by at least a year in 2nm race), and Chinese foundries are trying to catch up (SMIC reportedly producing 7nm-class chips despite sanctions). Moreover, Trump's tariff threats include a mention of tariffs on semiconductors – a somewhat puzzling idea given many chips are not directly imported to the U.S. but could imply tariffs on devices containing Taiwanese chips. If realized, that could disrupt Taiwan's electronics exports. TSMC's leadership has so far downplayed immediate impacts, saying customers haven't changed behavior yet and that any tariff discussion "is between countries" – keeping TSMC publicly neutral. Still, such policies introduce uncertainty for long-term investment planning. The industry is also grappling with talent and resource constraints: a shortage of skilled engineers and tight electricity supply at home. Companies like Nvidia have even suggested Taiwan use more AI and robotics to alleviate labor shortages in manufacturing.

In sum, Taiwan's manufacturing and electronics sector in 2025 is a study in strength and adaptation. The near-term outlook is bright – order books are strong, new technologies (AI, EVs) are providing fresh growth avenues, and private investment is forecast to rise over 6%. Government support for "national champion" industries remains robust (with initiatives in AI, 5G, biotech, etc.). But the sector is also in a strategic transition, expanding globally and bracing for external shocks. It will continue to be the critical driver of Taiwan's economy, and its performance is a bellwether for the macro outlook. If tech demand stays resilient and trade barriers are managed, Taiwan's manufacturers should lead the economy to a solid 2025. If, however, the tech cycle stumbles or geopolitical barriers rise, this highly concentrated sector would also be where the pain is felt most.

Real Estate

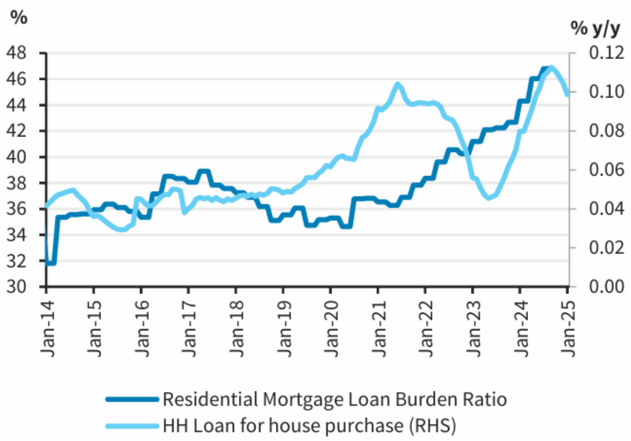
Taiwan's real estate sector has cooled from a boil to a simmer, as policymakers deliberately pump the brakes on a housing market that was running hot. During 2020–2022, ultra-low interest rates and ample liquidity fueled a surge in property prices across Taiwan's major cities. By 2022, housing was a top public concern, and the central bank began deploying rounds of selective credit controls (tightening mortgage terms, capping loans for second-home buyers, etc.) to curb speculation. These efforts continued through 2023 and 2024 – the CBC made its seventh round of credit control measures in September 2024 aimed squarely at real estate speculation. The measures included lower loan-to-value (LTV) limits and stricter lending rules for multiple-property owners. The impact was clear: transaction volumes and price growth started to slow in late 2024. Housing market sentiment shifted markedly within the year. In the first half of 2024, low borrowing costs (relative to inflation) and a new government-backed housing loan program for young buyers spurred brisk buying – so brisk that housing transactions in the six

Figure 26: Housing Prices Started to Stabilise After a Strong Upturn



Source: Sinyi Realty Corporation, Haver Analytics, Barclays Research

Figure 27: Housing Loan Growth Also Down from its Peak



Source: Central Bank of Republic of China, Barclays Research

largest cities hit an 11-year high in 2024, up 14.7% YoY. Pent-up demand from owner-occupiers, plus those subsidies, made H1 2024 a mini-boom. However, once the new credit curbs kicked in by Q3 2024, the "hot" market rapidly turned cool (Figure 26). Buying sentiment fell sharply and many speculative investors pulled back. In an online poll, "difficult" was chosen as the word best representing the 2024 housing market, reflecting the tougher environment for buyers and sellers after the mid-year policy shift.

By early 2025, the data confirm a soft landing in real estate rather than a crash. While full-year transaction numbers for 2024 were high (thanks to the strong first half), late 2024 and Q1 2025 saw volumes moderate. Home price appreciation, which was in the high single-digits annually, has decelerated to low single-digits according to industry reports. The central bank noted that its September 2024 credit tightening "resulted in a fall in transactions and a slowdown in home price growth" – exactly the intended outcome of curbing froth. Importantly, mortgage interest rates have risen only modestly (given the CBC's policy rate is 2%), so Taiwan has avoided the sharp spikes in housing mortgage costs (Figure 27) seen in the U.S. or Hong Kong. This means homeowners are not under severe financial stress from rate hikes; mortgage delinquency rates remain low. Construction activity is holding up in parts (developers still see genuine end-user demand), but speculative land buying has ebbed. One risk to watch is if the economy slows and unemployment rises, housing demand could weaken further and put slight downward pressure on prices. But with employment strong and wages inching up, a severe correction appears unlikely at this stage.

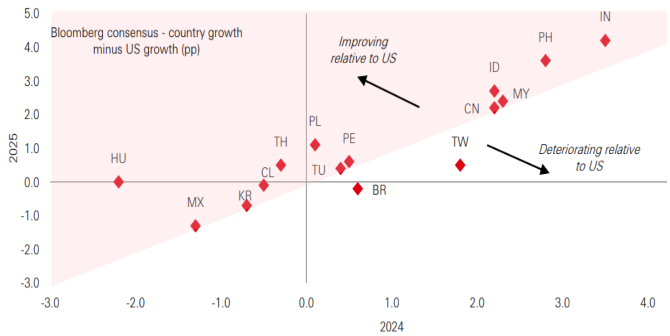
From a policy perspective, housing affordability remains a sensitive issue. President Lai's administration, like its predecessor, faces public pressure about high home prices, especially for young families in Taipei and other big cities. The government has launched or continued programs for social housing and offered tax incentives to deter property hoarding. The opposition TPP party also champions increased housing supply and even revisiting nuclear energy (to ensure stable power for construction and industry) – indicating how housing intersects with broader policy debates (land and energy availability). For now, regulatory actions (credit controls, new taxes on vacant homes, etc.) have had a noticeable effect: speculative transactions are down and end-user buyers have a better chance. The fact that the central bank did not impose an eighth round of housing measures in March 2025 is telling – they felt the market was already cooling enough. In real terms, house price growth is roughly flat once inflation is accounted for, a relief after years of increases.

Comparatively, Taiwan's housing adjustment has been gentler than some neighbors. Hong Kong, with U.S.-level interest rates due to its peg, saw property prices tumble ~15% from peak as borrowing costs soared. Singapore tightened aggressively via stamp duties and saw its price growth slow as well. Taiwan used the credit tool and mild rate hikes to engineer a similar slowdown without dramatic price declines. As a result, real estate's role in the economy is stabilizing – neither the runaway driver it was during the pandemic nor a drag. One side-effect of cooling the market is less construction activity down the line, which could marginally weigh on domestic investment. But overall, reining in housing speculation is seen as enhancing long-term financial stability. In summary, Taiwan's real estate sector in 2025 is in a healthier equilibrium: prices are high but stabilizing, transaction volumes are normalizing from record levels, and the authorities stand ready to fine-tune controls as needed. The phrase picked as 2024's housing word, "difficult," perhaps captures the sentiment of speculators who found it harder to profit – but for end-users and the economy's balance, this difficulty is by design and largely beneficial. The focus ahead will be on housing affordability and ensuring the market caters to genuine demand, thus reducing the risk of a future boom-bust cycle.

ASEAN Manufacturing Expansion

Facing a newly imposed **32% U.S. tariff on Taiwanese goods**, Taiwan's manufacturers are doubling down on their Southeast Asia diversification strategy. This strategic "Taiwan+1" approach – shifting portions of production to ASEAN countries – helps firms **hedge against trade and geopolitical risks**. By relocating final assembly and other supply-chain segments to the region, Taiwanese companies have deepened intra-firm trade networks: intermediate components from Taiwan are shipped to ASEAN affiliates for assembly, then exported globally. The payoff is twofold. First, it sustains Taiwan's export competitiveness despite tariff barriers, as many high-tech goods can be finished in lower-tariff jurisdictions. Second, it boosts Taiwan's external earnings – profits repatriated from overseas subsidiaries have significantly lifted Taiwan's primary income surplus (reaching US$11.45 billion in Q4 2024, up $3.6 billion year-on-year). In short, **ASEAN expansion is reinforcing Taiwan's role in global supply chains** while preserving its trade surplus and income growth.

Figure 28: EM Growth Differentials Vs the US



Source: Bloomberg, HSBC Asset Management (Mar 2025)

The choice of ASEAN production hubs is now evolving under the new tariff regime (Figure 28). Vietnam and Thailand had emerged in recent years as major beneficiaries of Taiwan's southbound investment – key destinations for electronics supply chain diversification, given their robust manufacturing ecosystems. However, Washington's 2025 tariff overhaul has sharply reduced their appeal for export-oriented production. Vietnam now faces a **46% U.S. tariff** on its exports and Thailand **36%**, rates even higher than the levy on Taiwan itself. Moreover, U.S. authorities have intensified scrutiny of **transshipment** (rerouting goods through third countries to dodge tariffs), a practice for which Vietnam and others had become known. This has made simplistic re-routing unsustainable and forced Taiwanese firms to seek genuinely tariff-efficient manufacturing bases. As a result, attention is shifting to ASEAN countries with **lower U.S. tariff exposure**. Notably, **Malaysia** and the **Philippines** stand out as viable alternatives, with U.S. import tariffs of roughly **24%** and **17%** respectively. In addition, these countries benefit from broad exemptions on high-value exports – for example, a large share of their semiconductor and electronics shipments to the U.S. are exempt from duties. Such advantages make Malaysia and the Philippines increasingly attractive for final assembly and supply-chain diversification in 2025, in contrast to the now tariff-heavy Vietnam or Thailand.

For **institutional investors**, Taiwan's ASEAN manufacturing expansion carries important macro-strategic implications. By recalibrating their production footprint toward lower-tariff jurisdictions, Taiwanese firms are **mitigating trade-war impacts and securing more stable market access** for their goods. This diversification is a form of geopolitical hedging as well – it reduces over-reliance on any single host country (notably lessening dependence on China) and fosters stronger economic linkages with multiple ASEAN nations. Over time, these investments should continue to bolster Taiwan's primary income and trade balances, as growing affiliate earnings and intra-industry exports from ASEAN feed back into Taiwan's economy. The regional spillovers are also meaningful: host countries like Malaysia and the Philippines could see **inflows of capital and technology**, strengthening their industrial bases and domestic growth prospects. From a portfolio perspective, investors may find opportunities both in ASEAN markets poised to benefit from Taiwanese FDI, and in Taiwanese companies that **enhance their resilience** by adapting supply chains.

However, **Taiwan's domestic industry** must ensure it retains the high-value activities. So far, the pattern is that lower-margin, labor-intensive assembly is moving out, while R&D, chip fabrication, and other high-tech processes stay in Taiwan (or go to allied countries like the U.S. and Japan). This means Taiwan keeps the brain and heart of production while outsourcing the arms and legs. It's a **structural shift** reminiscent of Japan and South Korea in past decades as they invested abroad. Over time, it could slightly reduce manufacturing's share of employment in Taiwan (as jobs are created overseas), but it also elevates Taiwan's position to more of a headquarters, design, and critical-components provider. The government is supportive of this insofar as it alleviates reliance on China and buffers against trade shocks. In fact, as U.S.-China decoupling continues, having production in ASEAN could even open opportunities: for instance, producing in the Philippines to sell to China's market, or to sell tariff-free to the U.S. under certain trade agreements that might benefit the Philippines.

In sum, Taiwan's expanded manufacturing footprint in ASEAN underscores the **resilience of its export model** in the face of protectionism, and points to a more geographically diversified production network – a development that supports more stable earnings streams and **improved risk management** for Taiwanese corporates and their investors.

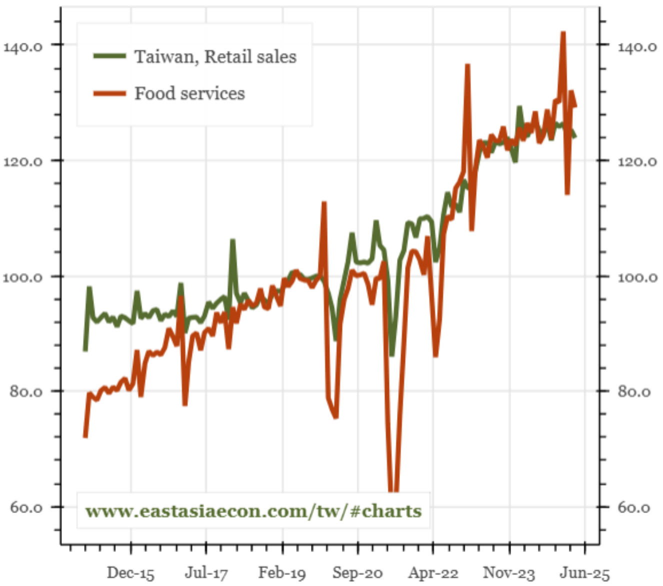
Market Sentiment

Figure 29: Taiwan Consumer Confidence Index

Source: EAE, RCTED (Apr 2025)

Consumer Confidence: Taiwan's consumers have been riding a **sentiment rollercoaster**, reflecting both economic fundamentals and the mood swings induced by global headlines. After recovering from pandemic-era caution, consumer confidence entered 2024 on a relatively solid footing. However, by late 2024 and into 2025, sentiment began to waver amid inflation concerns and international uncertainties. The **Consumer Confidence Index (CCI)**, as measured by National Central University, fell sharply in the spring of 2025 (Figure 29). In **April 2025, the CCI dropped to 68.21**, its lowest in nearly a year. This 3.65-point monthly fall in April was attributed primarily to **U.S. President Trump's chaotic tariff announcements**, which stirred fears about economic and market turbulence. Taiwanese consumers read about potential tariffs on Taiwan's goods and likely worried about job security in export industries and higher prices, denting their outlook. All sub-components of the index declined – notably, the **stock market outlook sub-index plunged to a 1-year low** (38.6, down 11 points) in April, indicating that households were pessimistic about equity returns and possibly their own wealth. The sub-indices for consumer prices, family finances, and employment prospects also weakened to their worst levels since mid-2024. Essentially, the tariff scare delivered a gut punch to confidence, which had already been softening under the weight of **elevated living costs**. Early in 2025, Taiwanese faced noticeable price increases in daily expenses – grocery bills were up due to expensive imports, electricity was rumored to rise (though postponed), and even news of forthcoming railway fare hikes added to an impression of mounting costs. It's telling that the **consumer prices confidence sub-index** hit its lowest level in nearly a year, implying many expect prices to keep climbing in the near term.

Figure 30: Taiwan Consumer Spending, Retail Sales and Food Services, Index



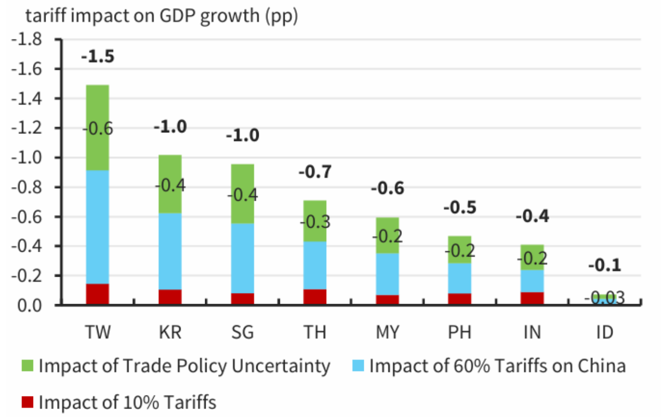
Source: EAE, DGBAS (Apr 2025)

Yet, on the ground, **consumer spending has been reasonably resilient** so far, even if confidence surveys are downbeat (Figure 30). Retail sales and restaurant revenues in late 2024 grew modestly as domestic demand normalized post-COVID. There is pent-up demand for travel and leisure: Taiwan's outbound tourism jumped once quarantine rules eased – a trend that both boosts morale (after years of closed borders) and ironically subtracts from domestic consumption (as locals spend abroad). Unemployment at **3.3% – a 25-year low for April** – provides a solid underpinning for spending. And wages are finally rising in many sectors (public servants got 3% more pay from May, minimum wage was hiked ~4% for 2024). These factors should, in theory, support consumption. The divergence between the **hard data** and **sentiment** suggests that while people are employed and earning, they remain **cautious and price-sensitive**. This might lead to more constrained discretionary spending – for instance, consumers may delay big-ticket purchases (hence a low durable goods sub-index) but continue spending on essentials and experiences. The government has noticed the sagging confidence and could consider measures if it persists, such as targeted vouchers or tax rebates to jolt sentiment. For now, households seem to be in a *wait-and-see* mode, following the tariff saga and inflation news closely. Should tariff threats recede (as they did with the 90-day pause), confidence could bounce back in the coming months, unleashing some deferred spending. Conversely, if inflation were to spike unexpectedly or trade tensions worsen, consumers might tighten their belts, damping one of the few bright spots of domestic demand. Monitoring CCI and consumer behavior will be key for gauging Taiwan's **internal demand momentum** in 2025.

Producer and Business Sentiment: On the production side, Taiwan's firms have mirrored a mix of **optimism about current demand and caution about the future**. Through late 2024, business indicators showed significant improvement. The government's composite business climate index even flashed "**red**" (boom territory) in August 2024 for the first time in nearly three years. This was spurred by a pick-up in exports and industrial production, particularly as **companies ramped up output ahead of tech product launches and holiday season**. Strong orders for AI chips and new iPhones meant factories ran at high utilization, and overtime hours increased. Confidence measures like the manufacturing PMI swung back above 50 (indicating expansion) by late 2024 after a contraction earlier that year. However, moving into 2025, **business sentiment bifurcated** by sector. **Electronics and**

exporters generally remain upbeat thanks to full order books (some chipmakers have waiting lists for certain advanced chips). This is corroborated by the MOEA's data: the leading index of the economy improved, driven by rises in semiconductor equipment imports and new construction for factories. Firms in these areas foresee at least **one strong upcoming quarter**, especially with inventory restocking and product cycles like AI servers ramping up. On the other hand, **traditional manufacturers** (chemicals, textiles) are less sanguine, facing squeezed margins from high input costs and slower global demand outside tech. Service-sector businesses – retailers, hotels – enjoyed a post-pandemic rebound but now worry whether consumer spending will keep up given the confidence drop.

Figure 31: Even without Any Tariff Hikes, Trade Policy Uncertainty is Likely to Weigh on Taiwan's Growth More as Expected by Officials



Note: Based on scenario where the US imposes a 10% tariff on all goods imports from all countries around mid-2025, but a 60% tariff on goods imports from China – and the affected trading partners retaliate fully and symmetrically.
Source: CEIC, Haver Analytics, Barclays Research

A recurrent theme in boardrooms is **uncertainty over trade policy**. The possibility of abrupt U.S. tariffs has introduced planning challenges (Figure 31). There was a clear reaction: many exporters **pulled in orders earlier than usual. Taiwan's PCB and electronics suppliers report that U.S.-China tariff tensions led to early order placements in Q1 2025** (clients effectively front-loaded purchases). This boosted Q1 sales (some companies beat earnings expectations as a result), but it also clouds **2H 2025 demand** – if those were orders that normally would have come later, the pipeline might thin out in Q3/Q4. As one industry publication noted, there are "clouds looming over 2H demand" after the rush shipments pass. Manufacturers are thus cautiously managing inventories: they remember 2022's inventory glut and do not wish to overproduce. The tariff issue also has companies considering contingency: a few are planning to re-route shipments or adjust their supply chain origin if needed (which ties into the earlier section on ASEAN expansion and friend-shoring). On the domestic front, **business sentiment is grappling with politics as well**. The opposition-led budget cuts mean some firms expecting government contracts or spending (e.g. infrastructure, IT projects) might see delays or reductions. An example: engineering and defense companies counting on government procurement are watching if budget freezes get resolved. This may introduce a slight drag to sentiment in construction and related sectors.

In capital spending decisions, corporate Taiwan remains confident enough to proceed with key investments (especially in semiconductors, green energy, and digitalization projects). Private **investment is forecast to rise 6.2% in 2025**, an upgrade from earlier projections. DGBAS attributed this to chipmakers expanding advanced process capacity and airlines buying new planes to meet travel demand. Such commitments signal that businesses view current challenges as navigable. **Producer sentiment surveys** (like TIER's manufacturing outlook or Taishin's PMI) show current conditions strong but expectations indices slightly lower – essentially *good now, uncertain later*. The **NDC's leading indicators** are still in positive territory but at a moderate growth pace. Summing up, Taiwan's producers exude a **guarded optimism**. They are buoyed by present tailwinds (AI demand, reopening, fiscal support packages) but are hedging against known risks (tariffs, global slowdown, political gridlock). Should the external environment stabilize (no major new tariffs, steady global growth), business sentiment could improve further and spur a virtuous cycle of hiring and investment. If instead external shocks hit, expect firms to turn conservative quickly – Taiwan's corporate sector has a history of reacting swiftly to protect margins (e.g., cutting overtime, delaying capex) at the first whiff of trouble. Therefore, tracking business surveys and order backlog commentary from major firms will be key in gauging the **trajectory of Taiwan's industrial momentum** through 2025.

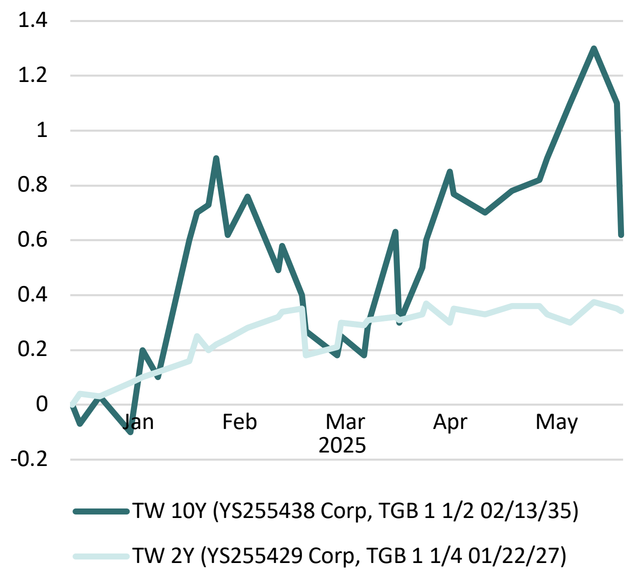
Capital Markets

Bonds

Current Yield Curve Slope

Taiwan's government bond yield curve in May 2025 is mildly upward sloping, reflecting a *normal* (though shallow) term structure. The 2-year government bond yield is about **1.33%**, while the 10-year yield is around **1.59%**, implying a **2–10 year spread of roughly 25–30 basis points (Figure 32)**. In other words, long-term yields are only slightly higher than short-term yields. This gentle slope indicates that investors are not demanding a large term premium for holding longer-duration Taiwan bonds. By comparison, a year ago the 2–10 spread was also near 30 bps, so the curve has remained relatively flat over the past year. Overall, Taiwan's yield curve currently shows a modest upward slope, signaling neither an inversion nor a significantly steep curve.

Figure 32: Taiwan 2Y Vs 10Y Government Bond Yield, % Appreciation



Source: Bloomberg

Recent Trend: Flattening or Steepening?

In recent months, Taiwan's yield curve **has seen little dramatic change in slope**, especially compared to other markets. Yields have edged *lower* across the curve in early 2025, largely tracking global bond market moves. However, the **2–10 spread has been essentially unchanged**, staying in the mid-20s basis points range. This suggests that the curve **has not steepened significantly**, despite global trends toward steepening. If anything, the curve experienced a slight *flattening* through late 2024 into early 2025, as short-term yields remained anchored and long-term yields drifted down marginally. The Central Bank of China (CBC) has kept short-term rates steady (policy rate at 2%) since March 2024, anchoring the short-end. Meanwhile, long-end yields have been subdued by stable inflation and global bond demand, resulting in only a **very mild upward slope**. In sum, Taiwan's curve has been **remarkably stable and flat**, lacking the pronounced flattening or inversion seen in some markets during the global rate hike cycle, but also not steepening much yet.

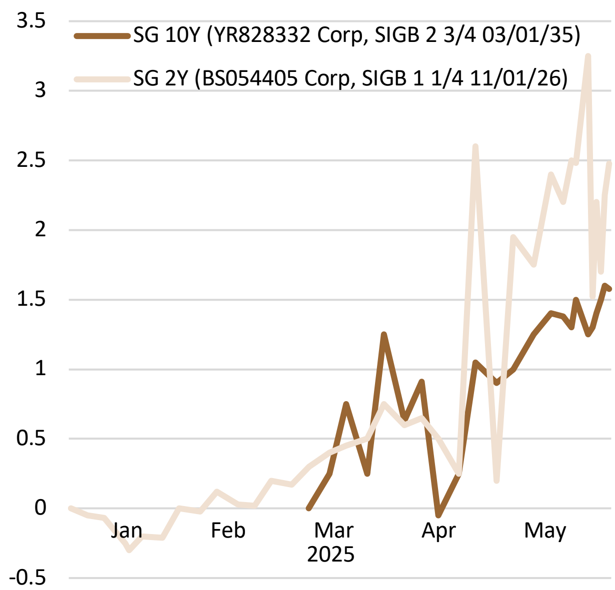
Figure 33: Hong Kong 2Y Vs 10Y Government Bond Yield, % Appreciation

Source: Bloomberg

Policy and Inflation Backdrop

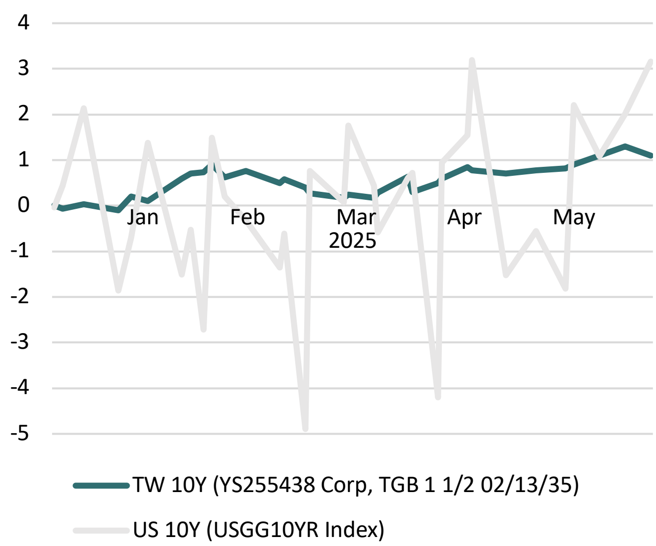
Taiwan's **monetary policy stance and inflation context** help explain the yield curve's shape. The CBC's benchmark discount rate stands at **2.00%** (held steady at the March 2025 meeting). Policymakers judge that rate cuts are not yet warranted given solid economic performance, while further hikes are unnecessary since **inflation is moderate (~2%).** Indeed, consumer price inflation has been hovering around the CBC's comfort zone (just under 2%), and the central bank projects inflation will remain near 1.8–2.0% through 2025. This stable inflation outlook has kept *real* interest rates near zero and allowed the CBC to pause its hiking cycle. As a result, **short-term yields (1–2 year tenors) reflect expectations of a prolonged hold** around current policy rates. The fact that 2-year bond yields (~1.3%) sit **below** the 2% policy rate suggests markets even price in a chance of future rate *cuts* over the next two years, given the benign inflation and growth outlook. However, the CBC has

Figure 34: Singapore 2Y Vs 10Y Government Bond Yield, % Appreciation



Source: Bloomberg

Figure 35: 10Y U.S. Treasury Vs 10Y Taiwan Government Bond Yield, % Appreciation



Source: Bloomberg

provided no explicit forward guidance, and consensus among analysts is for rates to finish 2025 roughly where they are now. In short, the central bank's **steady 2% policy and ~2% inflation** have anchored the front end of the curve, contributing to the curve's flat, low-yield profile.

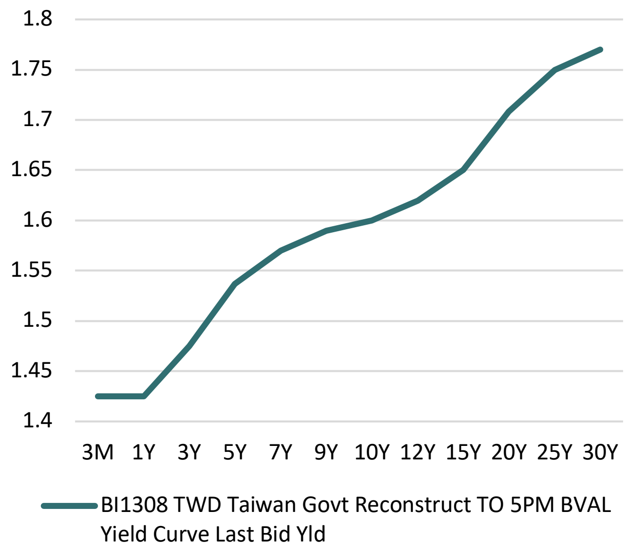
Forward-Looking Slope Projections

Looking ahead, the **slope of Taiwan's yield curve is expected to change only gradually**, barring major shifts in policy or global rates. With the CBC likely on hold (and some chance of a very late-2025 or 2026 rate cut), a dramatic bull steepening is not imminent. Market expectations and analyst forecasts generally see Taiwan's **interest rates remaining near 2.0% this year**, with perhaps a mild easing only if growth slows significantly. Accordingly, any steepening of the curve in coming months would probably come from **global forces** rather than domestic policy moves. For instance, if U.S. and global bond yields rise (or if global curves steepen as the Federal Reserve starts cutting short-term rates later on), Taiwan's long-end yields could drift up relative to the short-end. Conversely, if global yields fall on recession fears or Fed easing, Taiwan's long yields might also decline, keeping the curve flat. **Current market pricing implies only a modest steepening ahead** – analysts note that Taiwan's 10-2 year spread is roughly the same now as it was late last year. They expect any steepening to **"defer to wider UST trends"** (i.e. follow the U.S. Treasuries) and to be *milder* in Taiwan, given that CBC rate cuts are likely further out. In practical terms, this suggests the 2–10 spread could widen somewhat if and when global easing cycles begin (short-end yields would then fall or long-end yields rise). But such moves are projected to be **limited** in scale for Taiwan. Unless inflation unexpectedly surges or the CBC shifts stance, the baseline outlook is a **continued shallow yield curve**. Taiwan's term premium should remain low, with the curve perhaps **steepening slightly** by late 2025 as eventual rate-cut speculation creeps in, but likely staying far from the pronounced steepness that higher-yield markets might experience.

Regional Comparison: Hong Kong and Singapore

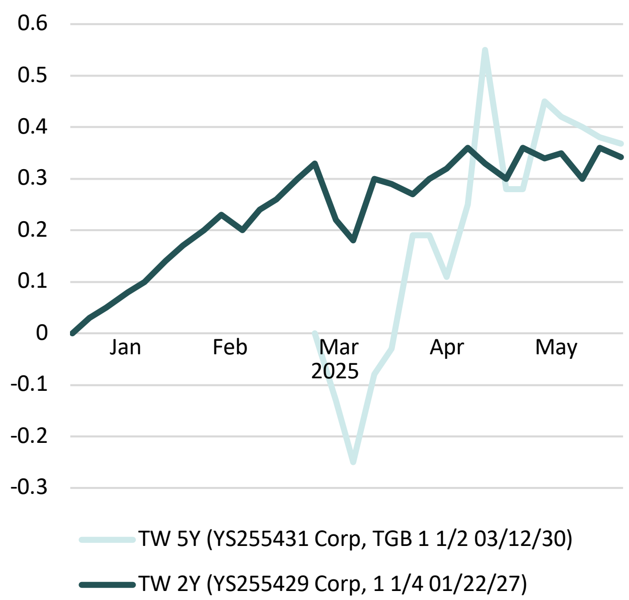
Taiwan's low yield environment contrasts notably with regional peers like Hong Kong and Singapore, both in level and curve shape. **Hong Kong's government bond yields are substantially higher**, reflecting its U.S.-linked interest rates. By late May 2025, Hong Kong's 2-year yield was about **1.91%** and the 10-year around **3.25%**, a spread of roughly **+134 bps** – a much steeper curve than Taiwan's (Figure 33). This steepness in Hong Kong emerged as its short-term yields fell sharply from late 2024 highs (pricing in future Fed rate cuts) while 10-year yields remained over 3%. Hong Kong's curve had even been *inverted* in 2023 when U.S. rates were rising, but by 2025 it has flipped to a **steep positive slope** as markets anticipate loosening U.S. monetary policy. **Singapore's yields** sit between Hong Kong's and Taiwan's in magnitude. Singapore's 2-year government bond yields ~**2.06%** and the 10-year ~**2.54%**, for a spread near **+48 bps (Figure 34)**. Singapore's curve is modestly upward sloping, steeper than Taiwan's but not as steep as Hong Kong's. This reflects Singapore's unique monetary policy (focused on exchange rates) and its AAA-credit, low-inflation status, which keep yields relatively low despite global trends. In summary, **Taiwan offers the lowest yields among these markets** – its 10-year yield (~1.6%) is a full percentage point below Singapore's (~2.5%) and far below Hong

Figure 36: Taiwan's Yield Curve, %



Source: Bloomberg

Figure 37: Taiwan 2Y Vs 5Y Government Bond Yield, % Appreciation



Source: Bloomberg

Kong's (~3.2%). Taiwan's curve is also the flattest of the three. Hong Kong, influenced by the U.S. rate cycle, currently shows the **steepest curve** as short-term HK rates are expected to fall from US-driven peaks. Singapore's curve is moderately sloped, underpinned by a stable currency and inflation outlook. These disparities imply different investor considerations across markets, from carry trades to duration positioning.

Implications for Capital Markets and Investor Positioning

The configuration of Taiwan's yield curve – **low-yielding and nearly flat – carries several implications** for capital markets and portfolio strategy. First, the slim 2–10 spread means there is minimal term premium or "carry" benefit in extending to long maturities domestically. Local investors seeking higher returns have often looked overseas: indeed, Taiwan is a traditionally *low-yield market*, and for years its institutional investors (especially life insurers) piled into higher-yield foreign bonds (e.g. U.S. Treasuries and corporates) to boost returns. This outbound capital flow has made Taiwan one of Asia's largest cross-border bond investors. With U.S. yields still considerably above Taiwan's, the incentive remains for Taiwanese funds to allocate abroad unless currency-adjusted yields narrow. On the flip side, **foreign investors may find Taiwan's bonds less attractive purely on yield** – the 10-year U.S. Treasury yields roughly 4% (May 2025) versus 1.6% for Taiwan's 10-year, a large gap (Figure 35). However, Taiwan's bonds offer high credit quality (AA+ rated) and low volatility, which can appeal to investors for diversification or defensive positioning despite the yield trade-off.

Secondly, the expectation that Taiwan's curve will **eventually steepen (albeit mildly)** as global rates ease suggests certain positioning strategies. Investors anticipating a **"bull steepening"** (short rates falling faster than long rates) might position in shorter-duration Taiwan bonds now – these would capture price gains if the CBC were to cut rates in the future (Figure 36). However, since CBC easing is not imminent, a cautious stance is warranted. Alternatively, if one expects *longer-end* yields to rise (for example, if global inflation or term premiums pick up), one might shorten duration exposure in Taiwan bonds to avoid capital losses on the long end. At present, with the curve so flat, **there is little reward for taking additional duration risk** in Taiwan. Many institutional investors may thus prefer the 2–5 year part of the curve for a balance of yield and limited duration, unless they strongly foresee rate cuts (Figure 37).

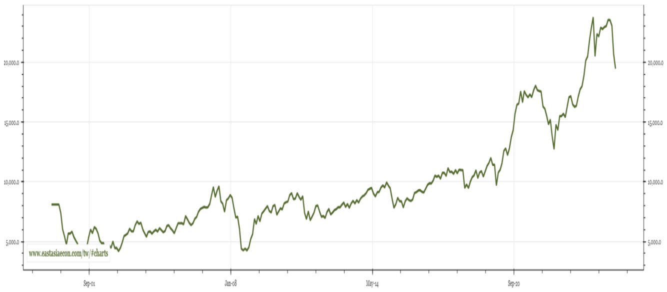
In comparison to regional peers, **relative value opportunities** emerge: for instance, Hong Kong's steeper curve provides higher carry for long-maturity bonds, but also potentially bigger gains if Fed-driven short rates drop – global funds might overweight Hong Kong or U.S. bonds over Taiwan to capture that dynamic. Singapore's bonds, with moderate yields and steepening YTD, could attract investors who want some yield pickup but with AAA safety. Taiwan's stable outlook means its bonds could serve as a *defensive allocation* – low beta to global turbulence – but investors will remain mindful of currency implications and the low absolute yields. Taiwan's currency (TWD) has been firm given its surplus and those past capital flows, so currency-hedged foreign investment in Taiwan debt carries costs that further eat into the thin yield.

Overall, the **implication for capital markets** is that Taiwan's bond market will likely stay a low-yield, low-duration play until a clear turn in the policy cycle. **Investor positioning** is therefore cautious and selective: domestic investors continue to diversify abroad for yield, while international investors view Taiwan bonds as part of a quality allocation rather than for income. If and when the CBC pivots to easing (or global rates fall), a steeper curve in Taiwan could boost the appeal of longer tenors – but until then, Taiwan's bond curve suggests a *wait-and-see approach*, with investors preferring to either stay short (for flexibility) or seek better yields in other markets. The subdued slope also means Taiwan's government borrowing costs remain low across maturities, a positive for its fiscal financing, but it limits domestic fixed-income returns. All in all, Taiwan's flat yield curve shows a **"steady as she goes" environment**: it reflects anchored expectations, and it invites investors to carefully weigh the trade-off between Taiwan's stability and the higher yields (and steeper curves) available in regional peers like Hong Kong and Singapore.

Equities

Taiwan in the spotlight. After a blockbuster **+29 % rally in 2024**, Taiwan's TAIEX entered 2025 near record territory and quickly became one of the most closely watched markets in Asia (Figure 38). The gains were powered by its world-leading semiconductor complex—chiefly TSMC—plus resurgent demand for AI, 5 G and EV hardware (Figure 40, 41 and 42). Domestic liquidity and generous dividends added torque, lifting the index above 20,000 for the first time in history. Yet 2025 has been a different story: trade-war headlines and profit-taking have injected volatility, leaving the TAIEX roughly flat year-to-date by late-May after an April tariff-driven 10 % draw-down (Figure 39). Foreign investors, who were net buyers through 2024, turned net sellers in Q1-2025, trimming exposures to Taiwan's tech champions as policy risk rose.

Figure 38: Taiwan TAIEX



Source: EAE (Apr 2025)

How does that compare with the most relevant peer—South Korea? (Figure 24) While both markets share a heavy weighting in semiconductors and electronics, their trajectories diverged last year: the KOSPI **fell ~9 % in 2024** as Samsung Electronics and memory-centric names languished. In 2025 the roles have partly reversed. Korea has clawed back about **+8 % YTD**, helped by a budding recovery in memory-chip pricing and hopes that the "Korea discount" will narrow on governance reform. Taiwan, by contrast, is consolidating last year's outsized gains as investors digest U.S. tariff risk and rich valuations (TAIEX forward P/E ~17× vs. KOSPI ~11×).

Figure 39: TWSE Index

Source: TradingView

One key driver for Taiwan's equity market has been foreign investor activity. In 2024, foreign institutional investors were strong **net buyers** of Taiwanese stocks, drawn by the tech upswing and Taiwan's high dividend yields. Robust foreign inflows (particularly in the second and third quarter of 2024) amplified the TAIEX rally, helping push the index above the 20,000 level for the first time. By end-2024, foreigners owned about **45%** of Taiwan's total market cap – a testament to global confidence in Taiwan's corporate sector. (Notably, many overseas investors increased positions in TSMC and other tech leaders, banking on their global competitiveness.) South Korea also saw foreign buying at times, but less consistently – Korea experienced episodes of outflows in 2024 as global funds rotated

Figure 40: Taiwan Equities Performance by Market Segments

Average performance	Tech				Non-Tech			
	TSMC	Tech Supply Chain	Semiconductors	Tech Components	Financials	Consumer	Industrials	Commodities
2Q 2024	24%	6%	12%	9%	7%	7%	23%	-5%
3Q 2024	-1%	-10%	-12%	-3%	3%	12%	-1%	-3%
4Q 2024	12%	5%	5%	2%	-2%	-7%	-5%	-24%
1Q 2025	4%	-1%	-4%	-2%	3%	3%	-2%	0%

Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research

Figure 41: 4Q24 Earnings Season So Far—Largely In-line with Earnings

	Reporting season progress			Actual vs Consensus, EPS			
	Reported	% Done	% Done, Weight	Agg. Surprise	% Beat	% Miss	% Inline
By Theme							
TSMC	1 / 1	100%	100%	2%	0%	0%	100%
Semiconductors	7 / 23	30%	20%	-20%	0%	43%	57%
Tech Supply Chain	1 / 10	10%	22%	-3%	0%	0%	100%
Tech Components	1 / 10	10%	12%	37%	100%	0%	0%
Tech Equipment	1 / 4	25%	18%	50%	100%	0%	0%
Financials	9 / 14	64%	67%	92%	57%	29%	14%
Industrials	0 / 7	0%	0%	-	-	-	-
Consumer	1 / 8	13%	37%	9%	100%	0%	0%
Commodities	4 / 7	57%	56%	-87%	0%	100%	0%
Total	**25 / 84**	**30%**	**75%**	**9%**	**30%**	**39%**	**30%**

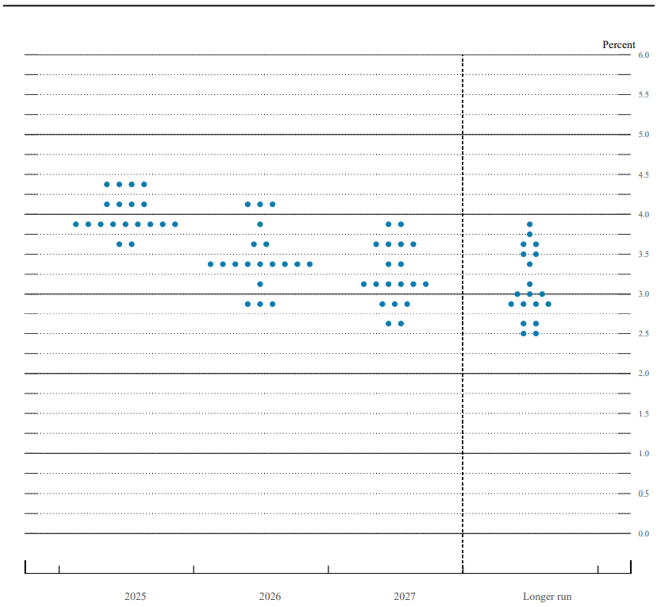
Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research

Figure 42: Taiwan Change in Foreign Ownership by Market Segments—Last 4 Quarters

Change in foreign ownership	Tech				Non-Tech			
	TSMC	Tech Supply Chain	Semiconductors	Tech Components	Financials	Consumer	Industrials	Commodities
2Q 2024	-0.11	-0.38	-0.55	0.30	-0.53	0.17	0.02	-1.28
3Q 2024	-0.87	-2.19	-1.32	-0.85	0.34	0.41	1.45	1.13
4Q 2024	0.01	-0.68	-0.67	-1.89	-0.68	-0.49	0.76	-0.08
1Q 2025	-0.04	-0.70	0.10	-0.29	-0.02	-0.13	-0.11	-0.42
Current	74	30	41	44	26	26	30	23

Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research

Figure 43: Dot Plot, Fed Fund Rates Stabilised



Source: The US Federal Reserve

toward markets like Taiwan and India with more immediate AI exposure.

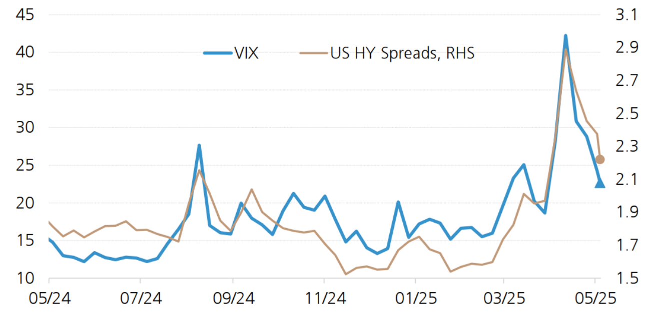
The tide shifted in **early 2025**: faced with rising global yields, a more **USD-strength** phase, and policy uncertainties, foreign investors turned cautious on Asian equities. Taiwan in particular saw notable **outflows** in Q1 2025. Foreign investors embarked on a prolonged selling streak (at one point, 17 consecutive sessions of net foreign outflows were recorded in Taipei), taking profits after 2024's run-up. This culminated in heavy foreign selling during the April tariff scare – on April 14, as semiconductor tariff fears spread, foreign institutions dumped a net NT$18.6 billion of Taiwanese shares in one session. The sharp withdrawal of foreign liquidity contributed to the TAIEX's volatility and highlighted Taiwan's vulnerability to swings in global risk appetite. Since April, however, there are signs of stabilization: the U.S. Federal Reserve's signals of a rate pause (Figure 43) and a resurgence of AI optimism (e.g. Nvidia's strong outlook) have helped entice foreign funds back into selective Asian markets. Taiwan saw foreign buying return in late April and May as the valuation pullback and strong earnings from tech firms made an attractive case. Korea, with its beaten-down valuations, also attracted some bargain-hunting inflows, especially into its semiconductor names once memory prices showed signs of bottoming. In sum, foreign flows remain a **barometer** for these markets – in 2024 they were a tailwind for Taiwan, but 2025 reminds that they can quickly reverse with shifting global conditions.

A supportive factor for Taiwan equities is ample liquidity and attractive dividends. Taiwan's stock market enjoys deep participation from domestic retail and institutional investors, contributing to high turnover (2024 trading value hit a record NT$100 trillion). Ample domestic liquidity – aided by moderate interest rates and substantial savings – provides a buffer to external shocks, as local investors often step in when foreigners sell. Moreover, Taiwan offers **relatively high dividend yields** by regional standards. The TAIEX's dividend yield averages around 3–4%, and many large-cap firms (TSMC, utilities, financials) pay steady dividends. This makes Taiwanese equities appealing for yield-focused investors, especially in a low-rate environment.

With that said, there are some key macro risks for Taiwan equities:

1. **Geopolitical Overhang**: Any escalation in China–Taiwan relations (military drills, political strife) could spook markets and lead to abrupt capital flight from Taiwanese assets. This risk imposes a **risk premium** on Taiwan equities that institutional investors constantly monitor (Figure 44).
2. **Trade and Policy Shocks: U.S.–China trade war** and tech export controls are a particular concern. The April 2025 tariff episode was a stark reminder: an unexpected U.S. tariff on tech goods caused a near-10% crash in Taiwan's market.
3. **Global Liquidity & Rates:** any renewed hawkishness or liquidity squeeze (for instance, a resurgent inflation forcing rate hikes, or a credit event tightening financial conditions) could curtail risk appetite. Taiwan's high foreign ownership makes it particularly sensitive to global fund flows.

Figure 44: Reversal of Global Risk Premium Barometers

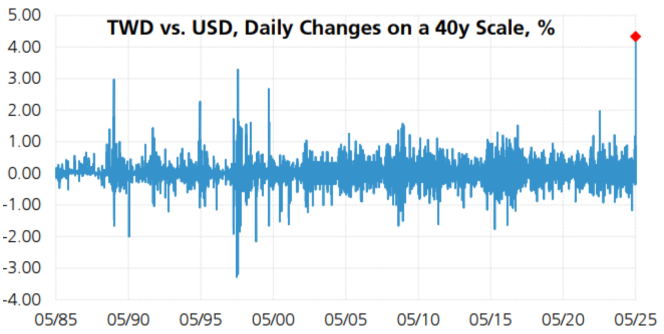


Source: UBS, Bloomberg

Figure 45: TWD Currency (TWD Spot)

Source: TradingView

Figure 46: TWD's Record Appreciation



Source: UBS, Bloomberg

4. **Sector Concentration & Cyclicality:** Inherent volatility in the semiconductor sector.

In summary, Taiwan's capital markets in 2025 reflect a solid fundamental backdrop tinged with risk-driven volatility. Bonds indicate confidence in low inflation and fiscal stability, while stocks are jostled by global sentiment swings even as corporate profits climb. For investors, Taiwan offers exposure to world-class tech leaders at reasonable valuations, but with the caveat of event risk that must be carefully monitored. Going forward, any clarity on trade policy (for better or worse) will likely be a deciding factor in whether Taiwan's equity market can break decisively upward or remains range-bound under a cloud of uncertainty.

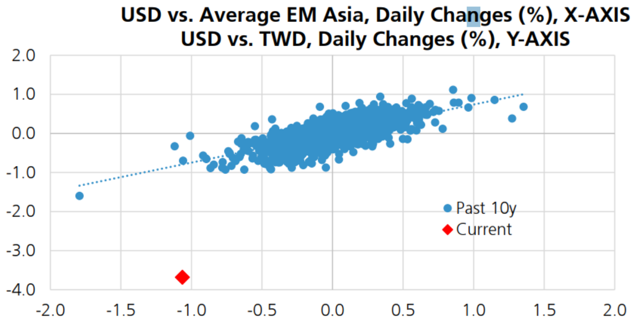
Currency and Structural Dynamics

TWD Exchange Rate: Historically Cheap Stability – The New Taiwan Dollar (TWD) has exhibited remarkable stability through the recent turbulence, yet it continues to trade at valuations that many consider undervalued relative to Taiwan's fundamentals. In the first half of 2025, the TWD has actually strengthened somewhat against the U.S. dollar. After a weak 2022–23 (when the Fed's rate hikes and global risk aversion pushed USD/TWD up to ~32), the TWD appreciated about 7–8% in early 2025, moving from the low-32s to roughly 30.0 NT$ per US$ by May (Figure 45).

The early May 2025 TWD rally marked more than a fleeting cyclical gain – it signaled a structural regime shift in Taiwan's FX dynamics. On May 2, the TWD surged roughly 5% in a single day – the largest intraday gain in over three decades (Figure 46). Such a **15-sigma** move cannot be explained by usual drivers; conventional metrics and global cues fell short of accounting for the magnitude (figure 47) . Crucially, an important stabilizing force was absent: the central bank's customary smoothing interventions were notably scaled back during the initial surge. This uncharacteristic hands-off approach stoked speculation that the authorities tacitly tolerated, or even quietly welcomed, a stronger TWD – potentially as a concession in US–Taiwan trade discussions. (Officials have denied any explicit currency component to trade talks, yet the timing and intensity of the TWD's jump fueled "Mar-a-Lago Accord" style rumors of Washington's influence.)

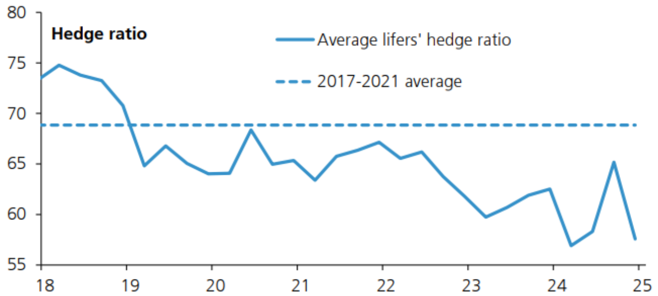
More fundamentally, the **drivers of TWD appreciation have shifted from cyclical to structural**. The rally was propelled by a sea change in local FX behavior: **exporters and institutional investors aggressively sold USD**, while previously under-hedged financial institutions scrambled to cover FX exposure. For instance, major tech exporters seized on the rally to convert USD earnings to TWD, reversing the typical pattern of gradual, opportunistic selling. This was *not* a one-off flurry: it reflected a newfound readiness among corporates to offload USD on any strength – a regime shift from the past when persistent USD strength was often taken for granted. At the same time, Taiwan's life insurers – among the largest overseas investors – **rushed to hedge their extensive USD bond portfolios as TWD spiked.** These insurers collectively hold roughly US$750+ billion in foreign assets (mostly USD bonds), yet had hedged only ~65% of that exposure by end-2024. This low hedge ratio, near

Figure 47: TWD's Deviation from Peers was a 15 Sigma Event on 10-year Scale



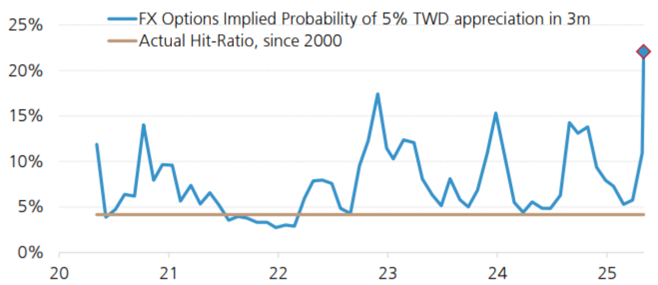
Source: UBS, Bloomberg

Figure 48: Insurance Companies Foreign Assets Underhedged, a Normalization of Hedge Ratio to '17-21 Average Would Be a $70bn Selling Flow



Source: UBS, Bloomberg

Figure 49: TWD FX Options and Forwards Have Also Swung Significantly After Recent Moves, Suggesting That Markets Are Starting to Worry About a Regime Shift Risk



Source: UBS, Bloomberg, UBS Neo T-Pricer

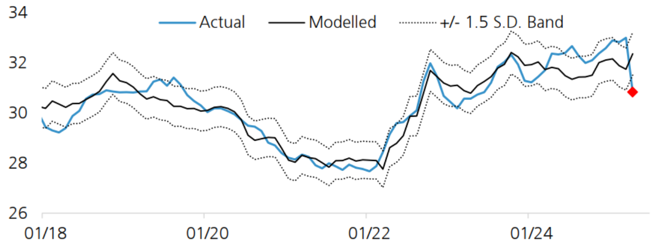
historic lows, meant the insurers were effectively *long USD* heading into 2025. The sharp TWD appreciation exposed that vulnerability, forcing **a behavioral regime change**: insurers are now "lightening up" USD positions in a way that **amplifies** TWD's moves higher. As such, Taiwan's financial sector had been "too long on the dollar" and is belatedly adjusting, creating a positive feedback loop for the TWD. In other words, what began as a market rally has evolved into a **structural re-balancing**, as local institutions normalize their hedging practices (Figure 48).

Evidence of this shift is apparent in market indicators. TWD quickly went from **modestly undervalued to rich** by ~2.7 standard deviations on financial fair-value models after the spike (Figure 50). FX derivatives markets are pricing in the most bullish TWD expectations in five years – a sign that investors believe a new, stronger TWD regime is here to stay. Indeed, the **nature of TWD's rally – breaking from its peers and traditional drivers – suggests a break in equilibrium**. Normally a high-beta follower of RMB or global risk trends, TWD diverged dramatically: its move was a clear outlier relative to other Asian FX (a ~15σ deviation from typical correlations). This shows that local factors (hedging flows, policy shifts) have superseded the usual external triggers. Notably, **stop-outs of carry trades funded in TWD** further magnified the appreciation. For years, TWD's low yield and stability made it a funding currency for carry trades (Figure 51); the sudden surge caught these positions off guard, forcing unwinds that added fuel to TWD's rise. In short, the early May episode was *not* merely a cyclical spurt tied to, say, a brief USD dip or a tech cycle swing – it was the **jolt that reset market paradigms**. Taiwan's FX has transitioned from a relatively range-bound, managed regime to a higher-volatility paradigm where local flows dominate. Going forward, **any USD/TWD rally is likely to be met with eager hedging and USD selling** by Taiwanese exporters, asset managers, and lifers, keeping TWD structurally supported on upticks (Figure 49). This marks a regime change: the TWD is no longer simply drifting in the wake of global currents, but is now anchored by a powerful domestic flow undercurrent that fundamentally alters its valuation dynamics.

Geopolitics and Risk Outlook

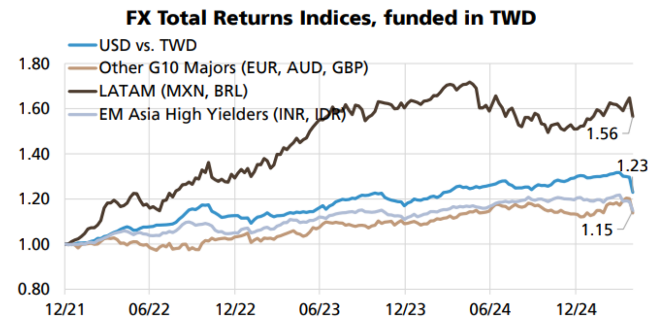
Trade Tensions – "Trump Tariffs 2.0": Geopolitical risks, particularly regarding trade, have moved to the forefront of Taiwan's 2025 outlook. With the change in U.S. administration, Taiwan faces a possible repeat of the turbulence experienced during the 2018–2019 trade war – this time with itself in the crosshairs. In early April 2025, **President Donald Trump abruptly announced sweeping tariffs** as part of a "reciprocal trade" agenda, aiming at countries with large trade surpluses vis-à-vis the U.S. (Taiwan included). The initial announcement on April 2 (U.S. time) rattled markets: it signaled high tariffs on a broad range of imports and even singled out **semiconductors** for potential duties. For Taiwan, which sends about 15% of its exports to the U.S. and is integral to U.S. tech supply chains, this was alarming. Within a week, however, the situation evolved – Trump's team *paused* the implementation of these high tariffs for 90 days (essentially a moratorium until early July) and in the interim imposed a baseline **10% tariff on all imports** from most countries. This on-again, off-again approach created confusion but gave a temporary reprieve. Taiwanese officials and businesses breathed a

Figure 50: Vis-à-vis Conventional Metrics (US Real Yields, Relative Equities, and Global Financial Conditions), TWD has Swung from a Position of undervaluation to ~2.7 S.D. Overvaluation



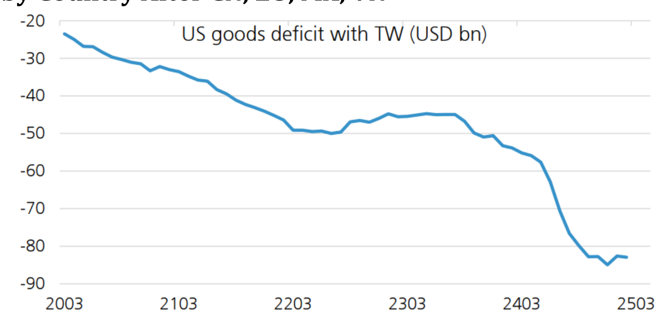
Source: UBS, Bloomberg UBS Neo T-Pricer

Figure 51: TWD's Historical Underperformance on Total Returns Vis-à-vis Global Peers, One of the Most Preferred Funders



Source: UBS, Bloomberg

Figure 52: US Goods Deficit with TW Has Risen by 60bn$/Annum Since 2018, Now the 5th Largest Deficit by Country After CN, EU, MX, VN



Source: UBS, Bloomberg, US Treasury Semi Annual Currency Reports, Haver

small sigh of relief with the pause, but the **uncertainty remains**: there is a real risk that by Q3 2025, if negotiations or U.S. objectives aren't met, the higher tariffs (perhaps 25% or more) could kick in on Taiwanese goods ranging from electronics to machinery.

The **economic implications** of "Trump Tariffs 2.0" are significant. The U.S. is Taiwan's second-largest export market (after China+HK), accounting for roughly 15-17% of exports. And importantly, Taiwan runs a **sizable surplus with the U.S.** American scrutiny has grown: Taiwan is now the 5th largest contributor to the U.S. trade deficit (Figure 52), making it a prime target in Trump's reciprocal tariff rhetoric. If broad tariffs were applied, it could potentially affect tens of billions of Taiwan's exports – notably **ICT products, electronics components, machinery, and chemicals**. Tariffs would raise the cost of Taiwanese goods in the U.S., likely reducing demand, squeezing Taiwanese firms' margins, or forcing them to absorb some costs. A simulation by local economists suggests that a full **gradual implementation of U.S. tariffs in Q2–Q3** could start to materially **drag on Taiwan's export growth by Q3 2025**, with the impact really biting in Q4. In plain terms, what has been a tailwind (U.S. AI demand) could turn into a headwind. The **DGBAS** warned that in a scenario with these tariffs and unresolved budget issues, Taiwan's GDP growth could dip below 3%, versus a baseline of ~3.1%. Moreover, the tariffs on semiconductors – if enacted – would be particularly painful: those chips are an essential import for many U.S. companies (Apple, NVIDIA, etc.), so tariffs could disrupt supply chains and perhaps accelerate trends of onshoring or shifting sourcing to fabs outside Taiwan (like TSMC's Arizona plant). It's a paradox: hitting Taiwan's chips would also hurt American businesses, but the threat alone casts a cloud of uncertainty.

Taiwan's **political and diplomatic response** to these tariff threats has been proactive and multi-pronged. President Lai's administration has engaged in **intense dialogue with U.S. officials** to seek either exemptions or at least mitigations. Taiwanese diplomats and trade negotiators have emphasized that Taiwan is a "like-minded partner" and that penalizing Taiwan ultimately benefits China – an argument they hope resonates in Washington. Recognizing the trade imbalance issue, Taiwan has signaled readiness to **address U.S. concerns**: one approach is to **import more from the U.S.** to narrow the deficit. There are discussions in Taipei about lowering tariffs on U.S. goods (Taiwan has some tariffs on U.S. agriculture and autos that could be cut). Taiwan could also agree to buy more American **energy (LNG, oil)** and **farm products** (soybeans, beef) as a goodwill gesture to reduce the surplus. Essentially, Taiwan might mirror the approach taken by countries like South Korea or Japan in past U.S. trade spats – voluntary import expansion to appease USTR demands. Another flank of the response is **investing in the U.S.**: Taiwan is highlighting its contributions to the U.S. economy through FDI. The high-profile expansion of TSMC's Arizona project (with an extra $100B investment announced) and other Taiwanese firms building facilities in America serve a diplomatic purpose – showcasing Taiwan as creating American jobs, not "stealing" them. This strategy channels Trump's own priorities (domestic jobs) to Taiwan's advantage.

On the home front, to **cushion the economy**, the Executive Yuan unveiled a **NT$88 billion (~US$2.8B) support package** in April

2025 specifically to buffer the impact of U.S. tariffs. This includes assistance to affected exporters (like subsidies, financing help), support for supply chain adjustments, and possibly relief for farmers if agricultural exports get hit. By late April, they expanded this into the NT$410B special budget, incorporating tariff relief and broader economic stimulus. The opposition has criticized some of these moves as reactive or politically driven, but broadly there's consensus that Taiwan must prepare for turbulence. One potential risk is **political fallout**: if tariffs cause a downturn, opposition parties could blame the ruling DPP for not handling U.S. relations more adeptly. Already, in a Taipei Times editorial, it was argued that **opposition legislators' brinkmanship (budget cuts) adds risk to an economy "already facing pressure from global trade tensions"**. There's a patriotic angle too – some factions in Taiwan see these U.S. tariffs as a betrayal of a friendly nation, which could complicate public sentiment towards the U.S. alliance if not managed carefully.
Beyond tariffs, **broader U.S.-China strategic moves** also impact Taiwan. The U.S. continues to tighten export controls on advanced tech to China, which indirectly affects Taiwan (e.g., TSMC cannot sell its most advanced chips to Chinese firms). This has reduced TSMC's revenue from China to just 7%, but it also means Taiwan's tech sector is heavily reliant on U.S. and other markets now – making it more aligned with U.S. policy but also more exposed if U.S. demand falters. On the flip side, **China's economic coercion** tactics are always a risk. Beijing has in the past banned certain Taiwanese food or agricultural imports as political punishment. If cross-strait relations worsen under Lai (whom Beijing labels a separatist), China could ramp up such measures or even try to dissuade countries from signing deals with Taiwan.

Cross-Strait Geopolitics: Militarily and diplomatically, the cross-strait situation remains tense. China has maintained near-daily military flights crossing the median line of the Taiwan Strait and has conducted large-scale exercises that simulate blockades or assaults, all as part of its **"coercion without violence"** strategy. This constant pressure aims to wear down Taiwan's readiness and resolve. In 2024 and 2025, there have been multiple instances of Chinese military drills in response to Taiwan's political events (e.g., when foreign delegations visit Taipei or around Taiwan's elections). The U.S. continues to support Taiwan's self-defense with arms sales (like missiles, drones, etc., some of which faced delays but are ongoing) and by transiting naval vessels through the Taiwan Strait to assert freedom of navigation. The risk of miscalculation is non-zero. A near-miss incident or an unintentional clash could escalate. The presence of a perhaps more hawkish U.S. administration complicates it further – Trump in his previous term oscillated between confrontational trade policy with China and admiration for Xi; how he handles Taiwan now is somewhat unpredictable, but his public stance has been to demand **Taiwan spend more on its own defense**, aligning with his general view on allies sharing the burden.

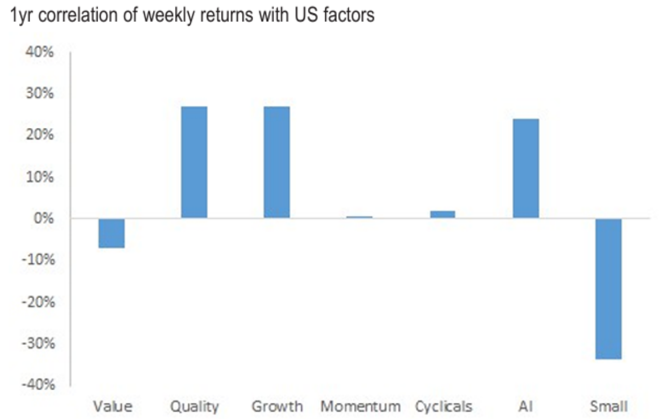
Taiwan is **stepping up defense** within the limits of public support. Lai's government modestly increased the defense budget and allocated special funds for asymmetric warfare capabilities. Yet, as noted, about 44% of the public opposed more defense spending in a recent poll, reflecting either complacency or fear of provocation. Taiwan's military is also adjusting strategies: focusing on smaller, mobile, survivable systems (anti-ship missiles, air defenses, UAVs) rather than big ticket items that China could easily target. Regionally, countries like **Japan and South Korea** are closely coordinating with the U.S. on potential Taiwan contingencies, which indirectly bolsters Taiwan's position by creating a more united front. Meanwhile, **diplomatically**, China continues to poach Taiwan's few remaining diplomatic allies (Honduras switched recognition to Beijing in 2023, for example), and pressures international organizations to exclude Taiwan. However, Taiwan has succeeded in deepening informal ties with major powers: the EU is pursuing a trade initiative, and the G7 often mentions peace in the Taiwan Strait in statements now.

The **bottom-line risk outlook** for Taiwan is that **geopolitics remain the primary tail risk**. In investors' minds, this is the scenario of a sudden crisis – be it a **trade rupture** if tariffs escalate into broader economic conflict, or a **security crisis** if China's coercion ever crossed into force. The probability of outright conflict is low in the near term (China is more likely to continue gray-zone tactics), but even small escalations could jolt markets and the economy. On the trade front, there's cautious optimism that cooler heads will prevail – the 90-day pause suggests room for negotiation. One scenario is that the U.S. and Taiwan reach some side agreements (maybe Taiwan agreeing to curtail steel or auto exports, or upping U.S. imports) and the harshest tariffs are shelved. That would remove a major downside risk and even could boost sentiment as pent-up investment is unleashed. Another scenario is that **Trump doubles down** (especially if he perceives it as politically beneficial domestically), and Taiwan has to weather a storm of tariffs, potentially pushing it closer economically to other partners and testing its resilience.

Finally, one emerging geopolitical angle is **Taiwan's alignment in the tech sphere**: The U.S. is forming "Chip 4" alliances, Japan and others are coordinating on semiconductor supply chains – Taiwan is central to these. Being a linchpin gives Taiwan leverage (the "silicon shield" concept that global economies need Taiwan's chips, hence will help protect it), but it also means Taiwan is inevitably in the middle of the U.S.-China tug-of-war. **Risk management** for Taiwan thus involves deepening ties with friendly nations (the recent entry into the U.S.-led Indo-Pacific Economic Framework, more trade deals like the Taiwan-Japan investment agreement, etc.) and continuing to make itself indispensable to the global economy. This strategy has worked so far, but as the geopolitical landscape shifts, Taiwan will constantly need to reassess and adapt.

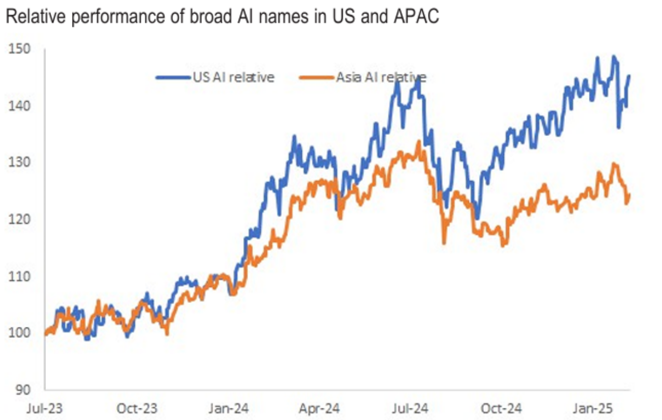
In summary, **geopolitics in 2025 is a double-edged sword for Taiwan**: on one side is the boon of strong Western support and integration into new supply chains; on the other is the threat of being a target in great power rivalry. How Taiwan navigates trade negotiations with the U.S. and deters aggression from China will be absolutely crucial. The risk outlook is highly contingent – things could markedly improve (tariff threat removed, status quo maintained) or deteriorate (tariffs imposed, military posturing intensifies). This binary makes Taiwan's risk profile a key focus for global investors and for Taiwanese policymakers who must be both vigilant and nimble in response.

Figure 53: Taiwan Continues to Display Close Linkage to Global AI "Thematic" Factor, Along with Quality-Growth



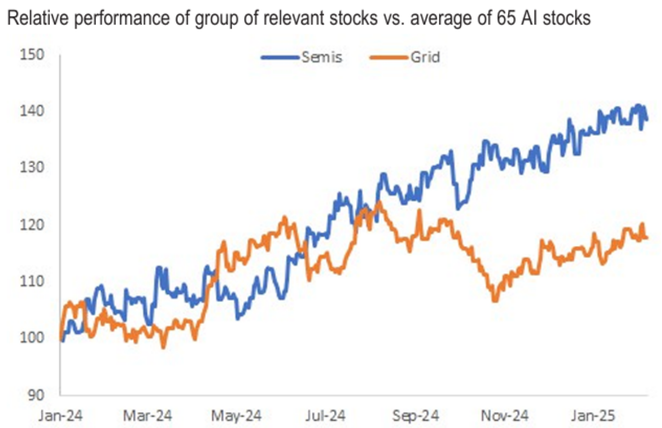
Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research

Figure 54: Through Periods of Volatility, AI Names Still Outperforming in the US, and Mostly Also in Asia



Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research

Figure 55: Within APAC AI Names, Names (TSMC) and Grid Names' Relative Performance Continues to Grind Higher



Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research

Strategic Growth Drivers

AI Revolution and DeepSeek – Taiwan's Strategic Tech Pivot

The rapid advancements in artificial intelligence (AI) and related technologies are proving to be a strategic boon for Taiwan, while also heralding new competitive dynamics (Figure 53). As discussed, surging demand for AI hardware (like high-end GPUs, AI accelerators, networking for data centers) has directly translated into outsized order growth for Taiwanese tech firms. Taiwan finds itself at the heart of the AI supply chain: companies like TSMC fabricate the cutting-edge AI chips for global giants, PCB and component makers supply critical parts for AI servers, and ODMs like Quanta and Wistron assemble AI computing systems. This has spurred what one might call an "AI gold rush" in Taiwan's tech sector. A striking metric: thanks in large part to AI, Taiwan's manufacturing output in computers, electronics, and optical products soared by 47% YoY in April 2025 to record levels. Executives note that orders for AI server motherboards, advanced substrates, and chip packaging services are booked out many months ahead. TSMC's CEO C.C. Wei highlighted that AI demand is exceptionally robust, helping offset weakness in other areas (Figure 54). This trend is expected to continue, with TSMC estimating that chips for AI and high-performance computing will comprise a larger share of its sales going forward (20% in 2025 up from 15% in 2024). Put simply, AI has become a key growth driver for Taiwan's economy: it stimulates exports, justifies new capital investments, and creates high-paying jobs in engineering and data science.

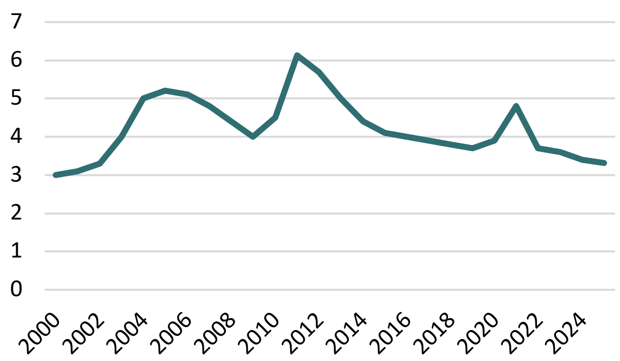
Moreover, Taiwan's strategic position in AI is underpinned by its deep expertise in semiconductors and hardware (Figure 55). While the AI revolution is often associated with software (like machine learning models), it's the hardware – the "brains" (chips) and "nervous system" (data center infrastructure) – where Taiwan excels. This gives Taiwan a comparative advantage as AI adoption accelerates globally. The term "AI revolution" in Taiwan's context really means a boom in the demand for ever more powerful chips (like 5nm, 3nm chips that TSMC makes for AI applications) and in the sophisticated manufacturing techniques to produce them (like advanced chip packaging which Taiwan leads). Additionally, Taiwanese companies are moving up the value chain in AI: we see firms like Foxconn investing in AI robotics (leveraging AI to automate factories) and HTC and Asus exploring AI software integration in their devices. The government too is promoting AI development – funding AI research centers, providing cloud computing resources for AI startups, and incorporating AI into its "Asian Silicon Valley" initiative to transform industries.

However, along with these opportunities, the AI race introduces new competition – not just from traditional rivals like South Korea or the U.S., but also from emerging AI players such as China's DeepSeek. DeepSeek, a Chinese AI startup that recently launched its own large language models and AI solutions, has drawn attention by offering "cheaper AI models" as an alternative to Western offerings. The success of firms like DeepSeek signals that China is pushing hard to develop an indigenous AI ecosystem, which could in time reduce its reliance on Taiwanese chips (if, for instance, they optimize AI to run on less advanced chips that Chinese fabs can make). DeepSeek's emergence was cited as one factor unsettling investors in AI chipmakers, as it hints at potential competition to the AI hardware arms race. For Taiwan, this means that while demand is hot now, it cannot be complacent. The AI revolution is dynamic – if new algorithms reduce the need for top-tier hardware or if alternative supply chains (say, via Chinese or American fabs) take root, Taiwan's dominance could be challenged. This is perhaps why TSMC and others are sprinting ahead on technology (planning 2nm, investing in quantum computing research, etc.) – to maintain the edge such that even with stiff competition, they remain the partner of choice for cutting-edge AI deployment.

Another factor is AI's impact on Taiwan's own productivity. Taiwan has an opportunity to harness AI domestically to address structural issues – for example, using AI-driven automation to counteract labor shortages in manufacturing or eldercare robots to cope with an aging society. The reference to Nvidia CEO Jensen Huang (a Taiwan-born tech leader) is emblematic: during a visit, he encouraged Taiwan to adopt AI and robotics to mitigate its labor shortfall and maintain industrial competitiveness. Taiwanese firms are indeed integrating AI in operations – Foxconn is developing AI for smart manufacturing, banks are using AI in fintech, and hospitals in Taiwan are trialing AI for diagnostics. There's also a budding AI startup scene in Taipei focused on applications from AI customer service to autonomous vehicles. The government's role is to ensure a supportive environment – providing regulatory sandboxes, data availability, and bridging the AI talent gap through education (adding AI and machine learning courses to curricula) and attracting Taiwanese AI researchers back from overseas.

In summary, the AI revolution is a strategic growth catalyst for Taiwan. It amplifies what Taiwan already does best (high-tech manufacturing), and it offers pathways to upgrade other sectors via AI adoption. Taiwan's heavy investment and focus on AI-related manufacturing are paying off in near-term economic gains. However, sustaining this momentum will require staying at the leading edge of tech – continuous innovation in chip technology, forging global partnerships (like with Nvidia, AMD, etc.), and perhaps moving beyond pure hardware into more of the AI value chain (software, services). The presence of competitors like DeepSeek is a reminder that the global AI landscape can shift; Taiwan will need to be agile, potentially collaborating where advantageous (for instance, TSMC providing chips to all AI model developers, East and West, as long as regulations allow) and doubling down on its strengths in precision manufacturing. If it does so, Taiwan can remain a linchpin of the AI era, translating into sustained economic growth and strategic importance on the world stage.

Figure 56: Taiwan Unemployment Rate, %

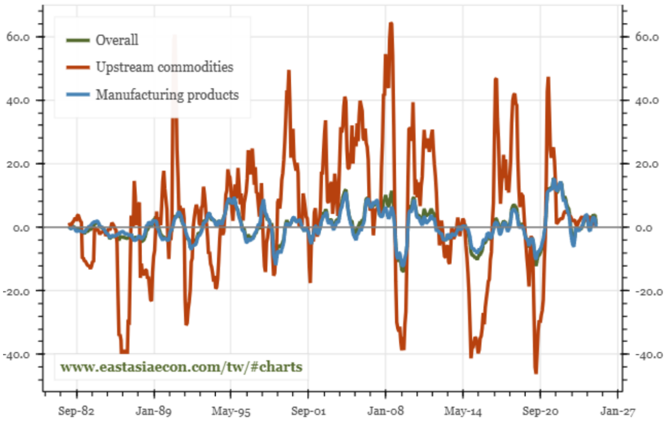


Source: DGBAS (Apr 2025)

Domestic Consumption and Wage Trends – Post-Pandemic Shifts

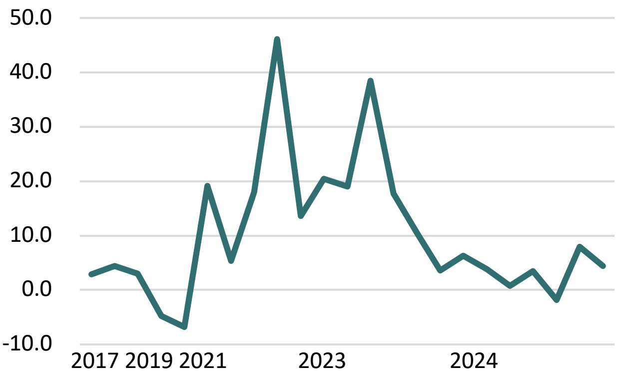
Taiwan's domestic economy – long in the shadow of the export sector – is slowly undergoing a structural shift in the post-pandemic period, driven by changes in the labor market and consumer behavior. One notable trend is the rise in wages after years of stagnation. In the past, Taiwan was notorious for relatively flat wage growth (the term "salary stagnation" was commonly lamented by young workers). Now, a confluence of factors is finally pushing pay packets upward. Unemployment is very low at 3.32% (Figure 56), meaning the labor market is tight and businesses must pay more to attract or retain

Figure 57: Taiwan Regular Earnings, Manufacturing, % MoM Annualised, 3mma



Source: EAE, DGBAS (Feb 2025)

Figure 58: Taiwan Sales of Food and Beverage Services, Annual Change Rate, %



Source: DGBAS (Dec 2024)

talent. The government has also proactively raised the minimum wage annually – for 2024 it rose by about 4%, and another hike came into effect in 2025. Additionally, as mentioned earlier, public sector wages were increased by 3% in 2025, which not only affects civil servants but often sets a benchmark that influences private sector raises. The result is that wage growth, while not explosive, is at its highest sustained pace in many years (Figure 57). For instance, real regular earnings in 2024 grew around 2%, and could accelerate if labor shortages in certain industries (like construction, tech manufacturing, healthcare) worsen. This uptick in incomes is gradually boosting domestic consumption capacity. Households have a bit more disposable income, which should support spending on goods and services from groceries to leisure activities.

We are already seeing some effects: private consumption grew about 3.5% in 2024 (Figure 58) and is forecast around 2.1% in 2025 as per official estimates. While this is not a consumer boom by any means, it marks a consistent contribution to GDP growth – a change from a decade ago when consumption was often tepid. Several post-pandemic behavioral shifts underlie this. First, there is pent-up demand for travel and experiences. After the border restrictions lifted, Taiwanese tourists have been flying out in droves (outbound tourism spend is up), and inbound tourism to Taiwan is recovering as well (especially from Japan, S. Korea, and SE Asia). This benefits airlines, hotels, restaurants, and retailers. Even though outbound travel technically sends money abroad, historically when Taiwanese travel more, they also become more confident spenders at home (and some money comes back via foreign tourists visiting Taiwan). Second, the pandemic accelerated digital adoption – more people shop online now, use food delivery, etc. Taiwanese e-commerce is thriving, and that often leads consumers to spend more (due to convenience and promotions). Companies like PChome and Momo (local e-commerce platforms) have reported strong sales growth. These trends indicate consumption patterns are shifting: spending is growing in categories like tech gadgets, health & wellness, dining out, and domestic tourism, whereas some traditional retail segments still struggle (small brick-and-mortar shops unless they've adapted).

Another structural change is the increase in household savings during the pandemic (with fewer opportunities to spend then), which has left some consumers with higher bank balances entering 2025. As confidence stabilizes, that savings could be deployed into consumption or big purchases (already there was an uptick in auto sales in late 2024, partly as supply shortages eased). However, as highlighted earlier, consumer sentiment has been fragile due to inflation in daily necessities. Wage growth, while helpful, has only recently outpaced inflation; prior to that, higher costs for food, rent, and fuel were eating into pay raises. The government's delaying of utility hikes (like electricity) and offering subsidies (like childcare credits, student subsidies) aims to ensure that these wage gains translate into actual spending power and are not entirely eroded by living costs.

One area to watch is housing costs and their effect on consumption. Taiwan's younger generation faces expensive housing, especially in Taipei, often requiring large down payments or high rents. This housing burden can suppress discretionary spending (the more one spends on rent or mortgage, the less on other goods). Any meaningful resolution – such as more affordable housing supply or slower house price growth as is happening now – could free up future disposable income for consumption. Additionally, as more dual-income households form (Taiwan's female workforce participation is gradually rising), household incomes get a boost, which typically lifts consumption as well. There is also a generational shift: retirees (a growing group) have different spending habits, often more on healthcare and less on, say, entertainment, whereas the younger generation spends more on digital goods and experiences. Businesses are adapting product offerings accordingly (for example, more packaged tours for seniors versus more adventure or niche travel for youth).

The post-pandemic era also made Taiwanese consumers more conscious of health and local supply chains. There's increased demand for locally-sourced food, health supplements, fitness services – trends that can spawn new domestic industries. At the same time, the experience of lockdowns and supply issues led some to value stability (thus potentially saving more) – but given Taiwan never had a full lockdown and managed COVID relatively well, the rebound in consumption has been smoother than many places.

Policy-wise, the government is not implementing broad stimulus now (no consumption vouchers in 2025 as it did in 2021), because the economy is growing and inflation is a concern. Instead, it's focusing on targeted measures: for example, continuing the popular "arts fun" vouchers to stimulate cultural event attendance, or energy subsidies to keep utility bills low which indirectly supports consumption by leaving more money in consumer pockets. In the longer run, raising productivity and wages in the service sector will be key to bolstering consumption. If wages continue to climb, consumers will naturally spend more, creating a virtuous cycle of domestic demand.

In essence, Taiwan's domestic consumption in 2025 is steadily improving but not booming. It remains a secondary engine compared to exports, yet its importance is growing as structural shifts take hold. A scenario to consider: if external demand falters (due to say tariffs or global recession), Taiwan might turn to its consumers and fiscal stimulus to pick up the slack – and thanks to recent wage gains and low unemployment, households might be in a position to do so modestly. Conversely, if confidence keeps dropping (due to inflation or other fears), consumption could underperform despite higher incomes, which would be a worrying sign. For now, the base case is that consumption provides a reliable, if moderate, boost to GDP, making growth a bit more balanced than the export-only narrative of the past. This rebalancing – though in early stages – is a healthy structural evolution for Taiwan's economy, enhancing its resilience against export volatility.

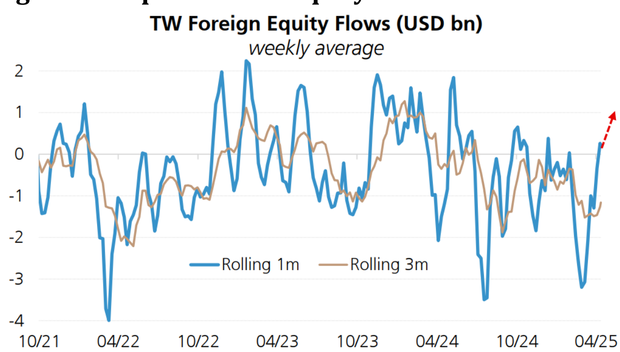
Forward Look: Scenario Analysis

In forecasting Taiwan's trajectory for the remainder of 2025 and beyond, it is useful to consider **scenarios** given the unusually high uncertainty. We outline a **Baseline** case and a **Downside** case, while acknowledging that outcomes could lie along a spectrum between the two.

1. Baseline Scenario – Resilient Growth amid Managed Risks: In the baseline, Taiwan navigates 2025 without major disruptions. **U.S. trade frictions are defused**: after intense negotiations, the sweeping tariffs are shelved beyond the 90-day pause (perhaps replaced by a modest framework for Taiwan to voluntarily buy more U.S. goods). The 10% baseline tariff might remain but is something businesses can absorb or circumvent. This outcome removes the biggest uncertainty, leading to a stabilization of business and consumer confidence in Q3. Taiwan's exports, while decelerating from 2024's breakneck pace, **continue to grow modestly** – demand for AI chips, 5G equipment, and automotive electronics offsets weakness in older tech segments. Inventory restocking transitions to inventory management, but no sharp correction. **GDP growth** under this scenario comes in around **3.0%–3.3% for 2025**, roughly in line with the central bank's 3.05% projection. **Inflation** trends downward: core inflation stays well below 2%, and even if electricity tariffs are hiked slightly in late 2025, annual CPI averages around **1.8%–2.0%**. The CBC in this scenario holds rates at 2.00% all year, with maybe a hint of easing in early 2026 if global central banks cut – but no drastic moves because inflation is near target and growth solid.

Domestically, the government manages to implement the special tariff relief budget effectively, softening any localized pains (such as helping affected SMEs diversify markets). **Fiscal policy** overall is neutral to slightly supportive: the cuts in public capex slow some projects, shaving a few tenths off growth, but the slack is picked up by strong **private investment** (for example, TSMC and others following through on expansion plans given clarity on trade). **Unemployment** remains low (~3.5% or below) as manufacturing hires due to output needs and services benefit from tourism. Wages continue to rise, bolstering consumption. **Consumer spending** in this baseline gradually picks up momentum – the tariff scare having passed, pent-up demand and higher incomes lead to a decent holiday season spend at end-2025. **Consumer confidence** recovers from its spring slump to more normal levels by year-end. On the external front, the **current account surplus** might narrow slightly (as imports remain strong and tourism imports grow with travel) but stays sizable (~12-13% of GDP), keeping Taiwan fundamentally robust externally. **Financial markets** in this benign scenario respond positively: equities rally in the second half of 2025, potentially challenging previous highs, as both local and foreign investors gain confidence with trade risks abating and earnings holding up (Figure 59). The TWD might appreciate mildly, perhaps ending the year in the high-28 to 29 per USD range if capital inflows resume, but the central bank would manage it to avoid hurting exporters. Overall, in the baseline Taiwan achieves a **"soft landing"** from the 2024 high-growth phase to a sustainable mid-3% growth path, with moderate inflation – a scenario of continuity and managed transitions.

Figure 59: Uptick in TW Equity Flows



Source: UBS, Bloomberg

2. Downside Scenario – External Shock and Political Stalemate: In a more adverse scenario, one or more key risks materialize sharply. The most probable trigger would be **trade shock**: talks with the Trump administration falter, and by late July 2025 the U.S. slaps a broad **25% tariff on all imports from Taiwan**, including semiconductors. Additionally, Trump's threatened tariffs on other major economies (EU, Korea, etc.) proceed, dampening global trade.

In this scenario, Taiwanese export orders abruptly drop in Q3 as U.S. customers cut back (either due to tariffs making goods costlier or due to uncertainty leading them to source elsewhere). There is also likely **retaliation or secondary effects** – perhaps China, sensing Taiwan's vulnerability, applies more economic pressure (maybe tightening customs inspections on Taiwanese goods or poaching another diplomatic ally, rattling confidence). The result: Taiwan's **export growth turns negative** in H2 2025. Key industries like machine tools, petrochemicals, and some electronics see double-digit drops in U.S.-bound orders. Even TSMC, while somewhat insulated due to lack of alternatives for its chips, might see some U.S. clients delay orders or negotiate price cuts to offset tariffs. The broader tech cycle could also disappoint – suppose the AI investment boom cools off (maybe corporate IT budgets tighten amid higher interest rates globally, reducing orders for new data center equipment). If **global demand for electronics weakens** concurrently, Taiwan faces a sharp industrial downturn.

Under this downside case, **GDP growth for 2025 could slump to ~1.5%–2.0%**, well below potential. Some forecasts even suggest that combined tariff impacts and a tech correction could bring a quarter or two of near-zero growth – not a full recession necessarily (given low base unemployment), but a stark slowdown from 2024. **Inflation** in this scenario might be mixed: initially, tariffs could raise import costs for certain U.S. goods (the baseline 10% tariff might drive up prices of some foods or consumer items, adding a few tenths to CPI). However, the growth slump and a likely drop in commodity prices (as worldwide demand ebbs) would exert disinflationary pressure. Taiwan could even see core inflation dip towards 1% or lower as demand softens, while headline might hover ~2% due to tariff-related adjustments. The central bank would face a dilemma but likely respond by **cutting rates** modestly (perhaps 25–50 bps) to support the economy, especially if inflation is contained. In fact, Governor Yang hinted rate cuts would be on the table if CPI fell below 1.5% – which in this slump could happen. The CBC might also intervene to stabilize the currency if needed: ironically, the TWD may come under *depreciation* pressure as exports fall and investors flee to safety. It could potentially slide past 32 or 33 per USD in a panic, but Taiwan's reserves can smooth that. A weaker TWD would import some inflation but also help exports at the margin.

Fiscal policy in the downside scenario would hopefully turn stimulative, but given the political gridlock, it might be slow. The government would push for a **stimulus package** – maybe expanding the special budget beyond NT$410 bn or introducing consumption vouchers to spur spending (as was done in past slowdowns). However, if the opposition remains obstinate, passing new budgets could be challenging. There's even a risk of deeper political strife (e.g., talk of a no-confidence vote has been brewing). A prolonged stalemate could mean an insufficient fiscal response, exacerbating the downturn. **Consumer confidence** would likely tank further in this scenario – possibly reaching levels akin to early pandemic or global financial crisis, as people worry about job security. With exports hurting, **layoffs or reduced work hours** in export industries could occur, nudging unemployment up (maybe into the 4% range). That further dampens consumption, creating a negative feedback loop. The **housing market** might also feel the pain: transactions could dry up and prices start inching down as investor confidence wanes and incomes fall, which, while good for long-term affordability, could hurt construction activity in the short run.

Internationally, Taiwan's relations might fray: being subject to U.S. tariffs could cause public sentiment in Taiwan to sour on the U.S., complicating the political climate. Conversely, the U.S. might double down on security assurances to Taiwan to show support even as it takes a tough economic line – a somewhat contradictory stance that could emerge. Markets would likely treat Taiwan as a risk asset in this scenario: **equities would drop** significantly (the TAIEX could enter a bear market, down >20%), led by electronics stocks. Foreign investors would probably continue selling, both on trade concerns and general emerging market outflows in a risk-off environment. Taiwan's credit default swaps might widen, though its sovereign is strong enough to avoid any real distress. Essentially, Taiwan could weather it (thanks to low debt and reserves) but would experience a **notable hit to growth and financial stability** for a period.

3. Between these scenarios, there are middle paths:
For instance, maybe some tariffs happen but at lower rates or excluding semiconductors, causing a milder slowdown. Also, **upside scenario** could be imagined: if global growth surprises to the upside, China's economy rebounds strongly (raising demand for Taiwan's goods), and no tariffs occur – Taiwan's growth could even outperform current forecasts, potentially exceeding 3.5%. That would see even tighter labor markets, possibly requiring more rate hikes – a high-class problem to have.

Key variables to monitor:

- Any announcements from the White House on trade (each tweet or statement could move markets)
- Taiwan's monthly export orders (a leading indicator – any sudden fall would signal trouble)
- Tech inventory levels (e.g., if there's reports of chip oversupply or, conversely, continued shortages)
- Local political developments (budget negotiations, special legislative sessions for stimulus)
- **Cross-strait relations**, particularly around July when China often conducts drills, as any spike in tensions could amplify downside effects by affecting investor sentiment or even disrupting shipping/air routes.

Taiwan enters this period with considerable **buffers** – huge reserves, fiscal headroom, a strong tech ecosystem – but also **exposures** – over-reliance on a few sectors and markets, and an increasingly fractious domestic political scene at a time when unity would be beneficial. The scenarios above show that 2025 could pivot in dramatically different directions.

In a **baseline/bullish case**, Taiwan remains a compelling story of an advanced economy leveraging new tech trends (AI, EVs) to drive growth, with manageable inflation and a gradual broadening of growth drivers. In a **bearish case**, Taiwan's vulnerabilities to external shocks and political constraints come to the fore, resulting in a rough patch that tests its vaunted stability. At this juncture (May 2025), the baseline of moderate growth with contained risks seems slightly more likely, given ongoing negotiations and the global economy's still-resilient demand for tech.

Figure 60: Repricing of 1m TWD IRS Forward Curve Increases the Cost of Hedging…

Source: Bloomberg, Marquee

Figure 61: … While Incentives of Hedging Makes NDF Points Have More To Go Down, Which Could Spill Over To Spot Movement

Source: TradingView

Trade Idea: Short USD/TWD via 3-6M Non-Deliverable Forward

We propose a directional FX trade to capitalize on *a structurally firmer TWD*. The sea change in TWD (and similar Asian FX) behavior – driven by persistent local hedging flows and more restrained central bank interference – calls for a fresh approach. Our preferred trade is to short USD/TWD, capitalizing on the TWD's regime shift and the fading strength of the USD leg. This position aligns with the new flow dynamics: Taiwanese life insurers and corporates are now natural USD sellers on rallies, and the central bank is less inclined to stand in their way, implying an asymmetric downside bias for USD/TWD going forward.

Trade Details:

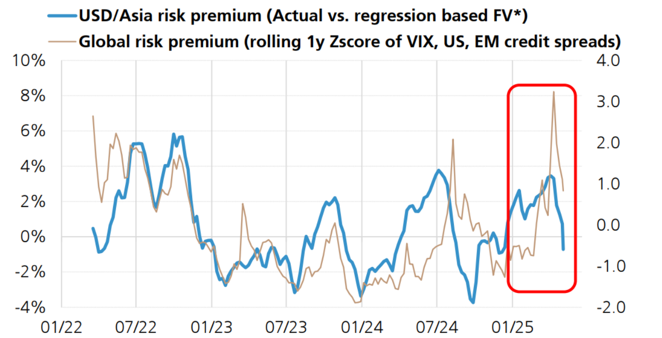
- **Position**: *Short* USD/TWD (long TWD). Execute via 3–6 month **NDF** (Non-Deliverable Forward) or forwards, given Taiwan's capital controls.
- **Entry Level**: Approximately **30.20** USDTWD (current market around 30.2). We would also be comfortable initiating on any bounce into the 30.3–30.5 zone, as local sellers are likely to step in on such upticks.
- **Target**: **29.00** USDTWD. This target is just above the TWD's early-May peak (~29.6) and approaches the lower end of our medium-term expectation (the pair potentially trading into the high-28s on a weaker USD backdrop). At 29.0, the TWD NEER would be nearing the strong end of the central bank's tolerance band, so we expect authorities to defend around those levels – making it a prudent point to take profit.
- **Stop-Loss**: **30.80** USDTWD. This is above the late-May local high and well outside the recent consolidation range. A move to 30.8 would likely indicate either a significant shift in global sentiment (e.g. a broad USD rebound) or an active policy response weakening the TWD – either scenario invalidates our strong TWD thesis in the near term.
- **Timeframe**: **3 months** (with the option to extend if the thesis unfolds more slowly). The structural flows are likely to play out over multiple months, but much of the repricing could occur in the next quarter as hedging activity and USD selling persist.
- **Risk/Reward**: Approximately 1: 2.5 (risking ~2% upside for ~5% potential gain). Entry at 30.2 with a stop at 30.8 is a 2.0% adverse move. Targeting 29.0 offers ~4% in our favor, which we find attractive given the strong fundamental tailwinds for TWD. Even a partial realization of the flow-driven downside could easily see mid-29s in the coming months, supporting a favorable skew.

Rationale:

This trade is built on the **macro and flow logic** outlined above. Taiwan's huge institutional investors are now **biased to sell USD** into any strength – for example, life insurers increasing hedge ratios and **front-loading USD sales** to avoid repeats of recent FX losses. Exporters, too, are actively converting receipts, adding sustained TWD demand on rallies. These flows effectively **cap USD/TWD upside** unless there is a dramatic external shock. Moreover, the **broader USD environment has turned less supportive**, as U.S. external imbalances and peaking Fed rates point to a softer dollar into late 2025. Thus, our short USD/TWD trade not only avoids the weak USD leg, but actually leverages it.

Supporting dynamics:
The **volatility regime** shift means any sudden spurts higher in USD/TWD (for instance, on a brief risk-off episode) are likely to be met with accelerated local hedging – a "sell the rally" mentality. In addition, regional trends reinforce our view: the TWD's structurally higher hedge demand has spurred **spillover strengthening in fellow surplus currencies** like the Korean won and Malaysian ringgit. All three are behaving differently now, with less official resistance to appreciation. Indeed, Korean authorities (also under U.S. monitoring) have been less aggressive in stemming KRW gains, and Malaysia's central bank has allowed the MYR to notch a firmer bias recently (Figure 62). By shorting USD/TWD, we effectively go long one of the strongest beneficiaries of this regional sea change. (We considered a **basket trade** shorting USD against TWD, KRW, and MYR to capture the broader theme. Institutional investors may opt to split exposure across those currencies. However, TWD offers the clearest single-currency expression, given its outsized NIIP and the concentrated hedging pivot by lifers.) We also prefer **direct USD/TWD shorts** to cross-currency pairs like TWD/KRW for now – the latter could be choppier as KRW is also strengthening with its own dynamics. If our thesis plays out, USD/TWD should grind lower towards the high-20s, delivering profits, while USD/KRW and USD/MYR likely follow similar (if slightly less pronounced) trajectories.

Figure 62: Historically, a Decline in Global Risk Premium Has Catalyzed a Decline in EM Asia Currencies' Risk Premium; Was Worth ~3% Until Last Week



Source: UBS, Bloomberg

Key risks:
The primary risk to this trade is a **resumption of heavy-handed intervention** or policy pushback if the TWD strengthens too quickly. For instance, if USD/TWD rapidly approached 29.0 before hedging flows moderate, the CBC might re-enter with sizable FX swaps or outright intervention to stabilize the rate (especially if export competitiveness becomes a concern). We mitigate this risk by setting our target just above levels that would likely trigger policy discomfort. Another risk is a **sharp global risk-off event or USD liquidity crunch** – in a severe flight-to-quality, USD/TWD could spike higher (TWD weakening) despite Taiwan's good fundamentals. However, even in such a case, we expect TWD to outperform regional peers given its now-stronger domestic support; moreover, Taiwan's hefty reserves provide confidence that the CBC could contain excessive volatility. Finally, **if U.S.–China trade tensions re-escalate or geopolitical shocks occur**, Taiwan's currency might face idiosyncratic pressure. Yet, those scenarios could equally prompt U.S. political support for Taiwan (potentially tolerating a weaker TWD), a complex risk to handicap. On balance, we judge that the **structural flow factors** are dominant in the near-term, and the risk/reward of shorting USD/TWD is favorable. In the event of adverse moves, our stop at 30.80 limits the downside. We also note that implied yields on TWD forwards have spiked amid the recent volatility (3M hedging costs jumped, reflecting intense demand for TWD). This means **holding a USD/TWD short via NDF currently earns positive carry** – an unusual situation that works to our benefit (it reflects how desperate the market is to short USD/TWD). As conditions normalize, this carry may ease, but it indicates the trade is aligned with the prevailing market pressure.

Alternate expressions:
For investors concerned about near-term volatility, an **options strategy** could be prudent. For example, buying a USD put/TWD call (6M expiry, strike ~30.0) would position for TWD upside while capping risk to the premium paid. Implied volatilities are higher now post-spike, but one could potentially finance the cost by selling a farther OTM put (e.g. strike ~28.5) to form a debit spread, given we don't expect USD/TWD to fall much below 28.5 in the medium term. Such a structure would profit from a gradual grind-down in USD/TWD without the need to time the entry perfectly. Nonetheless, for those able to tolerate mark-to-market swings, we favor the straightforward **short USD/TWD via NDF** to directly capture the structural trend. This trade idea is firmly grounded in the new reality of Taiwan's FX market: **a regime of a stronger TWD, underpinned by robust local flows and a strategic policy shift**. We believe positioning for TWD strength offers an attractive payoff as Taiwan's currency regime enters this new phase.

Entry: 30.20
Take Profit: 29.00
Stop Loss: 30.80
Risk Reward Ratio: 2.50

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