

Living in Interesting Times

Business Bottoms, But the Rally Stalls—Tread Even More Carefully

The incremental news this month is the rally in semiconductor sector stocks since the beginning of the year stalled in mid-February, adding spice to an already uncertain environment. “May you live in interesting times,” I understand to be a Chinese insult. And boy, do we.

The big picture across the semiconductor sector remains one of business weakness and disappointment to investor expectations as we enter a cyclical and seasonal business trough. Nevertheless, there are some bright spots: bookings have recovered; smartphone and tablet markets are strong; outperforming winners exist even beyond those markets; and share prices are attractive on a fundamental valuation basis across many issues in the sector. My recommendation remains to pick stocks with relatively attractive fundamental valuations to mitigate downside risk amid a plethora of macroeconomic risks and uncertainties—especially so since the rally appears to have stalled.

Below-Average January: January is usually a down month and this year it was below average, and by about as much as December missed its average. Chip industry statistics for world-wide sales released by the Semiconductor Industry Association (SIA) yesterday reflected a three-month rolling average decline of -2.8% compared to an average contraction of -2.5% over the last 22 years with a high of +1.0% and a low of -12.2%. January has grown only three times during that period. Europe came from behind to lead with a gain of +0.4% followed by Asia-Pacific with a decline of -2.5% and The Americas down by -3.5%. Japan continued to lag with a decline of -5.5%. I am a little surprised that January underperformed given company reports of a bookings recovery in late-December and the rush ahead of Chinese New Year. It could subsequently be revised upwards, but it is what it is at this point.

Near-term Challenges: Next month’s release of February data will probably be even worse than January both on an absolute basis as well as compared to historical averages. Blame the Snake. Chinese New Year fell on February 10 which means the holiday created a hole in February shipments due to factory closures. So, February will underperform relative to January. February has averaged a loss of -2.2% with a high of +1.9%, a low of -7.7%, and has grown only five times in the last 23 years—including only once in the last 10 years.

The 1Q outlook at -5% is also quite lackluster at this point. The first quarter is a seasonally slack period that has averaged a decline of -1.9% with a high of +8.8% and a low of -19.4%, but has only been positive during nine of the last 22 years—and only twice in the last eight years. Weighted revenue guidance from companies in the Tokeneke Universe calls for a below-average decline of -5.2% with a range of -8.1% to -2.4%. Even worse, these statistics have faded from -4.9% with a range of -7.8% to -2.0% with lingering 4Q announcements over the last three weeks. Nevertheless, market researchers are forecasting mid-single-digit sales growth for the semiconductor industry this year with continued strength expected from smartphones, tablets and automotive markets while PCs remain weak.

February Rally Sputters: The good news is that chip sector share prices continued to rally and outperform broader market indices (at least by some measures) last month. The bad news is that: February underperformed to January; the semiconductor sector underperformed broader equity markets by some measures last month; and both the sector and broader equities markets peaked mid-month before retreating.

Let’s start with the good news. The Philadelphia Semiconductor Index Option (SOX) gained +3.4% last month outperforming the NASDAQ, S&P500 and DOW which posted gains of +0.6%, +1.1%, and +1.4%, respectively. And year-to-date the gains are even more pronounced with the SOX up by +11.1% compared to those same three indices with gains of +4.7%, +6.2% and +7.3%, respectively. Semiconductor industry business conditions have entered both a cyclical and seasonal trough, but it appears that equities have been upgraded as a favored asset class among investors as the least-worst in an unattractive neighborhood and technology may be viewed as having better growth prospects and fundamental valuations than a number of sectors. As I noted last month, the magnitude of the rally in the sector has surprised me, but I am generally encouraged by the second-order effects whereby issues with relatively attractive fundamental valuations seem to be outperforming less attractive peers.

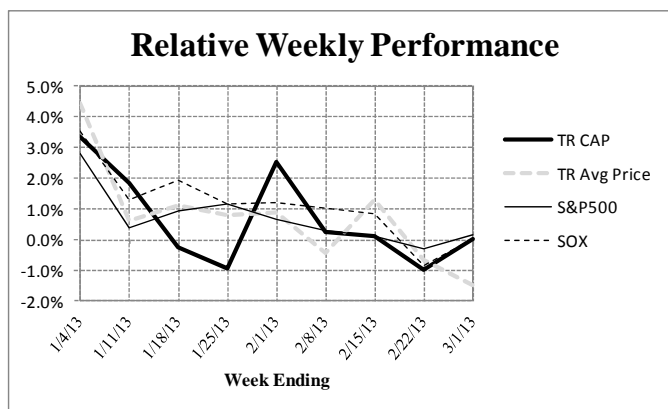
Unfortunately, the rally may be sputtering out. February’s gains were much less pronounced than January’s with the SOX fading to +3.4% from +7.5%, NASDAQ softening to +0.6% from +4.1%, S&P500 easing to +1.1% from +5.0%, and the DOW dropping to a gain of +1.4% from +5.8%. Also, slightly less than half of the stocks in my

Tokeneke Universe advanced last month—only 49 out of 102—and the average stock actually declined by -0.4%. The year-to-date performance of the average stock in my Universe is underperforming the SOX and more closely approximating the S&P500 with 66 out of 102 advancing an average of +6.5%. And finally, the SOX peaked mid-month during February with a gain of +5.1% before retreating by -1.6% and closing the period with its +3.4% gain, similar to its broader equity market brethren.

February				YTD				Indices		
Winners (49/102)		Losers		Winners (66/102)		Losers			Feb	YTD
SPWR	50.8%	GIG	-24.7%	SPWR	109.0%	GIG	-41.2%	SOX	3.4%	11.1%
IPHI	20.3%	EZCH	-21.2%	VIMC	47.5%	PSMI	-34.7%	SMH	2.4%	8.6%
VSH	20.0%	SQNS	-19.4%	FSL	40.1%	EZCH	-26.6%	NASDAQ	0.6%	4.7%
SUPX	18.1%	SIMO	-19.0%	MRVL	39.0%	SQNS	-23.5%	S&P500	1.1%	6.2%
MXL	13.5%	TSEM	-19.0%	TXCC	34.4%	CRUS	-17.0%	DOW	1.4%	7.3%
average stock -0.4%				SOX +3.4%		average stock +6.5%		SOX +11.1%		

Introducing TR CAP: Being less than satisfied with trading volume, average price changes and the constituents and idiosyncrasies of the SOX index, I starting looking at the changes in the stock market capitalization of the sum total of all issues in the Tokeneke Universe as a measure of funds flowing in and out of the sector in a quest to better understand semiconductor sector performance. I am calling it TR CAP for Tokeneke Research Capitalization and it totaled \$574B at the end of February. While it is not the silver bullet of metrics I was seeking, I like that it captures dollars over shares and more closely compares with the S&P500 as a market-weighted index, and I am intrigued by how its performance compares to average Universe price changes. Also worthy of note is the year-to-date performance of TR CAP at +6.0% which more closely aligns with the S&P500 than either the SOX or NASDAQ.

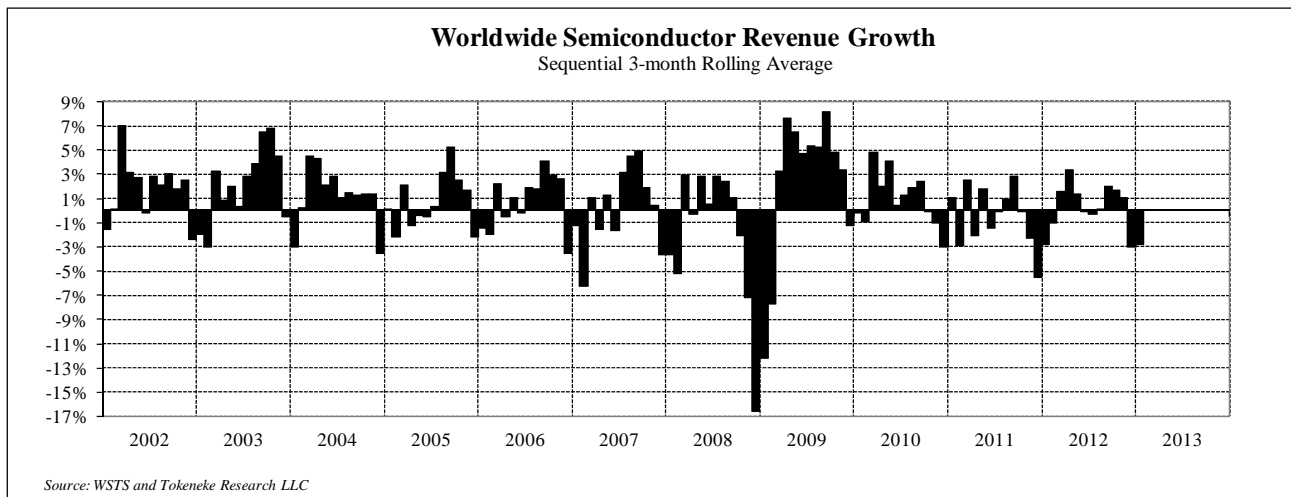
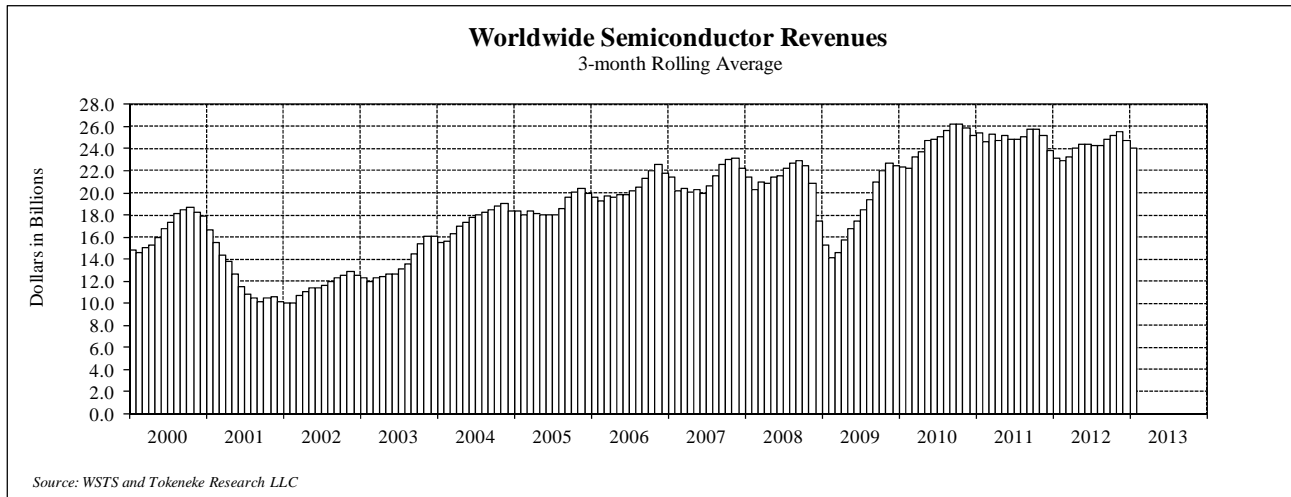
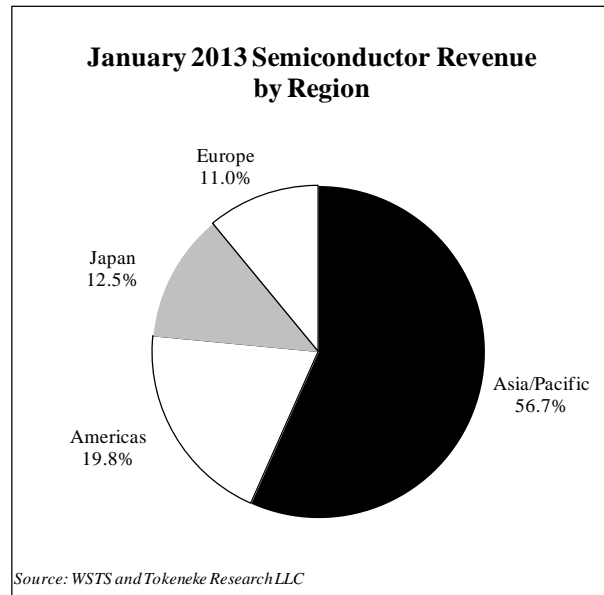
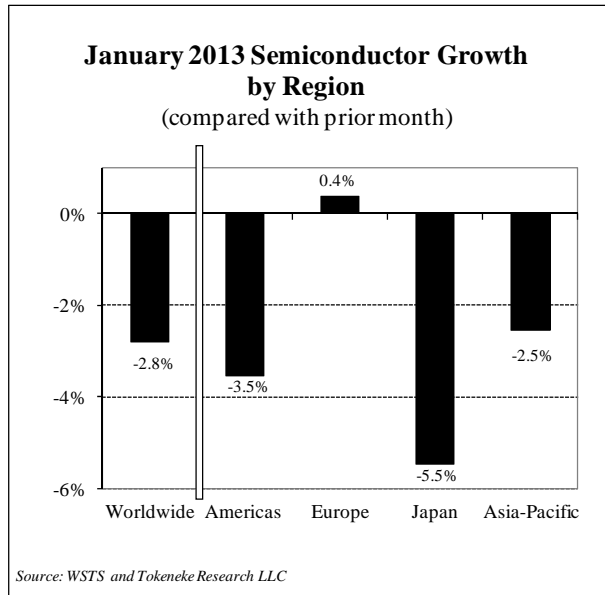
The adjacent chart reflects the percent changes for each week since the beginning of the year of four metrics: TR CAP which is the cumulative market cap of the Tokeneke Universe; TR Avg Price which is the average price change of all stocks in the Tokeneke Universe; the S&P500; and the SOX which consists of 12 established semiconductor issues and a handful of semiconductor capital equipment equities. Notice how all four have flattened around 0.0% over the last two weeks. Also notice the spike down in TR CAP the week of January 18 and back up February 1 despite a more stable performance of average prices during the same period. Why? INTC disappointed investors with its earnings announcement the week of January 18 and QCOM then enthused them the week ending February 1, but neither of those monster-cap events necessarily affected price changes uniformly throughout the rest of the Tokeneke Universe.

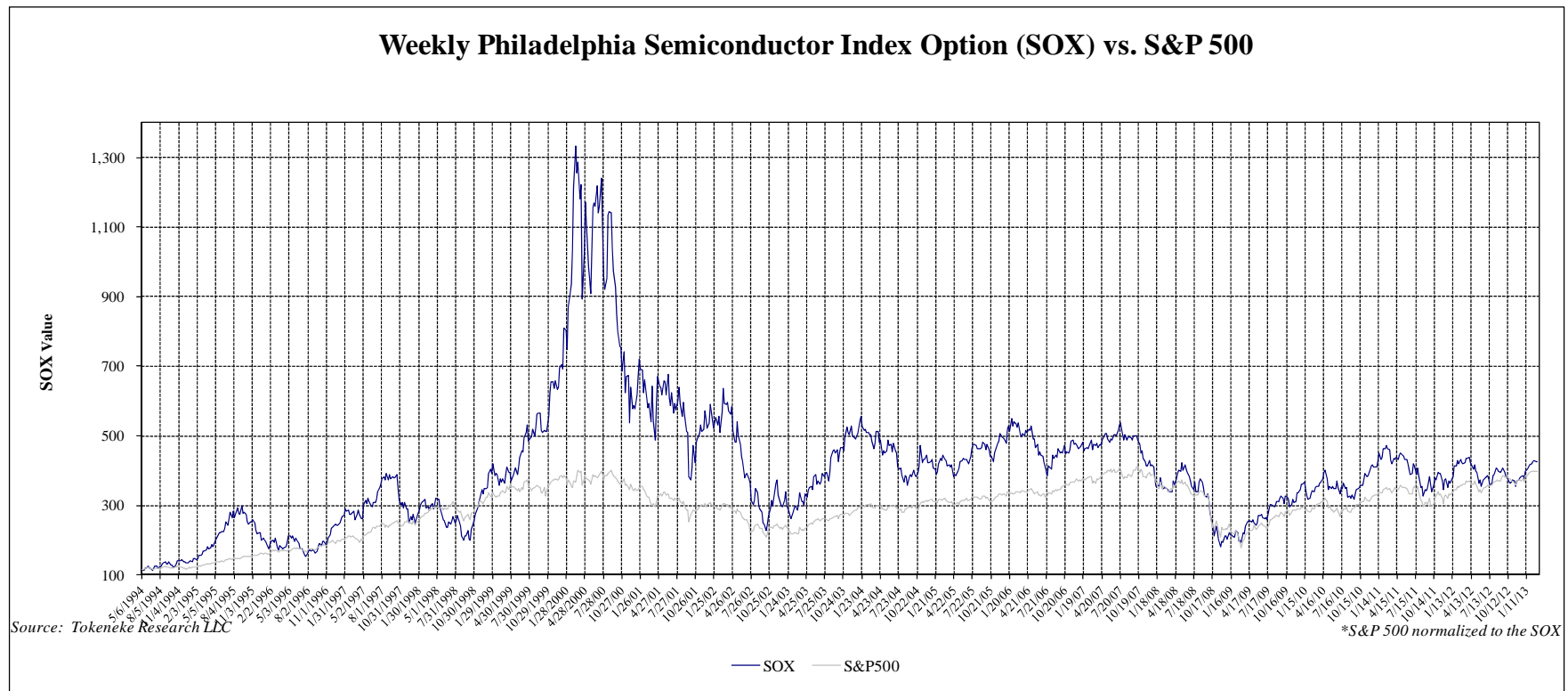


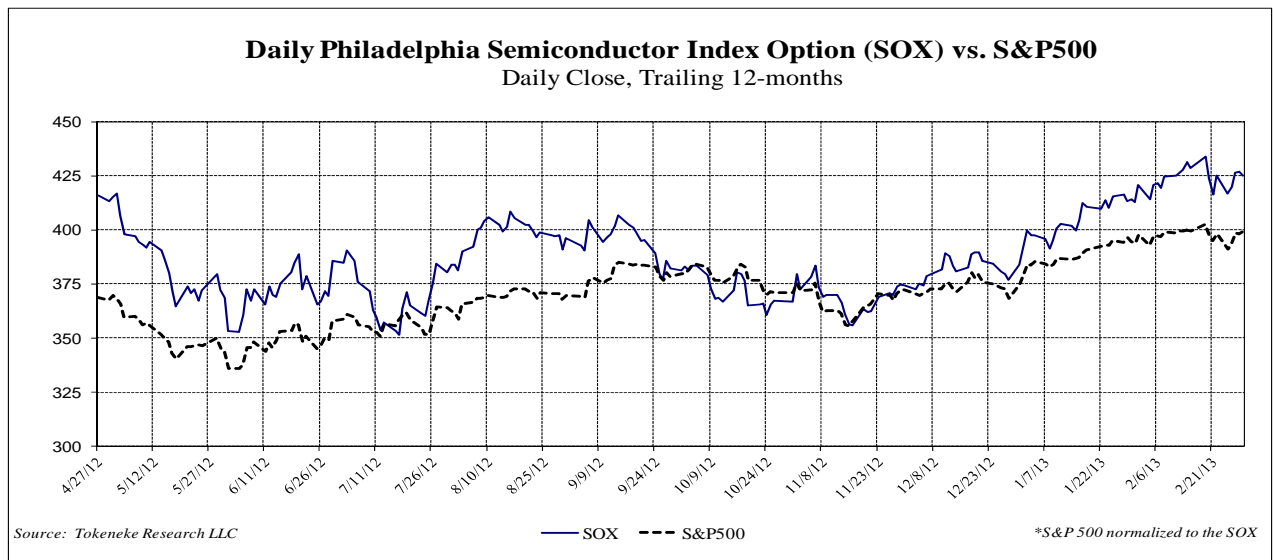
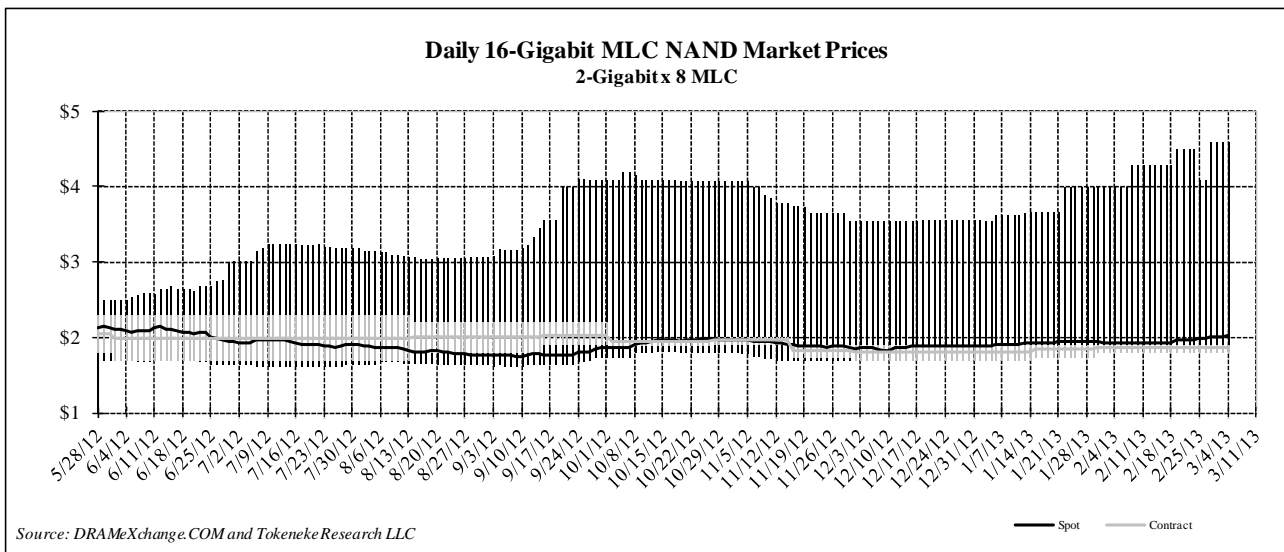
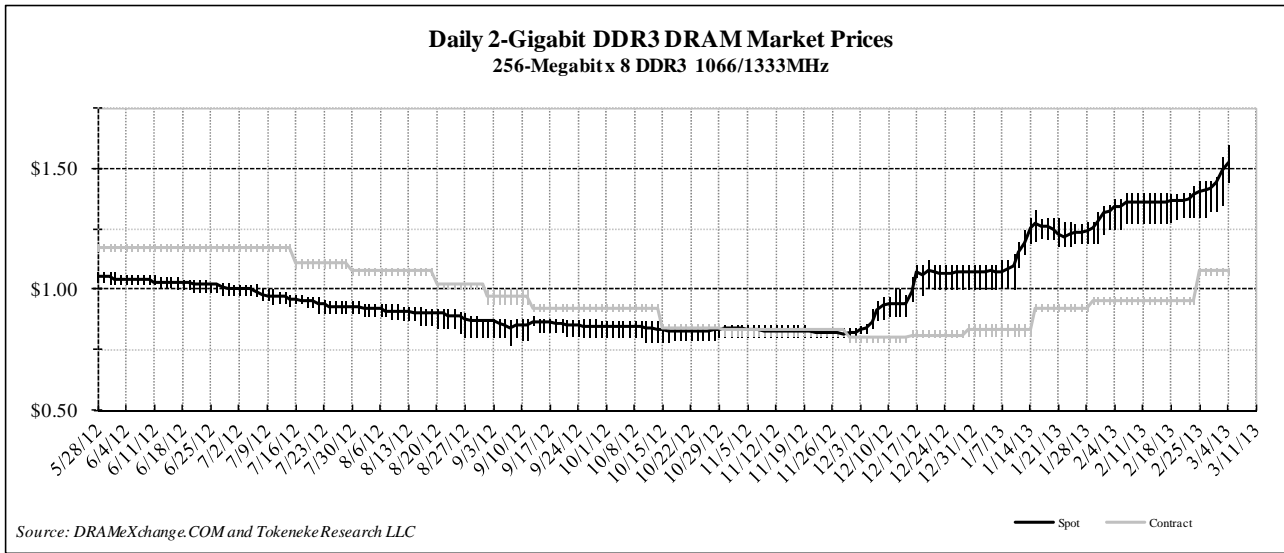
Attractive Valuations: There remains a sizable set of attractive share price valuations on a fundamental basis, in my opinion, across the chip sector. Companies with disproportionate exposure to popular end-markets such as smartphones and tablets continue to grow nicely, and several company-specific turn-around stories are making for extremely attractive risk-reward trade-offs despite broader financial market stress and uncertainty, in my opinion. Please note my latest Chip Investment Ideas publication, as well as company specific reports for more gory detail.

Tread More Carefully: The big picture for the chip sector remains one of business weakness and disappointment to investor expectations. Nevertheless, there are some bright spots: smartphones and tablets are strong; bookings have recovered; outperforming winners exist; and share prices are attractive on a fundamental valuation basis across many issues in the sector. My recommendation remains to pick stocks with relatively attractive fundamental valuations to mitigate downside risk as we approach the bottom of a business cycle with limited visibility to an upturn amid a plethora of macroeconomic risks and uncertainties. Investors can't afford NOT to have at least some semiconductor exposure at this point given the relative outperformance of the sector, but only so much as discomfort will allow—and that discomfort has increased over the last two weeks as the rally in the sector has stalled.

—Dan K. Scovel
Semiconductor Analyst







The Company

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My Background

I have an electrical engineering background, nearly 12 years of semiconductor industry experience, and was on Wall Street for nearly eight years where I was selected as the Best On The Street semiconductor analyst for 2002 by The Wall Street Journal, and third-rated Best of the Best across all sectors.

I obtained my undergraduate BS degree in electrical engineering from the University of Washington, and my MBA from Santa Clara University. My industry experience consists of nearly 12 years in various technical sales and marketing roles at four different semiconductor firms located in Silicon Valley beginning with Advanced Micro Devices in 1984, followed by two small start-up companies, and ending at Cirrus Logic where I supported the firm's Japanese market development. I joined Fahnstock & Co. as a senior semiconductor analyst in 1996 and was recruited by Needham & Co. in April 2000.

My formal coverage list as a sell-side analyst included the following equities: AMD, ALSC, ALTR, ARTI, ATML, CUBE, CY, ESST, GNSS, INTC, ISSI, LSI, MOSY, MU, OIIM, OVTI, RMTR, SIII, SMSC, STEC, SVTG, TDFX, TSRA, TXN, and ZRAN.

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