Rally in May Amid a Fragile Economy

Normal Semiconductor Seasonality after Cyclical Trough: No Rebound?

The good news is that the semiconductor industry is now recovering after its recent cyclical downturn. The caveat is the shallowness of the magnitude of the recovery that appears to be occurring within historical seasonal norms amid a fragile economy and mine field of potential political risks. And the bad news is that share prices across the sector raced ahead on overly bullish growth expectations last month, in my opinion. This environment has increased my bearishness at the macro level, although a mix-master of business conditions within the sector continues to offer attractive investment opportunities—albeit on a very selective basis. Stock-picking remains the play.

Flattish April: April has been an uninspiring month in recent years, and this year was no exception. Semiconductor industry statistics for world-wide sales released by the Semiconductor Industry Association (SIA) last week reflected a three-month rolling average gain of +0.6% compared to average growth of +1.4% over the last 23 years with a high of +7.6%, a low of -4.7%, and declines eight times across those two decades including five of the last eight years. Asia-Pacific was the only region posting a gain at +2.0% followed by declines from Europe and the Americas both at -0.6%, and Japan down by -2.9%.

Next month's release of May data usually mimics the uninspiring April, albeit shaded to the upside. May has averaged a gain of +1.4% with a high of +6.5%, a low of -7.5%, and has declined only five times in the last 23 years including only once in the last 11.

Average 2Q Growth: 2Q is typically a growth period as consumer market seasonal strength offsets the PC market trough: it has averaged a gain of +3.8% with a high of +20.0%, a low of -19.9%, and has declined only five times in the last 23 years, although three of those declines occurred over the last eight years. Tokeneke Universe guidance from 1Q earnings calls for a near-average gain of +4.3% with a range of +1.4% to +7.2%. The good news is that the chip industry is growing after its recent downturn. Unfortunately, it begs the question: where is the rebound?

Forecast Softens: Last week the SIA/WSTS also quietly released its half-yearly spring forecast dropping expected world-wide industry revenue growth for 2013 to +2.1% from +4.5% last fall. 2014 was edged down to +5.1% from +5.2% and 2015 was introduced at +3.8%. Outperforming sectors this year include Asia-Pacific at +5.7%, Europe at +5.3%, sensors at +4.5% and memories at +5.9%. Underperformers include Japan at -13.8%, discretes at -5.2%, and microprocessors at -2.9%. Market researchers continue to forecast mid-single-digit sales growth for the chip industry this year with strength expected from smartphones, tablets and automotive markets while PCs remain weak.

Semiconductor Industry Sales Growth Forecasts

Source	2013	Prior Fcst
SIA/WSTS	2.1%	4.5%
IDC	4.9%	6.2%
Gartner	4.5%	
Databeans	7.0%	
IC Insights	5.0%	6.0%

Big Rally in May: Semiconductor sector stocks rallied nicely and outperformed broader equity markets during May, much to my surprise and not necessarily consistent with any noticeable economic or business gains. The Philadelphia Semiconductor Index Option (SOX) gained +5.5% last month, the average stock in the Tokeneke Universe did even better with growth of +8.7%, and a solid 78 out of 101 of those issues posted gains compared to increases from the NASDAQ, S&P500 and DOW of +3.8%, +2.1%, and +1.9%, respectively. Year-to-date the advantage improved for the SOX which is now up by +22.0% compared to those same three indices with gains of +14.5%, +14.3% and +15.3%, respectively. However, this SOX advantage is not quite as pronounced across my Universe where the average stock is up by +16.9% so far this year with 74 out of 101 posting gains.

April Divergence: I don't feel guilty missing May's rally because financial market conditions have made me increasingly uncomfortable since the end of March. Take the April divergence, for example, where the SOX gained +1.8% but the average stock in my Universe declined by -1.9% and only 37 out of 101 of those issues posted gains. Why the inconsistency? Aside from the semiconductor capital equipment issues that make up nine of the 30 equities behind the SOX index, it is more heavily weighted to highly liquid large cap issues that offer dividends compared to my Universe. Only about one-quarter of the Tokeneke Universe offers dividends, while about half of the SOX do. Liquidity and dividends appear more favored to investors than technology and/or the chip sector, in my opinion.

May			
Winners *(78/101)*		Losers	
GIG	85.4%	IKAN	-17.2%
SPWR	42.1%	ACTS	-12.2%
MSPD	41.9%	SPRD	-11.0%
AMD	41.8%	GSIT	-10.3%
INVN	38.2%	QLGC	-10.2%
average stock +8.7%		*SOX +5.5%*	

QTD *(2Q)*			
Winners *(62/101)*		Losers	
GIG	69.5%	IKAN	-32.5%
SPWR	67.3%	NLST	-21.8%
AMD	56.9%	STEC	-19.9%
INFN	50.4%	CRUS	-19.8%
MEMS	50.0%	QLGC	-16.0%
average stock +6.5%		*SOX +7.3%*	

YTD			
Winners *(74/101)*		Losers	
SPWR	243.6%	CRUS	-37.0%
HIMX	200.0%	SQNS	-33.3%
MU	84.2%	MSPD	-30.6%
INFN	81.2%	PSMI	-29.3%
ACTS	80.5%	STEC	-28.2%
average stock +16.9%		*SOX +22.0%*	

Indices	*May*	*QTD*	*YTD*
SOX	5.5%	7.3%	22.0%
SMH	3.3%	7.8%	18.4%
NASDAQ	3.8%	5.8%	14.5%
S&P500	2.1%	3.9%	14.3%
DOW	1.9%	3.7%	15.3%

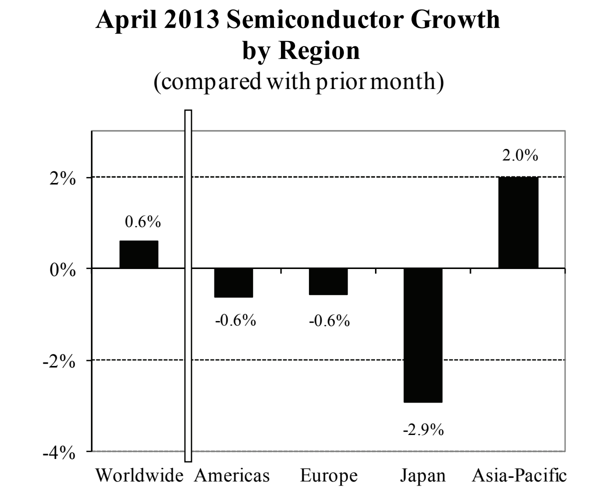
Pick Stocks: Overall semiconductor industry growth is fairly subdued, but growth is occurring and may even be slightly improving at the margin—albeit within the range of historical seasonal norms. In addition, the semiconductor industry does not seem to be getting any kind of meaningful boost from overall macroeconomic conditions that I would describe as 'fragile.'

The subdued growth of the chip industry is really the net effect of a mix-master collection of strengths and weaknesses. PCs are weak and entering a seasonal trough, but DRAMs are strong. Smartphones and tablets are strong, but the market is heavily concentrated and not all chip suppliers are benefiting. Consumer markets are entering seasonal strength, but end-markets for video games, TVs, camera and toys are subdued. Wireless infrastructure markets promise strength pending the LTE roll-out, but actual purchase orders are elusive.

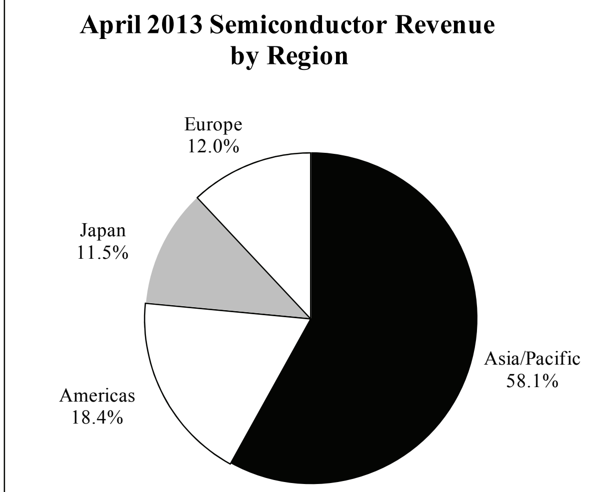
So how does an equity investor entertain the semiconductor sector in this kind of environment? Short answer: pick stocks. Specifically, stocks with both favorable business and share price valuation fundamentals. Consideration of 'investor expectations' is especially critical after last month's rally amid a business environment of subdued growth. Many equity valuations appear to have raced ahead on overly bullish investor expectations of growth, in my opinion.

Skew the Odds Heavily in Your Favor: Semiconductor industry business conditions are growing and improving at a very modest pace amid a diverse collection of end-market strengths and weaknesses. While the risk-reward trade-off has shifted unfavorably over the last month following the rally across the sector, attractive investment opportunities continue to exist as noted in my latest Chip Investment Ideas publication, in my opinion. I recommend to carefully pick stocks with pronounced attractive fundamental valuations to mitigate potential downside risk—but only so much as discomfort will allow for your particular situation.

—Dan K. Scovel
Semiconductor Analyst



Source: WSTS and Tokeneke Research LLC



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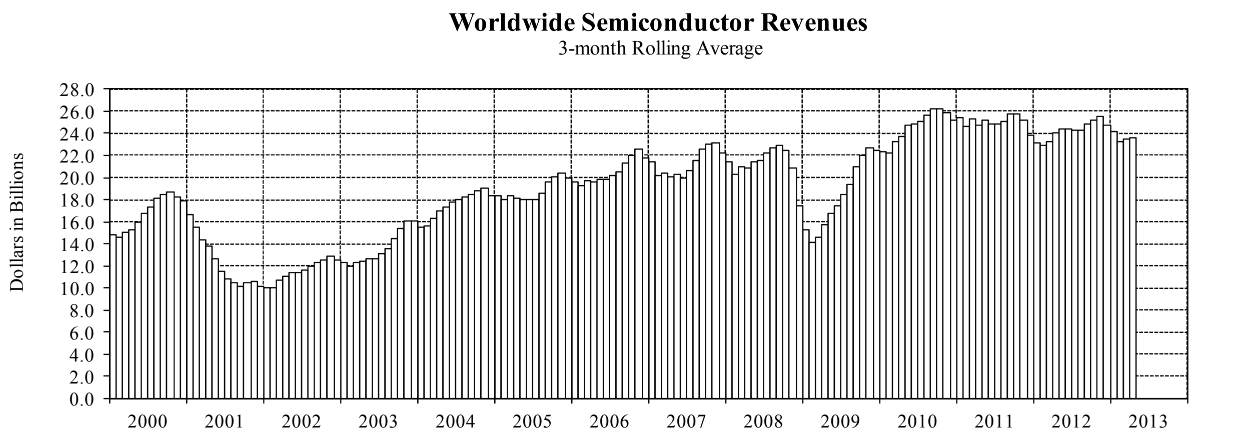

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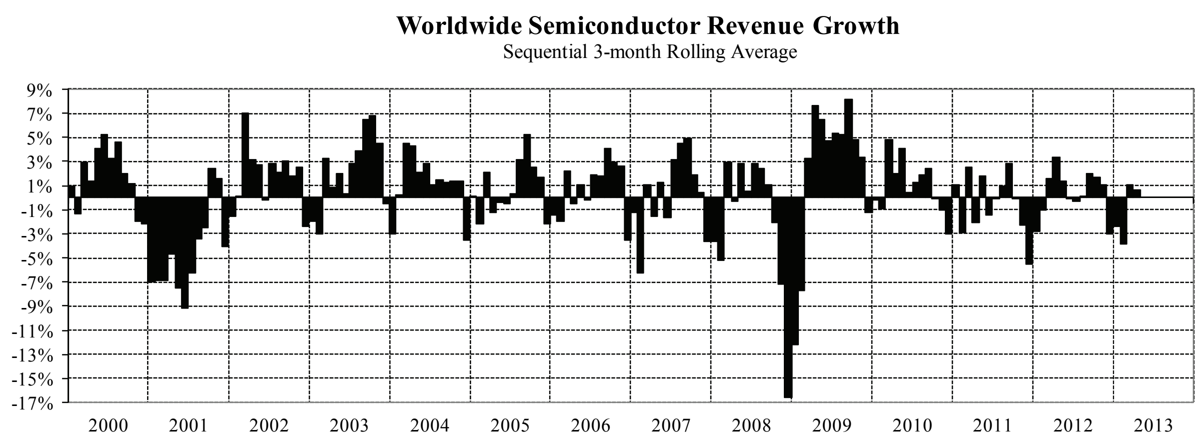
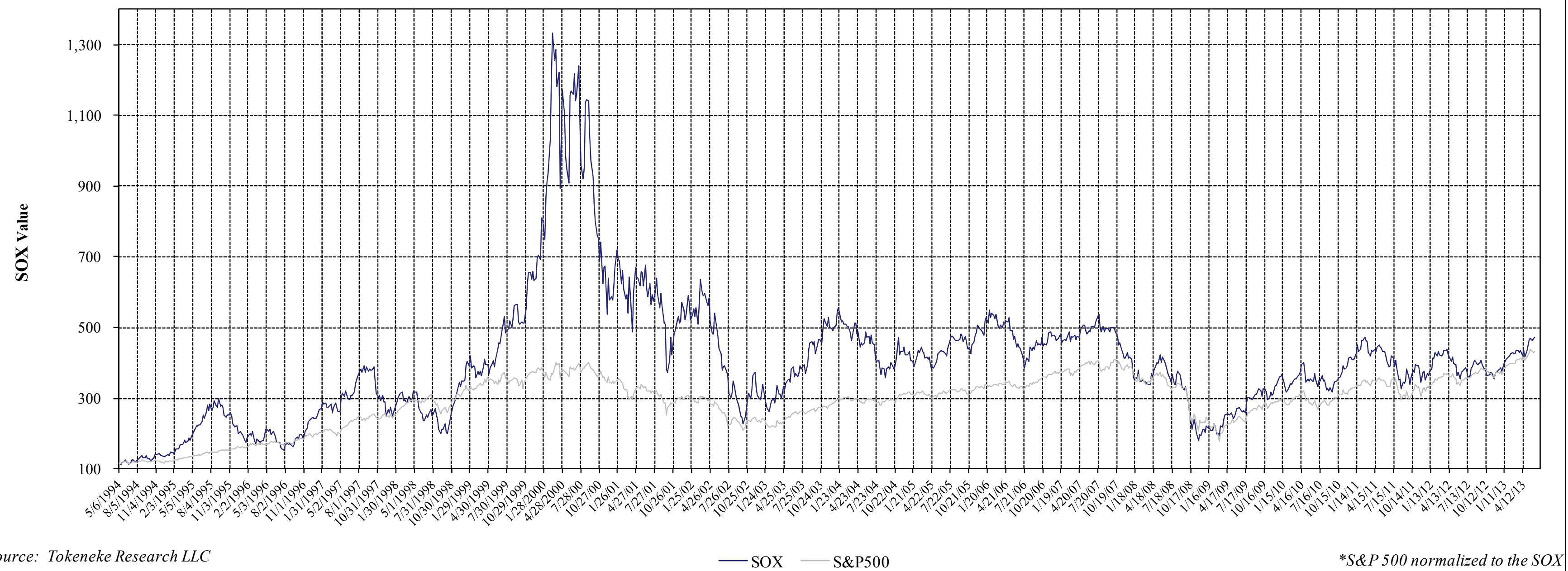


Source: WSTS and Tokeneke Research LLC

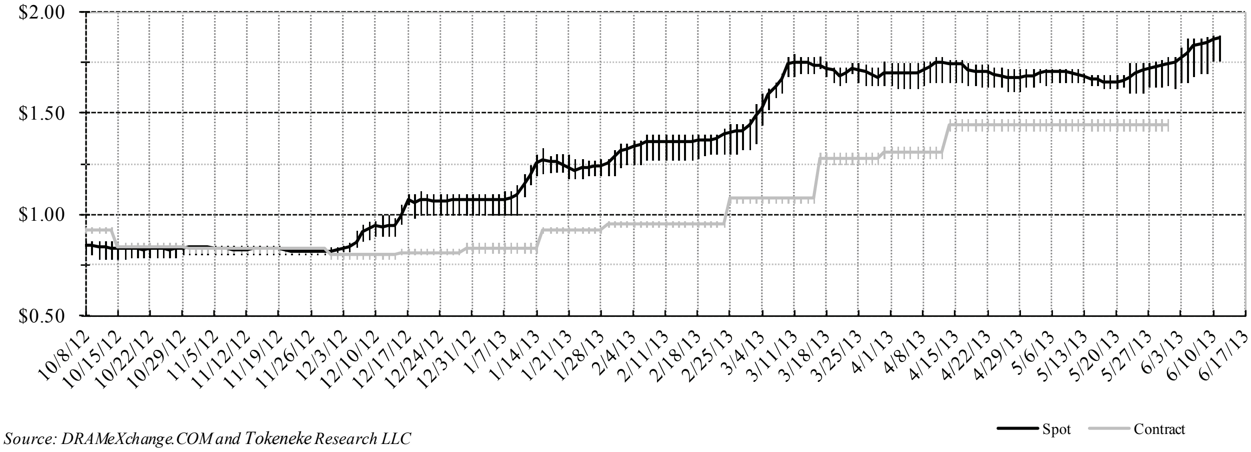
Weekly Philadelphia Semiconductor Index Option (SOX) vs. S&P 500



Source: Tokeneke Research LLC

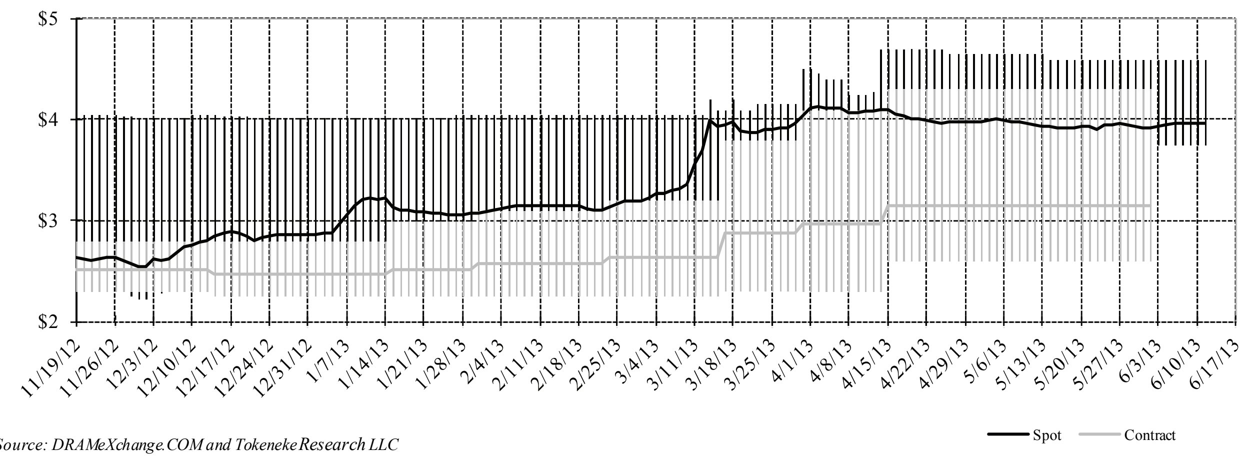
**S&P 500 normalized to the SOX*

Daily 2-Gigabit DDR3 DRAM Market Prices
256-Megabit x 8 DDR3 1333/1066MHz



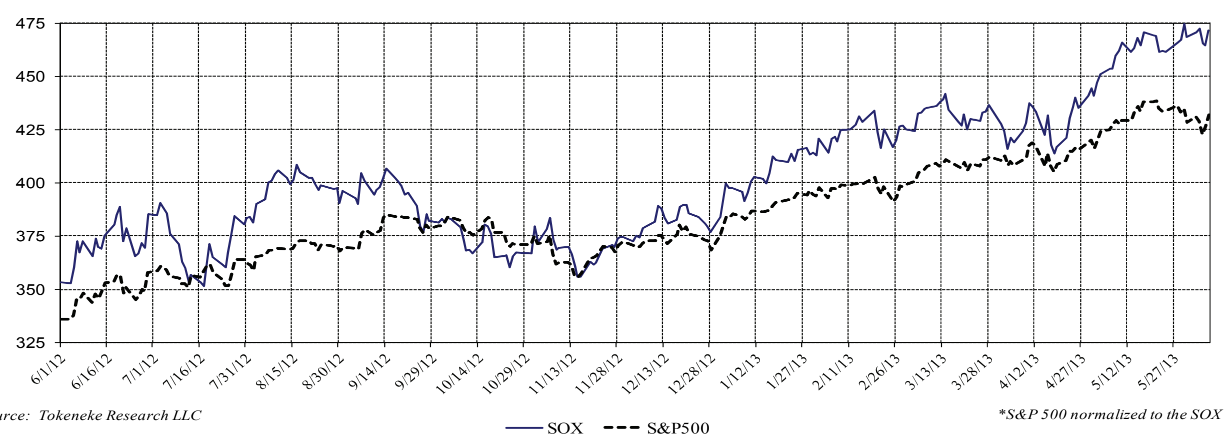
Source: DRAMeXchange.COM and Tokeneke Research LLC

Daily 32-Gigabit MLC NAND Market Prices
4-Gigabit x 8 MLC



Source: DRAMeXchange.COM and Tokeneke Research LLC

Daily Philadelphia Semiconductor Index Option (SOX) vs. S&P500
Daily Close, Trailing 12-months



Source: Tokeneke Research LLC

**S&P 500 normalized to the SOX*

The Company

Tokeneke Research is an independent research firm specializing in semiconductor industry business issues, providing fundamental research focused on US equities across all market capitalizations within the sector to investors. The company was founded in 2005 and is based in Connecticut.

The Offering

- *Monthly Newsletter:* A summarized review of noteworthy industry business developments, sales statistics, and sector equity market performance, as well as a near-term and annual outlook for sector business fundamentals and share prices. This report typically includes two pages of text and a handful of recurring charts and tables. It is intended for relatively broad-based distribution.
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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 Fahnestock & 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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