

Chip Business Deteriorates, but the Sector Rallies
Go Figure . . . Risk Remains to the Downside

Semiconductor industry business conditions have deteriorated with soft August industry statistics and 3Q preannouncements skewing negative, but sector share prices rallied last month. Go figure. Personally, I have turned even more cautious. Nevertheless, I continue to believe specific opportunities for stock picking remain attractive.

Anemic August: August growth underperformed relative to July’s +2.6% this year, which is somewhat unusual. Chip industry statistics for world-wide sales released by the Semiconductor Industry Association (SIA) reflected a three-month rolling average gain of +1.3% for August compared to average growth of +1.8% with a high of +5.2%, a low of -3.5%, and declines only four times over the last 23 years—including none of the last 11. Japan lead again for the second month with growth of +3.7% followed by The Americas with growth of +2.5% and Europe at +2.0%. Asia-Pacific lagged with growth of only +0.3%.

Next month’s release of September data is usually fairly robust: it has averaged a gain of +3.1% with a high of +8.2%, a low of -2.5%, and has declined only once in the last 23 years—and that was 12 years ago.

Weak 3Q Outlook: The 3Q outlook for growth is well below average based on management guidance during 2Q earnings season—and preannouncements edged it lower still. The Tokeneke Universe anticipates 3Q growth around +4% compared to the historical average just over +6%. The industry has averaged a gain of +6.3% with a high of +19.9%, a low of -11.7%, and has declined only twice in the last 23 years. Guidance from 2Q earnings called for a below-average gain of +4.4% with a range of +1.2% to +7.5%, and preannouncements slightly lowered the mid-point to +4.1% and narrowed the range to +1.4% to +6.8%. Preannouncements totaled 13 and skewed negative with five lowering guidance (ACTS, CEVA, CY, IDCC, and RDA), seven reiterating or narrowing the range (BRCM, DIOD, MCHP, MSCC, SIMO, TSM and TXN), and only one raising expectations (UMC—and not by much).

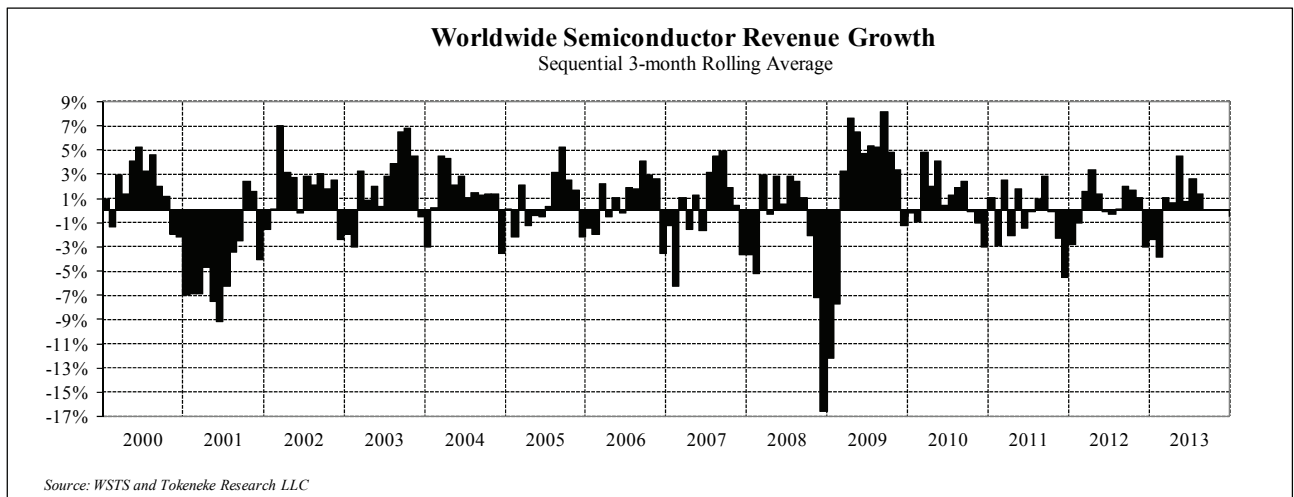
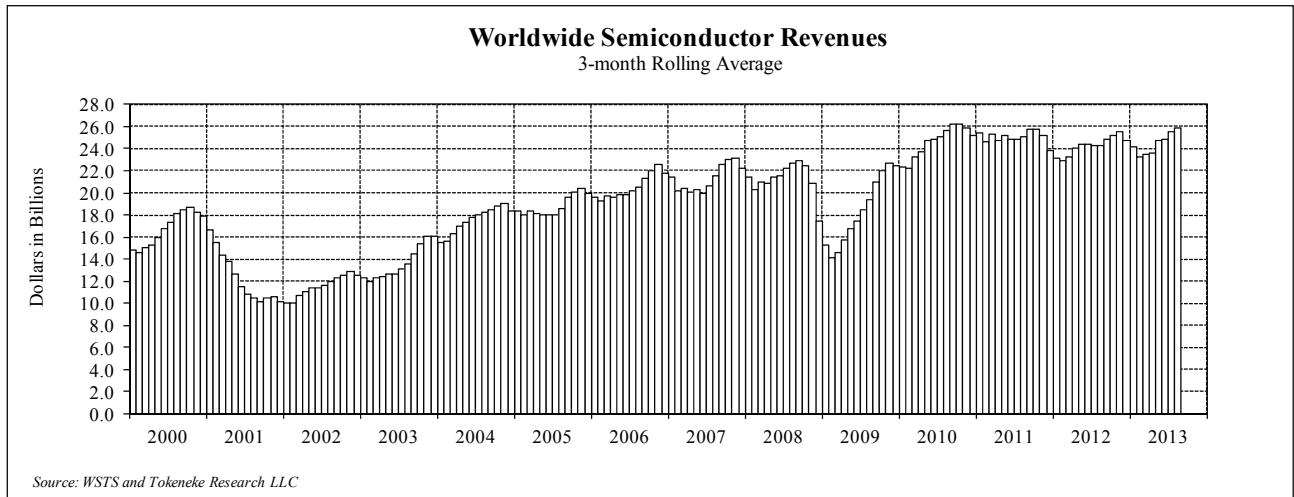
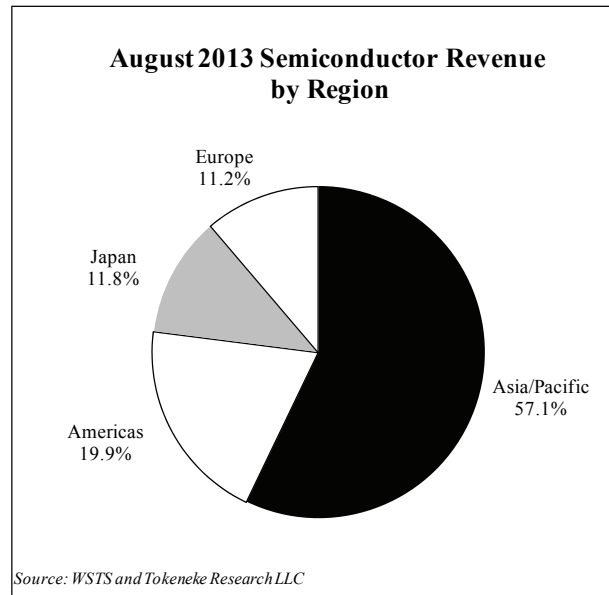
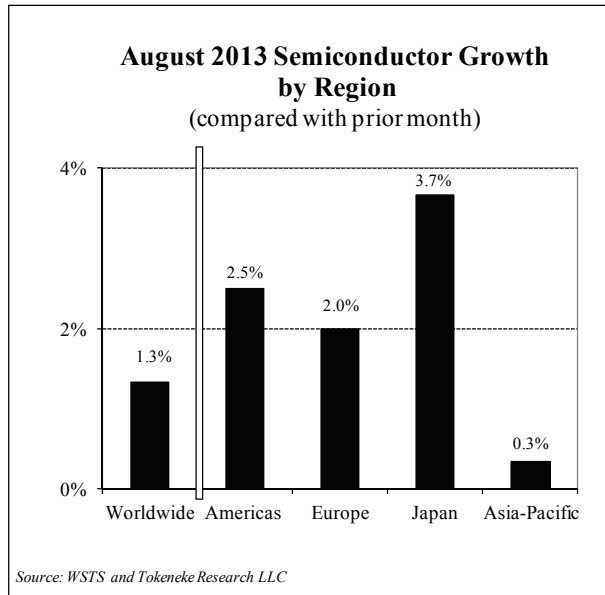
As I noted the last three months: the worldwide economy remains fragile; PC markets have deteriorated off of no-growth expectations; consumer markets are being cannibalized by smartphones (think digital cameras); and higher-growth expectations for both China (in general) and smartphones and tablets (in particular) have tempered. I expect 3Q sequential growth across the semiconductor industry to be supported by new video game platforms, continued strength from automotive and industrial markets, persistent inertia from smartphones and tablets, and possible incremental gains from communication infrastructure and PCs. Unfortunately it appears growth may fall short of seasonal norms largely due to weak macroeconomics and PC markets.

But Chip Sector Rally Outperforms: Semiconductor sector stocks rallied and outperformed broader equity markets during September, mostly during the first half of the month. The Philadelphia Semiconductor Index Option (SOX) gained +7.2% last month and the average stock in the Tokeneke Universe grew by +6.5% with 79 out of 100 advancing. This compares quite favorably to broader equity market gains from the NASDAQ, S&P500 and DOW of +5.1%, +3.0%, and +2.2%, respectively. Year-to-date the chip sector extended its outperformance: the SOX is up by +27.8% with the average stock in my Universe up by a similar +26.9% with 80 out of 100 posting gains, compared to those same three indices with gains of +24.9%, +17.9% and +15.5%, respectively.

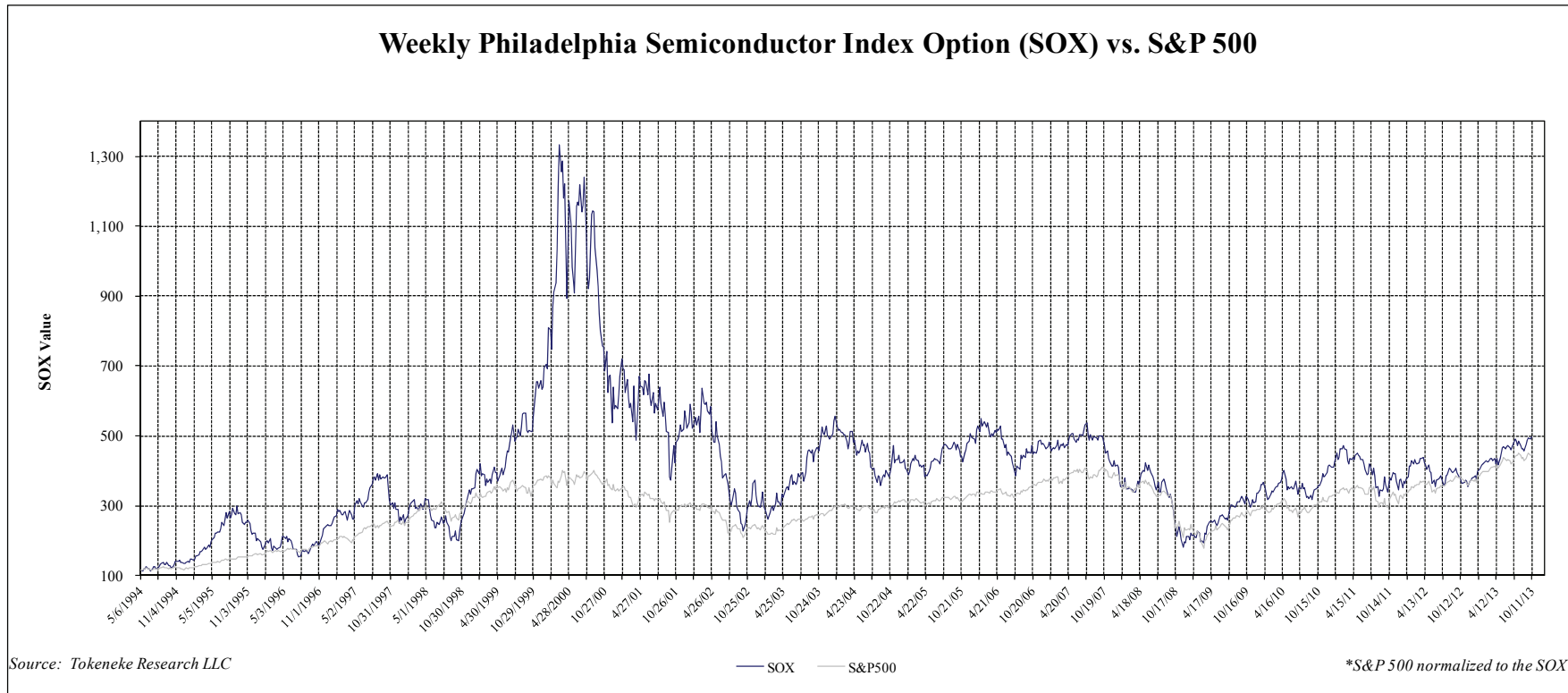
September				3Q				YTD				Indices				
Winners (79/100)		Losers		Winners (62/100)		Losers		Winners (80/100)		Losers		Sept	3Q	YTD		
HIMX	64.7%	PSMI	-18.5%	HIMX	91.6%	TXCC	-27.8%	SPWR	365.5%	TXCC	-57.4%	SOX	7.2%	4.8%	27.8%	
AMBA	36.1%	CY	-17.4%	VLTR	63.1%	MLNX	-23.3%	HIMX	316.7%	PSMI	-41.4%	SMH	7.4%	5.8%	23.4%	
RDA	34.2%	EZCH	-13.5%	SQNS	62.3%	BRCM	-23.0%	MU	175.6%	TSEM	-38.7%	NASDAQ	5.1%	10.8%	24.9%	
MU	28.7%	ACTS	-11.1%	AMCC	46.6%	CODE	-19.4%	INFN	94.8%	MLNX	-36.1%	S&P500	3.0%	4.7%	17.9%	
SQNS	23.1%	LSCC	-6.3%	ISIL	44.0%	ACTS	-18.6%	RMBS	93.0%	MSPD	-35.0%	DOW	2.2%	1.5%	15.5%	
average stock +6.5%		SOX +7.2%		average stock +6.9%		SOX +4.8%		average stock +26.9%		SOX +27.8%						

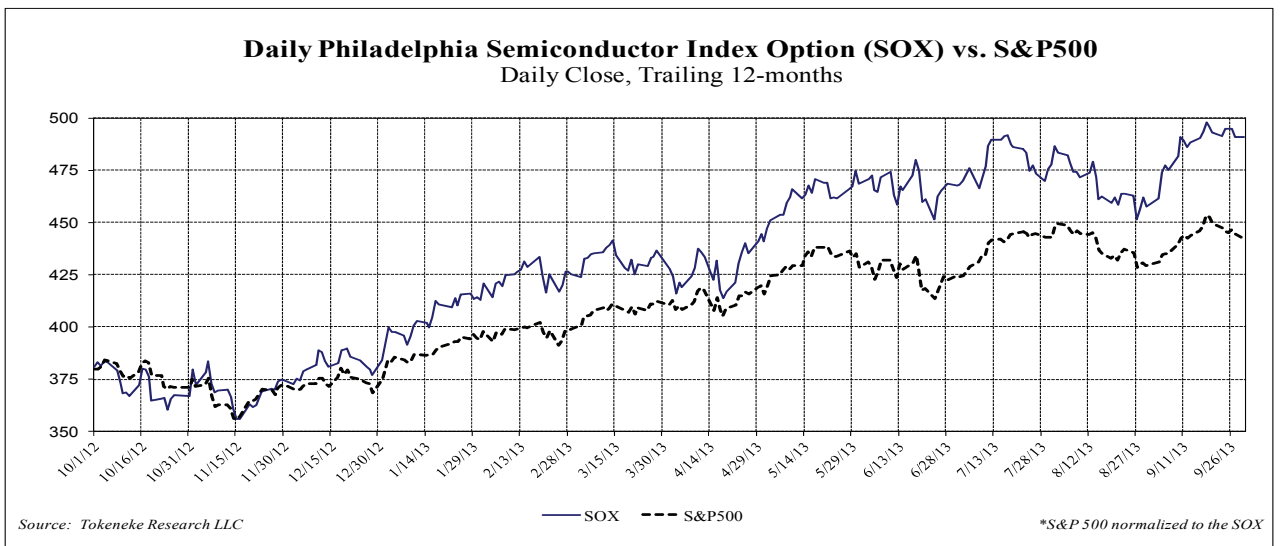
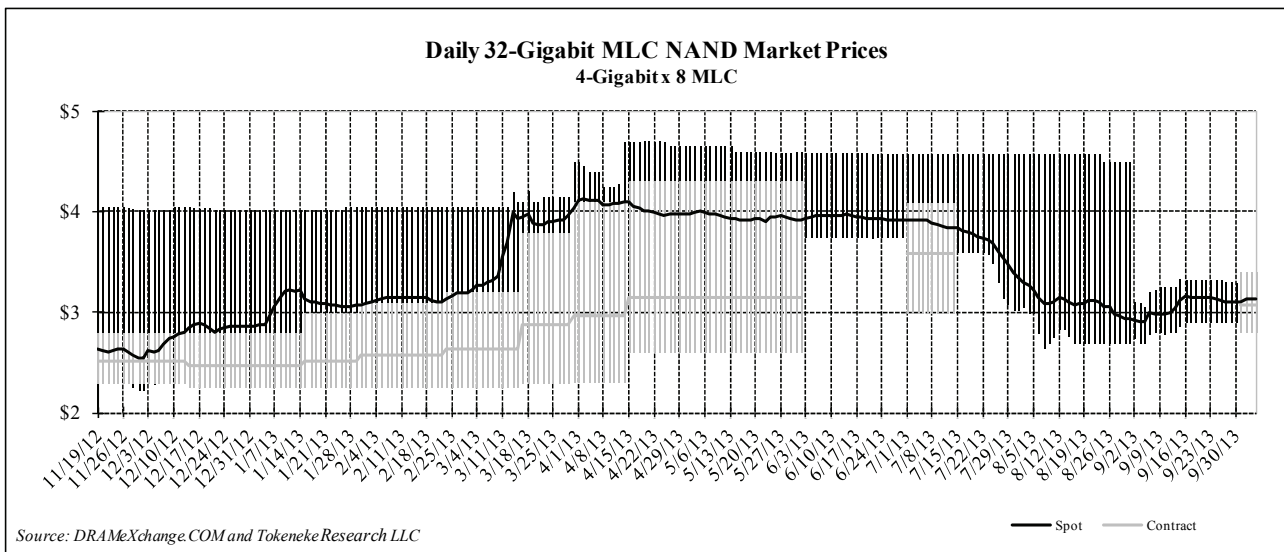
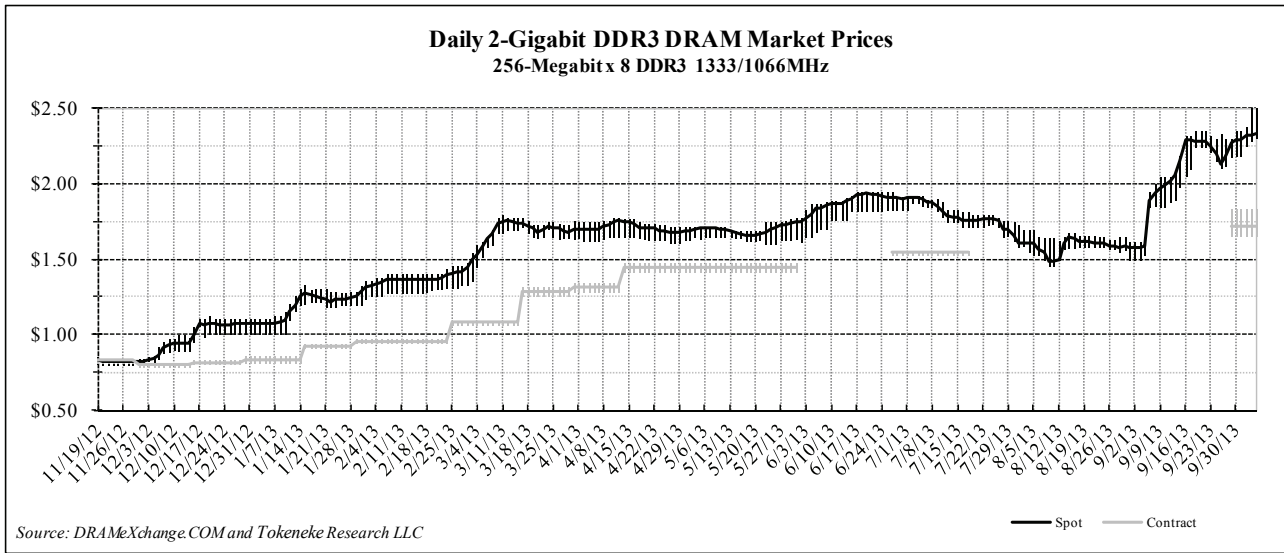
Go Figure: So. Semiconductor industry business conditions deteriorate, but share prices rally. Go figure. The risk-reward trade-off has shifted even more unfavorably, in my opinion. Nevertheless, I continue to recommend specific stocks with pronounced attractive fundamental valuations to mitigate potential downside risk—but only so much as discomfort will allow for your particular situation. See my latest Chip Investment Ideas publication.

—Dan K. Scovel
Semiconductor Analyst



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





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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