

Embrace the Turbulence

Business is Boring, but Stocks are Volatile

Semiconductor industry business conditions remain subdued, although next week's 1Q earnings season is likely to offer some hope in the form of guidance into seasonal 2Q strength. In the mean time, I don't foresee any relief or stability to equity market volatility we have experienced so far this year. My advice is to recognize the turbulence for what it is, and try to accommodate it as best you can within your own personal tolerance for risk and uncertainty.

February as Good as Could be Expected: Worldwide semiconductor industry revenue declined by a better-than-average -1.4% sequentially during February, according to statistics released by the Semiconductor Industry Association (SIA) last week. This compares to an average loss of -2.3% with a high of +1.9%, a low of -7.7%, and gains only five times in the last 24 years—including none of the last nine. Europe once again lead the pack by a nearly flat -0.1%, followed by Asia-Pacific with a decline of -0.4% and Japan with drop of -0.5%. The Americas brought up the rear at -5.6% for the second month in a row.

February was pretty much as good as it could have been and still underperformed to January's -1.4%, given Chinese New Year falling on January 31 with most of the holiday period occurring during February and the trend of that holiday causing the month in which it falls in to be weaker. Next month's release of March data is usually reflects a solid period of growth: it has averaged a gain of +2.5% with a high of +7.0%, a low of -6.9%, and declines only three times in the last 24 years—none of which occurred over the last 12 years.

1Q Weakness: The 1Q earnings season begins in earnest next week with Intel kicking off on Tuesday, and the reported numbers for the period are unlikely to be inspiring to investors. Original guidance for 1Q from companies in the Tokeneke Universe when they announced 4Q results called for a weighted average decline approximating -5.5% which is significantly below seasonal norms, although this has tempered to -5.0% after preannouncements.

The specific range of weighted sales for 1Q from the 4Q earnings season called for a decline centered at -5.6% ranging from -8.1% to -3.1%, which has improved as of this writing to -5.0% ranging from -7.5% to -2.6% after eight preannouncements, including: upside from four (CY, MONT, SIMO and TSM); downside from two (EXAR, OIIM); and reiteration from two (DIOD, QLGC). The semiconductor industry has averaged a 1Q sequential decline of -2.1% with a high of +8.8% and a low of -19.4%, but has been negative 14-times in the last 23 years—including seven of the last nine, according to industry statistics.

2Q Recovery: While 1Q results are likely to be weak, the earnings season could well be salvaged for investors by 2Q guidance that is likely to be encouraging due to consumer market seasonality as noted below. Specifically, 2Q has averaged a gain of +3.9% ranging from a high of +20.0%, a low of -19.9%, and declines only five times in the last 24 years—although that includes three in the last 12.

A word of caution with respect to this good news: First of all, the seasonal trend holds true for consumer markets in general, including smartphones—but *not* for PC markets that have historically experienced a trough during the 2Q; And secondly, the magnitude of this recovery will be measured against upside that is already baked into expectations on a company by company basis. Nevertheless, the good news is that companies with significance consumer/smartphone market exposure can experience solid double-digit percentage growth sequentially.

Chip Stocks Rally and Outperform: Semiconductor sector stocks rallied nicely once again during March and finished strong on the quarter. The Philadelphia Semiconductor Index Option (SOX) gained +4.1% last month while the average stock in the Tokeneke Universe grew by a comparable +4.3% with 71 out of 97 issues advancing. This was noticeably better than broader equity market performance from the NASDAQ, S&P500 and DOW of -2.5%, +0.7%, and +0.8%, respectively. The relative outperformance of the chip sector was even more pronounced for 1Q with the SOX up by +9.7% and 74 out of 97 Tokeneke stocks up by an average of +12.5% compared to those same three indices at +0.5%, +1.3% and -0.7%, respectively.

March				1Q				Indices		
Winners (71/97)		Losers		Winners (74/97)		Losers			Mar	1Q
VIMC	67.9%	AMBA	-20.1%	NLST	156.8%	MX	-28.5%	SOX	4.1%	9.7%
ISSI	27.7%	HIMX	-16.6%	VIMC	156.2%	IKAN	-27.5%	SMH	4.5%	7.5%
MONT	27.3%	AMCC	-13.6%	TQNT	60.6%	AMCC	-26.0%	NASDAQ	-2.5%	0.5%
IPHI	22.4%	OIIM	-12.5%	TSEM	56.5%	HIMX	-21.7%	S&P500	0.7%	1.3%
MTSI	21.2%	SMI	-11.1%	RFMD	52.7%	AMBA	-21.2%	DOW	0.8%	-0.7%
average stock +4.3%		SOX +4.1%		average stock +12.5%		SOX +9.7%				

2014 Is What it Is: I'm sticking with my forecast for 2014 since the beginning of the year: Semiconductor industry business conditions will continue to grow at the slow pace and pattern established over the last couple of years with annual growth in the mid-single digit percent range.

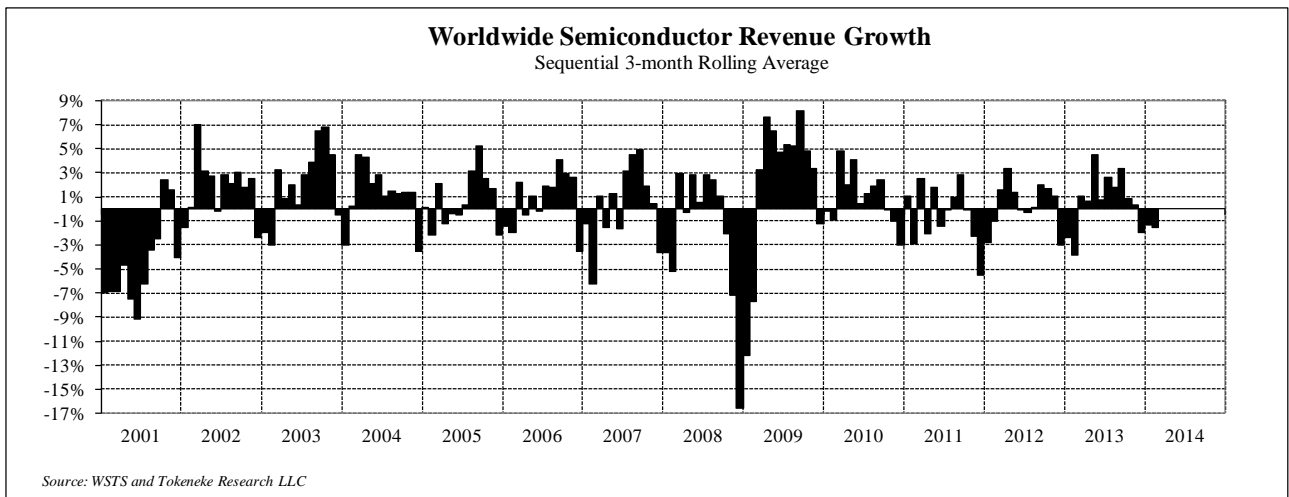
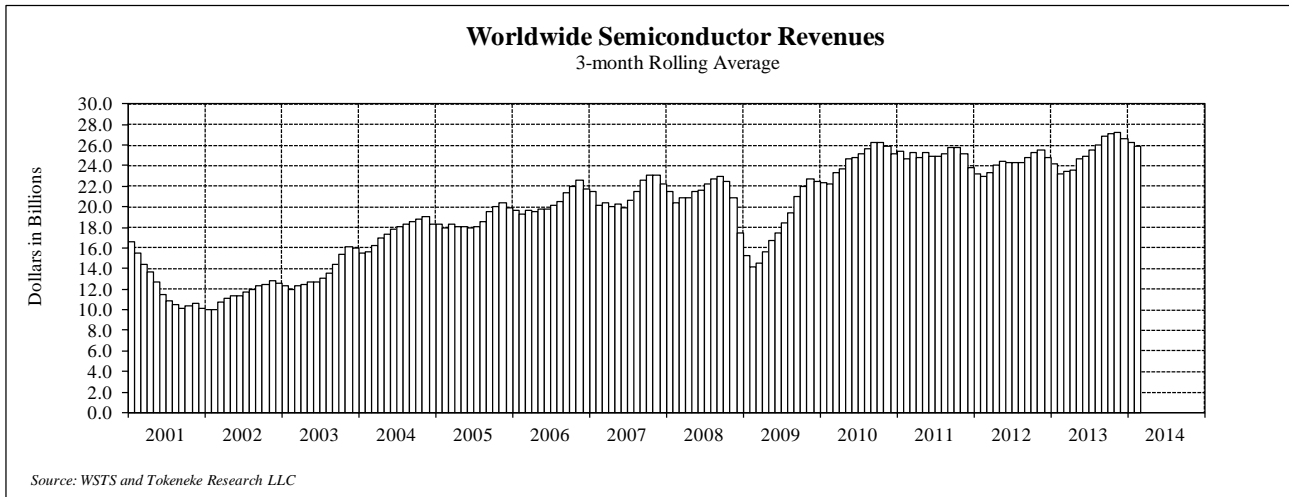
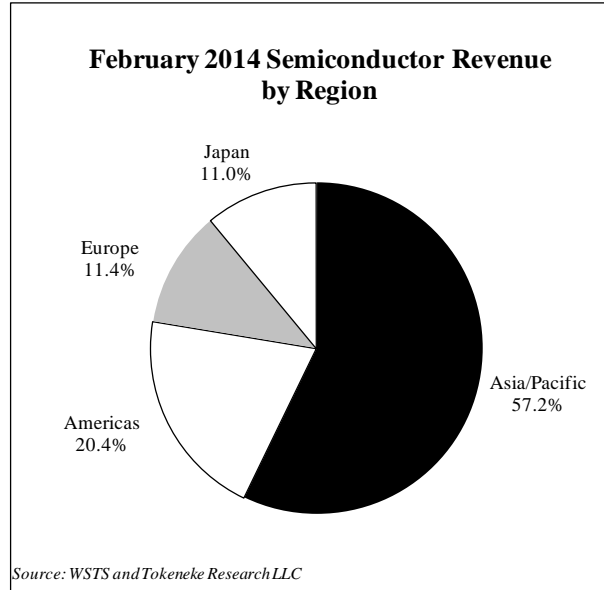
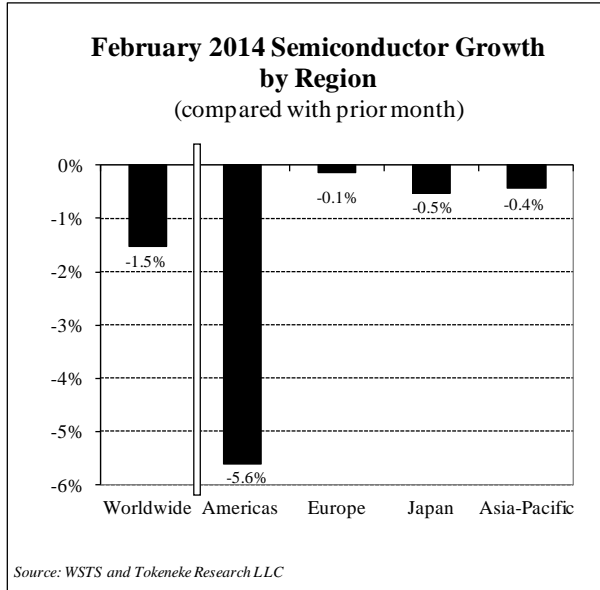
Several years ago semiconductor industry seasonality largely tracked PC market supply characteristics, with a weaker first half of the year including a trough during 2Q, followed by a stronger second half with a 4Q peak. But the world changed after the financial crises in 2008: anemic worldwide macroeconomic conditions have accentuated the relative impact of seasonal business fluctuations; and the rise of the smartphone—and triumph over the PC in terms of total chip sales—has shifted industry seasonality to be more consistent with the traditional consumer market pattern of a 1Q trough, 2Q recovery, 3Q peak and then 4Q decline. While this is very much a gross over-simplification of a \$300B+ industry with many moving parts across a variety of products, geographies and markets, I also don't consider it necessarily inaccurate.

The general pattern of 'consumer market' seasonality has largely played out across the semiconductor industry over the last couple of years, and given persistently lackluster macroeconomic conditions I don't foresee much of a change to that pattern this year.

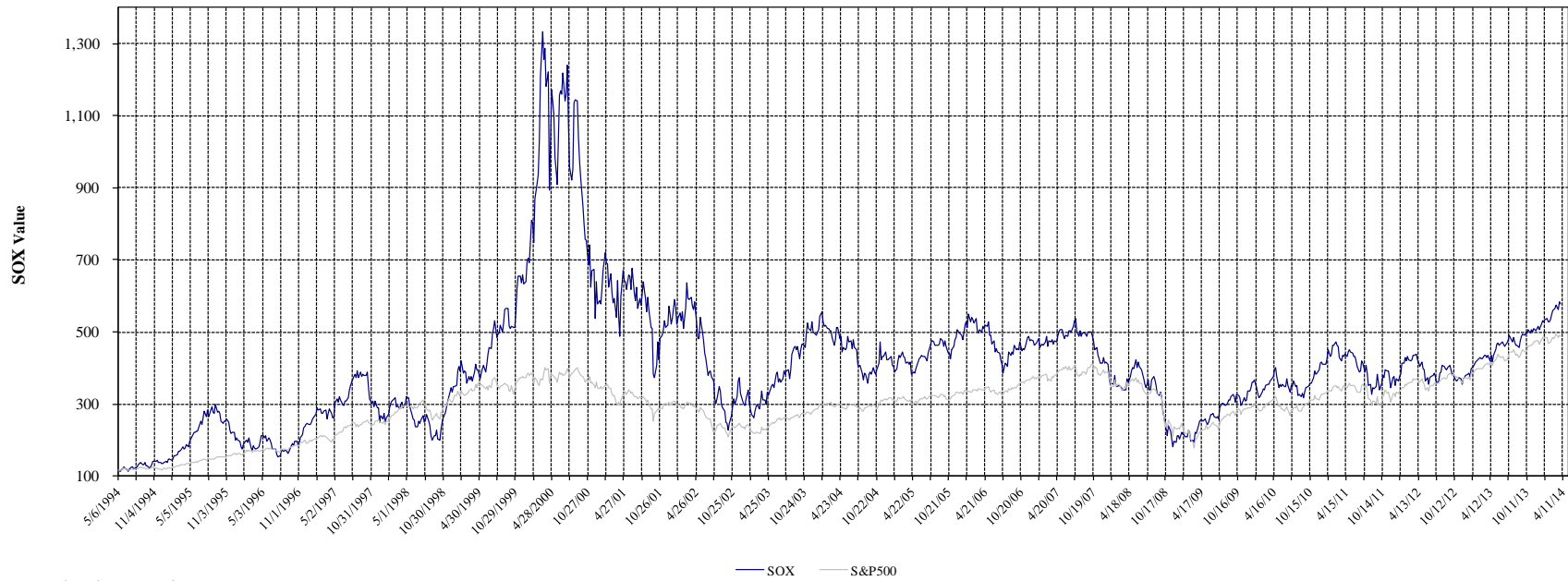
Equity Market Volatility Persists: I am also sticking with my previous equity market characterization of persistent volatility. Most financial market prognosticators originally predicted 2014 to be a year of modest gains after last year's oversized rally. While those forecasts may prove prescience by the time it draws to a close, I think the year will more accurately be characterized as a whirlwind of frustration for investors given the volatility we have already experienced over the first three months. Somehow I can't see the boredom of predictable stability any time soon.

I continue to notice interesting rotations within my Universe as market capitalization, growth and value alternately shift with thematic money flows, as reflected in the elevated frequency of rating changes in my bi-weekly Semiconductor Investment Ideas publication. My advice is to recognize the turbulence for what it is, and try to accommodate it as best you can within your own personal tolerance for risk and uncertainty.

—Dan K. Scovel
Semiconductor Analyst

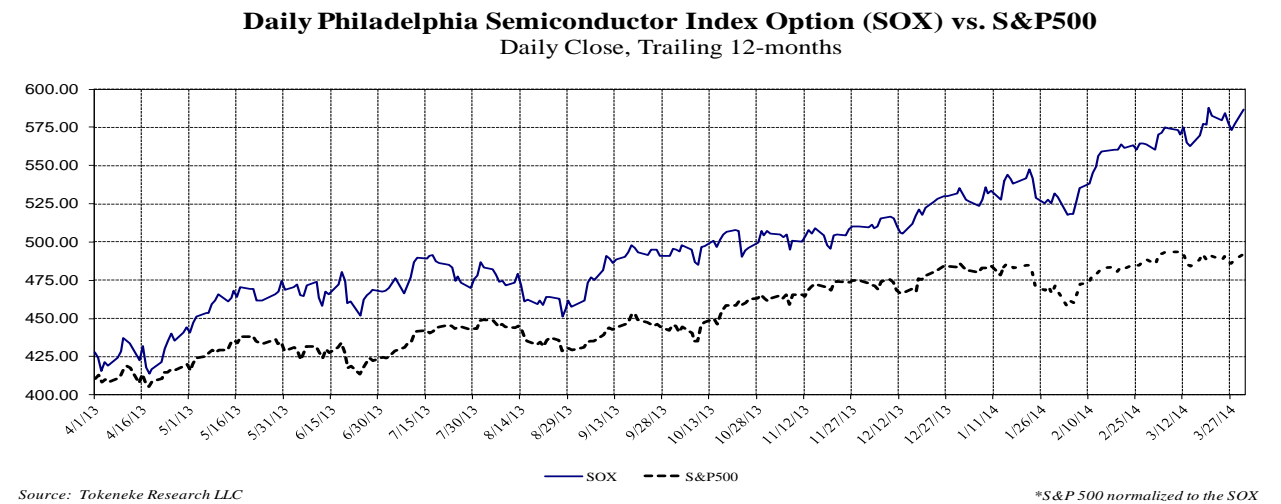
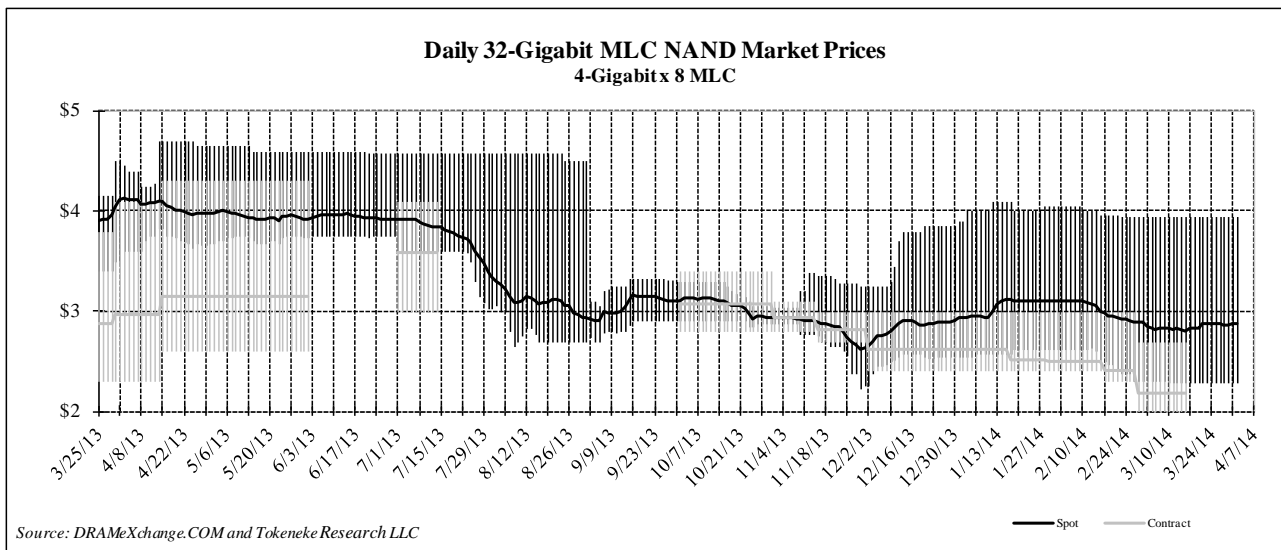
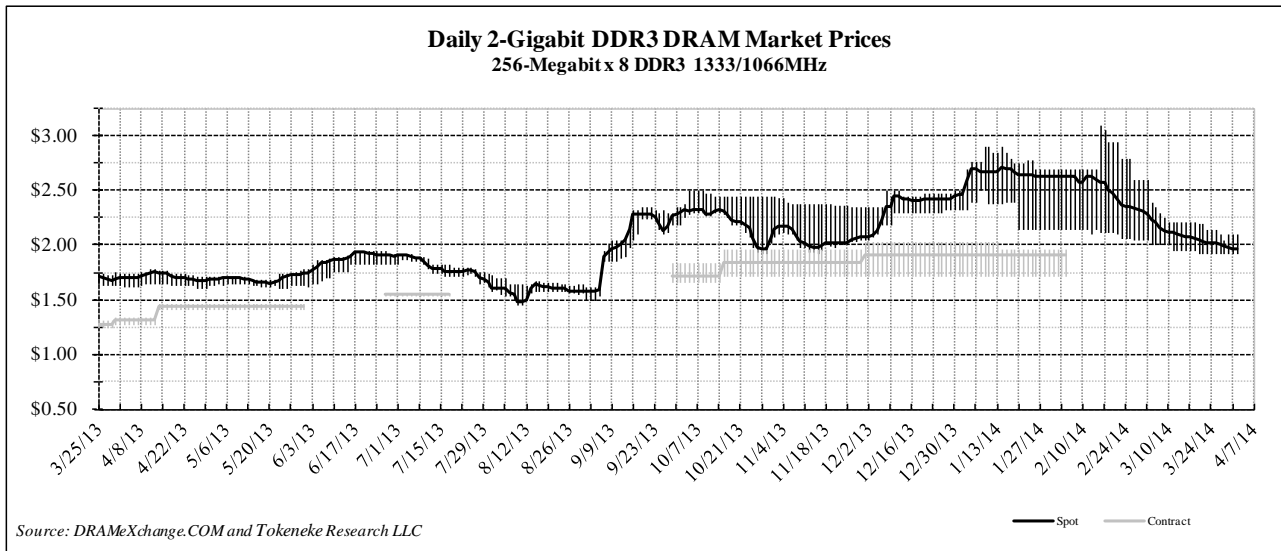


Weekly Philadelphia Semiconductor Index Option (SOX) vs. S&P 500



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

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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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