Sulking Out of the Year with a Whimper

Thai Flooding Tempers PCs, Downturn Offsets Seasonal Strength

Bad, bad, bad. Everything is very, very bad. The semiconductor industry is experiencing a counter-seasonal, cyclical downturn that is likely to be further aggravated over the next few weeks by indirect effects of the recent flood in Thailand, and the stock market is highly volatile and correlated with low trading volumes amid monetary and fiscal gyrations in Europe. I won't trust this market as an investor until stocks finally establish bottoms where bad news of a fundamental nature no longer hurts share prices. Nevertheless, until then there are many potential opportunities across the sector for traders with extremely short time horizons and a high tolerance for risk.

October Weakness: The seasonally strong month of October for the semiconductor industry was unusually flat—and even that description is a bit gratuitous. Semiconductor industry statistics for October world-wide sales released yesterday by the SIA (Semiconductor Industry Association) reported a slight sequential decline of -0.1% on a three-month rolling average basis. While a flat-ish month amid a cyclical downturn may not appear that bad at first blush, the fact is that this is one of the worst Octobers in two decades. In the last 21 years the month has averaged sequential growth of +2.7% with a high of +6.8%, a low of -2.0%, and dropped into negative territory only twice. On a relative basis, October was pretty darn bad. Japan lead the world with growth of +2.2% as it continued to recover from its earthquake and tsunami earlier in the year, followed by The Americas with +1.3%, then Asia-Pacific with a decline of -0.8%, and finally Europe with a drop of -1.6%.

Next month's release of November sales could easily reflect a more pronounced decline despite its history of seasonal strength due to continuing macroeconomic softness, the beginning of constraints due to flooding in Thailand, and the month's history of being slightly weaker than October. November has averaged growth of +1.9% with a high of +6.3%, a low of -7.2%, and has fallen into negative territory three times in the last 21 years.

3Q Slowdown: Company earnings announcements for 3Q are complete, and the stragglers over the last few weeks brought the reported averages down even more. As I noted last month, industry statistics for the 3Q reflecting sequential quarterly growth of +3.5% was half of the two-decade average of +6.6% and actually overstates the weighted growth of the over-100 companies in the Tokeneke Universe that fell to +2.6% from +2.8% over the last four weeks. And if I slide behemoth Intel out of the numbers, that weighted growth rate remains at +0.3%. At the final tally, a solid 80% of reporting companies missed some combination of published expectations of 3Q sales, 3Q earnings, and 4Q outlook—despite the 27 negative preannouncements from a solid one-quarter of my Universe going into the period.

4Q Decline: As bad as 3Q was, this quarter will be even worse. Historical average growth for 4Q is +2.1% with a high of +16.0%, a low of -24.2%, and negative growth in seven out of the last 21 years. The Tokeneke Universe of companies is guiding for weighted sales growth this quarter of -5.0% to +0.7% centered on -2.1%, down by 50 basis points in the last four weeks. And on a per-company basis the average guidance ranges from -9.0% to -3.4%. Indeed, market researchers have been lowering expectations for annual chip industry revenue growth this year over the last few weeks into the low single-digits.

Thai Flooding Downside Risk: While the current counter-seasonal slowdown in the second half of the year is clearly reflecting a macroeconomic cyclical downturn across the semiconductor industry, I would argue that the flooding in Thailand during October is likely to offer incremental downside risk in the near-term—primarily from the relatively opaque indirect impact to PC markets.

The direct impact to the disk drive business appears to be acknowledged at this point, with a shortfall of some one-third of the 175M units of disk drives manufactured each quarter beginning in December as inventories are flushed through the supply chain, with the worst of the shortage occurring during the first quarter next year. Indeed, just last week Western Digital was able to announce a resumption of manufacturing at certain facilities. In addition, chip companies with direct exposure to test and assembly operations in Thailand were largely able to size the potential impact to manufacturing constraints as part of their 4Q guidance. These companies included LSI, ONNN, NXPI, MSCC, INFN and MCHP, among others. I believe the direct impact from the flooding has been well accounted for and is unlikely to trigger any incremental downside risk across the semiconductor industry at this point.

However, the indirect impact is much less understood and such uncertainty was well acknowledged by company managements during their 3Q earnings announcements. Specifically, PC unit shipments could be shorted in the range of 10% this quarter (and even greater next quarter) due to the lack of disk drive availability, and this clearly has potential ramifications for microprocessors, DRAMs, and a wide variety of ancillary ICs and components. I believe the potential for downside risk to 4Q expectations is very likely at this point—especially from companies with exposure to PC markets—and we are just now entering the period of mid-quarter updates where those factors will begin to become apparent.

Narrowing Safe Havens: Even the worst of times has its winners—think of Apple, for example—and chip makers supplying smartphones, PCs, tablets and automotive markets have so far fared better than most. Unfortunately, I think this short list will get even shorter before a cyclical recovery can establish itself sometime next year. PC markets are at risk, as I noted above, but the smartphone and tablet markets are already beginning to shake out the losers from the winners. Specifically, Apple and Samsung smartphones appear to be exhibiting strength, but some of their competitors are starting to slide (think RIM and HTC, for example). Likewise in the tablet space that Apple dominates and Amazon's Kindle and Barnes and Noble's Nook appear to have established a foothold. But if you're not one of them, you can't give them away (think HP and RIM, for example). I guess that leaves automotive, although even here there are recent reports of dark clouds surrounding unit sales expectations at the margin in the electric vehicle segment.

Equities Crater: November was not a good month for stocks, either—at least in the chip sector. The Philadelphia Semiconductor Index Option (SOX) fell by -3.4% and underperformed both the NASDAQ at -2.4% and the S&P500 at -0.5%. Even worse, the average company in the Tokeneke Universe dropped by -4.8% and a solid 70% of the Universe declined during the period. The worse news is that bad news continues to hurt share prices, indicating a bottom has still not been achieved. There were a couple glimmers of hope where bad news rallied stocks anyway, but not enough to call it a trend—at least not yet, in my opinion.

November

Winners *(31/104)*		**Losers**	
NLST	81.6%	RMBS	-54.9%
INVN	50.1%	TRID	-51.9%
AATI	31.9%	OVTI	-33.8%
TSRA	26.0%	QUIK	-25.7%
TXCC	19.6%	SIMG	-23.8%
average stock -4.8%		*SOX -3.4%*	

QTD ***(4Q)***

Winners *(67/104)*		**Losers**	
NLST	139.2%	TRID	-50.0%
SIMO	68.7%	RMBS	-43.0%
INVN	50.1%	NPTN	-31.1%
TSRA	45.3%	CODE	-28.5%
AMCC	38.9%	MXL	-25.4%
average stock +8.2%		*SOX +10.2%*	

YTD

Winners *(27/104)*		**Losers**	
SIMO	358.8%	TRID	-85.4%
NETL	57.3%	MIPS	-68.4%
INVN	50.1%	ANAD	-67.5%
AATI	43.4%	QUIK	-64.4%
CEVA	40.5%	OVTI	-63.6%
average stock -16.7%		*SOX -9.3%*	

Indices

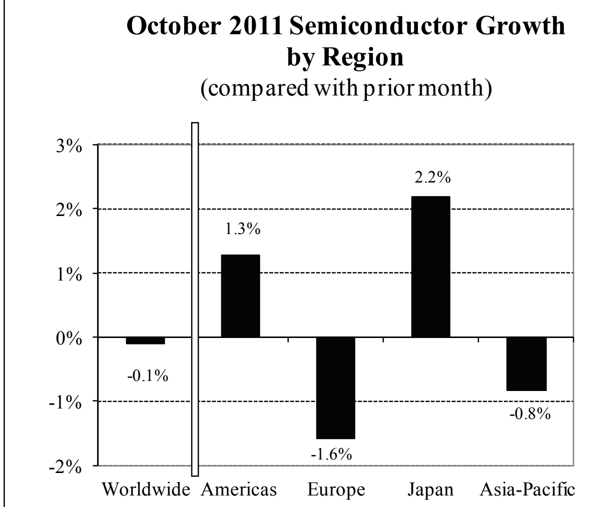
	Nov	***QTD***	***YTD***
SOX	-3.4%	10.2%	-9.3%
SMH	-3.4%	7.8%	-5.7%
NAS	-2.4%	8.5%	-1.2%
S&P500	-0.5%	10.2%	-0.8%
DOW	0.8%	10.4%	4.0%

Trading Opportunities: Allow me to repeat my rant from last month. Trading volumes are extremely low, correlation among stocks is extremely high, and all eyes of the investment community are watching and reacting to the daily comings and goings of European sovereign debt. No one seems to be paying attention to industry fundamentals, and those who do are incorrectly extrapolating the strength at INTC and QCOM throughout the rest of the sector. And all this is working to support to chip sector share prices when they should be finding a bottom. In short, I simply don't trust this market. And I won't, until sector share prices find a bottom.

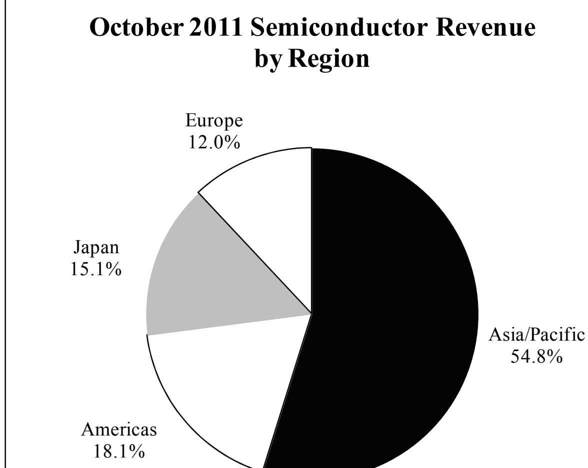
I feel better now. All that having been repeated, fundamental valuations are largely attractive across my entire Universe and there are many opportunities for short-term traders, albeit mostly in the smaller and mid-market capitalization spaces. I consider these potential opportunities more so trading rather than investing in nature due to the volatility of equity markets, the depressed magnitude of fundamental valuation levels compared to historical averages across the sector, and the relatively weak and uncertain business conditions throughout the industry. The best way to play them at this point, in my opinion, is to rent these stocks instead of owning them, and taking profits after modest double-digit gains that are likely to follow a spot of good news from the European banking morass.

The good news is that I think equity markets are incrementally closer to establishing some kind of bottom over the last month, although that has yet to be achieved on a broad basis. And the bad news is that I think the Thai floods will indirectly be a source of incremental downside of a fundamental nature in the near term. While there are fairly limited opportunities for longer term investors in the current chip business and equity market environment, a fair number of significantly attractive fundamental valuations amid share price volatility offer numerous potential opportunities for traders with high risk tolerance and unusually short attention spans. Tread very, very carefully.

—Dan K. Scovel
Semiconductor Analyst



Source: WSTS and Tokeneke Research LLC



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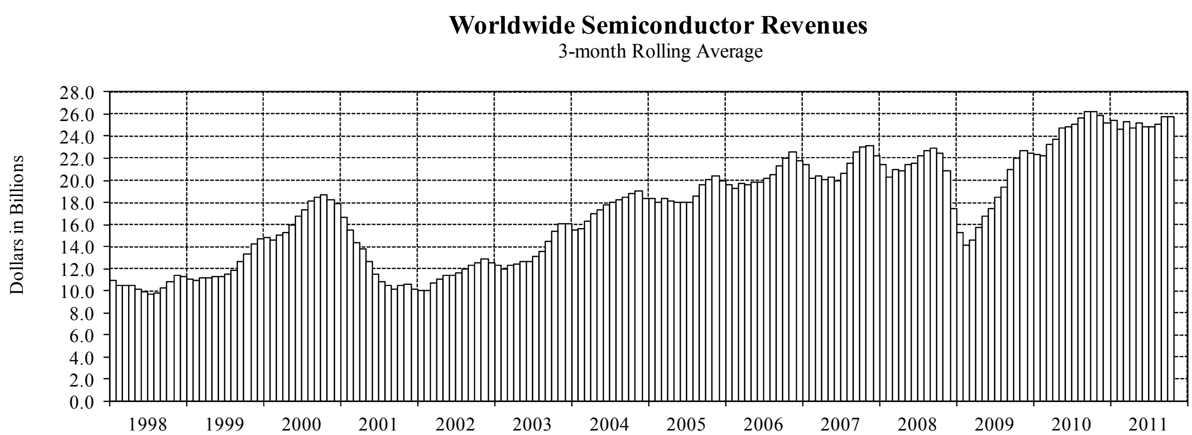

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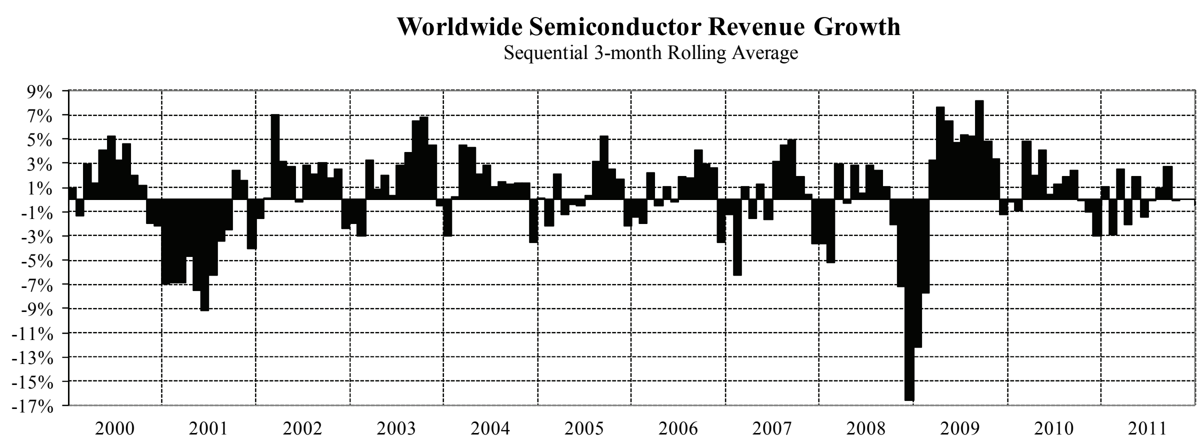
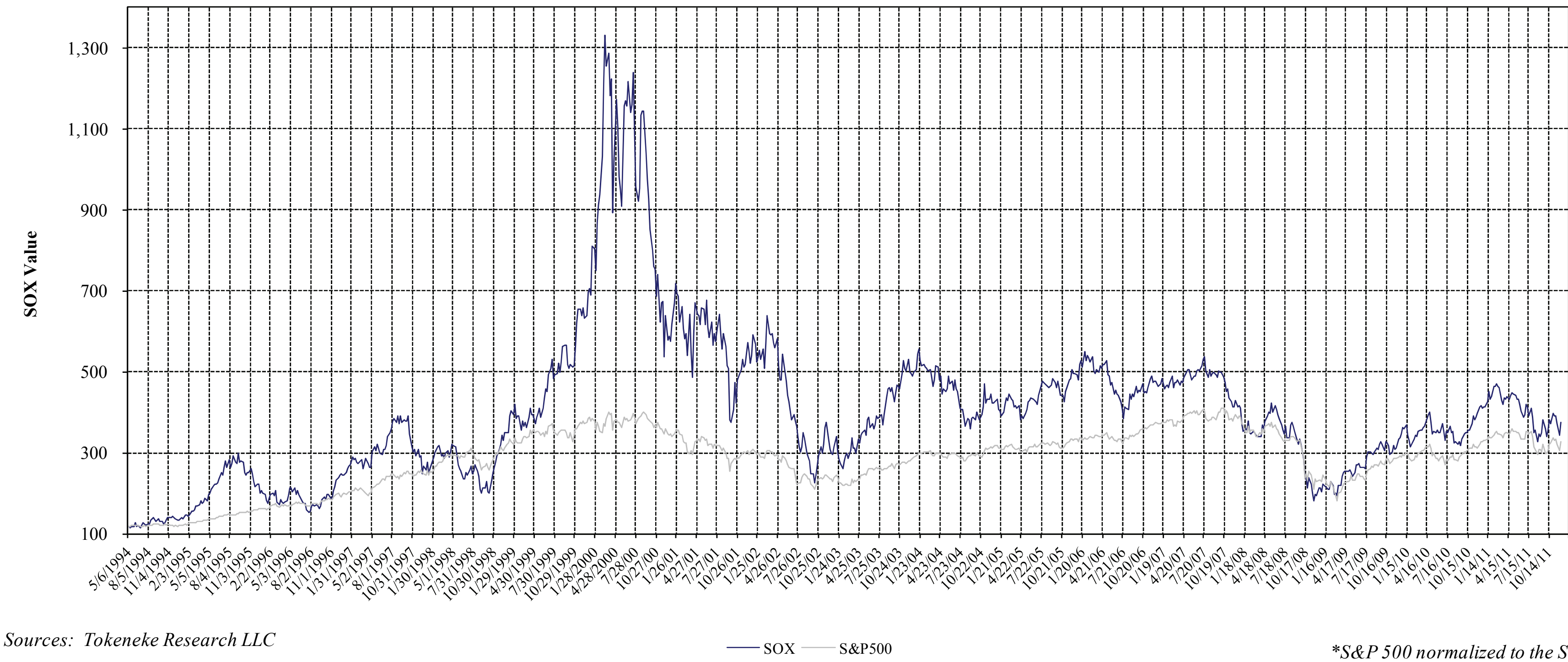


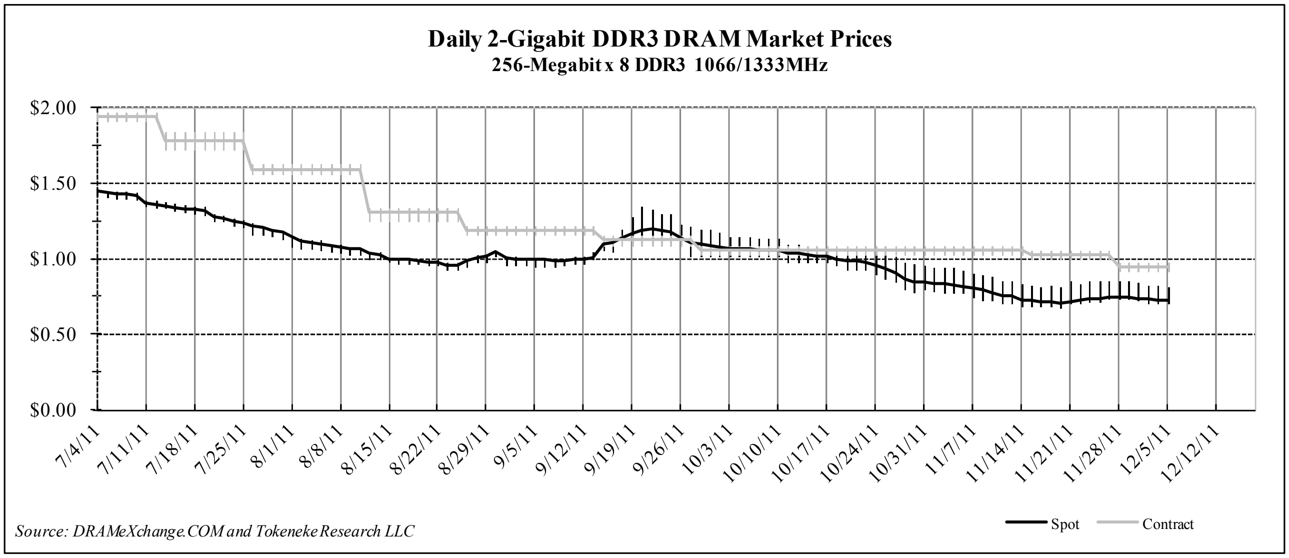
Source: WSTS and Tokeneke Research LLC

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



Sources: Tokeneke Research LLC

***S&P 500 normalized to the SOX**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256-Megabit x 8 DDR3 1066/1333MHz
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$1.50
$1.00
$0.50
$0.00
7/4/11
7/11/11
7/18/11
7/25/11
8/1/11
8/8/11
8/15/11
8/22/11
8/29/11
9/5/11
9/12/11
9/19/11
9/26/11
10/3/11
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10/17/11
10/24/11
10/31/11
11/7/11
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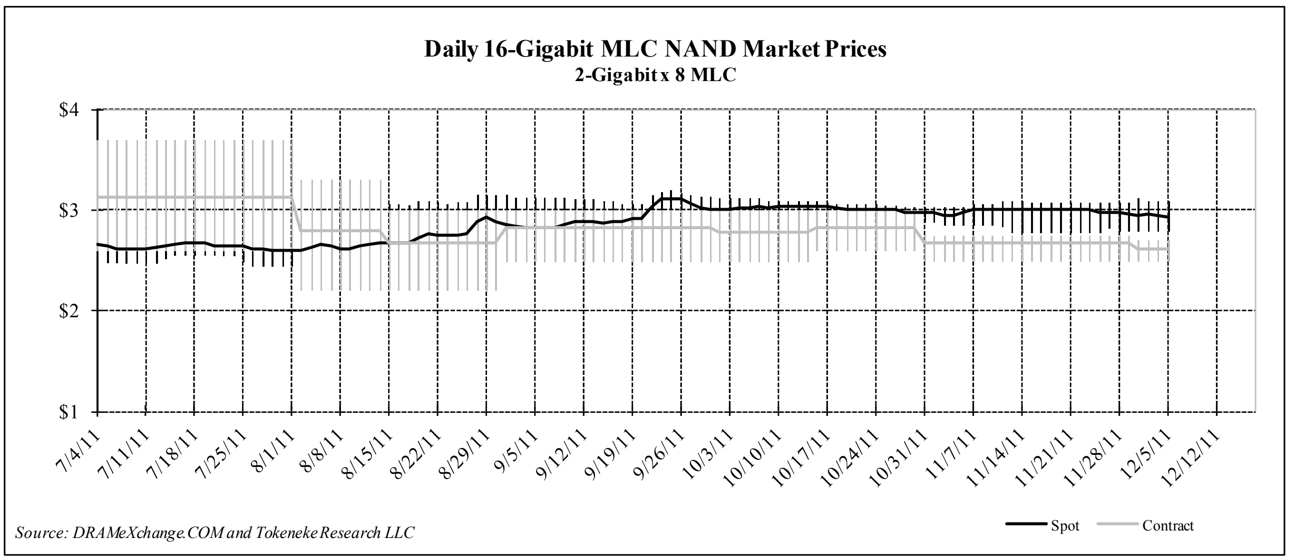
Spot
Contract
Source: DRAMeXchange.COM and Tokeneke Research LLC


Daily 16-Gigabit MLC NAND Market Prices
2-Gigabit x 8 MLC
$4
$3
$2
$1
7/4/11
7/11/11
7/18/11
7/25/11
8/1/11
8/8/11
8/15/11
8/22/11
8/29/11
9/5/11
9/12/11
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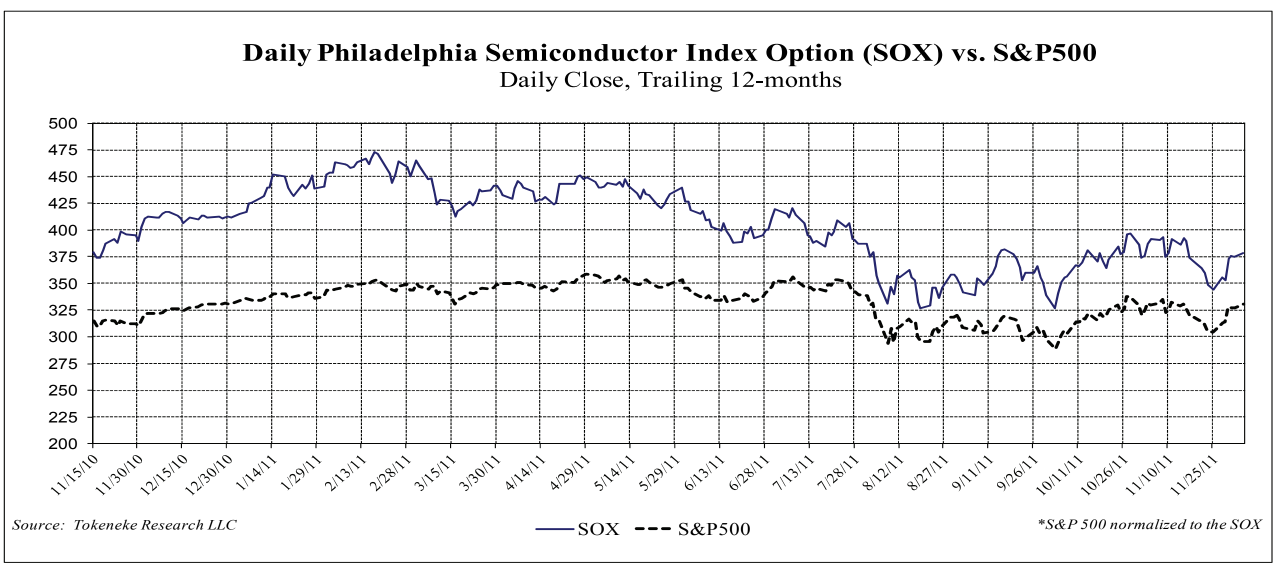
Spot
Contract
Source: DRAMeXchange.COM and Tokeneke Research LLC


Daily Philadelphia Semiconductor Index Option (SOX) vs. S&P500
Daily Close, Trailing 12-months
500
475
450
425
400
375
350
325
300
275
250
225
200
11/15/10
11/30/10
12/15/10
12/30/10
1/14/11
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10/26/11
11/10/11
11/25/11
SOX
S&P500
Source: Tokeneke Research LLC
*S&P 500 normalized to the SOX

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 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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