

**3Q Strength—and Upside—a Foregone Conclusion
But 4Q Business is Still Unclear**

Summary: I expect current chip industry business strength to be reinforced with continuing preannouncements of expected 3Q upside over the next few weeks, resulting in solid double-digit percentage sales growth across the industry this quarter. Nevertheless, I think it remains a stock-pickers market for short-term traders amid a valuation mine-field that could easily correct as 4Q turns out to be something less than expected seasonal strength.

July Marches Up: Semiconductor industry statistics for July were released earlier last week, and worldwide sales grew by 5.3% over the prior month on a three-month rolling average basis. This compares quite favorably with the 3.7% growth posted during June, and establishes record high growth for the month of July since 1990. July has averaged growth of 1.2% with a previous high of 3.3%, a low of -6.3%, and sequential declines only three times in the last 19 years. All regions contributed meaningful growth led by Japan with 7.9% and followed by the Americas with 5.9%, Europe at 5.3% and Asia-Pacific at 4.3%--which now accounts for over half of total industry revenue.

I expect continuing mid-single digit growth when August sales are reported next month consistent with expected 3Q strength this year. August sequential growth has averaged 1.7% since 1990 with a high of 4.6%, a low of -3.5%, and negative growth only four times in the last 19 years.

3Q Strength: Double-digit sequential growth 3Q is a foregone conclusion at this point given guidance going into the period during 2Q earnings announcements. Management guidance this quarter seems nearly as conservative as that offered in the prior quarter given customer backlog and bookings trends, and I would not be surprised if we see reported revenue top the high-end of guidance for a significant percentage of companies across the sector once again this quarter. In fact, as of this writing we have already seen six preannouncements of expected 3Q strength above that originally guided at the beginning of the period from ALTR, ATHR, CHRT, INTC, MCHP and TSEM. This has pushed expected weighted average growth across the Tokeneke Universe from a range of +4% to +11%, to a range of +6% to +12%. The average low-end and high-end of guidance by company is +8% to +15%.

Current business strength is due to three factors: stabilizing end-market consumption; re-stocking of extremely lean channel inventories; and channel-filling to support expected seasonal strength during the second half of the year. Unfortunately, two out of three of these are inventory related—and end-market demand remains muted across most end-markets. Nevertheless, islands of growth persist among netbooks, smart phones, LCD TVs, MEMS and steady market price improvements in DRAMs and NAND flash memories.

Rally Persists: Share prices across the chip sector continue to climb, but are starting to under perform relative to the broader equity indices. During the month of August the chip sector (as reflected in the SOX and SMH) largely reflected the performance of the NASDAQ, but underperformed relative to the broader Dow and S&P500 indices that are catching up on a quarter-to-date basis (although still lag meaningfully year-to-date).

August		QTD (3Q)		YTD		Indices			
Winners (63/113)	Losers	Winners (93/113)	Losers	Winners (99/113)	Losers	Aug	QTD	YTD	
PXLW 102.9%	IDCC -29.2%	TSEM 171.1%	IXYS -32.8%	STEC 851.4%	SPWR -31.5%	SOX	1.5%	16.4%	44.3%
CNXT 82.0%	SPWR -21.3%	LOGC 124.4%	EZCH -27.7%	TSEM 635.7%	SIMG -27.6%	SMH	2.0%	18.6%	44.5%
TSEM 74.6%	MSPD -16.7%	PXLW 109.1%	INFN -23.3%	ENR 510.0%	EZCH -25.1%	NAS	1.5%	9.5%	27.4%
NSLT 72.2%	MLNX -13.8%	CNXT 89.6%	QUIK -17.6%	RFMD 502.6%	IDCC -23.8%	S&P500	3.4%	11.0%	13.0%
MOSY 53.1%	SIMG -12.7%	STEC 74.8%	TUNE -15.4%	PXLW 376.2%	INFN -21.9%	DOW	3.5%	12.4%	8.2%
average stock +6.8%	SOX +1.5%	average stock +19.6%	SOX +16.4%	average stock +90.3%	SOX +44.3%				

I believe the rally in the sector is running out of steam as fundamental valuations revert to their respective statistical means. On a long-term average trailing price-sales ratio basis, fundamental valuations in the Tokeneke Universe are becoming less attractive. True, the sector is still pretty attractive with nearly 80% of my Universe issues trading below their averages. But this number has dropped below 80% in recent weeks after being above it for a few months; falls to nearly 70% if we include stocks that are less than 10% below their respective average; and 60% for those below 30% of average. (I use a 30% discount as a break-point to trigger potential investment interest as a meaningful number amid the inherent volatility of the sector.) I still consider the sector to be relatively attractive,

but it is becoming less and less compelling as share prices rise and valuations become strained. Equity selection is becoming more and more critical.

I wrote at some length last month about my discomfort with the uncertainty of financial modeling amid the current macroeconomic environment, and my desire to offset this risk with more conservative fundamental valuation metrics. This phenomenon persists, and manifests itself as a preference for greater than normal discounts. This means my traditional 30% discount is closer to 50% in order to satisfy somewhat similar confidence—and that renders less than half the Tokeneke Universe attractive on a fundamental basis.

Start Again, Stop Again: Nevertheless, I expect the chip sector to outperform over the next few weeks primarily due to anticipated preannouncements of expected 3Q upside. This bullish sentiment will also be supported by a longer term view that technology is well positioned to lead whenever a macroeconomic recovery finally does materialize due to lean inventory and sharp operational cuts at this onset of the downturn. While the timing of this factor will decidedly *NOT* be consistent with current business strength, I still believe it will be employed when making investment and trading decisions.

However, this good news could abruptly turn negative as we penetrate the month of October and the beginning of the 3Q earnings season due to uncertainty (or certainty) associated with potential 4Q weakness. I believe current valuations largely reflect a typical, seasonally strong 4Q. But I fear that consumers are in no position to support that, and the current inventory build will trigger a subsequent correction. Visibility into 4Q business conditions does not appear to have materialized yet. If I am correct, then the chip sector will correct to the downside during the October earnings season.

However, if I'm wrong, then I get another chance to be right as the New Year rolls into traditional 1Q seasonal weakness. The only way I can be wrong here is if a macroeconomic recovery happens to coincide and offset such seasonality—a scenario I consider highly unlikely.

Longer-term Health: Longer-term investors that can withstand these near-term gyrations are extremely well positioned to benefit from exposure to the semiconductor sector as long as they stick with solid balance sheets and business franchises (or at least avoid the weaklings). Why? As cited above, I believe the sector is well positioned to lead whatever macroeconomic recovery occurs due to lean inventories and operations. I'll call the 'long-term' somewhere in the neighborhood of two to five years—but I'm not convinced that the depth and breadth of current macroeconomic weakness will allow equity markets to avoid significant gyrations of greed and disappointment within the next year or so.

I continue to believe we reside in a stock-pickers market for short-term traders. Strap-in and enjoy the ride.

—Dan K. Scovel
Semiconductor Analyst

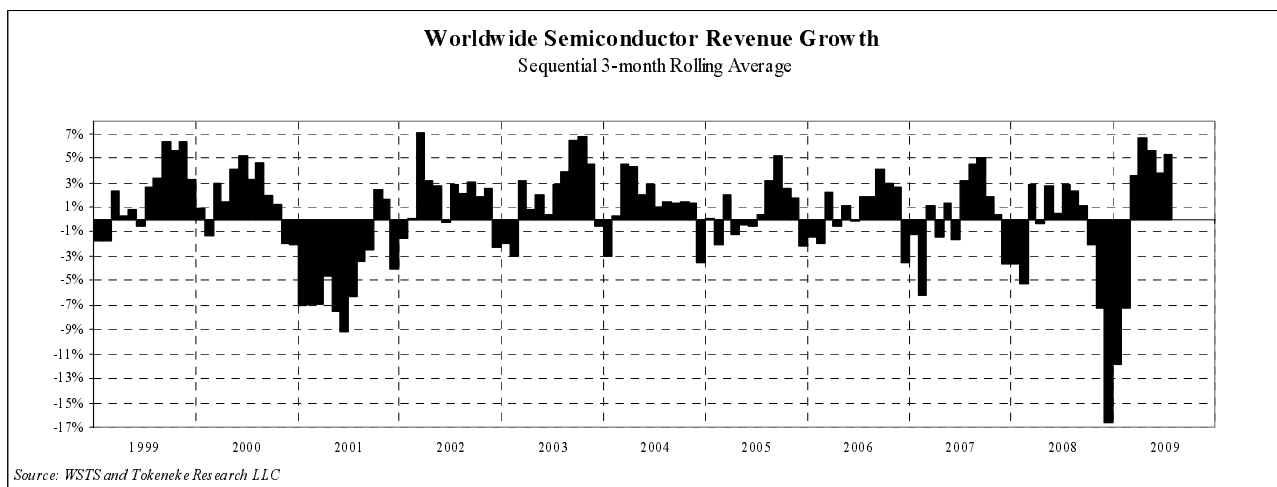
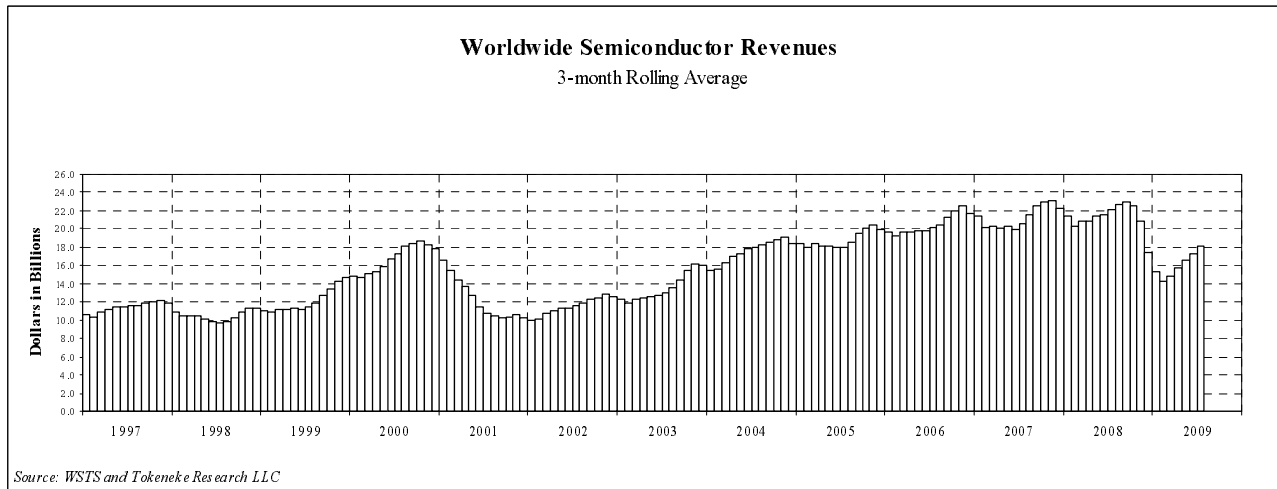
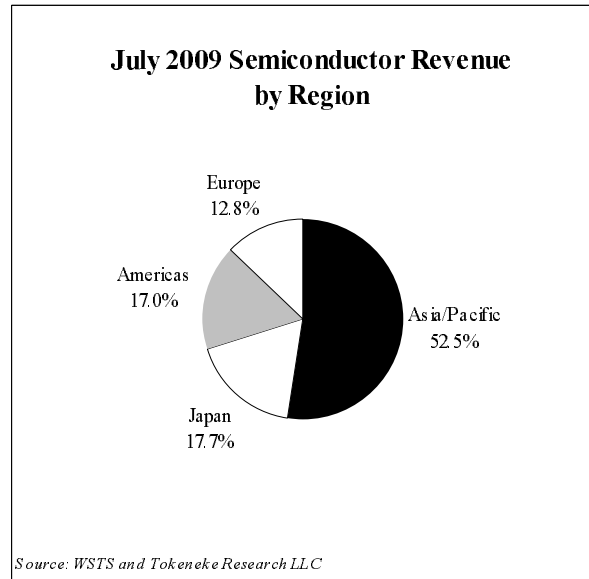
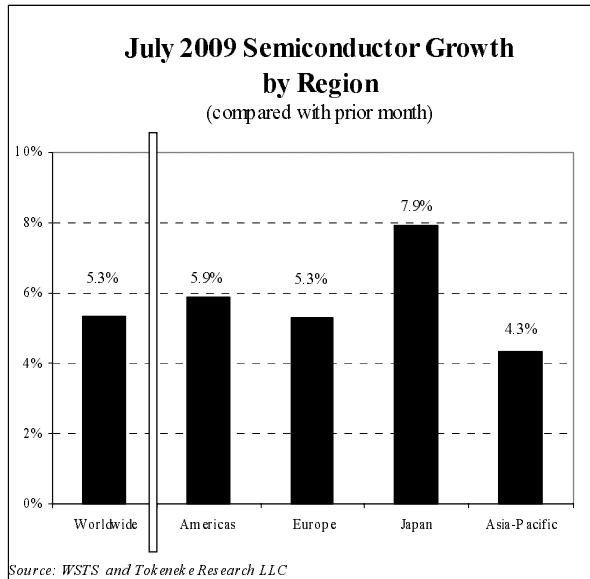
Stock Recommendations: Please see the most recently published reports for additional information.

MU: Buy recommendation with a 12-month target price of \$10—for the unusually risk-tolerant investor.

TXN: Buy with a 12-month target price of \$26. Trade it between technical support around \$14 and \$26.

INTC: Hold. Fully valued at \$22. Trade it between \$15 and \$22.

NSM: Hold. Fully valued at \$15. Trade it between technical support around \$9.50 and \$15.



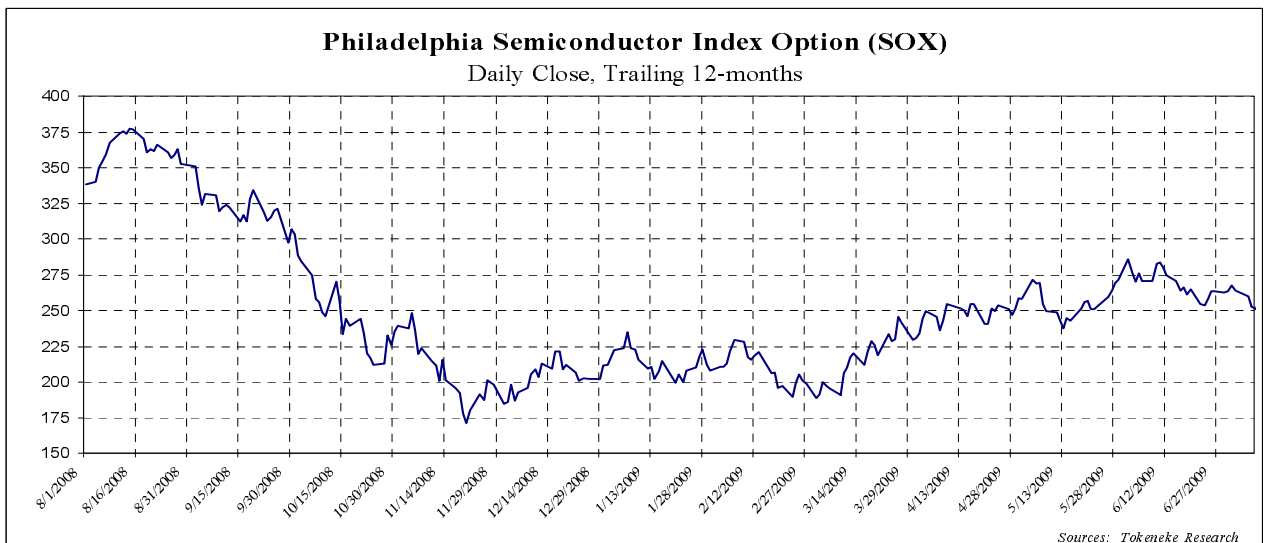
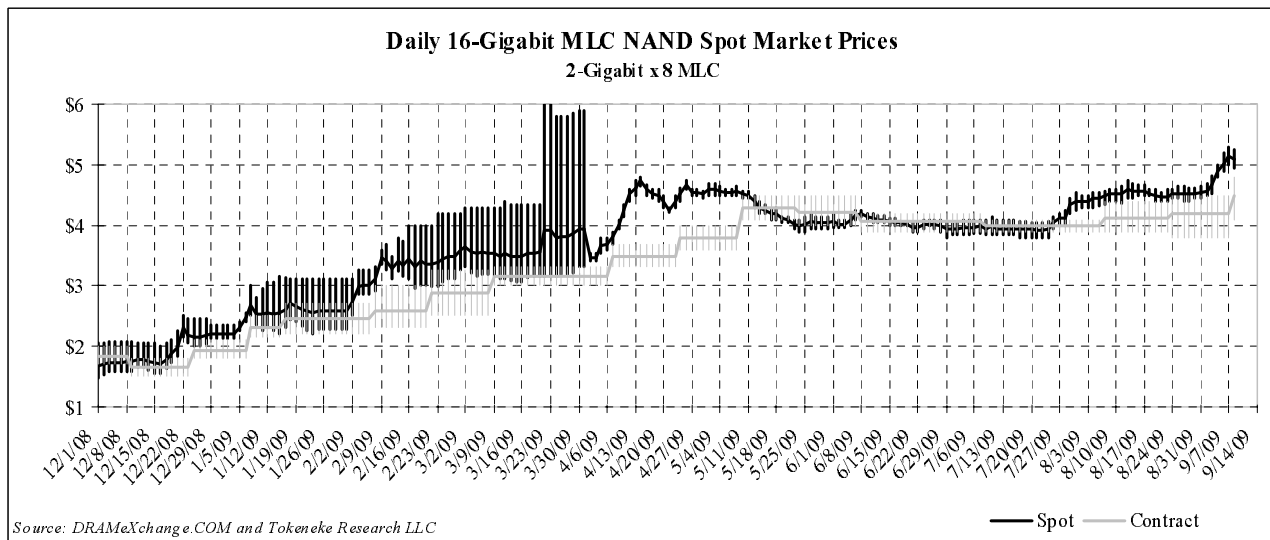
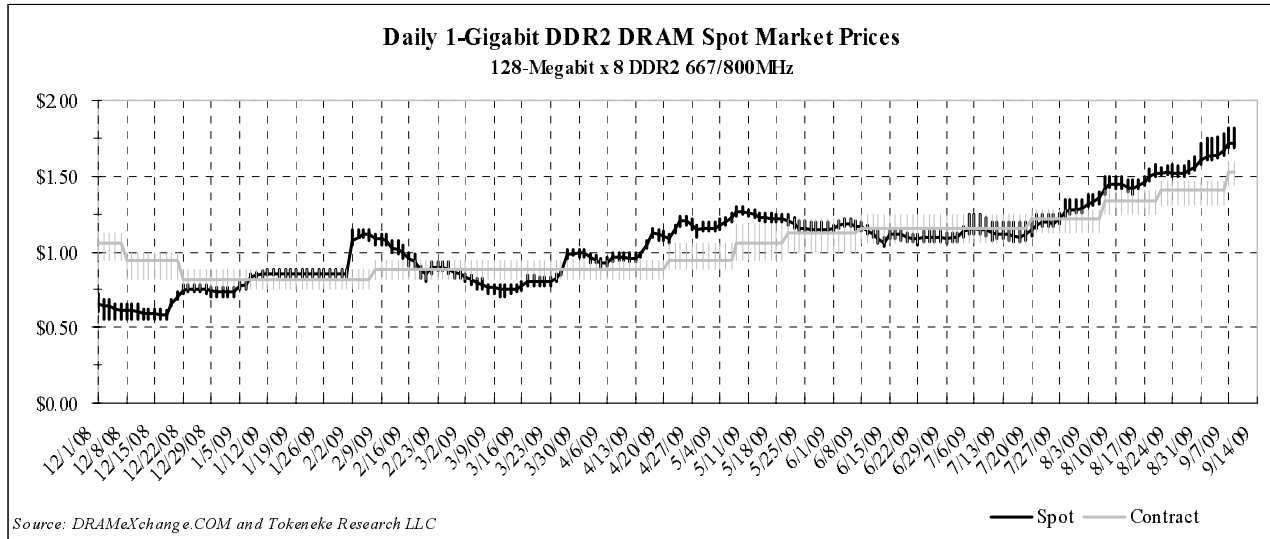
Weekly Philadelphia Semiconductor Index Option (SOX) vs. S&P 500



Sources: Tokeneke Research LLC

— SOX — S&P500

*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 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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