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TRACKING THE NUMBERS

Quite Contrary

Placing a Wager On the Chip Sector

Maxim Strategist Ritholtz Sees Tax-Incentives Sunset Picking Up Semiconductors

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After taking a sustained beating from analysts this summer, the semiconductor sector is sporting a shiner.

Some of the biggest names in the business suffered a rash of well-publicized downgrades from chip analysts last month, sending the Philadelphia Stock Exchange Semiconductor Index down just over 14% in July. Better earnings offer companies no solace: The same day **Intel** Corp. reported a 96% jump in second-quarter net income, its shares tumbled 11% over concerns about inventory and profit margins.

Merrill Lynch recently downgraded chip stocks to "underweight" from "overweight," and UBS last week downgraded semis to underweight from a "neutral" rating. Morgan Stanley said it expects Intel's third-quarter revenue to come in below estimates. Deutsche Bank cut Intel's rating to "hold" from "buy," Lehman trimmed its earnings targets, and Merrill downgraded the company to neutral from buy.

And yet, industry groups are talking about huge gains for chip sales this year, and hopes for capital spending and economic growth are still primarily upbeat. Global semiconductor sales in the second quarter rose 9.5% from the first quarter to $53.45 billion, according to the Semiconductor Industry Association. In June, sales were up 40% year over year. As such, there are still those on Wall Street who believe that chip companies will finish 2004 in good shape.

Barry Ritholtz, chief market strategist at Maxim Group in New York, an investment bank with about $5 billion under management, thinks chip companies could shine in the fourth quarter thanks to tax incentives that end this year, motivating businesses to spend on technology before the sunset. He thinks that growth in chip sales could come even if the broader U.S. economy slows, as it recently has been showing signs of doing.

WSJ: Semiconductor Equipment and Materials International predicted sales for suppliers to the chip industry will leap 63% this year, and the Semiconductor Industry Association projects global chip sales will rise by about 29%. Do you agree with all the recent pessimism coming

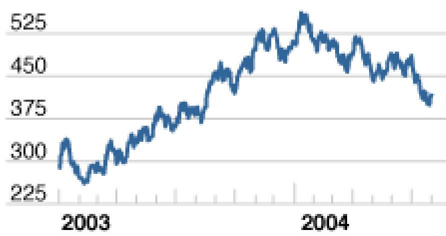
from Wall Street about the outlook for the chip sector?

Mr. Ritholtz: To use a recently popular phrase, this sounds like a bit of groupthink to me.

BETTING HIS CHIPS WILL COME IN

Surging semiconductor sales
Global, year-over-year change

The sector's stocks sink
Philadelphia Stock Exchange's Semiconductor Sector Index



Maxim Group chief market strategist **Barry Ritholtz** *at his office in New York's Chrysler building.*

Sources: Semiconductor Industry Association; Thomson Datastream

I don't agree with the specific pessimism for the rest of 2004, but my macroeconomic model shows some real problems by mid- to late 2005. That's not specific to semiconductors -- it's more a [question] of, how will the economy keep going once the "pig is through the python," once all of the tax and interest-rate stimulus are gone? With higher interest rates, increased commodity prices, raised taxes regardless of who wins in November and the stimulus fading, why will the recovery keep expanding?

Longer term, I think the semiconductor cycle can remain somewhat insulated from the broader economy. As long as demand for iPods, laptops and phones remains robust, semiconductors should do well. It would take the economy to grind to a full stop to derail the semiconductor cycle here.

The U.S. is but one of the world's major economies. Asia -- especially China, but also Japan's recovery, along with healthy outlooks in Singapore and South Korea -- will continue to stoke demand for semiconductors. Even Europe, whose economy has lagged the rest of the world's recovery, shows a continuing demand for electronics. My expectations for a robust semicycle assumes that Europe maintains a humdrum growth pace. If their economy ever woke up, semiconductor sales would soar.

As long as the Asian-rim recovery keeps humming along, semiconductor sales can still grow, even if the U.S. recovery remains anemic.

Do you think Intel's outlook -- which predicted revenue growth of about 10% in the third quarter -- indicates chip and chip-equipment stocks may avoid the fate Merrill laid out for them? There still seemed to be concerns about profit margins and inventories.

I think some of Intel's problems are due to the real competition developing in the CPU space. One of the unsung aspects of Intel's margin pressure was **Advanced Micro Devices**. They have matured into a real competitor, and are no longer just an also-ran. Their new server chip got rave reviews, is well priced, and will migrate to the desktop.

Some analysts are concerned that a glut of inventory capacity may hurt pricing power. What do you see happening?

I am expecting a surge of orders in the fourth quarter to take advantage before [the] sunset on the accelerated depreciation-tax rule passed a few years ago. It behooves big buyers of hardware and capital improvements to step up and make their buys in 2004 rather than wait until 2005. The semiconductor companies' expectations of this surge helps to explain the inventory build-up: You have to make hay while the sun is shining, and it will shine brightly in the fourth quarter.

Of course, this sort of "reverse channel stuffing" could hurt sales in 2005. That's the law of unintended consequences.

Historically, what kind of performance have chip stocks had at this stage in an economic recovery?

It's hard to make any sort of comparison between this cycle and any previous cycle. There has been incredible post-bubble damage, 9/11, unprecedented stimulus and a war -- all the while with very tepid job creation. I simply cannot find an analogous era with which to compare the cycle to.

The soon-to-be-gone accelerated depreciation will be the driver in the fourth quarter. I'm looking for a bounce into the end of the year, and possibly the first or second quarter of 2005.

How about valuations?

Tech valuations are usually too high. The question is, are they absurdly overpriced, or merely expensive? Intel, AMD and **SanDisk** have become, if not cheap, well, certainly more reasonably priced than they were.

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