

Rally, Retreat: Repeat

Market Rally Turns, But Bullish Indications Multiply. This Bear Turns (Slightly) Bullish.

Summary: Business conditions across the semiconductor industry continue to unfold consistent with my expectations: a bottom appears to have been reached and certain near-term incremental improvements have surfaced, although this plateau has occurred at a fairly depressed level and the timing and profile of the ultimate macroeconomic recovery remains elusive. I continue to believe we remain in an equity market environment that will be characterized by rallies followed by retreats, but my macro outlook has turned to slightly bullish from moderately bearish following the Fed's move last week to inject \$1 trillion into treasury and mortgage bonds.

Fundamentals Turn Bullish: Three macroeconomic events have occurred over the last week that has tipped my fundamentally bearish views on the overall economy and equity markets to a slightly bullish one: likely changes associated with mark-to-market accounting by FASB, bullish quarterly comments by big banks, and the Fed's injection of considerable capital into treasury bonds, Fannie Mae and Freddie Mac.

I used to work at Fahnestock and Company several years ago (before it became Oppenheimer) and we had a market technician by the name of Joe Barthel who had a nice way of mixing a bit of fundamental macroeconomics with his chartist ideology in a simple and easy-to-digest manner. Three of his most powerful truisms have popped into the front of my cortex in recent days: Don't fight the Fed; Volume is the weapon of the Bull; and Bull markets need a wall-of-worry. We now have such a winning trifecta, in my opinion.

Don't Fight the Fed: Just when we thought the Fed was out of ammunition with interest rates at 0%, Helicopter-Ben delivers a command performance on 60-Minutes and then craters the long-bond three days later by printing and injecting \$1 trillion into treasury and mortgage bonds. Inflationary? Yes (buy gold, other commodities, and equities—like semiconductors!). But let's avoid a potential depression first by unfreezing the banking sector so companies can get back to doing business, and then worry about the next problem. I think investors have the timing wrong on this issue: near-term we need to restore confidence over the next few months to avoid a depression; after that we can worry about the inflation problem—inflation is certainly NOT an issue today.

Volume is the Weapon of the Bull: Equity market trading volume was above the average so far this year during the rally that began on March 10 triggered by surprisingly positive quarterly business comments from large banks, and then spiked to levels not seen since last November when the Fed announced its capital injection on Wednesday. The upside from the big banks was clearly unexpected; can easily be supported by the expected changes in mark-to-market reporting for 1Q; and is a giant step forward in the stabilization of the banking sector—in my opinion. Bond spreads are supporting profitable banking operations, and the mark-to-market change will likely alleviate the confidence-killing, pro-cyclical, kitchen-sink write-offs that have rendered big-bank losses at the levels of oil company profits in recent quarters.

Wall of Worry: Plenty to go around—especially given the weakness in equities at the end of last week. The lack of visibility into the timing and profile of a recovery will continue to pressure fundamental valuations and eventually curtail optimistic (and opportunistic) short-term rallies, in my opinion. In addition, see my downside discontinuities specified below for even bigger walls to worry about.

As the year unfolds I think we will enjoy a long series of incrementally positive news of a fundamental economic nature, first as the banking sector quits losing money—and actually start to make some ('as any idiot can with a 400 basis point spread between the long and short bond'), and then as businesses begin to report incremental improvements in quarterly revenue and earnings.

From the chip sector I continue to expect positive fundamental news during April: February monthly industry sales will be reported around April 1 and is very likely to improve on a sequential monthly basis for the first time in several months and clearly denote a revenue bottom; and 1Q earnings announcements during April are already shaping-up to be better than originally expected with no fewer than 10 preannouncements to date—all to the upside, with only two reiterations of original revenue expectations.

However, this good news will be tempered by the fact that 1Q will still contract by around 10% sequentially, and my expectation for generally flat-ish 2Q guidance will continue to render the recovery as elusive.

Rally, Retreat; Repeat: I still believe we remain in an equity market that will be characterized by a series of advances and corrections this year, but I no longer believe it will be accurate to describe it as bear market rallies. Instead, I think we will see these 20%+ rally and retreats exhibiting incrementally higher-lows and higher-highs as typified by a bull market, rather than the lower-lows and lower-highs of a bear market. The operative word may well be 'incremental' as we bounce along a channel of dashed optimism and tempered pessimism in search of the timing and profile of an elusive recovery.

Downside Discontinuities: Except for the union card-check issue, I don't foresee any negative discontinuities from a macroeconomic perspective—mostly because a plethora of bad news has already been baked into the investor psyche. Increasing unemployment as a lagging indicator is a foregone conclusion, and the current administration's tax and fiscal policy can probably only get better as congress waters down its more egregious elements. From a fundamental macroeconomic perspective, I think the union card-check issue is the one potentially likely negative discontinuity that could dash my bullish perspective and trigger lower equity market lows. I don't think it will (and certainly hope it doesn't) come to pass, but it could easily end-up being an extremely close call.

On the other hand, I think the biggest issues that could likely trigger unexpected negative discontinuities and new equity market lows would be geopolitical destabilization in the form of terrorist attacks, assassinations and/or strategic power plays by America's adversaries. Recent headlines that could prove to become quite bothersome, in my opinion, include: North Korea's plans to launch a satellite; The Russian threat to base bombers in Cuba and/or Venezuela; and Iran's persistent nuclear activities.

Agreement with Barron's: I pretty much agree with this week's Eric Savitz Technology Trader column titled 'Be Wary of the Big Rally in Semiconductor Stocks, the chip rally will crumble.' Yes, we have just experienced a nice rally; and yes, it's probably time to take profits. The article cites the lack of end-demand improvements to support recent inventory-replenishment-based upside (not inconsistent with the message from the recent TXN mid-quarter update), and I consider this wholly consistent with my articulation of the lack of visibility into the timing and profile of the recovery.

In addition, I very much agree with the Jonathan Laing suffix to Kopin Tan's The Trader column, subtitled 'Wednesday Changed Everything,' that the Fed's \$1 trillion injection is a game-changing event.

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