

BY STEPHEN BRENNAN

Does October Hold a Surprise?

I AM STILL FEELING BULLISH AFTER reversing my long-held bearishness at the end of July. I now expect October to meet expectations for volatility, and to surprise folks with strong gains. It is extremely difficult to make any market predictions a month in advance, let alone several. Yet I think there is a very good chance that much of November and December will be spent digesting stock market gains made in September and October.

Traditionally, October has been among the best and worst times for the stock market. Following the East Asian Crisis market bottom of 1998, the S&P 500 rose more than 10 percent in October. In 1987 the market dropped more than 20 percent in this single month. Other years were much less dramatic, but 2002 has been nothing if not volatile, and I expect the excitement to continue.

BEATING LOW EXPECTATIONS

Why expect good things instead of bad in October? Many companies and analysts – especially in the technology sector – have purposefully set the bar of expectations very low after having been too optimistic in the past. Given this situation, the third quarter earnings season is more likely to surprise with good news than bad.

Beyond “diminished expectations,” though, is a real opportunity. Right now companies in the semiconductor sector and other technology arenas are also about as lean and mean as they can get. The weak have died or been consumed by the strong. The strong have cut fat and are little more than muscle and bone now. The costs from layoffs and write-offs from wastefulness (like unwise acquisitions) are largely paid, and the dirty accounting laundry of the 1990s is mostly aired out and cleaned up. Cost structures are in place that can weather a tough environment and produce very healthy profits from any pickup in demand.

VALUATIONS ARE FINE

Given the earnings potential in corporate America, I don't mind price-to-earnings ratios that have not

fallen as far as some want. Actually, I think semiconductor stock valuations at the end of August looked compelling given the state of the industry. For example price-to-sales ratios for profitable companies like Intel, Applied Materials, Novellus and KLA-Tencor are around four. In other words, for every four dollars of equity there is a dollar in sales backing it up.

The price-to-sales ratios for many chip stocks have been as high as twice this level and as low as half the level at respective valuation peaks and troughs. So, valuations have been cheaper. But what is important to consider is the current level, given the existing environment. Sales are anemic. When revenues begin to improve, the trend will not be toward lower price-to-earnings or price-to-sales ratios, but will be in favor of higher stock prices and more expensive valuations.

THE CYCLE CONTINUES

Every semiconductor industry cycle seems to end in a torrent of over-spending, during which otherwise smart folks argue that on this occasion the good times will keep going. Then there is a bottom, which is much more severe than ever thought possible, and companies cut back to the bone. The over-spending and under-spending feed into one another and are so extreme that everyone agrees that they will not do this again – and then they do.

In this cycle as well, we had our over-investment, and we are well into a period of under-investment to set up a mad dash to spend when chip demand turns around. After predicting in March that there would be little strength in the second half of this year, I believe it is very likely that a true industry upturn will gain traction in the first half of 2003. Semiconductor (SMH), software (SWH), pharmaceutical (PPH), utility (XLU) and even broadband (BDH) stocks all look like they have the potential to lead the major indices – S&P 500 (SPY), Dow Jones (DIA) and Nasdaq (QQQ) – higher while small-cap indices such as the Russell 2000 (IWM) also could outperform. ☞

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