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Chips Hit a Sticking Point

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The run-up in semiconductor stocks stalled during the past week as a mixed bag of financial reports proved a drag on the sector's already steep gains.

"Investors wanted everything rosy-plus," says Kim Arthur, managing director at Main Management in San Francisco. "They got rosy, but not the plus."

Reports throughout the chip sector showed strong results for the seasonally weak second quarter but relatively cautious expectations for the third quarter. Although caution is not a new word in the chip executive's lexicon, investors had been building stocks up during the previous two months on the hope that fundamentals would improve sharply and to the right.

The Philadelphia Semiconductor Index is up 23% since May and 12% since the start of July. For the year, the index is up 9%. The **Nasdaq Composite** (Nasdaq:Index) is up 14% since April and 6.5% in July, making it barely positive for the year.

In its earnings report on July 19, **Intel** (INTC:Nasdaq) beat Wall Street's earnings target for the second quarter but didn't have the confidence to move its full-year gross margin target higher.

Likewise, PC shipments rose sharply in the second quarter, but industry researchers were hesitant about the pace continuing through the year's final six months.

Demand should accelerate for many electronics-related companies in the months leading into the back-to-school and holiday shopping seasons, but the dog days of summer could stretch through August. With a lack of news and data points, investors could be stuck in their current positions without a concrete reason to pick up additional holdings.

Arthur says that indicators for medium-term chip demand are positive, including increasing factory utilization, strong demand for cell phones and MP3 players, and stable memory prices. But he also didn't see much on the horizon that would truly spur investors.

"For near-term catalysts, there's nothing over the next few months, which is why there could be a little time-out here," he says.

Bill Gorman, vice president of equity research at PNC Advisors, sees a similar scenario. "We're in summer, it's seasonally slow, and there might not be any breaking events that could change some of the caution that's set in over the past several days."

Indeed, the SOX has flattened since July 20, the day after Intel reported results. Since that time, the chip index has been down nominally while broader stock market indices have eked out gains.

Gorman speculates that third-quarter results and fourth-quarter expectations might have to be announced before tech investors have reason to buy again.

Still, others see the uncertainty as evidence that the best is yet to come. "People forget that there's a process at work and it's one of doubters being converted into believers," says Ian Fraley, managing principal with San Francisco-based hedge fund **Financia Capital**.

He says recent gains show that many people have become fans of all tech stocks, but that the conversion cycle isn't yet complete. "I hear more bullishness on tech right now, but I think it's an 'and/but' bullishness: 'but stocks are pricey,' 'but I don't see a killer app,' 'but stocks can't go much further.' "

And Fraley points to the sharp drop in tech stocks from March to May as evidence of room for investors to fully commit to the sector. "The fact that people are that on edge and that any kind of a selloff gets everyone immediately running for the exits -- that's very bullish."

A bull that's running in place, maybe.

Chip companies are expected to perform well in the second half of the year, but initial third-quarter targets have set-up a speed bump. Stocks have held up so far, but they haven't moved up. That might be good enough for now.
