TrendMacrolytics

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MARKET CALLS

Until Intel

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Earnings season was full of pleasant surprises -- until Intel. But was Intel's miss really a surprise?

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The exhilarating rally off of last Thursday's lows hit a big speed bump after the bell yesterday when **Intel** announced Q3 earnings of $0.11, or $0.02 below consensus -- *and* guided Q4 revenues down to a point that implies an earnings miss of $0.04 below the $0.16 consensus. Intel's stock immediately collapsed in after-hours trading, and technology stocks are giving up some of their recent gains across a broad front, in sympathy. But we're not at all convinced that Intel has derailed an overall equity markets recovery.

As we pointed out in a report yesterday, the rally of the last four days has been driven in part by surprisingly good -- or to be more accurate, surprisingly not horrible -- earnings reports from blue chips like **General Electric**, **General Motors** and **Citigroup** (see "Godzilla Meets Bambi" October 15, 2002). That is, until Intel. But can anyone honestly say that they had any real reason to be surprised by Intel's earnings miss and guide-down? *We* certainly can't.

We've observed over and over that the present post-boom-and-bust recovery is marked by a depression in technology capital equipment spending, and an economy-wide risk aversion inimical to investment in new projects (see, most recently, "The Tech Depression: Will It Never End?" October 8, 2002). On the conference call last night, should anyone really have been shocked when **CFO Andy Bryant** forecasted that "soft demand in end markets" would continue through the fourth quarter, with PC demand coming in at the low end of their forecasts (which have already been lowered many times over the last two years)?

We've pointed out for months that Information Technology and Telecom sector earnings have shown virtually no recovery at all, while over the last six months the other sectors of the S&P 500 have managed to return to within a couple percent of all-time peak earnings (see, most recently, "Earnings Tell the Tale" October 3, 2002). Yet at the same time, we've pointed out that Information Technology remains the single most overvalued sector.

We've noted that Intel will find no relief during the technology spending depression by grabbing market share from competitors, since for all practical purposes it already enjoys a monopoly in PC microprocessors (see "Let's Play Survivor" September 24, 2002). But companies like **Cisco Systems** and **Dell Computer**, on the other hand, can offset losses in overall market opportunity by growing *relative* share within their more fragmented competitive domains. And when the technology spending depression finally ends, *they* will emerge with renewed competitive advantage.

All Intel can hope to do is shrink its way to greatness by cost-cutting. And in last night's conference call, Bryant admitted that Intel had "hit a wall" last quarter in achieving new cost savings -- from here on out it's all about revenues. But *what* revenues? And *when*? Thanks to **Moore's Law**, which dictates that the cost-effectiveness of semiconductors will double every 18 months, Intel has to double the aggregate processing power shipped to customers every 18 months just to keep revenues no worse than flat (see "Semiconductors: Down By Law" May 22, 2002). In an anemic global recovery, that's a death-race Intel is bound to lose.

The speed bump of Intel's non-surprise surprise may well put a crimp in the stock market's big rally. Something had to -- it might as well be this. But this particular speed bump may not have the power to entirely derail further recovery for a market that is, overall, still deeply undervalued. It may end up doing nothing more than reveal the starkly two-tiered nature of the economy's anemic recovery. As earnings season moves on, the men may finally get separated from the boys -- the undervalued non-tech recoverers from the overvalued tech depressed, and the tech victims from the tech survivors.

It won't be easy. You know how they separate the men from the boys on Wall Street... with a crowbar. TM

The author, a principal of Trend Macrolytics LLC, holds positions in the shares of Cisco Systems and General Electric.