

**INSIDE THIS ISSUE:**

Early Rises for Small Stocks...  
...Followed by Pains and Gains  
Themes to Consider

**KEY TAKEAWAYS**

- ⇒ *Stocks should continue to rise this week followed by seasonal declines*
- ⇒ *Small cap stocks poised to return to prominence on favorable valuations and rotations away from big caps*
- ⇒ *Heavy bullish sentiment and quarter-end institutional portfolio restructuring mean end of month performance could be poor*
- ⇒ *These two semi stocks benefit from the new Apple iPhone6 and could enjoy a big week*

**KEY STATISTICS**

| Index        | Close | 2014 |
|--------------|-------|------|
| DJIA         | 17098 | 3.1% |
| S&P 500      | 2003  | 8.4% |
| NASDAQ       | 4580  | 9.6% |
| Russell 2000 | 1174  | 0.9% |

(figures are rounded)

**A SMALL CAP RALLY TO FOLLOW SEASONAL SWOON**

Happy Labor Day weekend! Interestingly, in 2014, this holiday is typically associated with the end of summer and the beginning of the school year. According to the Department of Labor, the national holiday traces its roots to 1882, when the first Labor Day holiday was celebrated on Tuesday, September 5, 1882, in New York City, in accordance with the plans of the Central Labor Union. As of 1894, it became a federal holiday to honor the contributions and achievements of Americans like the lovable one below.



On a serious note, I don't think that it is a coincidence that the cover story for this week's *Barron's* is titled "The Decline of Work." It highlights many of the same sentiments we have written in these pages, such as the troublesome declining worker participation rate that does not bode well for the future health of the economy. Before we look that far head, it is time to focus on what we expect will occur in the next few weeks. After all, we are now two-thirds of the way through calendar year 2014 and big caps have dominated small caps despite the strong August performance of the Russell 2000 Index which nearly rose by 5% from July.

So, where do we go from here? Our crystal ball tells us that stocks will continue to rock for a spell only to be followed by a weak market and then a small cap rally. Here are seven contributing factors to these moves.

## Early Rises for Small Stocks...

### Key #1: Big vs. Small

Our market timing track record has been pretty good the past few weeks. We called the market drop and later forecasted the upward trend during the big market move in August, even though we were initially negative on it. Still, despite the fact that August bucked the historical negative trends, this September may not be so lucky for big caps as it has essentially been the group's worst performing month of the year, going back to 1950. In contrast, small cap stocks have done much better than their larger cap brethren in September and they are positioned to continue their recent ascent.

### Key #2: Valuation Favors Small Stocks

At current levels, the forward 12-month P/E on the NASDAQ 100 and the Russell 2000 Index are roughly the same, at 19.4x—19.8x, despite higher growth expected for small stocks. Moreover, small stocks are overdue for a big move.

|              | P/E RATIO              |                       |                       |
|--------------|------------------------|-----------------------|-----------------------|
|              | 8/29/2014 <sup>†</sup> | Year ago <sup>†</sup> | Estimate <sup>^</sup> |
| Russell 2000 | 81.17                  | 85.28                 | 19.35                 |
| Nasdaq 100   | 23.52                  | 20.26                 | 19.81                 |
| S&P 500      | 19.19                  | 17.63                 | 16.75                 |

<sup>†</sup> Trailing 12 months                      <sup>^</sup> Forward 12 months

Source: Birinyi Associates

### Key #3: Early Economic Reports Should Drive Stocks

This week we have no fewer than 12 economic reports over the four day week, which is a big number. They include August vehicle sales, chain store sales (back to school highlights), semiconductor billings, factory orders, future inflation index, employment, etc. Barring a really poor series of reports, stocks should have a good week in response to the reports, and move higher on the biggest volume rise we have seen in months.

### Key #4: Europe Issues and Higher GDP Are Positives for Small Caps

The Russia/Ukraine crisis and the start of another broad-based economic quagmire in Europe mean that multinational U.S. big cap stocks could be negatively affected in the coming months, thus dropping their valuations. In contrast, a strong GDP growth rate at home could result in a Q4 rotation into small stocks, which would be largely unaffected by Europe's malaise.

## ***...Followed by Pains, Then Gains***

### **Key #5: Beware Seasonality**

Despite our early month optimism, September is still scary. The middle of the month usually sees the start of profit-taking as institutional investors begin to restructure and right-size their portfolios. Negative Q3 pre-announcements can also weigh on stocks. With saber-rattling by ISIS and an impotent U.S. foreign policy, it is likely that September 11th will be met with some trepidation. Adjust your portfolio accordingly by having some exposure to defense and security stocks and/or ETFs.

### **Key #6: Heavily Bullish Sentiment Could Mean Big Fall Later**

We noted last week that we were getting close to overly optimistic territory with respect to the weekly AAI Sentiment Survey. At 51.9%, and up 5.8 points from just a week earlier, optimism has now exceeded 50% for the first time since last December, and for just the fourth time since February 2011. By the way, the Neutral stance last week was generally unchanged while the Bearish stance dropped 4.4 points to 19.2%. Typical bullish/bearish figures are 39% and 30%, respectively. Clearly, the solid Q2 company earnings and overall market resiliency has led to this optimism. Nonetheless, these big swings and bullish/bearish disparities in sentiment are usually followed by weaker than normal stock performance.

### **Key #7: The Bad Outweighs the Good**

According to Lipper, equity fund outflows were \$16.4B for the week ending August 6th, in response to the big drop in stocks at that time. Since then, net inflows have risen by \$17.3B, and will likely show more increases when new figures are announced at the end of this week. As we noted in our last issue, investors are now more willing to take on risk, which is a danger sign. Given that the tangible good news is already in the market in the form of higher inflows, greater risk appetite, higher bullish sentiment, and a likely return to more volume after weeks of gains on low volume, it seems as if the stars are aligned for upside ahead. Still, all good things must come to an end and with the foreign policy issues coming home to roost, higher big cap valuations, and all the good news reflected above, where are the other drivers? Clearly, the bottom could fall out later this month for the reasons and timing we cited above. This is shaping up to be a classic case of when good news is really bad, until a small cap rally in Q4.

## Portfolio-Growing Themes

Despite our big cap stocks concerns, here are 2 themes to consider this week.

### Theme #1: Sum of the Parts

eBay (NASDAQ—EBAY—\$55.50) is purportedly considering a split into two companies: the legacy eBay business and PayPal. If this were to occur, it would unlock the value that has yet to be realized due to the integration of the two businesses. The stock is probably approaching fair value with upside of 12-15% from here. However, if a spin-off were to occur, we would sell the eBay stock and keep PayPal which can carry a higher valuation in line with its stand-alone business, resulting in a greater overall return.

### Theme #2: Apple is a Beast in an Up or Down Market

Betting against **Apple (NASDAQ—AAPL—\$102.50)** is usually a losing proposition. Still, in addition to playing it directly, there are two stocks in the semiconductor space that serve as suppliers to Apple that have been on the rise of late and could see more gains this week. **Avago Technologies (NASDAQ—AVGO—\$82.09)** was a big winner on Friday after beating estimates and word has come out that the company could be a big beneficiary of its Apple vendor relationship for the iPhone 6. Plus, the Street expects AVGO to enjoy big earnings gains from its recent acquisitions.

**NXP Semiconductors (NASDAQ—NXPI—\$68.52)** is another Apple vendor primed to enjoy gains from the company. The chipmaker will reportedly supply secure near-field communications-designed (NFC) chips to Apple's iPhone 6.

We should note that both companies are fabless semiconductor firms, in that they only design products, they do not produce them. As a result these companies can earn much greater profit through licensing and royalty revenue than their peers. With the semiconductor billings figures due out on Friday, the leverage of the Apple relationships, and reasonable valuations relative to their high EPS projected growth, these stocks could prove to be solid short term trades.

Have a great week!



# The Goldman Guide

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