Goldman SMALL CAP RESEARCH

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INSIDE THIS ISSUE:

KEY TAKEAWAYS

- ⇒ *Mega M&A deals in technology have been on fire of late*
- ⇒ *In most cases, these deals are positives for the market but we view them as negatives*
- ⇒ *Deals had to be for market value and market share retention not for growth*
- ⇒ *Big companies may see future divestitures*
- ⇒ *Small cap correction phase is a positive since stocks bounced off of key low*
- ⇒ *Now that big caps are sliding, we can get out of neutral and have needed shake-out and re-*

KEY STATISTICS

Index	Close	2014
DJIA	16491	0.5%
S&P 500	1878	1.6%
NASDAQ	4091	-2.1%
Russell 2000	1103	-5.2%

(figures are rounded)

BIG M&A IS A BIG PROBLEM

*I*n the past 24 hours it has been confirmed that AT&T (NYSE—T), the second largest mobile provider, has finally placed a bid for DirecTV (NASDAQ—DTV). This news is on the heels of the recent Comcast (NASDAQ- CMCSA) news that it plans to acquire rival TimeWarner Cable.

These mega-deals dwarf two other billion multi-billion dollar-plus technology deals involving tech behemoths. Apple (NASDAQ—AAPL) is buying Beats, the headphone producer, and Google (NASDAQ—GOOG) is buying Twitch, a video game streaming site.

In most cases, we, along with others, would cheer these deals, as they often indicate the strength of a given sector or segment and a sign for a prosperous stock market ahead. It also usually portends future M&A of varying sizes.

Alas, we take the contrarian approach to these events. Instead of a bullish signal, we view them as a bearish one. An argument could be made that these deals are being proposed because the acquirers *must* do them, not because they wish to do them to complement their existing business or future models. In essence, the transactions tell us how management teams have thrown in the towel and must execute lest market values decline.

Comcast and AT&T are having difficulty growing organically. Apple is truly a consumer products tech firm and Google seeks to be the king of web services. Unfortunately, recent history (15-20 years) has shown us that conglomerates grown largely through M&A end up having problems in integration, operations, vision, etc. and end up becoming divestiture candidates as market values decline. Don't follow the hype because it could be deja vu all over again.

The Small Cap Correction is a Good Thing

Last week, the Russell 2000 Index finally broke below a key figure and officially hit the 10% correction territory. We were hoping this would happen a few weeks ago but now it seems to have market players spooked. Truth be told, at 18.x forward 12-month earnings, these stocks are still a tad pricey. Moreover, with financial services and producer durables comprising the two largest sector weightings of the index, more declines should follow. Nonetheless, unlike the rest of the Street, we welcome these events and view them as positives for the market later in the year.

As one would expect, small cap stocks quickly bore the brunt of last week's sell-off, just like it has for the past few weeks. However, the Russell 2000 Index, which appeared to be in a freefall early on, briefly touched the 1082 mark, its lowest point since February 5th of this year, before bouncing slightly off of it. This bounce is significant and likely saved us from more damage since the 1082 figure is an important support level. Any retreat further would likely mean that we are headed toward the 1030's. While that range is still possible, the bounce could serve as a double bottom if we base here.

Another reason why this event is significant is because of the big, early volume associated with the stock market retreat. While I would not characterize it as a capitulation sell-off, which would be a bullish signal, volume was definitely higher than in recent sessions. Finally, the divergence of the big caps moving higher and the small caps tumbling has kept a lot of investors perplexed and in neutral. The Wal-Mart (NYSE—WMT) miss now can allow the big caps to begin their journey down as well. The sooner this trek begins the sooner the recovery from this corrective phase can occur. Having divergent market trends and being stuck in neutral can be more maddening than waves of selling.

Now that the first quarter financial season is over, the next few days will provide us with some direction. If NASDAQ and the Russell 2000 begin a short term trend upward, I would hop on board for a quick trade. Just a few short weeks ago, the NASDAQ Composite dropped nearly 8% in two weeks only to enjoy a 6% gain in a matter of days. While it might only be a dead cat bounce, a bounce of any size can be good for a trade in this uncertain environment. Moreover, since the Russell 2000 did bounce from nicely the 1082 level, the next uptrend may actually have some legs and give is reasonable valuations later in the year.

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