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Boots on the Ground: Getting Defensive with the Defense Industry

Hollywood is obsessed with sequels and remakes, even decades after the original movie was released. It makes sense; blockbuster productions are risky and expensive so tapping into the nostalgia of older audiences brings some reassurance to studio executives that filmgoers will fill up theater seats.

According to *Variety*, the long-anticipated sequel to "Top Gun" will be released in July of next year. The film's director, Joseph Kosinski, has talked about making a movie that is appropriate for the times we live in.

What would that look like? Our military and the defense industry are quite different than they were in 1986, so obviously, the movie's theme must showcase today's technological advances, aircrafts, and defense tactics. The plot has been kept under wraps, but early internet rumors suggest it may explore the end of air-to-air combat (aka dogfighting) and the rise of drone technology.

It is an interesting theory. After all, drones—or unmanned aerial vehicles (UAVs)—are increasingly being used in global defense for surveillance and strike. UAVs have grown in popularity because of efficiency and safety. A drone can stay in flight for over 24 hours and there is no loss of life should a mission fail. As technology evolves, drones are also becoming more sophisticated, incorporating artificial intelligence and machine-learning. The Office of the Under Secretary of Defense reports that the Fiscal Year 2019 budget request for UAVs is $3.4 billion. Goldman Sachs estimates that drone technology for global military applications will be an estimated $70 billion market by 2020. Given this trajectory, drones are one of the fastest growing areas in defense.

When it comes to investing, we often like to quote legendary hockey player Wayne Gretzky, who said "Skate to where the puck is going." With drone technology or any emerging trend for that matter, we want to follow the flow of money to uncover stocks that are benefitting from the demand. While the fundamentals of a company are critical to long-term value creation, correctly identifying early trends can provide an excellent tailwind for companies that play to themes in favor.

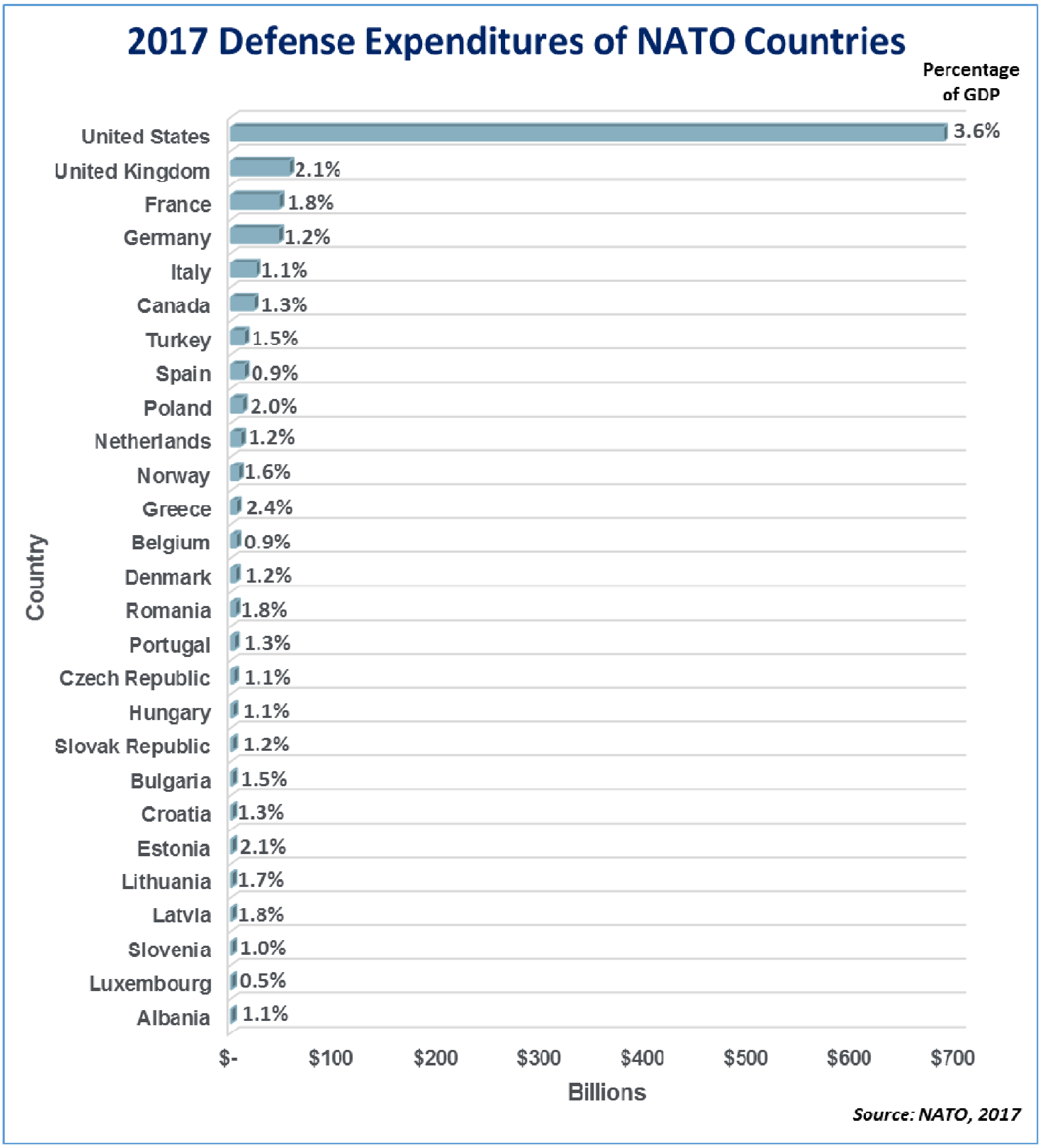
Drones have led us to explore opportunities in the defense industry. We are two years into an upcycle in US defense spending that began in 2016, when Department of Defense (DOD) cash outlays turned positive in 3Q16. Obama's last approved defense budget request to Congress for Fiscal Year 2017 allocated $606 billion to the DOD. Trump's defense budget request for Fiscal Year 2019 is $716 million, of which $686 billion is for the DOD. This is a 13.2% increase over Obama's enacted levels in just two fiscal years (Source: Department of Defense). The defense industry has now shifted to growth as budgets have expanded at a rate not seen since the Cold

War era of the 1980's or the War on Terror in the early-to-mid 2000's.

Trump has repeatedly stated his national defense goals of rebuilding and modernizing our military, eliminating ISIS, and aggressively deterring threats from North Korea and Iran. The 2018 National Defense Strategy (NDS), released in February of this year, articulated the central challenge to US prosperity is the long-term, strategic competition by China and Russia. China is leveraging military modernization and economic growth to increase global influence. Defending these concerns requires incrementally higher defense spending and Congress has generally been on board. Historically, upcycles in defense spending have lasted in excess of 10 years (Source: RBC Capital Markets). If this proves to be the case, then we are still in the early years of a significant acceleration in the defense industry.

The large US defense contractors have been experiencing strong international demand, where margins are typically higher than margins for products sold domestically to the DOD. In April, the Trump administration released a national security memo supporting US defense exports. By opening up additional opportunities for US-based defense companies to sell more equipment to other nations, the administration is providing further revenue visibility to the defense industry.

Earlier this month, Trump continued to aggressively push NATO allies to increase defense spending at the NATO Summit in Brussels. The 2014 Wales Summit ended in member nations pledging to allocate 2% of their GDP to defense by 2024, with at least 20% allotted to major new equipment. The chart below shows that only five of 29 NATO nations are currently meeting or exceeding the 2% pledge.



The US contributed approximately two-thirds of the $917 billion total spent on defense by NATO in 2017 (Source: NATO). Trump tweeted up a storm that the US is getting a “bad deal“ and US taxpayers are paying too much for protecting allies. He demanded that NATO nations “must pay 2% of GDP IMMEDIATELY, not by 2025” (Source: Twitter). The threats received a lot of global attention and many leaders of member nations acknowledged that they would try to do more.

It is a tricky situation; 15 NATO allies spend in excess of 50% of their defense budgets on pension costs and salaries to military personnel (Source: NATO). Given the high military overhead and lackluster economic growth for many member nations, meeting the 2% of GDP target could be difficult without restructuring pensions and operating costs. However, in 2017, 26 allies spent more in real terms on major equipment than they did in 2016. The number of allies meeting the 20% expenditure on new major equipment NATO guideline rose to 12 in 2017 (Source: NATO Secretary General's Annual Report 2017). With US defense exports opening up and the rise in spending on equipment by allies, we see even greater earnings potential for US defense stocks.

The defense industry benefits from a low correlation to the economic cycle, a growth rate that far exceeds the inflation rate, and strong barriers to entry. We believe it is time to get defensive with defense stocks as military modernization continues to be a powerful theme that will play out in the years ahead.