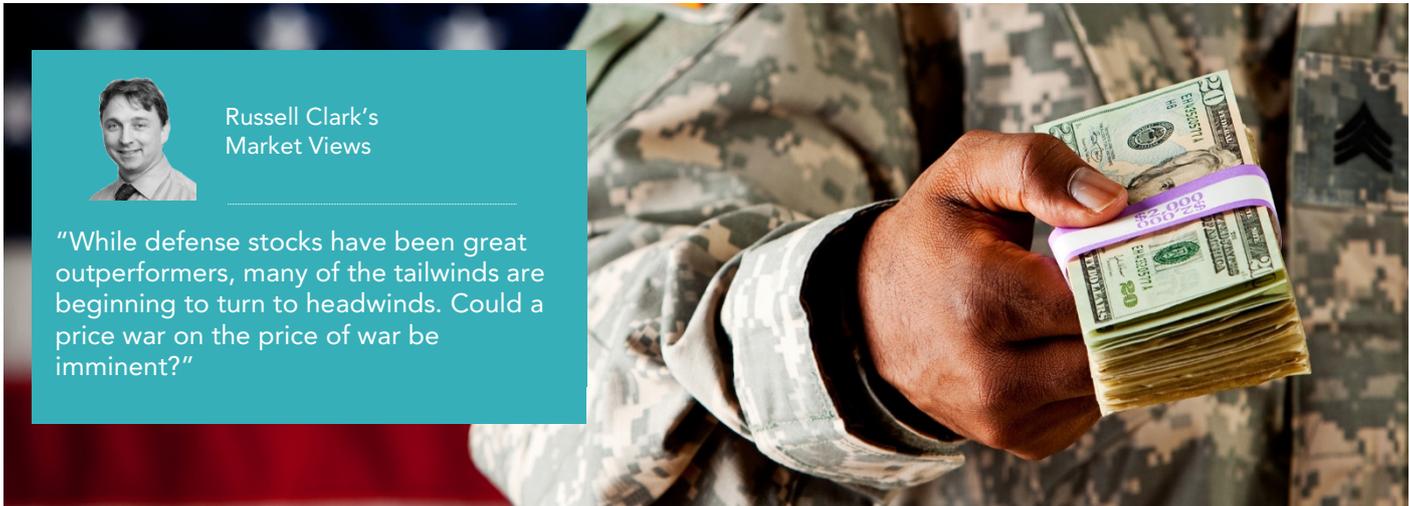


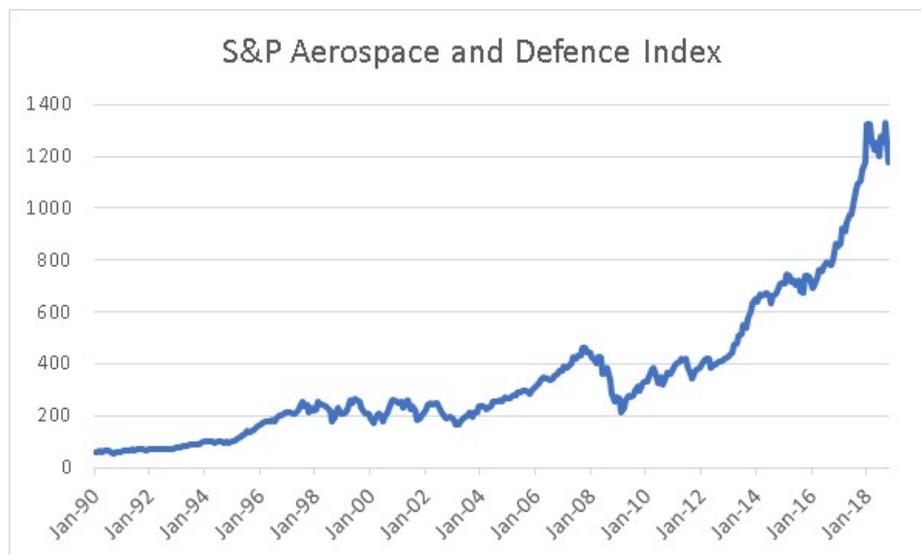
PRICE WAR



Russell Clark's
Market Views

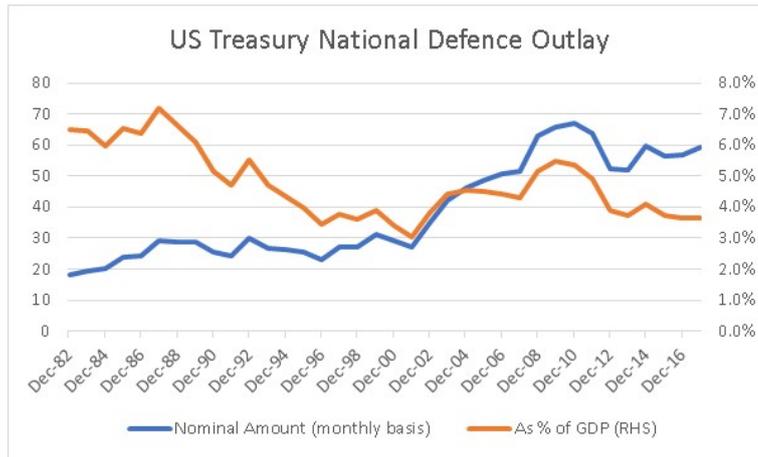
"While defense stocks have been great outperformers, many of the tailwinds are beginning to turn to headwinds. Could a price war on the price of war be imminent?"

Most companies in the Aerospace and Defense Index have both civil and military lines of business. This note will just look at the defense industry, and a future note will look at the civil aerospace industry. The S&P Aerospace and Defense sector has been one of the best places to invest over the last few years. From the lows in 2009, the Index has risen nearly 600%.

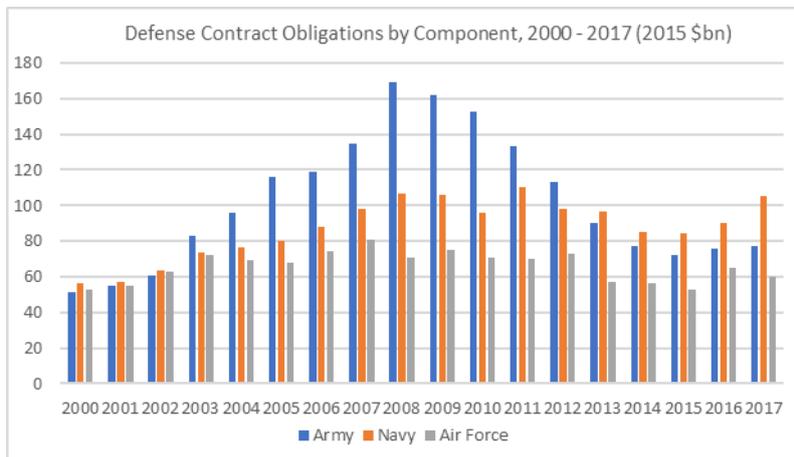


To my mind, there have been three drivers of this outperformance. Firstly, even as defense spending has been cut, spending on hardware has remained strong. Secondly, the industry has consolidated dramatically, reducing competitive pressures. And finally, highly lucrative international sales have grown substantially. All three look to be turning from tail winds to head winds.

US military spending has been flat in nominal terms since 2007.



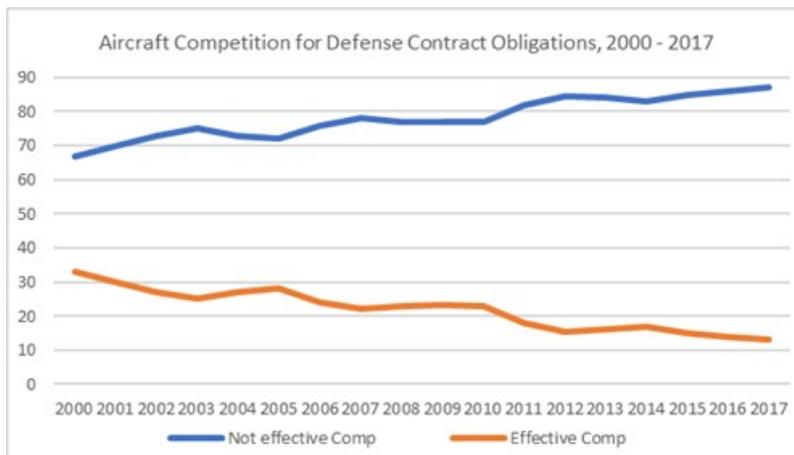
However, when we break up Department of Defense into Army, Navy and Air Force, we see that the Army has taken the lion’s share of the cut. A large amount of Navy spending is devoted to aircraft.



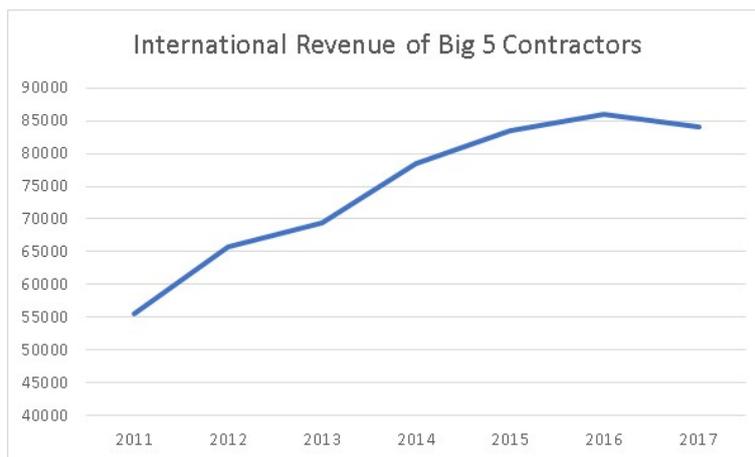
The money to maintain product procurement has largely come from freezing military pay in real terms, but the Trump administration would like to increase the size of the military. In a tight labour market, below inflation pay rises look unsustainable. If the wage bill rises, then the Department of Defense would look for other areas to squeeze.



Furthermore, according to the Department of Defense’s own analysis, effective competition for aircraft has declined in recent years, to a degree where there is almost no competition. If the Department of Defense believes there is little competition in aircraft, then it will also look to squeeze prices.



International revenue for the big 5 contractors has grown substantially in recent years. Internationally sales tend to have high profit margins, as typically domestic sales have covered R&D expenses.

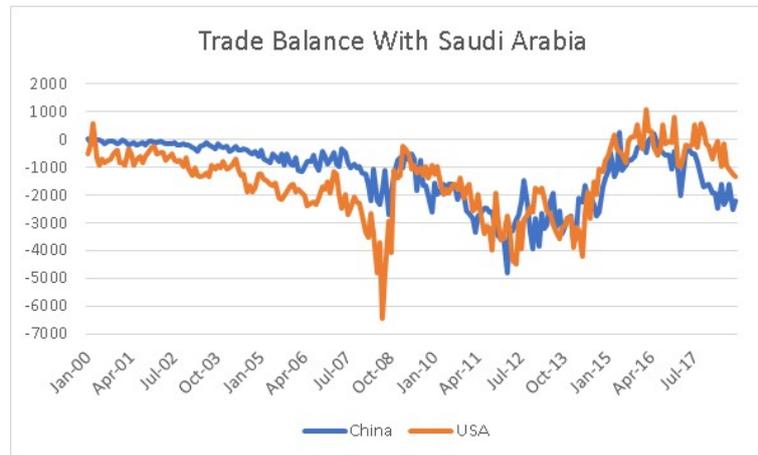


The largest market for international sales is the Middle East, and particularly Saudi Arabia, which spends even more than Russia.

2018 Military Expenditure USD bn	
US	610
China	228
Saudi	69.4
Russia	66.3
India	63.9
France	57.8
UK	47.2
Japan	45.4
Germany	44.3
S. Korea	39.2

Historically, Western arms makers have dominated sales to Saudi Arabia, but China is increasing the competition. According to recent reports, Chinese made unarmed aerial vehicles (UAV), have similar capabilities to the American made “Predator” at one quarter of the price. The product is making headway in the Middle East.

It strikes me that Saudi Arabia now has a larger trade surplus with China than it does with the US. Currently Saudi Arabia makes military purchases from the UK and the US. China must increasingly offer an attractive alternative and increasing trade dynamics are favouring Chinese producers. Even if Saudi Arabia continues to purchase its equipment from the US and the UK, Chinese competition must pressure prices.



While defense stocks have been great outperformers, many of the tailwinds are beginning to turn to headwinds. In international markets, competition is beginning to rise, while domestically, other defense departments have taken a squeeze while procurement has been largely spared. The Department of Defense must surely have noticed that Chinese made equipment is being sold at much lower prices. It looks like a price war on the price of war is imminent.

INFORMATION

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