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Why These Catalysts Could Help Drive US Defence Stocks Higher

Since President Trump was elected in 2016, the aerospace and defence sector has been on a tear.

While a lot of attention has been directed towards tech stocks in recent times, the aerospace and defence sector has quietly played an integral role in the US stock market rally. In fact, gains among defence stocks over the last few years have performed broadly in line with the remarkable results achieved by that of the NASDAQ index.

With an ever-increasing level of federal funds being apportioned to military spending, the sector has seen a wave of bullish sentiment carry through into 2020 as many investors anticipate that run to continue. What's more, rising geopolitical tension and the prospect of a Republican election victory further underpin exposure to a thematic that remains a key industry within the US economy.

Military expenditure and funding continues to surge

In 2020, the Pentagon is once again set to receive a funding boost, with the US government allocating more capital towards the defence budget. Whereas last year's total of USD 717 billion for the defence sector was already approaching the historic highs achieved during the Iraq war, that amount is set to be topped by the USD 738 billion set aside by the government as part of its FY20 budget worth USD 1.4 trillion.

Now entering the fifth consecutive year in which the US military budget has grown, this trend has all the potential to continue into the future as the government assigns some of the highest spending towards the military since World War 2. To put this into context, the US is spending more on defence initiatives and developments than the next seven countries combined.

These funds are earmarked for investment towards everything from aircraft to combat vehicles, missiles and defence systems, ships and many other areas of the military. The US government's history of spending big in order to maintain its position at the forefront of the military field offers potential earnings growth for key players in this industry and the broader defence sector.

Geopolitical tension across a number of fronts

Although the US has always played a role in geopolitical affairs across the world, the turn of the year has brought with it heightened tension that could prove opportunistic for defence stocks. Affairs between Iran and the US have been hanging precariously over the last few weeks amid a series of escalating blows between the two countries in the Middle East.

Both sides have seemingly stepped away from escalating matters any further, however, the risk remains that this could prove to be just a temporary respite. After all, the two countries are clearly on a different wavelength and have been feuding for some time, which has only served to fuel US presence in the region and the need for investment in defence systems and equipment.

As one of several spot-fires in the Middle East, as well as regions like Afghanistan and Syria where the US is stepping back from its role in the region, there is no assurance that any one of these feuds will be resolved as easily as expected and without permutations for the rest of the region. It's also worth noting that in the six months after a major conflict event in the Middle East, gains in defence stocks (6.7%) have more than doubled those of the S&P 500 (3.3%) since the 1990 Gulf War.

Elsewhere, the US government remains committed to denuclearising North Korea, and although it has finally struck an interim trade deal with China, there are still many matters of dispute between the countries including policy on Hong Kong and Taiwan. The US also wants to keep up with efforts from China and Russia to invest in next-generation state-of-the-art defence technology.

Adding to the equation is President Trump's concerted effort to hold other NATO members to account as far as their contributions towards international defence expenditure. So far there has been an increase in the number of NATO nations meeting their historic pledge to spend 2% of GDP on defence by 2024. It is almost inevitable this pressure will be upheld, which has the potential to drive sales growth for arms manufacturers and developers of intelligence defence systems.

Domestic political persuasions remain a boon to defence strength

Since President Trump was elected in 2016, the aerospace and defence sector has been on a tear. One of the key funds that tracks this sector is the 'iShares US Aerospace and Defense' ETF, which has gained nearly 80% in just over three years. This is significantly higher than the performance of the S&P 500, which has achieved just over 50% across the same timeframe.

More recently, attention has started to shift towards this year's upcoming US presidential election. This has arguably weighed on the sector since there are concerns that a change in government would have risks for defence stocks due to the risk of a cut in spending. Already, key Democrat candidates Bernie Sanders and Elizabeth Warren have opposed an increase in the defence budget.

In the meantime, however, many aerospace and defence stocks haven't seen their earnings multiples reflect their growth in the broader market, not to mention the distinct likelihood that the Republican Party, with history on its side, could be re-elected and ramp up defence spending further. Add to that the threat of conflict, which remains present, and as long as the budget is still growing, the defence sector is one area of the stock market that has a history of outperforming.

Global Growth Portfolio - Dec 2019 Update

<i>Index</i>	<i>December Performance</i>	<i>YTD Performance (Dec 2019)</i>
<i>Dow Jones</i>	2.4%	23.66%
<i>NASDAQ</i>	4.4%	36.40%
<i>S&P 500</i>	3.4%	28.34%
<i>Global Growth Portfolio</i>	0.33%	29.44%

Australian Yeild Portfolio - Nov Update

<i>Index</i>	<i>December Performance</i>	<i>YTD Performance (Dec 2019)</i>
<i>ASX 200</i>	-2.36%	18.38%
<i>ALLORDS</i>	-2.10%	19.14%
<i>Australian Yeild Portfolio</i>	-1.20%	2.10% (Oct Inception)

For more information please don't hesitate to get in touch

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