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**ECONOTE No. 110 Making sense of 2022 and a Defense ( pun intended) for 2023 Nov. Dec. 2022**

## Summary

The year 2022 may end up as the year where nothing went right and where Murphy's Law key precept, that "if something can go wrong, it will" held in full glory. War in the Ukraine, March burst of Covid 19 infection and energy crisis, especially in Europe, following the sanctions on Russia. Then, as a consequence of sanctions/war, raw material shortages followed, and especially food, which accelerated the existing inflation trends in several countries and especially in the US. This then caused interest hikes leading to falling GDP growth in the countries involved. Deep breath now. Stock and bond prices collapsed, the USD soared versus most currencies and to add volatility, UK's absurd fiscal experiment was the cherry on the cake. China reconfirmed its market -unfriendly stance and continues with zero Covid which maintains supply strains. Cryptos all but vanished. Asset - wise, there was nowhere to run and hide .Or so it seemed.

## Investment Conclusions

As both equity and bond prices fell, and the USD strengthened, the only safe asset appeared to be USD cash. Assets immune to higher interest rates and higher inflation were, and are, difficult or impossible to find and all major and minor markets fell. Energy companies registered record profits but the longer term prospects for fossil fuels stayed weak despite the poor results from COP27.Looking forward to the peaking of the USD interest rates which could signal recovery is, at present, a faint hope. We draw attention to Defence stocks, but strictly within our the regulatory constraints. The globally rising Defence expenses are not knee jerk reactions to Ukraine but a long term policy shift. Defence spending is immune from rate hikes, inflation and sharp policy shifts.

## The USD forex rate and interest rates.

Before turning to Defence, we outline the peculiarities of the recent strength of USD which it continues to influence overall market expectations and it illustrates the difficulties of the present circumstances in defining clear investment targets. The steep 75bps hikes of the US Fed caused (a) a crash in US equities with collateral damage to all other equity markets and ( b) a strengthening of the USD which, putatively, added to macro woes by accelerating inflation already in place by the rising energy and commodities prices as all these are priced in USD.As Fig.1 and Fig.2 show there is an inherent danger in mixing absolute an relative effects of price changes in forex rates.Fig.1 shows that the strength of the USD vs EU and GBP was relatively short-lived especially after the recovery from the incoherent UK mini budget of Sept.2022. The JPY weakness peaked and then recovered despite the misunderstood Japanese contrarian interest rate policies. Fig. 2 also gives lies to widespread belief that Asian exchange rates are effectively pegged to the USD ( bar HKD and opportunistically the CNY) and the strength of the USD must lead to their weakness. Logically this does not make sense. Allowing their forex rates to weaken would add to their exports competitiveness but to the cost of potential inflationary pressures from higher import prices. The vary variable performance of Asian forex rates also reflected the varied interest rate policies of their central banks.

Not all of them followed the absolutes of Fed hikes. PBOC actually cut rates. Economies such as S.Korea may have benefited by the relative movement of KRW in one of its main exports markets, China, and against one of its exports competitor, Taiwan. Relativities count but are usually ignored in favor of headlines-catching absolutes. Some Latam rates, the Brazilian real and Uruguayan peso, actually strengthened at the back of strong food prices.

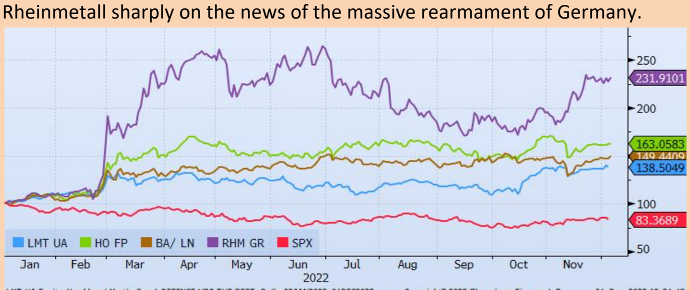
Fig 1. Forex of majors DXY,EUR,GBP,JPY. Jan 2022=100. ( Bloomberg)

## Defending and explaining Defence.

**Figure 3 in the box below shows that key representative companies of the Defence sectors in the US, EU and UK have outperformed the S&P 500 during 2022**.Globally, the outlook for Defence is bright given the mounting new Defence spending from 2022 onwards coming from the US, EU and from most of Asia and Australia. The reasons for this swift increase in Defence spending are mainly global such the Ukraine war and the containment of China, but also from the reheating of local confrontations such as North and South Korea, Greece-Turkey, China-Taiwan (possibly global ?), India-China, South China Sea-China-neighboring countries, Japan-Russia-China over islands etc. Defence spending is long term, requires laborious planning and execution and is relatively difficult to reverse quickly. All these factors point to Defence sector companies as offering attractive prospects over the medium to long term. This particular point is emphasized by Fig. 4 which shows that the performance of major defence stocks over 2007 was not Impressive with only Thales, and recently Rheinmetall, outperforming at times S&P 500. Since 2022, the Russo-Ukraine war and the refocusing on the role of China in Asia and the Pacific, among other various factors, has created a not a temporary but a much longer term shift of attention on rearmament. **Hence the outperformance of the Defence sector versus major indices in 2022 ( Fig.3 ) is not a knee-jerk reaction but a very likely paradigm shift caused by a continuous stream of state expenditures which will favor the Defence corporates**. We will return repeatedly on this single theme, especially as Defence spending trends in Asia confirm the similarity of this shift to those of major western countries.

### FIG. 3 Defence stocks and S&P 500 in 2022, Jan.2022=100

Fig. 3 and 4 shows the defence sector as represented by the share performance of Lockheed Martin ( blue), Thales ( green),BA Systems (brown),Rheinmetall ( mauve ) and S&P 500 ( red).With the exception of Thales, the rest of shares underperformed S&P500 to about end 2021.(Fig.4) The outbreak of the Russo-Ukraine war in February 2022 propelled Rheinmetall sharply on the news of the massive rearmament of Germany.




### Fig.2: Forex of Asians, DXY, CNY, SGD,TWD,KRW, INR,Jan.2022=100


Source: Bloomberg

### FIG. 4 Defence stocks and S&P 500, 2007-2022, 2007=100


**Defence investing: moral and ethical issues:** Investing in arms is, to put it mildly, contentious as ESG experience has shown. Making money out of instruments of war does not make it any easier. My personal view is simple. Countries which are not armed pay the price in terms of loss of sovereignty, let alone independence and freedom. The disarmament argument that if we all do not do it, then no one would, is based on such a naïve view of human nature, that defies belief or is, at best, suicidal. Investing in Defence will not be made easier by the recent highly critical focusing on ESG-led investment and the related metrics. Couple that with the almost surreal obligation of Defence firms explaining not only their social obligations but also their climate policies, and the pictures become darker. There have been moves to excuse, or at least to allow more leeway, to Defence related corporates when it comes to ESG definitions and metrics but the situation will not become easier.

**Compliance and regulation:** The header of this report signals very clearly that for compliance reasons, we cannot recommend buy, sell or hold of named and specific stocks. We are here signaling that we are bullish **on a sector of the economies** but not necessarily on all the companies in that sector. The report uses data from four major US, EU and UK defence stocks **NOT as recommendations** but as more focused indicators of the overall outperformance of the Defence sector. Investors planning to consider investment in Defence stocks, should seek specific and qualified advice not available here. There are more than 60 stocks in this area in the US,UK and EU geographical region and more in Asia etc, and it would be absurd and wrong to imply that just because they are all Defence stocks they are or will do well. The same goes, of course, for the 4 stocks used as illustrations here of the overall performance of the Defence sector.

**Looking forward:** Two further reports will examine in more detail the Defence sectors in Asia and in some additional countries as well as examining in more detail the background against which we consider the outlook for the Defence sector to be bright. There are intriguing structural issues in this area. The single largest Defence sector is that of the US, and several "national Defence corporations" in other countries are closely related to the US. The sectors of Russia and China are also very large and are keen competitors to the US in the export of arms. However, under present circumstances investing in Russian or Chinese Defence stocks might be impossible and, let alone, politically correct.