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ECONOTE No. 111 Investing in the Defence sector Part I: The basic analytics **6 March 2023**

Summary	Investment Conclusions
<p>In Econote No. 110 (Nov.Dec 2022) we broached the topic of investing in the Defence sectors of various West and Asian economies. The reasons for this were very simple: First, the war in the Ukraine resulted to a sharp rise in defence spending in western countries and, second, this rise would not cease with the end of the war but presented a pivot to higher defence spending, not only in western countries, but also in areas such as Asia. Hence the outlook for Defence stocks was, and is very bright, as witnessed by their persistent outperformance of the S&P 500 and still reasonable valuations. We highlight here some key characteristics of the Defence sector both in the west and in Asia. We then illustrate recent turning points and their impact on the relative stock performance and valuations of Defence shares. In the following Part II of this report we will revisit a number of individual country Defence sectors and examine their prospects .</p>	<p>For compliance reasons this report does not contain any “buy-sell-hold” on any individual or named defence stocks. This report looks at the Defence sector and comments on its overall financial outlook. The stock valuations shown here are not meant to be interpreted as an encouragement to buy-sell-hold as this will depend on the overall performance of any single stock a task which, for compliance reasons, is also outside the scope of this research report. The analysis of the Defence sector is based on political factors, and the likely persistence of a positive outlook also depends on global political trends examined here and in the follow-up Part II report. Investors will need to seek specialist advice on comparative and portfolio valuations and actual “buy-sell-hold” decision on the sector as a whole and individual shares.</p>

Setting the Defence scene: Now and the next decade

The key reasons posited by this report as to the bullish outlook for defence companies is based on the following three developments. **First**, the outbreak of the Ukraine war in February 2022 highlighted the role of defence industries in the NATO countries as they would be the direct beneficiaries of the military aid extended to Ukraine. This included not only the immediate dispatch to arms from existing stocks, and thus necessitating their replacement, but the clear consequences of the war in pivoting upwards most of the NATO military budgets, and that of Germany in particular. **Second**, the implications of “neighboring wars” focused more attention than ever to friction points across the world, and Asia in particular, thus triggering defence budget revisions and increases across the region and for countries which were not connected to the Ukraine war. **Third**, the eventual ending of the Ukraine war would be unlikely to help end this defence spending boom as the shock of this war forced extensive rethinking of global defence balances and strategic reconsiderations. These included the re-emergence of a NATO much more united and even expanding with Finland and Sweden planning to join. The reasons why we also consider that this “shifting upwards” of the defence spending curve will last, is based primarily on the second reason expounded above. Consider some the following friction points in Europe which have been recently refocused:

Greece and Turkey territorial disputes, Russia’s other disputes with Georgia and Moldavia. In Asia, and centered on China, the Taiwan dispute dialed up to serious level, the fast rearmament of Japan conflicting with China and N.Korea, the permanent but nuclear-fueled North-South Korea dispute, the islands and seaways disputes between China, Japan, and SE Asian countries and the China-India border issues.



The analytics in brief

Fig. 1 shows the performance of five major “west” defence stocks vs S&P500: Lockheed Martin (green), Thales (blue),BAE Systems (brown),Rheinmetall (mauve),Raytheon (orange) and SPX (red).All stocks outperformed S&P500 since the start of 2022.**Fig. 2** shows the performance of 5 major Asian Defence stocks vs S&P 500: Hanwha (blue),Hindustan Aero(mauve),Taiwan Airspace (orange),ST Engineering (green), Mitsubishi Group (yellow), S&P500 (red).With the exception of Hanwha ,the other four stocks outperformed S&P500 during most of 2022-23.**The Box** below shows that US companies dominate the field in terms of size of revenues, although three Chinese companies make it to the list. The P/E of a selection of big western and Asian/Japanese companies shows that these P/E are not significantly different from that of S&P500 with the exception of Mitsubishi and Hanwha. However 6 of these companies are in the overbought area (RSI 60 and over).In sum, during 2022 and nearly 1Q.23 these stocks performed strongly, all sharing one common characteristic that of being in the Defence sector.

10 major defence companies ranked in terms of revenues

“Global”	Asian and Japanese
Lockheed Martin (US 96.0%)	Aviation Ind Corp of China(China, 37.0%)
Raytheon Tech (US 65.0%)	China State Shipbuilding Corp(China 20.0%)
Boeing (US 56.0%)	China North Ingroup Corp(China 22.05)
Northrop Grumman (US 88.0%)	China Electronics Tech.Group (China 25.0%)
General Dynamics (US 80.0%)	China South Ind.Group(China 31.0%)
Aviation Ind.Corp.of China (China 37.0%)	China Aerospace Science Ind Corp(China 32.0%)
BAE systems (UK 96.0%)	Mitsubishi Group (Japan 60.0%)
China State Shipbuilding (China, 20%)	Hanwha (S.Korra 67.0%)
China North Industries Group (China 22.0%)	Hindustan Aeronautics (India 93.0%)
L3 Harris Tech (US 84.0%)	ST Engineering (Sing.38.0%)

Source: Defence News,(X country,% or revenues from defence,2021).All the Chinese firms listed are in the “prohibited” list of the US.

Metrics of 10 major Global and Asian/Japanese stocks.(Bloomberg 4-6/3/23)

Stock	P/E	RSI
S&P 500	18.2	46.2
Lockheed (US)	17.7	56.3
Raytheon Tech (US)	19.8	48.7
Thales (France)	17.2	65.7
BA Systems (UK)	15.3	61.3
Rheinmetall Germany	19.6	63.6
Mitsubishi Grp Japan	9.1	70.9
Hanwha (S.Korea)	2.3	32.8
Hindustan Aero India	17.9	63.5
ST Engineering Sing.	18.3	32.5
Taiwan Airspace IDC	15.6	62.8

Fig.2 Major Asian defence stocks vs SP500,2022-23, 2022=100



Source: Bloomberg

Summary and broad investment implications

First, as indicated at the start of this report, for compliance reasons we cannot offer buy-sell-hold recommendations in any of these stocks, but simply use their recent and future expected performance as illustrations why we expect the Defence sector to continue performing comparatively strongly. Specific sectoral comparisons must take into consideration that defence spending is very industry- focused although it may well hold collateral benefits for industries related or suppliers to Defence companies. For investing in individual companies, specialist and compliant advice should be sought. **Second**, the quantitative tools used here for performance analysis are simple but direct in their conclusions. In the past, Defence stocks did not necessarily outperform key indices, such as S&P500, but since the start of 2022, they have, and for the reasons we have given. Needless to say individual Defence companies can vary widely in terms of their specialization, from electronics to mechanics ,from shipbuilding to aircraft etc and so can their individual financial performance including their leverage. Hence their P/E and RSI may reflect widely differing balance sheet structures. **Third**, all the companies here share the common characteristic in their production of defence goods and in their clients being overwhelmingly governments. **Fourth**, this raises an interesting consideration in that although higher interest rates will affect differently the balance sheets of differently leveraged Defence companies, the high rates will have relatively little impact on the behavior of their clients, namely governments, and of their demand for defence products. Hence Defence companies are “interest rate proof” candidates, subject to their leverage, when it comes to portfolio structures at the time of rising rates, as is now. **Fifth**, in previous Econote publications posted in LinkedIn (see link) we have explored at some length the sensitive moral and ethical issues in investing in “instruments of war”. This issue has come home to roost in the recent wave of criticism on the investment usefulness and transparency of the ESG metrics. Several major institutional investors have indicated their skepticism and reluctance to adhere to ESG precepts, something which, however cynical this may sound, is to the advantage of Defence stocks where low or poor ESG scores and metrics could easily prevail under present circumstances.

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