CREDO WEALTH

What a difference a year makes

Exactly twelve months ago, we last wrote about the defence sector. At the time, we saw an attractive opportunity, with the sector trading at the lowest absolute valuation in many years and the lowest relative valuation in decades. Out of favour areas of the market can often provide opportunities if the risks are priced in. Low valuations provide a foundation for outsized returns when positive earnings surprises eventuate.

Last year, the market was worried about the prospect of budget cuts by the US Department of Defence (DoD) and the subsequent impact on earnings growth in the sector. The reason for these worries stemmed from when Joe Biden was still Vice President. In the aftermath of the Global Financial Crisis, just as Congress had passed a stimulus package sending federal spending soaring, the Obama-Biden administration passed a law which capped the US spending on defence for ten years. Despite pledging to maintain the superiority of the US military on the campaign trail a decade later, Biden caveated this with the proviso that this must be done affordably and criticised President Trump's consistent increases in spending. It seemed reasonable that cuts would need to be made by the DoD to cross-subsidise increased social and stimulus spending priorities.

A year ago, we considered that consensus earnings estimates were already reflecting these prospective cuts. With defence companies trading at comparatively low valuations as a result, we believed that we were being fairly compensated for this well flagged risk. Prime US defence companies such as Northrop Grumman, Lockheed Martin and Raytheon Technologies are highly profitable and cash generative businesses. They possess wide moats, including technological expertise, approvals to work on "classified" projects, and experience in tendering. Government defence programs can span across decades and are agreed based upon a certain level of profitability, thus stable margins and returns can be ensured.

We further considered that, whilst cuts may indeed be made overall, growing geo-political tensions also made it likely that increased investment would in fact be necessary in areas which would allow the US to maintain its superiority over China and Russia. We preferred companies operating in the advanced technological space, involved in developing capabilities in areas such as nuclear deterrence, cyber, space, intelligence and surveillance. Those projects which ensure that the US military remained at the forefront from a technological point of view would be less at risk in our opinion.

What we could never have predicted at the time was that Russia would invade Ukraine. Few people really expected that we would see war in Europe again.

In response to this invasion, President Biden has called for the largest ever level of military spending: $813 billion in 2023. The increase is more than double the rate the administration sought in last year's budget.

We have seen a similar about-turn in Europe. In February, Germany's Chancellor, Olaf Scholz, announced a €100m fund to modernise its military and vowed that Germany would meet its NATO commitment to spend 2% of GDP yearly on defence. Ironically, this is something which several US presidents, including most recently and explicitly President Trump, have tried and failed to achieve. Of NATO's members, only a few countries were previously meeting the spending commitment. Just a few weeks previously, Berlin had faced international incredulity after offering 5,000 helmets to Ukraine while Russia was in the process of amassing more than 100,000 troops on its borders. In March, Germany ordered 35 US F-35A fighter jets, which have the ability to stealthily deliver nuclear weapons.

Additionally, the perception of the defence sector is changing. Just a few months ago, the defence sector was strictly verboten in ESG circles. The narrative that “defence is bad” was in large part fuelled by the West’s mistaken wars in places like Iraq, and Afghanistan over the last two decades, the carnage inflicted on innocent civilians and the loss of Western troops and treasure which were unpopular at home. However, the conflict in Ukraine is changing that narrative. Western weapons are proving effective at turning back the Russian advance and protecting Western ideals of freedom and democracy without risking “boots on the ground”. Moreover, there is almost unanimous support in the US, UK and EU for increasing military aid to Ukraine. This has also helped to remove another overhang for the sector.

With the improved budget outlook, the earnings outlook for the defence sector has improved significantly. In response, shares in defence companies have re-rated materially. We are pleased that in this instance, our strategy of buying quality but unloved companies has paid off. ■

Important notice