Global Research Unlocked

Our intel suggests a long and clear runway for defense spend

Key takeaways

- Our industry leading analysts join the podcast to discuss emerging risks, opportunities and growth themes in global markets.
- Geopolitics are leading to bipartisan focus on defense spending. Ron Epstein expects spend as a share of GDP to rise.
- In addition to the favorable outlook for spending, US Presidential election years tend to be good for defense stocks.

The tactical and strategic case for defense stocks

The US spends about 2.8% of GDP on defense. And although overall US budget deficits are rising, which could affect other areas of spending, Ron Epstein believes defense spend is likely to rise, potentially to 4% of GDP or more. And part of this will fund greater innovation as the US will have to stay ahead of adversaries. But it's not just about ordering more equipment, Ron suggests that the industrial base for submarines, which are a key area of focus for the Department, is smaller than it needs to be. There were six years after the Berlin Wall came down where the US didn't build any new submarines and the industrial base, from workers to supply chains, must be bolstered. An increase in defense spend and innovation should translate positively for defense stocks which also tend to do well during US presidential election years. In fact, going back to 1980, defense stocks on average outperform the S&P by over 13% in those years with performance weighted toward the second half of the year.

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Full Transcript

The question that has to be answered is Pax Americana. If you want to have that post-World War II peace that the US has preserved, that's going to cost money.

– Ron Epstein, Senior US Aerospace and Defense Analyst

T.J. Thornton, Head of Product Marketing: Hello and welcome to Global Research Unlocked, where we discuss what's rising from growth industries to rising risks and opportunities in global markets. I'm T.J. Thornton, Head of Product Marketing at BofA Global Research, and we're recording this episode on Tuesday, January 16, 2024. A quick look at the global headlines, and it's easy to understand the case for increasing defense spend. But have the various conflicts translated to meaningfully more spending, even outside of munitions and consumables? And with deficits already so high, is growth in defense been difficult to achieve politically? It's been argued that defense stocks should benefit from multiple expansion, given that backdrop, but has that happened and what's left? We'll discuss those questions and a few more with Ron Epstein, who covers US Aerospace and Defense for BofA Global Research. Thank you, Ron, for joining us today.

Ron Epstein: Good to be here. Thanks.

T.J. Thornton: So, Ron, as we sit here today, a US budget agreement seems close, but it's not yet a done deal. Something should be done by the time this podcast is out. In broad terms, how does the budget look for defense spending?

Ron Epstein: Yeah, the budget looks actually really quite good. If you look at what's being framed right now, it's $886 billion in baseline defense spending, plus another $105 billion in supplemental spending. So, if you add that up, that's $991 billion, just a hair under a trillion dollars of defense spending. We were expecting to get to about a trillion dollars of defense spending by 2026. So, this is actually ahead of where we thought, fiscal year 2026. So, this is actually ahead of where we thought we would be at this time. So, from a budget perspective, it's actually a very robust budget.

T.J. Thornton: Okay. And you recently hosted a defense forum with experts from industry, from the US Armed Forces and others. Not surprisingly, it seemed that the view from that forum was that there needs to be even more spend than what we'll get from the '24 budget. Do you think that's realistic, though, in the years ahead?

Ron Epstein: Yeah, I do. I mean, when you think about the years ahead, the question that has to be answered is Pax Americana. If you want to have that post-World War II peace that the US has preserved, that's going to cost money. Right now, the US is spending about 2.8 percent of GDP on defense. That probably has to rise to somewhere between, call it, four to five percent of GDP to allow that to happen. Now, from a political perspective, the question you have to ask is, who is going to be or who wants to be the Congress or the administration that lets Pax Americana slide away? And my guess is, probably, nobody soon. And if you want to preserve that, again, you have to get to four to five percent of GDP. And currently, we're just under three.

T.J. Thornton: Okay. And I mentioned lots of interesting guests at the forum. Anything else from that worth highlighting, do you think?

Ron Epstein: Yeah. I mean, I think probably one of the more interesting takeaways, and this was uniform across pretty much every speaker, and the way I kind of frame it is, everything, everywhere, all at once, there's a sense of urgency in the Department of Defense that we have to be ready as a nation to act. And that's not being communicated very well to the broad public, that how the situation from a national security perspective, globally and regionally, isn't broadly appreciated by the public. And that's something, that communication has to happen. Another, I think, important takeaway was the focus on innovation. So, kind of frame that one, innovation, innovation, innovation. And the point here is, given the speed at which our adversaries are advancing, the experts at the conference highlighted, we have to do that too. So, it's not just a matter of kind of keeping up with the Joneses, but it's keeping ahead of the Joneses. And in a matter to do that, you have to innovate much quicker.

T.J. Thornton: Got it. Okay. And you talked about needing to spend probably even more relative to GDP on defense, but of course, there's also been a lot of discussion about overall defense spending, or rather overall spending already being too high. How do you respond to that? I mean, as a percentage of GDP, our deficits have been sort of trending higher. Perhaps, we should be plateauing that or at least taking it down. And that's difficult if we think about what could be even more growth in defense spend. So, is that a hurdle or does that spend come out of other areas of the budget?

Ron Epstein: Yeah, typically, it would have to come from one of two places, either more revenue generation, which would be taxes, or from other places in the budget. And again, it kind of gets back to T.J., this whole concept of, Do you want to preserve the world that we have or not? And in some ways, it's okay if you don't. That's just a political decision and the US position in the world will change. And then, the question becomes, What political regime in the US wants to take that as their legacy?

T.J. Thornton: Last weekend, long weekend, I was in Providence, Rhode Island. There were ads from a major submarine builder, actually, on the boards of a hockey arena, looking for employees. And I know you've written about this. In fact, I think it was one of the things that came out of the defense forum, submarines specifically. So, whether it's for submarines or other areas of defense supply chain, is that a real limiting factor, the need for employees? And does that prevent us from being able to maybe expand as much as we'd like?

Ron Epstein: Yeah, it most certainly is. The defense industrial base, broadly, is challenged right now. The submarine industrial base is kind of the poster child for it. But you could talk about this for military aircraft, kind of across the board. We've also seen it in munitions and weapons. But let's look at submarines as an example. Right now, the US is building two major submarine programs. The Virginia Class Submarine, which is replacing the Los Angeles Class. That's a fast attack submarine. And the Columbia Class Submarine, which is replacing the Ohio Class ballistic missile submarine. The Virginia, the rate at which we would like to purchase Virginias right now, is about 2.3 per year. That would be, you know, every third year, you get an extra submarine. Every third year, that extra submarine would go to Australia. Something I think we'll talk about in a little bit, you know, demand for US goods overseas. So, we'll be shipping, supposedly, we'll be shipping a submarine to Australia every three years. So, 2.3 per year. Currently, the industrial base is struggling at 1.3. So, we're an entire boat behind where the industrial base wants to be. Now, the orders are happening. So, you're seeing a buildup of backlog for submarines. And that's something we haven't seen since, you know, the Reagan era. Now, part of this is a byproduct of in the peace dividend after the Berlin Wall fell down, we stopped building submarines for six years and the industrial base shrunk dramatically. So, we're dealing with not just challenges on the labor front, but the entire supply chain. So, you're retooling an industrial base to support these new levels of demand. And we're seeing that across the entire defense industrial base, everything from space, all the way down to undersea.

T.J. Thornton: Let's talk a little bit about elections, at least presidential election years. I know they've tended to be good for defense stocks. How much outperformance do we tend to see on average for defense stocks in election years?

Ron Epstein: Yeah, so defense stocks tend to do well during presidential election years. We've looked at this closely. If you go back to 1980 and look at how a basket of defense stocks would do, on average, they outperform the S&P by over 13 percent. Now, it turns out if you peel back the onion even more, a lot of that happens in the second half of the election year. So, the setup going into this year is, from that perspective, pretty darn good for defense. So, you've got a defense budget that's record high and you're going into an election year. So broadly, for the defense sector, it's a good setup.

T.J. Thornton: We did a podcast almost two years ago, soon after the Ukraine war started. And I know one of the things we talked about back then was the case for defense multiples, how they seemed low to you in absolute terms relative to the S&P. But curious, now that almost two years have elapsed, what have multiples done? And you've made a pretty good case for sort of the revenue side. But what about the multiples for these defense names going forward? How much room is there to go?

Ron Epstein: Yeah, so it's interesting. When we did that, defense stocks were trading at almost a two standard deviation away from their mean on forward multiples. And then, we saw that recover and they traded about one standard deviation above their mean. And then they gave some of that back. So, right now, we're a little bit around mean, maybe a smidge above that. So, on a relative valuation basis, they're pretty, how can I say, reasonably priced at this point. But the Ukraine war was priced in relatively quickly. And if you go back to two years ago, the stocks were priced almost at a level that we hadn't seen since, at least on a forward multiple from the fall of the Berlin Wall. They got really, really inexpensive. And the call at the time was, that's just not sustainable, just from a valuation perspective, but broadly from, not that we were calling for a war in the Ukraine, but something would happen somewhere that would trigger some focus on national security.

T.J. Thornton: So, we've mostly focused on the US so far, but I did want to talk about areas outside of the US. Of course, US allies have been providing funding too for some of these conflicts, wars that are ongoing. Where do we stand in terms of defense budgets for US allies? I know, again, there were some adjustments right after Ukraine. Is there much more room to go, just like what we've potentially could see with the US?

Ron Epstein: Yeah, for sure. After the Ukraine war started, we saw a lot of US allies articulate what they wanted to spend on defense. And pretty much across the board, it was increasing defense spending. The countries on the frontier, if you will, those kind of just backed right up to Russia, were the first to increase defense spending. But we've seen that trickle through to other countries. Broadly, if you look at NATO, kind of the NATO handshake agreement is every country should be spending about two percent of GDP on defense. Not every country was. We've seen more movement towards that. So globally, we are seeing more spending on defense. Another area that's important is the Pacific Rim. We've got allies in the Pacific Rim, Japan, South Korea, Australia. Australia is a particularly interesting example, where they also are taking a more aggressive stance with regard to their national security and their spending. So one, I think, important point is this agreement that the US has with the US, the UK, France and Australia called the AUKUS agreement. And a part of AUKUS is the US supplying nuclear submarines to Australia. And that's the first export deal for nuclear submarines ever in the history of the US. And that's just based on the Australians just trying to bolster their own national security.

T.J. Thornton: Well Ron, thanks very much for joining us today. I think in addition to looking at defense stocks, I'll be looking at real estate in Connecticut and Providence, based on your pitch for subs. So, I appreciate your time.

Ron Epstein: Thank you.

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