



Policy Perspective

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National Security: From Sea to Shining Sea

Kim Wallace

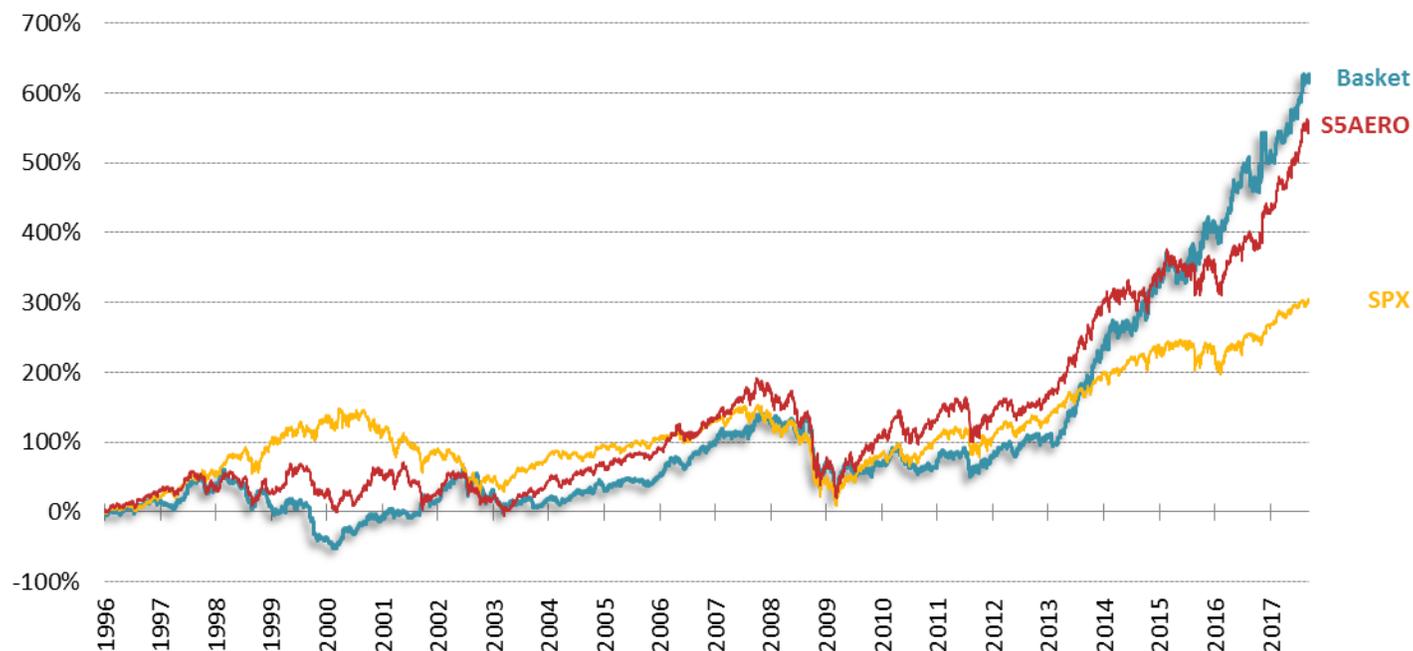
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War spending to fight ISIS has been the policy catalyst for defense names' outperformance the past five years, including FY17. **December fiscal decisions will indicate whether this supportive trend will continue to differentiate defense stocks going forward.** This is one of many fiscal questions likely to create plenty of 4Q17 headline volatility for markets.

US defense stocks in the past month have taken a breather in part due to rich valuations over the past 4+ years, Navy's accidents causing concerns about spending on readiness vs acquisition, and the rising global equity market allowing for many attractive alternatives. **Topping the list of uncertainties for defense names and other soft assets has to be a renewed focus on the fiscal balance as Washington attempts to increase spending and cut taxes.**

The US defense aerospace sector is up 23% YTD, with our defense pure plays (LMT, NOC, RTN) outperforming the broad group. Most of this beat over the past 5 years is attributed to the average \$60B in war-fighting funds provided through the Overseas Contingency Operations account.

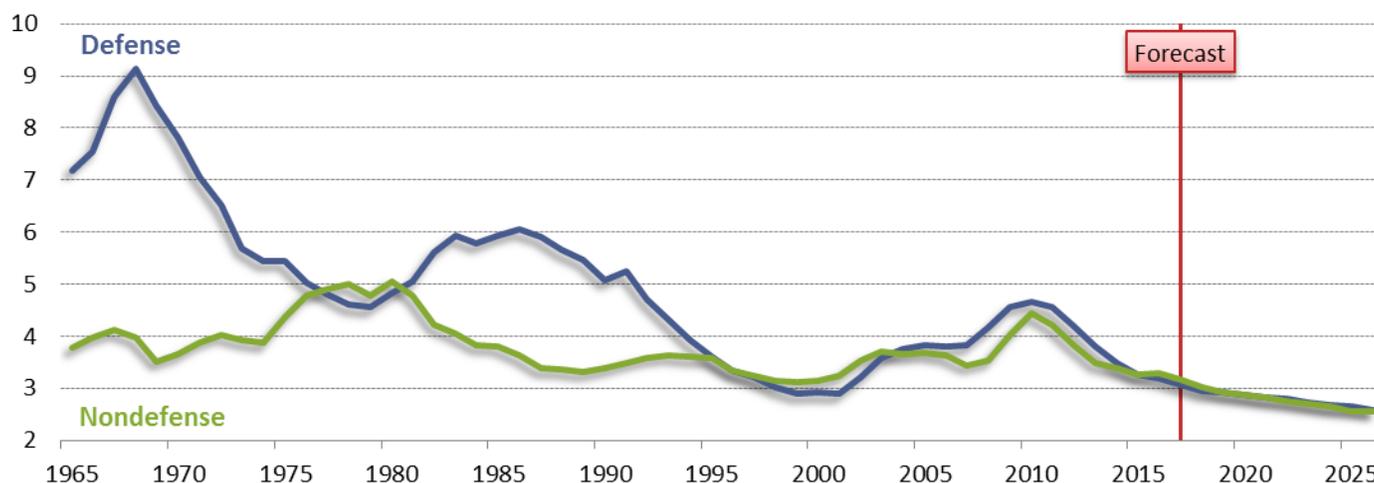
Defense Basket: LMT, NOC, RTN (cap-weighted % appreciation)



Source: Bloomberg, RenMac

December will be an important tell for the direction of defense spending. Before leaving town for yearend holidays, Congress and the President will decide at least three crucial, related policies for the broad group. **The 2011 budget deal (Budget Control Act) caps defense and non-defense discretionary spending at identical levels** and includes a provision for sequestration to reduce such spending (although those across-the-board cuts have been implemented fully only once in the past seven fiscal years of the ten-year deal.)

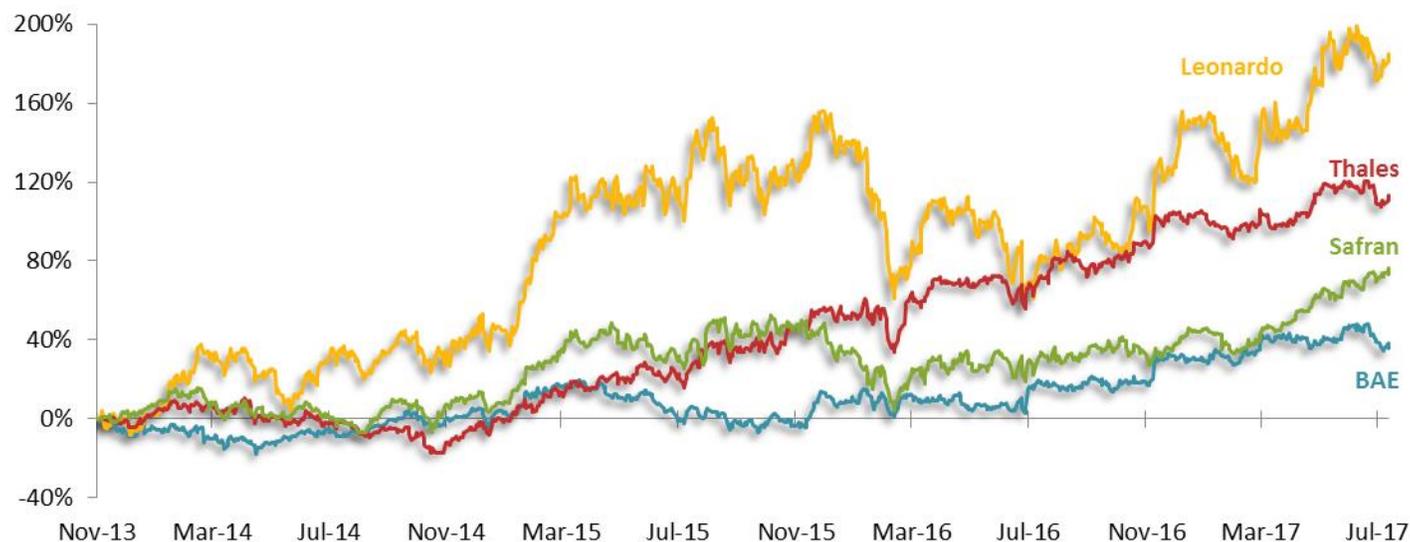
Discretionary outlays (% GDP)



Source: CBO

- ❖ Many Republicans favor de-coupling the two accounts, allowing increases for defense and flat spending or cuts for non-defense. Almost all Democrats oppose this de-coupling. The outcome here depends on where the votes are in December. Whatever is proposed will need 60 votes in the Senate.
- ❖ The same political dynamic exists for sequestration, with a probable fix being to again terminate planned cuts to both defense and non-defense accounts.
- ❖ The Trump administration has requested \$60B for FY18 OCO outlays, equivalent to the 8 year average.

Geopolitical uncertainty providing impetus for a fiscal lever that lifts defense and aerospace names is hardly confined to the Western hemisphere. Whether reinforcing borders, fighting distant enemies, or jockeying for position on the never-static geopolitical chessboard, providing for the common defense is entering a new phase of an old story. European defense names generally are up over the past 6 quarters, according to work done by our colleague Todd Mariano. We'll discuss trends on the other side of the Atlantic in our weekly report.

Major European defense stocks (cumulative % appreciation)


Source: Bloomberg, RenMac

December sets up to answer the bell on many fiscal fronts including taxes and discretionary spending. **Defense names have as much at stake as any market-relevant discretionary account. A surprise would be if Washington adds mandatory spending reductions or reforms to the list of fiscal items addressed in December.** An even bigger surprise would be if the Pentagon undergoes and completes a full financial audit next year as requested by the Administration.

Policy Calendar

Wednesday

- 10am EDT, Senate Judiciary Committee hearing on immigration policy for "Dreamers"
- 10am, Senate Commerce began process of passing a version of House's autonomous vehicles legislation
- 3pm, European Commission President Juncker's State of the Union address

Thursday

- 3:30am EDT, Swiss National Bank decision on policy rates
- 7am, BOE follows the SNB
- 9am, US Climate Prediction Center releases monthly forecast of El Niño/LA Niña impact on winter natural gas supplies
- 10am, Senate Finance Committee hearing on individual tax reform
- 10am, Senate Health Committee hearing on health care premiums
- 11:30am, Bundesbank's Weidmann speaks in Frankfurt
- FDA advisory panel scheduled to consider Perdue Pharma's pediatric management drug, Butrans, Alan opioid skin patch

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