



Commentary

The release of specifics for the government’s FY-2013 budget have been delayed by a week, but so far the news (ie. what’s been announced and what’s been leaked) has been positive.

The declines in the defense budget that are coming, and which we’ve all known about for some time, appear to be manageable. While growth in the international defense business and commercial aerospace sectors that readers of this letter have heard from me before, are gaining increasing traction and attention.

The recent newscycle has given us the possible early pullout by France from the Afghanistan coalition, leading some to question whether the U.S. will reconsider its end-of-2014 timetable (the Taliban is just biding time until we leave anyway); and a new Israeli intelligence report that Iran’s rocket development program is being designed to reach the East coast of the U.S. compared to “previous” comments in the news that the missiles are just capable of hitting Israel and parts of Europe. I quote “previous” because a longer range rocket is just a matter of time one you figure out the nuances of orbital flight. Iran has been working on an orbital satellite program for “scientific” purposes so why wouldn’t the nation use the fact that they could damage the U.S. as political leverage?

SPADE Defense Index Statistics

1/31/12 Close: 2187.84
 All-time Close: 2747.67
 Date of all-time close: 9 October 2007

	SPADE Defense	S&P500
January 2012	5.75%	4.36%
2011	[2.75%]	0.00%

The Israeli statement bringing the U.S. into the threat matrix adds a new dynamic both to:

- a> Iran’s upcoming elections and their willingness to not create an environment that leads to a pre-emptive attack on its soil by the U.S. or Israel to disrupt their nuclear and/or launch capabilities; and
- b> U.S. politicians calling for significant defense cuts that could impede our efforts to identify an attack by Iran, or related parties, on the United States with nuclear materials.

But first things first. Details of the FY-2013 budget will be known within the next two weeks, and then some attention will focus on dealing with sequestration and whether new rules pursued by the Congress will diminish the impact on defense spending.

In the meantime the news and the topline budget numbers have favored defense companies which in all likelihood is why the sector has outperformed the market in January

Above its 50-day and 200-day moving averages and diverging higher with the market as a whole, A&D stocks are trending higher while the P/E and other technicals remain at oversold levels.

Sequestration Update

Sen. Jon Kyl (the #2 Republican in the Senate) and Sen. John McCain (the top Republican on the Armed Services Committee) unveiled legislation to offset \$110 billion of the automatic, across-the-board sequestration cuts that would take place next January and spare the Pentagon from deep spending cuts. The legislation would be paid for via a pay freeze for federal employees, a 5% reduction in the workforce, and limiting hiring to two employees for every three who leave.

While we wait for the budget specifics, topline defense spending...

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Base	528	528	531	525	534	546	556	567
OCO	163	159	115	88	TBD			
Total	691	687	646	614				

Budget Control Act Mandated Reductions call for:

FY2012-2021: \$487 B over 10 years

FY2013-2017: \$259 B over 5 years

Let’s look inside the numbers:

While the OCO (Overseas Contingency Budget) declines by 73% from 163B in FY10 to an estimated \$44B in FY17, the base budget actually grows by 7% from \$528B to \$567B. Overall, the budget shrinks by 12%.

In real \$FY13 dollars, when factoring in inflation, the base budget will decline by \$28B or 5%. Overall, the budget shrinks by 22%.

	FY12	FY13	FY14	FY15	FY16	FY17	FY13-17
Nominal Growth		-1.0%	1.5%	2.3%	1.8%	2.1%	6.8%
Real Growth		-2.3%	0.3%	0.6%	-0.2%	0.1%	-1.6%

Jan 2012 Top Gainers			Jan 2012 Laggards			YTD Top Gainers			YTD Laggards		
1	Textron	37.80%	1	NCI Information	[37.17%]	1	Textron	37.80%	1	NCI Information	[37.17%]
2	Ceradyne	23.56%	2	Aerovironment	[11.44%]	2	Ceradyne	23.56%	2	Aerovironment	[11.44%]
3	Huntington Ingalls	20.46%	3	Digital Globe	[8.30%]	3	Huntington Ingalls	20.46%	3	Digital Globe	[8.30%]
4	URS Corporation	17.17%	4	TASER	[7.03%]	4	URS Corporation	17.17%	4	TASER	[7.03%]
5	Kratos Defense	14.07%	5	Heico	[4.92%]	5	Kratos Defense	14.07%	5	Heico	[4.92%]
6	Harris Corp.	13.76%	6	Moog	[2.98%]	6	Harris Corp.	13.76%	6	Moog	[2.98%]
7	Oshkosh Truck	13.56%	7	GeoEye	[1.40%]	7	Oshkosh Truck	13.56%	7	GeoEye	[1.40%]
8	Ducommun	13.33%	8	Raytheon	[0.81%]	8	Ducommun	13.33%	8	Raytheon	[0.81%]
9	LMI Aerospace	12.76%	9	Northrop Grumman	[0.74%]	9	LMI Aerospace	12.76%	9	Northrop Grumman	[0.74%]
10	Mantech Int'l	12.48%	10	Precision Castparts	[0.67%]	10	Mantech Int'l	12.48%	10	Precision Castparts	[0.67%]

Largest Defense Prime Contractors		
	January	2011
Lockheed Martin	1.76%	15.72%
Boeing	1.13%	12.40%
General Dynamics	4.14%	[6.41%]
Northrop Grumman	[0.74%]	[9.73%]
Raytheon	[0.81%]	4.40%
L-3	6.09%	[5.41%]

ETF Statistics (NYSEarca: PPA) Powershares Aerospace & Defense	
Exchange / Ticker Symbol:	NYSE / PPA
Assets (1/31/12)	\$58 M
Closing Price (1/31/12)	\$19.26
Yield (12-Month Yield)	1.00%
January 2012 Volume	283,600
Turnover	12%
source: Marketwatch	

Portfolio Price / Earnings	11.86
Portfolio Price / Book	1.93
Portfolio Price / Sales	0.74
Portfolio Price / Cash Flow	8.30
Earnings Growth Rate	3.65%
Beta (3 year)	1.05
Alpha (3 year)	[3.70]
R-squared (3 year)	84.97
Yahoo Finance - 12/31/11	

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Contracts and Other Numbers

\$49.7 Billion - Sales of civil aircraft in 2011 according to the Aerospace Industries Association.

\$7.39 Billion - South Korea invited bids from Boeing, EADS and Lockheed Martin for a fighter aircraft contract. The deadline for proposals will be June 18, but did not specify how many fighters the country would buy

\$5.7 Billion - The Pentagon greenlighted the U.S. Army's Common Infrared Countermeasure program that equips helicopters with infrared capabilities to confuse guidance systems of missiles aimed at the helicopters.

\$3.48 Billion - To Boeing, which beat out Lockheed to keep its role as prime contractor for a Missile Defense Agency, seven-year contract focused on the Ground-based, Midcourse Missile Defense system which includes interceptors in Alaska and California, ground and seas based radar, and satellites and a command and control system. The Boeing team includes Northrop Grumman. Lockheed's included Raytheon.

\$1.96 Billion - To Lockheed from the UAE to supply them with a missile defense system -- two THAAD systems that include interceptors, launchers, and radars.

\$1.78 Billion - Boeing and the Indian air force finalized a contract

for 10 C-17s, after three years of negotiations.

\$377 Million - From the USAF to Boeing for a ninth Wideband Global Satcom satellite. A contract for the 8th came a month earlier, for a total of \$673 million.

\$370 Million - The Army awarded Boeing a contract to build 14 CH-47F Chinook helicopters. Australia will receive 7, the UAE, 6, the US Army, 1.

238.5 Million - Lockheed Martin was awarded a contract to begin building the 3rd and 4th satellites for the next generation of GPS.

New Programs and Other News

* Sec. Panetta gave his backing to the Lockheed Martin F-35B, lifting a year-long probation on the Marine Corps version of the jet to show that it has improved reliability. The Marines plan to buy about 340 of the planes that can take off like a fighter and land like a helicopter. India is also buying as many as 60. - 22Jan12

* The Pentagon wants to bulk up the Massive Ordnance Penetrator bomb, which weighs 30,000 pounds, so that it could destroy Iran's underground facilities

* The USAF Force revealed details about its latest spy plane, the X-56A by Lockheed Martin's Skunk Works.

* The Pentagon will cut order for V-22 Ospreys by 24 in its five-year budget. The order for the aircraft produced through a Boeing-Bell Helicopter joint venture would total 98 aircraft

PPA (blue)
 S&P500 (red)
 Orange (50-day)
 Green (200-day)



Three-Month Chart

1. The Aerospace & Defense sector has **begun to diverge to the upside** from the broader markets. The Powershares Aerospace & Defense ETF (NYSE: PPA) in blue vs. the S&P500 in red.
2. PPA is currently above the 50-day (green) and 200-day (orange) moving averages with the 50-day in a rising formation.
3. The MACD for PPA is positive and rising.

About the SPADE Defense Index

The SPADE Defense Index (NYSE: DXS) provides an investment benchmark for the value that the market ascribes to companies involved with defense, homeland security, and space.

The Index is designed to reflect the broad diversity of activities that is representative of companies involved with the sector – including industrial firms that manufacture aircraft, tanks, ships, and missiles; and those involved with current and next generation systems related to network centric warfare and information technology; intelligence, surveillance, and reconnaissance; satellites; border security; and defense systems that protect the lives of our servicemen and servicewomen.

SPADE Indexes publishes a variety of private and public sector and regional indexes. Public indexes listed on the NYSE include: the SPADE Defense Index (ticker: DXS), the SPADE Oklahoma Index (ticker: OKLAH); and the SPADE Texas Index (ticker: TEXAS).

Licensed Products

Exchange Traded Fund - ETF

Licensed to Invesco Powershares, the Powershares Aerospace & Defense Portfolio ETF (NYSE: PPA) is designed to track the performance of the SPADE Defense Index.

Rules

The Index was designed to be RIC (registered investment company) compliant for the purpose of enabling financial products. Companies are required to meet a variety of eligibility criteria including market valuation, liquidity, and listing on a major U.S. exchange. Full details are available on our website.

- * Market Cap: Minimum \$100M
- * Share Price: Minimum \$5.00
- * Sufficient Liquidity

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instead of 122.

* The U.S. ranked behind Finland, Israel and Sweden in a new report analyzing the ability of countries to defend themselves against cyber attacks. Produced by the Security & Defense Agenda, a Brussels-based think tank, and the cybersecurity company McAfee.

* The Pentagon included a global strike weapon for submarines as part of its FY13 budget. The U.S. Navy will oversee development of an "undersea conventional prompt global strike option.

* Pentagon will boost drones by 30% as it cuts military personnel under the new strategy. - WSJ 1/26

* The Air Force ended development of the Defense Weather Satellite System because of an act passed for FY-2012. Prime contractor Northrop Grumman Aerospace Systems was to stop work on the project. *Spaceflight Now* (1/24)

Excerpts from Quarterly Reports

Northrop Grumman reported net income of \$550 million for the fourth quarter, compared with \$306 million in the same quarter a year earlier.

Lockheed Martin reported a 29% decrease in profit on a year-over-year basis for the fourth quarter, posting \$683 million in net income for the quarter, compared to \$961 million in the same quarter the previous year.

Raytheon Co.'s missile and space units drove a rise in fourth-quarter profits of 9.4% although the 2012 outlook fell on lower anticipated sales.

United Technologies reported an 11% jump in profit for the 4Q, to \$1.33 billion, compared with \$1.2 billion for the same quarter in the previous year led by results from its aerospace unit.

General Dynamics reported a 17% drop in profit for the fourth quarter as compared to the same quarter the previous year due to an \$111 million impairment charge, and losses of \$78 million for Jet Aviation. The company forecast stronger earnings in 2012.

Boeing posted a 20% increase in fourth-quarter profit to \$1.39 billion, compared with the same quarter a year earlier. The firm offered a conservative forecast for 2012 with earnings per share of \$4.05 to \$4.25. *"Despite pockets of economic uncertainty and defense-budget pressures, our markets remain large and growing,"*

Textron offered guidance for 2012 of earnings of \$1.80 to \$2 a share exceeding analysts' estimates.

Rockwell Collins said business- and commercial-jet manufacturers are increasing their orders this year in a sign that the sagging industry may begin to turn around after three years. Rockwell's fiscal first-quarter earnings fell 14%, but beat analyst predictions.

"It's not a land rush, but after three years of misery, any improvement is encouraging, and we're seeing that improvement generally across the board," said Rockwell Collins CEO Clay Jones.

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