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When the Tides Change and the Market Shifts...Ride the Wave

As the first wave of Russian tanks and troops enter the Ukraine, and missiles and drones attack from the sky and the sea, investor attention is quickly turning toward the defense and security sector. This should not be a surprise. The images and videos coming from the region offer us a fear of the unknown and of what's to come. Defense stocks provide people with a sense of stability. But like any trend, investors should understand the bigger picture to decide whether we are looking at short-term news or a more sustainable development.

The Russian invasion of Ukraine is likely the first domino to fall. There is no doubt that inside the offices of Xi Jinping, President of China, there is a discussion wondering if Russia's action provides a blueprint (and necessary diversion) that will allow China to move its troops into Taiwan. The Chinese leadership will be closely monitoring the reaction by the West to the Russia/Ukraine situation and determining whether they can withstand a similar economic retaliation by the United States and Europe (or more likely if they believe the US and EU would be willing to act and suffer the consequences of ceasing trade with China.) In this respect China is much better positioned than Russia.

China isn't the only one who bears watching as other nations (i.e., North Korea, Iran, Afghanistan, etc.) and non-nation states (i.e., terrorist organizations) may seek to take advantage of the current instability. Meanwhile, Western democracies are slowly sliding toward more divisive and combative politics that are eroding democratic freedoms. Instead of the world moving toward increased globalization and greater openness, it is sliding into a period where defense and security will be of paramount importance.

The economic sanctions already imposed on Russia by nations around the world will likely have a devastating impact—especially if a block to the SWIFT banking transaction system is imposed. Doing so would essentially prohibit Russia from receiving funds from the sale of oil and natural gas on the international markets. By the end of the first day of the invasion, the ruble had plummeted, and its national stock market declined by a third. However, most of us are well aware that the Russian people have become accustomed over the past century to hardship and believe that a bit of suffering is necessary for the good of their nation.

For individuals and investors in the United States, a destabilized world means that supply chain issues are likely to remain as it will take time for production activity to increasingly shift to onshore sources. It is also likely that inflation will continue to rise toward (at least) historical averages. So, for investors, can there be any safer place for stocks than firms operating in the defense sector?

To identify opportunities, the holdings of Invesco's Defense ETF(NYSE: PPA), which tracks the benchmark SPADE Defense Index, offers a good starting point. However, even within this thematic basket there will likely be winners and losers. The challenge for investors is making the right call.

As commented upon in the January 2022 issue of *The SPADE Investor* and blogs such as Seeking Alpha, there have been only two occurrences since 1990 when the defense index produced positive gains but underperformed the broader market over a two-to-three year period—2020 and 2021 being the most recent. Each time, defense stocks soared over the next decade, more than doubling the returns of the S&P 500. Additionally, over the past 25 years, any short-term declines from investing in the sector have been recouped within three years' time.

In coming years, as defense and security receive greater attention, a wide range of companies operating in the space will likely benefit. The F-35 aircraft built by Lockheed Martin for the US and its allies will likely be in high demand. Raytheon should receive increasing orders for its air defense and radar systems. Helicopters from Textron will be in needed. Boeing military aircraft and helicopters should see steady orders, although its stock market performance will depend on global stability and how passenger and cargo air traffic will (or will not) be impacted. Additionally, with Russia as an adversary, it is likely to see increased military (and commercial) spending on cyber protection products and services offered by firms such as CACI, Mantech, and Mandiant as threats to our digital economy increase. It should be noted that not all ETFs offer similar baskets of stocks. While each of the aforementioned companies are components of the SPADE Defense Index (and of the PPA ETF), its competitor, the iShares Aerospace ETF (NYSE: ITA), does not include the pure cyber firms working with the Pentagon and the intelligence community, only those involved with industrial activity. PPA holds