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Defense industry braces for spending slowdown

by Lou Whiteman

The defense sector appeared an attractive target as Congress attempted to hash out a deal on future spending. But the industry, although set to absorb some cuts, seems to have largely dodged a bullet in the compromise signed into law by President Obama on Tuesday.

Washington's deal to raise the debt ceiling includes about $350 billion in defense cuts over 10 years. More worrisome for the industry is a planned second round of cuts to total $1.5 trillion across the entire government budget. If those targets aren't hit, an enforcement mechanism would mandate about $500 billion in additional defense cuts beginning in 2013.

Rep. J. Randy Forbes of Virginia, Republican chairman of the House Armed Services Committee's Readiness Subcommittee, voted against a compromise that he called "a security risk imposed upon the American people that I am unwilling to accept." Forbes in a statement rattles off a litany of Pentagon worries, including a shrinking force and aging equipment battered by years of war in the Middle East.

Industry trade group Aerospace Industries Association goes a step further, saying the deal "dangles a Sword of Damocles" with potential cuts "so draconian that it's hard to believe they are even on the table."

Some on the other side of the debate would counter that there is likely substantial room to cut. The United States, according to Cato Institute, accounts for 48% of total global military spending, with 2010 spending, according to the Stockholm International Peace Research Institute, more than 6 times that of second place China. But the talk of cuts has rattled the markets, sending the Spade Defense Index down about 10% over the last month.

Austerity has been a long-running concern among defense watchers, with the prospect of reduced spending as the U.S. pulls out of Middle East conflicts coupled with concerns about government spending levels that hit a fevered pitch during the 2010 elections.

Defense titans like **Boeing Co.** (NYSE:BA) and **General Dynamics Corp.** (NYSE:GD) have been buying up specialists in areas expected to better weather anticipated cuts, while smaller players more vulnerable to cuts in individual programs have sought the safety of being part of a larger enterprise.

While the latest political compromise figures to do little to reverse that trend, it also seems unlikely to starve defense contractors. **Credit Suisse Group** (NYSE:CS) analyst Robert Spingarn notes that the initial $350 billion in cuts is actually somewhat bullish for the sector, as it is below the White House's $400 billion request and far below the $1 trillion in cuts figure floated in the Senate.

Spingarn warns the second round of cuts could end up bearish for investors. The analyst expects negotiations to start from the $500 billion figure in the contingency plan, and will likely end up at least matching the $350 billion to be cut as part of the initial deal.

Much of those savings will come from reduced procurement budgets, as it is easier to trim new spending than it is to quickly reduce the size of the military.

A defense banker reached Tuesday argues that even the full amount of potential cuts will not handcuff the sector, noting that much of the needed savings will be achieved if the U.S. follows through on plans to pull out of Iraq and Afghanistan. So-called overseas contingencies will account for more than $300 billion in spending in 2010 and 2011, according to the Office of Management and Budget estimates.

"It's a slowdown, not the nuclear option," the banker says. "And the industry is well-prepared for a slowdown."