

Research @ Citi Podcast, Episode 13: Money and Might — Financing the Future of Defense

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Transcript:

Lucy Baldwin (00:02)

Welcome to the Research @ Citi Podcast. I'm Lucy Baldwin, Global Head of Research at Citi. In each podcast episode, we bring you our thought-leading views and analysis across asset classes, sectors, and economies from around the globe. Now, let me hand you over to our host today.

Rob Rowe (00:22)

Hi, everyone. I'm Rob Rowe, U.S. Regional Director of Research here at Citi, and also with me on the podcast today is Jason Gursky, who's the head of our Aerospace & Defense analysis on the equity side. Jason, I know that you and several of our other partners have published a new piece on the Aerospace & Defense industry, and specifically with a focus on defense, which is obviously a big topic considering all the geopolitical concerns going on right now. And I think you just told me prior to the podcast that you do lose a lot of sleep over this. So I do want folks to know that you are thinking about this very seriously. But maybe we can start off by just asking, and I think the focus will be on defense spending, not just by the U.S., but globally. What would you say right now? I mean, I know it seems like an obvious question with all the various conflicts going on, but what do you think is driving the recent uptick in defense spending?

Jason Gursky (01:24)

Yeah, Sure. Look, I think there are two primary obvious ones, and then maybe one that is a little bit less obvious to some of the listeners here, and my comments will be largely driven around comments around Western allies, the United States and our allies, both in Europe, as well as in the Indo-Pacific region of the world as well. But look, the two most obvious ones are Ukraine and what's going on in the Middle East. And the involvement of both the United States and some of our European allies in Ukraine has been supply of munitions in particular. So that's driving destocking of a lot of the materiel and munitions that we have as NATO allies in particular. And so we've got lots of orders flowing back into the defense industrial base to restock the munitions that we've been sending over to Ukraine. In addition to that, to support Ukraine, there's been a lot of intelligence assets that have been utilized, particularly space-based assets that help our partner the Ukrainians in particular, have a good idea of situational awareness, what's going on around them, help them identify where there might be enemy targets and deploying things in a couple of different ways, munitions and then intelligence. And then obviously, the Middle East has been another hot spot here recently. We just continue to see U.S. assets in particular helping the Israelis in particular defend against inbound missile attacks. So that's another good example of kind of a hot spot and reasons that defense spending is going a bit higher.

The less obvious one maybe to the average listener might be the United States's national strategic posture, and its growing need or desire to increase defense spending to defend against what they describe as "near peers". It's Russia and China are the two primary countries that have been identified as near peers. And we are investing in assets that we

believe are going to help deter direct conflict with either one of those countries. So the posture is about identifying threats, coming up with a strategy — which we've determined is deterrence — and then figuring out the tactics behind actually deterring people, and right now that's military modernization and recapitalizing a lot of the assets that we have here. And that's the third part that's kind of driving defense spending. So Ukraine, Middle East and deterrence against near peers.

Rob Rowe (03:58)

And Jason, can we think about this a little more with a longer-term outlook for both the U.S. and Europe, and specifically, I guess what you've cited is (1) restocking. So have those inventories of ammunition, et cetera, really gone down a lot? Then, of course, you're also talking about the current conflicts. Is there anticipation on the part of governments that we're looking at longer-term geopolitical imbalance, if you will, or unrest? And so we're also preparing for future conflicts that we think might be anticipated. Is that a good way of positioning it as far as, let's call it the NATO Alliance governments or U.S. and Europe?

Jason Gursky (04:42)

Yeah, I think that's right. I think one of the lessons that we're coming away with here is that perhaps our stockpiles of munitions were maybe a little bit lower than they should have been. Both here in the United States, as well as with our NATO partners. You know, there have been press reports out there suggesting that there's X number of days of inventory left to certain types of munitions and those are, you know, uncomfortable levels. So, you know, as we talk to participants in the industrial base, when you watch what statements from DoD and NATO, the leadership at NATO, particularly on the military side, it's very clear that not only are we going to restock, but we're going to probably come out the other side of this carrying more inventory of various munitions than we did before. Lots of orders will flow back into the industrial base on that front. And then, look, on the second part of your question about the longer-term side of it, I suggested a minute ago that there are— the United States is preparing itself to deter conflict in the future. They've identified a number of different threats, Russia and China being the near peers that are of most concern, but then there are other countries around the world that are problematic for the United States and some of its allies, including North Korea and Iran, and then there's the always-persistent threat of global terrorism as well.

And so in the U.S., it seems that we're particularly focused on the Indo-Pacific region of the world and making sure that we can engage in conflict if we need to, and importantly, win, and we're making investments to deter that conflict to begin with. But in Europe, they've got a mandate to be a part of NATO to be spending roughly 2% of GDP on defense. Coming into the Ukrainian conflict, most European countries were closer to 1½. So there has been an uptick in spending here of late. We've now got most European NATO countries approaching that 2% level. And the question then becomes, do they sustain that after the Ukrainian conflict or maybe move it a bit higher given the fact that they've now got the sense that there's an increased threat environment with Russia to its east. So the long-term enduring things here, I think, for the United States are China in particular, and for Europe, it's making sure that they're at that 2% mandate and preparing themselves to deter a more aggressive Russia over time.

Rob Rowe (07:06)

And what is the percentage for the U.S., what's the defense budget percentage?

Jason Gursky (07:11)

Yeah, it's closer to 3½. During the Iraqi and Afghanistan campaigns, you get closer to 5, and the peak of spending during the Reagan era, was over 6%.

Rob Rowe (07:25)

We think that it could reach those levels, or do we think it will stay around 3½ or go higher, do you think?

Jason Gursky (07:31)

Well, that's part of the debate. We've got certainly members of Congress that are advocating for something closer to 5%. We do have a need to recapitalize a lot of the tools of deterrence, and you've got members of Congress that are advocating for 5%. We'll see where it all shakes out. I think this report that we've recently published here lays out some scenarios where things could go lower as a percentage of GDP, maintain where they are today or maybe go higher. Look, the big decision point there is: What's the enduring threat environment look like? If we feel threatened, we tend to spend more.

Rob Rowe (08:11)

Right.

Jason Gursky (08:12)

So that's probably the answers. It depends on what the threat environment — perceived threat environment — is going forward.

Rob Rowe (08:17)

And let me ask on a new element. And really, this question is focused on the conflict in the Ukraine and the Middle East. And I'm thinking of this — and maybe you're thinking of it differently, Jason, you just tell me — but I'm thinking of this from an innovation standpoint, what have we learned from the conflict in the Ukraine? I know there's a lot of technical innovation going on there in the military and also in the Middle East.

Jason Gursky (08:40)

Yeah, look, I think there's probably one really visible lesson that we've learned here and maybe one that's a little bit less visible. The more visible one is just the use of drones or UAVs — more appropriately, maybe, named unmanned aerial vehicles. That has been kind of an “Aha” moment, both from an intelligence perspective and the ability to loiter and identify where enemies are as well as offensive — these things can be used effectively as missiles in and of themselves. That's certainly been one of the big lessons, and the United States has picked up on that. Last year, DoD launched something called Project Replicator, where we are trying to by 2025 field thousands and thousands of drones so that we can use them in a swarming kind of technique both offensively as well as defensively. So even the United States, [which] is viewed to be kind of on the cutting edge of all things related to defense technology, has got some pretty key takeaways from this conflict, and we've stood up an actual initiative inside DoD to try to replicate what's been going on over there to make sure that we're prepared for that kind of environment.

Look, I think the less visible one is the importance of space coming out of Ukraine and the Ukrainian conflict, I should say. The United States has been investing heavily in its ability to access space and to have resilient assets in space. But I mentioned earlier on in the podcast here that intel — intelligence — has been, was pretty key to what's been going on in Ukraine and the use of our assets over there. That's really the hit and “Aha” moment here because

we've been able to use both commercial as well as government-owned classified satellites, electro-optical capabilities, synthetic aperture radar capabilities. Importantly, RF capabilities to identify where the enemy is and able to generate targets out of that. It has been incredibly powerful. In addition, on the communications side, the proliferation of low earth orbit satellites, particularly owned by commercial entities, not necessarily defense assets — or government assets — has been a key enabler of that conflict. So I think this has been a really good proof point about the importance of space. It is the new domain in warfare. It's the ultimate high ground. The importance of having space-based assets and survivable resilient space-based assets both across commercial and government entities is a really, really important thing.

Rob Rowe (11:34)

You said space-based assets. Is that primarily satellites? Or, I mean, I've heard a lot about potential missile platforms in space. I don't know where everyone's progress is on that or how dangerous that would be. Is there development along those lines or other types of space assets?

Jason Gursky (11:45)

Yeah. So space assets, I'm primarily referring to satellites that either provide communication services back down to earth or have sensor payloads that are pointing back down to earth and monitoring what's going on on Earth. So it can be a electro-optical, so the kinds of images that we see in our own eye or you see from a normal camera, there's another phenomenology called synthetic-aperture radar where you can see through clouds and at night, and then there's RF, you can pick up cell phone signals, for example, which have been pretty important to identifying what's going on on the ground. As far as offensive things are concerned, or assets that are not traditional, those assets do exist as well, both offense as well as defensive kinds of things. Also that's behind a classified veil.

Rob Rowe (12:37)

Okay.

Jason Gursky (12:38)

But if you can go up and do space-based manufacturing through robotic arms, which we have been deploying those kinds of assets, you can use those kinds of things to take things apart as well which would be a little bit more offensive in nature.

Rob Rowe (12:51)

Yeah, yeah, I got it. And just thinking we're starting to get into space, it's very interesting. What do you see, given all of that and given the development of drones as a rather potent military weapon — and I've also heard about these electronic countermeasures now interfering with GPS systems on commercial flights — but what do you think the spending priorities will be for the U.S. and Europe, given that? I always think is the tank becoming archaic given that a drone can take one out.

Jason Gursky (13:19)

Yeah, although I mean, ironically, there's been some reporting out here about the Bradley Fighting Vehicle and how effective that has been in Ukraine in particular, but [M1] Abrams, maybe a little bit less so. Look, I think from a spending priority perspective, I think there're kind of two buckets going on here right now. There are enduring things that are going to help us over the longer-term deter near peers, and that would be nuclear deterrence. The United

States in particular in Europe as well, are recapitalizing some of our nuclear assets. The nuclear triad here in the United States consists of silos in Montana, South Dakota, Nebraska, those kinds of areas. That's one part of the triad. The second part is the long-range strike bomber and recapitalizing the B-2 into something called the B-21. And then submarines. The ability to deliver nuclear warheads from a submarine, we've got a program today called Columbia class. We are today, as a country, recapitalizing the nuclear triad. You mentioned losing sleep earlier in the podcast, this is one area where I lose sleep because—

Rob Rowe (14:24)

*[laughs]* I bet.

Jason Gursky (14:25)

You think about when we put all of these assets into place, it was decades and decades ago. Think analog versus digital. It's an acute need here in the United States to upgrade our nuclear triad to deter near peers in the future. Second area that I think is going to be enduring, something we've already talked a little bit about, but that's space and this new domain of warfare, and the ability through easy access to launch — cost-affordable launch — to be able to put satellites and lots of them up into space. With lots of assets up there, we can handle having a few of them get destroyed. We talked a little bit earlier about the offensive nature of some of the capabilities that are possible. We have countries that have demonstrated the ability to blow up satellites. So we need to you have, you know, a really resilient architecture up there so that we have the ultimate high ground available to us at any time. So we're investing a lot there as well. Third and fourth areas, I think are maybe some of the more near-term lessons that we've learned here. That's the UAV side of things, the drones, and we talked a little bit about Project Replicator and this urgent need that the United States feels in being able to field those kinds of assets and putting a lot of money behind that. We're doing that.

And then the fourth area is something called JADC2: Joint All-Domain Command and Control. We all watch the movies and we see a supposed president sitting in a situation room in which he's got all kinds of screens around him and says, you know, pull up that corner in XYZ location and tell me if the bad guy is there. Hey, the bad guy is there. So hey, let's put kinetic energy on that target right away. That doesn't exist today, that kind of environment, and we would like it to. We are here in the United States, spending a lot of money on putting out enough sensors, space-based air, land, sea or underneath the sea kind of sensors to be able to understand what's going on out there in the world, sense everything. But importantly, funnel all of that information into AI and ML capabilities to identify the targets. Then importantly in a joint fashion, figure out who is best positioned to eliminate a potential threat. Now, the Air Force has its sensors and its own command structure, the Army and the Navy have theirs. What we are trying to do is an Army sensor pick something up and you can have a Naval asset eliminate the threat is ultimately what we're trying to do. That's the jointness it all. We don't have those capabilities today, but there's a lot of money being spent there that would certainly help in a Ukrainian kind of theater.

Rob Rowe (16:57)

Jason, let me ask you, given everything we've talked about, I actually have two questions here, but given everything we've been talking about, how do you see the defense industrial base ecosystem changing? You know, what are some of the other players that may be coming in or coming out? And then second of all, I mean, we touched on it in terms of the context of the U.S. defense budget or other budget, given fiscal, how are we going to afford to increase defense budgets in this environment?

Jason Gursky (17:23)

So on the first one on the ecosystem, DoD has been very deliberate in reaching out to the Silicon Valley and other areas of historic innovation in this country. So Boston and Austin, Texas as well. It stood up in 2015, an organization called the Defense Innovation Unit that has been trying to identify technologies that have been developed in these innovation centers around the country that can be utilized for defense purposes, (a) to be able to make sure that we maintain an advantage over near peers, and secondly, probably to keep that kind of technology out of the hands of some of our near peers. It's been kind of a dual purpose, but identifying technology. They've been successful identifying some flowing contracts into these companies, I think educating techies, so to speak, on the patriotic nature of coming back to where Silicon Valley started, which was largely supporting the defense franchise or the defense industrial base. So out in Silicon Valley, defense is becoming cool again, with that has come VC funding as well. We have seen a big influx of venture capital money to support these kinds of things in part because the Defense Innovation Unit has done a good job of identifying technologies and supporting those companies through contracts.

And then the last part, I just suggested contracts, but they're coming up with innovative ways, contract structures that are making it easier for new entrants to identify where they should go spend some R&D because they know that there are going to be contracts available to them, the SDA — the Space Development Agency — in particular has been buying satellites in tranches. They're giving visibility to the industrial baseline. Demand is coming and they're allowing new entrants to come in and compete in these various tranches. So the ecosystem's changing. We've got new entrants here with some high-profile companies have raised a lot of money, and they're winning some high-profile contracts at this point. The ecosystem's changing. Defense primes have got huge installed bases, and it's a big benefit for them. But in the future, we're trying to rapidly innovate. DoD has been very purposeful in their actions here, and VC money is starting to flow into it. So the ecosystem are certainly changing.

And then, look, how are we going to afford all of this? This report that we've recently published, from an empirical basis looking historically, it's largely had to come through higher debt and deficits. It's the way that we've done this in the past. Spending priorities are difficult, choices are difficult. Do you cut spending on Social Security kinds of needs or social platforms? And what we've seen historically across most of the OECD countries — NATO and the United States included — defense spending goes up, so do debt and deficits.

Rob Rowe (20:07)

Well, Jason, thanks so much for participating in our podcast today. All of this is entirely intriguing. I have a friend who followed me around with a drone, and I didn't know it for quite some time. That might say more about my friend than the drone. But in any case— *[laughs]*

Jason Gursky (20:21)

Or your self awareness. *[laughs]*

Rob Rowe (20:24)

*[laughs]* That's right. Well, listen, thank you so much. And thanks everyone for listening, and we'll be back with another podcast soon.

Lucy Baldwin (20:32)

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[Disclaimer] (20:57)

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