

Morgan Stanley & Co. Incorporated

Heidi Wood

Heidi.Wood@morganstanley.com
+1 (1)212 761 4407

Lee Rawlings

Leon.Rawlings@morganstanley.com
+1 (1)212 761 6172

Matthew McDonnell

Matthew.McDonnell@morganstanley.com
+1 (1)212 761 4180

Mathew Schneider

Mathew.Schneider@morganstanley.com
+1 (1)212 761 3483

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Industry View
In-Line

Aerospace & Defense

Early Thoughts on Obama & Defense

Possible Puts/Takes Ahead - Defense Budget Cuts Could Be 18 Months Away:

We believe the Obama Administration intends to curtail defense spending growth, with an eye for a potential defense budget peak possibly in 2010 or the year after (FY11/FY12). Obama has apparently agreed with his defense leaders that he will not cut the DoD budget within his first 18 months in office. Obama's defense leadership intends to attack management of the highly inefficient O&M accounts, which if successful could yield more dollar to support weapons funding.

Possible Winners/Losers: Obama's defense team includes the inventors of the F-35 and staunch opponents of F-22. Unmanned will likely receive strong budget support, Space will remain crucial, Navy ships/subs secure with sharp eye on affordability, which strengthens LCS and sustains the question on DD1000. Missile defense might be cut back. This new team intends fewer new program starts, possibly shorter-lived programs, less over-reaching technology, focus on affordability, cost control and greater interoperability with US allies.

Retaining In-Line View for Defense: After being long time bulls on defense, we remain on the sidelines with only 2 Overweights (LMT, GD) and will watch developments as the new defense team's assesses whether defense spending needs to be cut in the years ahead. It's reasonable to expect the February FY10 budget will be revised through the Spring/Summer but expect few major muscle movements in the first year of this new Administration.

Recent Reports

Title	Date
Aerospace & Defense: Moving Industry View To In Line Ahead Of Elections Heidi Wood / Lee Rawlings / Matthew McDonnell / Mathew Schneider	Oct 27, 2008

GICS Sector: Industrials

Stratigist's Recommended Weight	8.5%
S&P 500 Weight	11.0%

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Investment Case

Early Thoughts on Obama and Implications for Defense

Now that Obama is weeks away from being sworn in as the next President and with Democrats controlling both houses in Congress, we have early impressions about the outlook for the defense sector under this new Democratic leadership.

During the elections the Democrats already assembled a highly organized defense team. Barack Obama has two defense teams, a transition team and a team of the likely new defense leaders and behind these groups lies a cadre of about 350 people committed and ready to take the various appointee jobs so the next President could get a fast start out of the gates.

The defense team for Obama contains many of the major players from the Clinton days back in the 1990s, including Richard Danzig, Jacques Gansler, Rudy de Leon, Whitten Peters, David Oliver, Paul Kaminsky as well as highly respected Republicans like John Hamre. The views of the leading Democrats in defense has been evolving, forged in many respects from lessons learned under Clinton and now Bush. As we understand it, many of the DoD leaders presently have been regularly sitting down with the Obama defense teams and discussing frankly what has transpired over the last few years, rationale for the programs, mistakes made, so the new DoD leaders are steeped in background before taking the helm.

The single biggest takeaway, we believe, is that the leanings of the Obama Administration will be to cut back on defense spending after a reasonable time in office. The Democrats are sensitive about appearing weak on defense, and we don't expect strong cuts to defense. However, the days of large-year over year DoD budget increases may be over. As we understand it, Obama has been advised and agrees that there is no peace dividend, but the next steps are for the government to spend more efficiently, not more in defense. In addition, we believe, based on discussions with industry sources, that Obama has agreed not to cut the defense budget at least until the first 18 months of his term as the national security situation becomes better understood.

Major Takeaways:

- **Defense budgets may be 1- 2 years from a peak** – The Obama Administration appears unlikely to trim defense spending before 2010 (earliest) or 2011

(more likely). However, markets tend to discount the peak far ahead.

- **Clear winners, in our view, include:** F-35 (Joint Strike Fight), Navy ships (surface combatants & subs, with a focus on smaller, affordable), space, unmanned systems (initiated during Clinton days), cyber-warfare. Top likely DoD leaders in the Obama Administration played major roles in creating programs like JSF, Global Hawk, FIA, SBIRS. Given focus on diplomacy, interoperability with allies, there may be chance the F-35 could be pulled forward. We believe the Army recapitalization continues as well as focus on light tactical and special operations forces.
- **Questionable outlook/Subject to review:** FCS (Future Combat Systems) will be reviewed given concerns on costs. F-22 faces high hurdles (viewed as a “cold war relic” view by some of Obama's defense leaders). Missile Defense could take a hit with bigger cuts to land based systems (especially now with Senator Stevens gone) and greater emphasis on ship-borne systems. DD1000 is apt to be viewed as too costly. And the future of the C-17 will be answered by this team, as will future F-18E/F/Gs.

Key Likely Themes from Obama Defense Team: The leading Democrats in defense who will be taking up various positions including Secretary of Defense, Secretary of State, National Security Adviser, Director of Homeland Security have been incubating their thoughts for the last 8 years. And early days represent the maximum “can do” stage of a new Administration, so the following touch on what we think the Obama team will be attempting. Through the course of time, there will be a clearer demarcation between what is desired vs. what is possible.

- **Focus on transatlantic cooperation** – Taking the esprit of global reach with allies, enhancing diplomacy vs. addressing global security solo. This was a theme during the Clinton days, which potentially re-emerges in force. This portends more allowance for transatlantic M&A and possibly programs designed to attract more allied teaming arrangement, similar to what happened on F-35.
- **Focus on “soft power”** – Likely major theme under Obama, we believe the focus will be on diplomacy,

and harnessing U.S. defense capabilities to influence behaviour as opposed to directly coercive measures. We don't exactly know how this will or if it will flow into programs for the defense industrial base, but anticipate much discussion and attention will be devoted to this approach, particularly against terrorists.

- **Competition** – There are questions surrounding whether defense sector has over-consolidated and how to enhance weapon system competitiveness going forward. Many of the players on Obama's team were involved in the 1990's consolidation wave and believe now, long after, that they possibly erred in allowing it to be taken too far. How that will be remedied is far from clear.
- **Attack O&M** – O&M (Operations & Maintenance) is \$180B or 35% of the DoD budget of \$515B. O&M is poorly run, harbors pet Congress pork barrel spending and is notoriously over-budget every year. The Obama team intends to take a sharp look at how O&M is managed to cut costs and thus better protect Procurement and RDT&E (weapons aka investment accounts). This would be a strong plus for the defense industry. But we'll watch for the transition from noble intent to actual execution; we're skeptical.
- **Focus on Affordability, Cost Control** – Program costs under Bush have risen precipitously, some of it a function of a country at war, with many generals and admirals called out to action and thus supervisory focus on programs has been sacrificed. Under Obama the new DoD leaders intend to enhance

accountability on costs, with the first step being to improve their own house. We would assert that much of the cost blame lies on the shoulders of the customer.

Implications for Defense Sector – Investors Could Grow More Wary In 2009

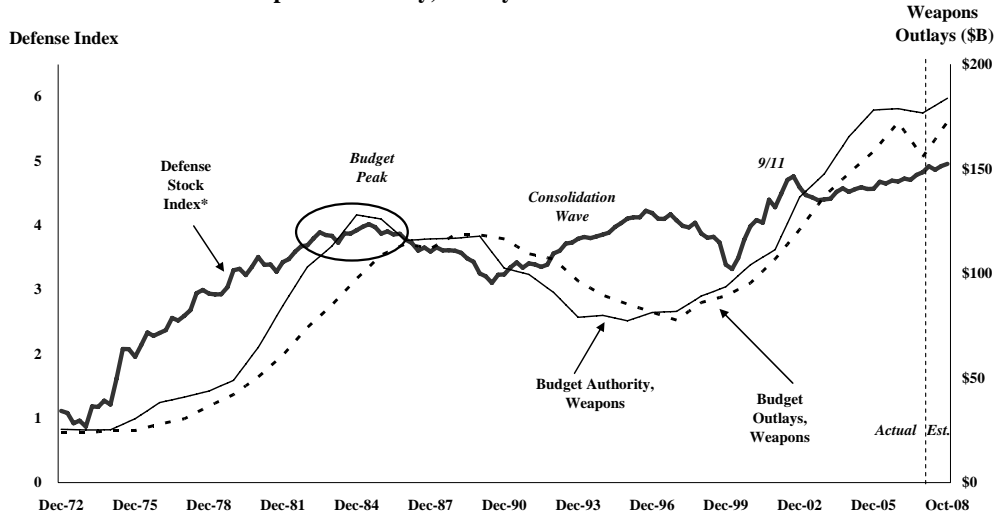
Referring back to the Reagan era build-up, the market incorrectly called the peak 2 years ahead of the actual peak. Once investors started to believe the peak was imminent, the defense sector only achieved incremental stock gains, despite still sizable DoD spending increases. The budget surged 24% in two years time from FY83 budget authority for weapons of \$103B to \$128B in FY85. By 1985, the FY86 budget was released and was \$126B, \$2B less than the prior year and it was clear the defense build-up had peaked and the investors fled defense. Defense had outperformed for 11 consecutive years (1974-1985) and then underperformed for 5 years after (1985-1990).

We're concerned and on the sidelines for the defense sector (In Line view) with only 2 Overweights (LMT, GD) so we can gather more information and better decide whether the defense budget is again close to peaking. The defense group has outperformed the S&P for 8 of the last 9 years (its close this year and 2003 was the outlier), similar to those heydays of the 1980's. But now we are actively wondering whether the threat environment (which remains high) can be contained under the current DoD budget or whether, after much examination, the Obama defense leaders conclude the upward trajectory in defense needs to continue. What we do believe is that they have given themselves 18 months to decide.

Exhibit 1

During Last Years Of Reagan Buildup, Market Anticipated The Peak Years Ahead – Defense Budget Kept Advancing But Investors Were Convinced The Peak Was Nigh

Weapons Authority, Outlays vs. Defense Relative Price



Pres.	Nixon	Ford	Carter	Reagan	Bush I	Clinton	Bush II			
Events	Vietnam			Gorbachev	Berlin Wall Falls	Gulf War	Highest Peacetime Optempo	9/11	Afganistan War	Iraq War

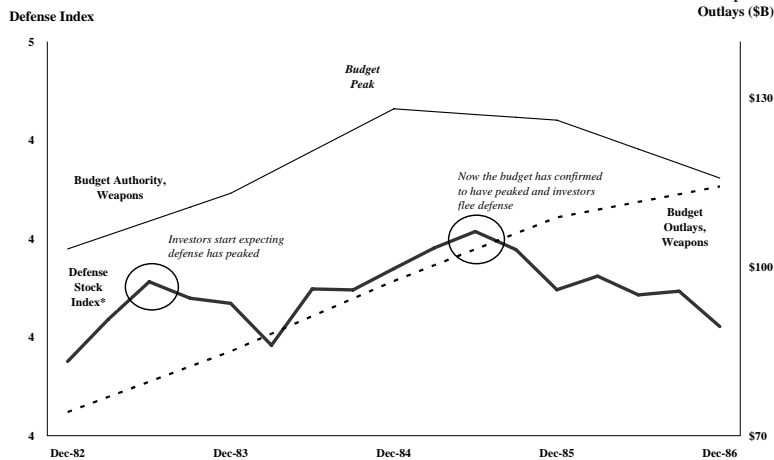
* Index includes GD, LK, MD, ML, NOC, RTN, LLL, ESY and LOR.

Source: Company data, Morgan Stanley Research

Exhibit 2

Market's Early Discounting Mechanism – Investor Enthusiasm For Defense Wanes Despite Still Sizable Defense Increases – DoD Budget Grew 24% While Stock Index Only Rose 3 Pts From Expected To Actual Peak

Weapons Authority, Outlays vs. Defense Relative Price



* Index includes GD, LK, MD, ML, NOC, RTN, LLL, ESY and LOR. Relative to S&P500.

Source: Company data, Morgan Stanley Research

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	Count	% of Total	Count	% of Total IBC	% of Rating Category
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Underweight/Sell	403	18%	89	14%	22%
Total	2,255		650		

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The Americas

1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1) 212 761 4000

Europe

20 Bank Street, Canary Wharf
London E14 4AD
United Kingdom
Tel: +44 (0) 20 7 425 8000

Japan

4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008
Japan
Tel: +81 (0) 3 5424 5000

Asia/Pacific

Three Exchange Square
Central
Hong Kong
Tel: +852 2848 5200

Industry Coverage: Aerospace & Defense

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Heidi Wood		
Alliant Techsystems Inc. (ATK.N)	E (06/12/2007)	\$87.1
Boeing Company (BA.N)	O (03/14/2008)	\$53.62
General Dynamics (GD.N)	O (10/14/2003)	\$63.77
Goodrich Corp (GR.N)	E (09/10/2004)	\$39.85
L-3 Communications (LLL.N)	U (09/25/2003)	\$82.93
Lockheed Martin Corp. (LMT.N)	O (03/19/2003)	\$85.91
Northrop Grumman Corp. (NOC.N)	E (10/18/2002)	\$48.06
Raytheon (RTN.N)	E (10/27/2008)	\$50.73
Rockwell Collins (COL.N)	E (10/27/2008)	\$38.73
Spirit AeroSystems Holdings Inc. (SPR.N)	O (10/11/2007)	\$16.06
Textron Inc. (TXT.N)	U (10/21/2008)	\$18.64
United Technologies (UTX.N)	E (10/21/2008)	\$57.25
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