



Economics & Financial Markets

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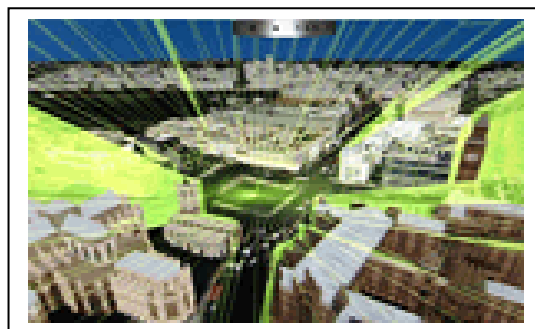
United States Equity Markets

January 25, 2009

L3 Communications (LLL) and Harris Corp. (HRS) Continued Beneficiaries of Expanded War on Terror and Larger Afghani Role



L3 Communication 4.0 Quad Band SATCOM
Terminal (QST)



Harris Corp. 3D urban Model Full
situation awareness Urban Model

I. Introduction

Last week Keith Olbermann on MSNBC's countdown interviewed former NSA analyst Russell Tice who stated that "NSA under the Bush administration secretly collected data on civilians, including journalists." Olbermann made a big deal of this but almost no one in Congress said a word. It made none of the Sunday news shows and the story had limited legs. **Why? Everyone expected as much, or already knew what was going on, even if they did not know that the press was a target.**

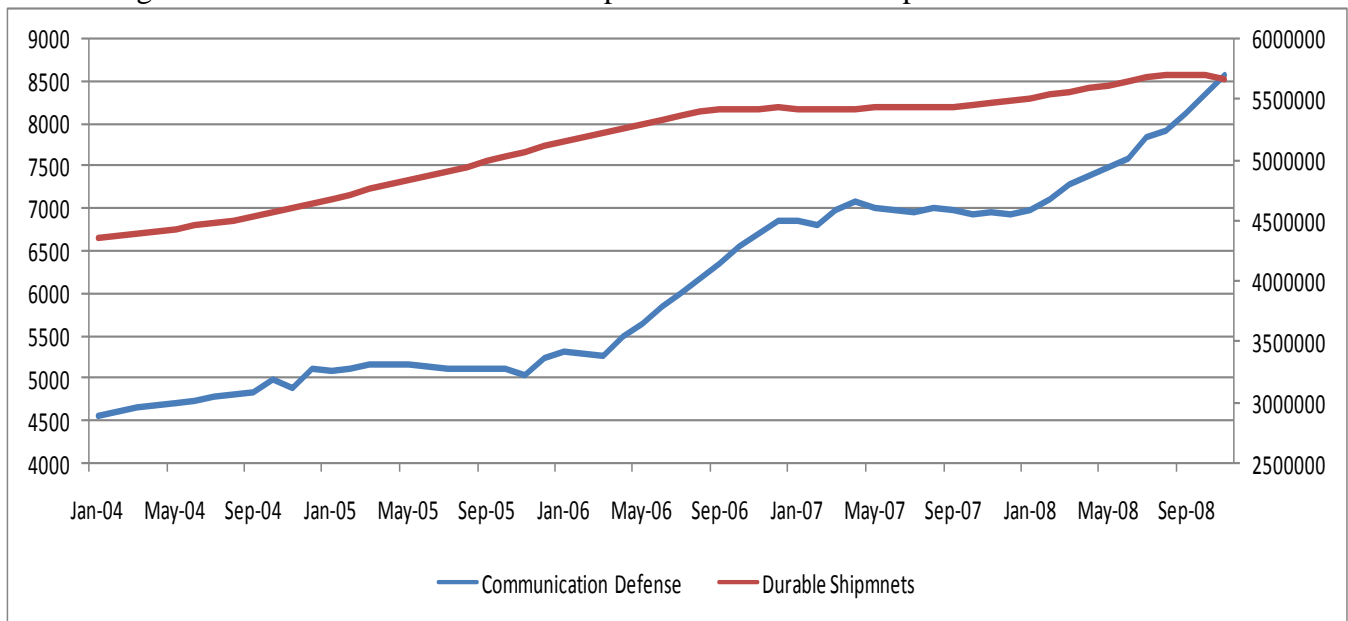
There are various facts that we at SISR believe have a extremely high probability of occurring going forward: 1) the defense budget will be brought in somewhat, but the communication defense budget will continue to expand; 2) the level of surveillance that was developed under the Bush administration which includes everyone and everything, will continue at the same pace, if not faster, as technology improves

(the groups that are targeted may change, but the level of surveillance will only increase); 3) the war in Afghanistan will not be over for at least the next two years (Russia could not solve Afghanistan, Pakistan is not willing to currently have American troops fighting on their land, and the population in Pakistan is currently putting pressure on their leadership in different and significant ways, not to allow U.S. or Allied forces to enter their country); and 4) the drug trade out of Afghanistan is way to profitable for those participants to easily let that revenue go; 5) President Obama opposed the war in Iraq because he believed, that was not where the war on terror emanated from. He however, is not a Bertrand Russell type pacifist, and if anything, good diplomacy is always associated with good information, derived from communication technology.

II. Recommending Harris (HRS) and L3 Communications (LLL)

Harris Corporation and L-3 Communication we believe are best positions to benefit from the repositioning of the Defense Budget under the Obama Administration. Last year we saw that shipments of Defense Communication increased 23% whereas all other durable shipments have been sagging significantly. We see no reason at this point, for this pattern not to continue despite the full onset of the recession during the first half of this year. We feel that HRS will continue to be stronger company, because the nature of their products meet the needs in Afghanistan better than do other companies.

Figure 1: Communication Defense Shipments vs. Durable Shipments 2004 to Nov. 2008



Source: Department of Commerce, SISR

In Figure I we plot the relationship between all durable shipments from Jan. 2004 through Nov. 2008 (December will not be out till the first week in February). The rate of growth of communication defense equipment has been constant since 2004 and has even accelerated over the past year. This could be for various reasons: 1) the old administration always wants to make an imprint on the next administrations budget, 2) defense expenditures are a well know area to increase government expenditures during recessionary periods; and 3) there is a real growth in this area given the wars in Iraq and Afghanistan,

and the demands of homeland security. HRS and L-3 Communications are the major U.S. contractors with a communications concentration, while Lockheed Martin and Raytheon have growing segments.

III. Hiding in Defense

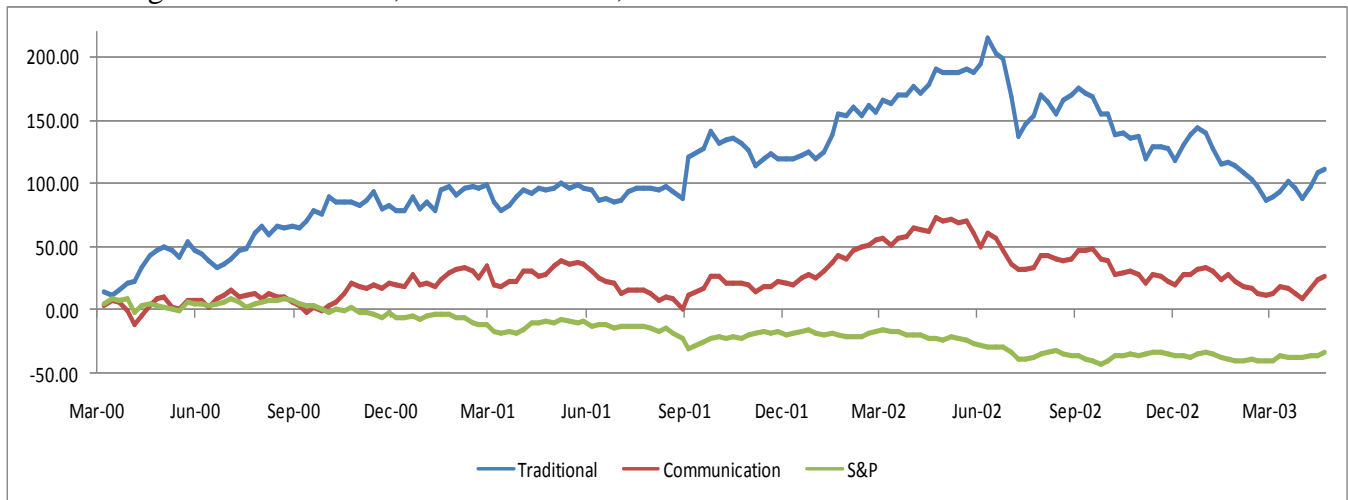
On March 19th 2008 in our report entitled “Hiding in Defense,” in anticipation of the recession that few believed was coming at that time, we wrote that:

Communication Defense will be one of the strongest areas in the market during the year 2008 and a safe haven during a possible recession. With the economy likely to go into a recession in the coming months we believe that Communication Defense will be one of the strongest industries in the economy. Like the 2000 to 2003 period we feel that Defense will again outperform the market, however unlike 2000 to 2003 we believe that Communication Defense will outperform Traditional Defense. Given the current and expected future emphasis within the “War on Terror” on the interception of communications and other information, and less on the deployment of traditional military activities, we at SISR believes that Communication Defense will outperform both the markets and Traditional Defense (SISR, *Hiding in Defense Communication*, March 19, 2008, p. 1).

Since then Harris Corp (HRS) is down 5%, L3 Communications is down 28%, while the S&P 500 is down 36%. Lockheed Martin (LMT) and Raytheon (RTN) were down 20%. Both LMT and RTN of the traditional defense contractors invested heavily in Defense Communication since 911, whereas the other major stalwarts of the Defense industry: General Dynamics (GD) was down 36%, Northrop Grumman (NOC) was down 40%, and Boeing (BA) was down 42% . **The S&P 500 fared much worse than any of the major Defense Contractors with a major communication interest, whereas the other top 5 Defense contractors market performed, Northrop, Boeing, and General Dynamics despite the fact that the country has been in two war for over 6 years now.** Going forward we believe that the Communication Defense Sector will continue to outperform the market.

A. Traditional Defense vs. Communication Defense: The 2001 Recession

Figure II: Traditional, Communication, and S&P 500 from March 2000 to March 2003



Source: Reuters, SISR

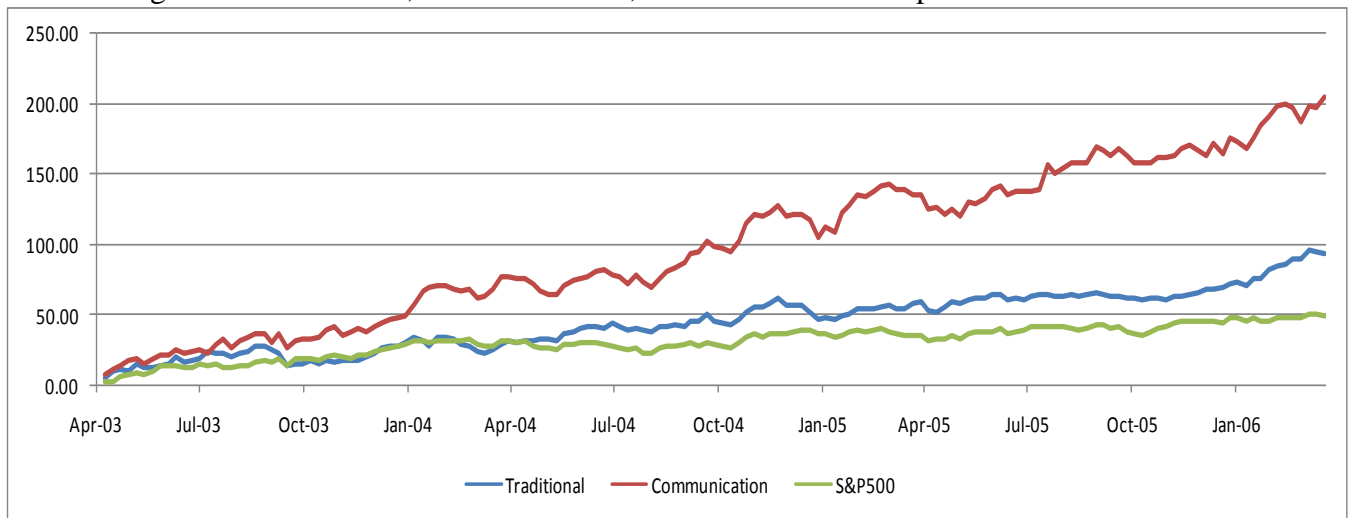
One of the strongest sectors during the 2001 recession was Traditional Defense. Many of the defense contractors were up over 200% from March 2000 to June of 2002 when the S&P 500 was down nearly 30%. Communication Defense during the same period was up nearly 50% while the markets and nondefense communication were tumbling and the technology sector was fairing even worse.

The recession of 2000 was a period of traditional defense buildup. Even before 911 traditional defense was up over 100% since March of 2000. The recession had no effect on the defense industry, and in fact the additional spending on defense was seen as way for Government expenditures to help the economy.

B. Post 911 Emphasis on Communication Defense

From 2000 to 2003 Traditional Defense outperformed Communication Defense with the buildup to the war in Iraq, as seen in Figure II. However, from April 2003 through April 2006 Communication Defense significantly outperformed Traditional Defense, with the Communication Defense contractors up nearly 200% as compared to 100% for Traditional Defense, as seen in Figure III. Communication Defense began to expand in importance with the Department of Homeland Security in conjunction with military intelligence in the Department of Defense taking up a similar emphasis on secured information as compared to building multibillion dollar stealth bombers, when the war on terror is not a traditional war.

Figure III: Traditional, Communication, and S&P 500 from April 2003 to March 2006



Source: Reuters, SISR

The post 911 need created one of the biggest pushed into communication technology. Once the war if ever begins to end there will be an enormous technology payback to the consumer of these new technologies, however, currently we believe it is still early for a full roll out of some of these highly technical advances.

C. The John Murtha Rebalance 2006 to Mar 2008

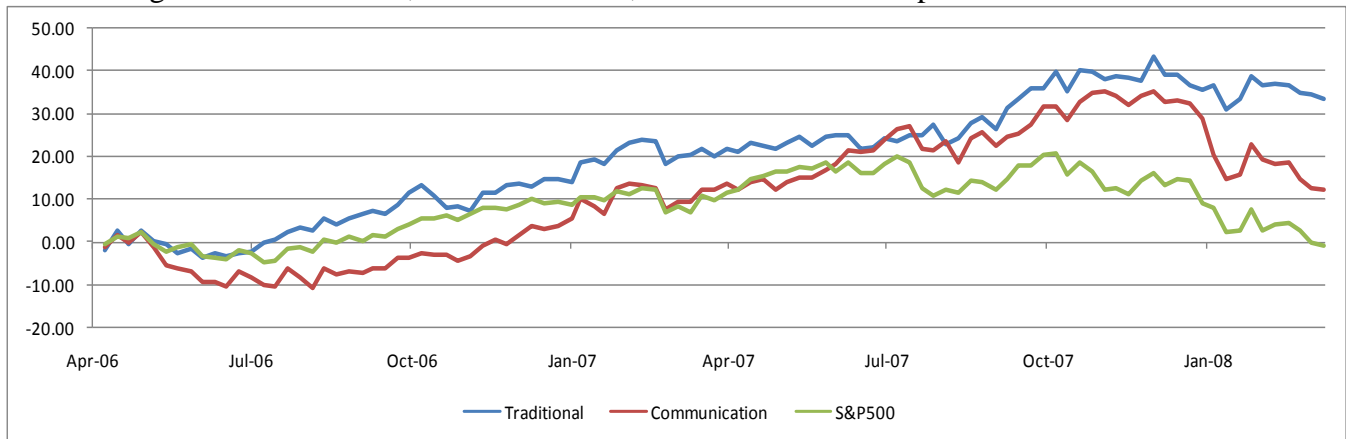
On November 18, 2005 one of the great Military Stalwart in the House of Representatives, Democratic Congressman John P. Murtha of Pennsylvania, a Vietnam combat veteran and strong supporter the Iraq War called for a withdrawal of the troops in Iraq. He said that “Our military has done everything that has

been asked of them. It is time to bring them home.” (New York Times.com November 18, 2005). The reaction was fierce from the Republican Party with almost everyone weighing in on Murtha’s statement.

When the dust settled and cooler heads prevailed the call for a pullout may have been directed more toward the impact on Traditional Defense over the past few years, than a actual rejection of the war in Iraq. During the 2004 to November 2005 period, Traditional Defense barely outperforming the S&P 500, while Communication Defense were getting all the attention, and we found that many of the Traditional Defense contractors like Lockheed Martin (LMT) and Raytheon (RTN) were making major investments in Communication Defense where the action was.

Additionally, throughout the 2005 to 2006 period there were constant discussions by the Department of Defense regarding cutting back on some of the big ticket items. Programs like the B2 Bomber programs, some nuclear submarines, and other large ticket items, were all being considered for cuts in an attempt to bring down the huge government deficits. It was during this period that despite the ongoing war, the military contractors were not doing well. Murtha’s comments were a call for troop withdrawal so that the U.S. can get back to buying expensive military equipment. Murtha’s objectives were heard and not one word has come from him about the need for a withdrawal of troops since then.

Figure IV: Traditional, Communication, and S&P 500 from April 2006 to March 2008



Source: Reuters, SISR

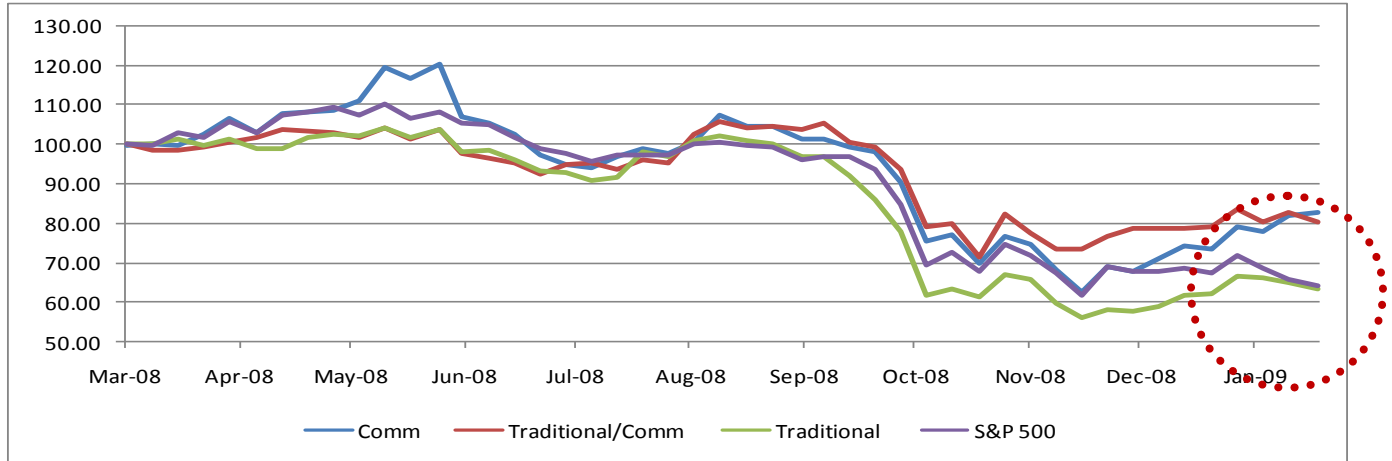
From Figure IV we see that from early April 2006 there was a dip in Communication Defense over Traditional Defense during 2006 and into early 2007. During this period Traditional Defense has slightly outperformed Communication Defense

D. March 2008 to January 2009

In March of 2008 we argued that Communication Defense would outperform the S&P 500 and the Traditional Defense because all the new emphasis was on communication, as the economy was beginning to slow. In Figure V we divided Traditional Defense into those companies that are exclusively traditional like General Dynamics (GD) and Northrop Grumman (NOC) and the traditional defense contractors who have made a major investment in communication defense over the past two years, Lockheed Martin (LMT), and Raytheon (RTN). We have as we usually do excluded Boeing (B) not

because they are not a major defense contractor but about half of their revenues comes from Commercial Aircraft manufacturing, which has been abysmal over the past year.

Figure V: Traditional, Communication, Trad/Comm and S&P 500 from Mar 2008 to Jan 2009



From Figure V we find that traditional defense has market performed down about 35% since March 2008, whereas communication and traditional/communication has outperformed being down about 18%. HRS has been the strongest performer down only 8% since March of 2008. L-3 with all of their acquisitions should almost be treated like a traditional/communications as opposed to a pure play communications company given the direction of their growth.

IV. Conclusion: President Obama and the New Defense Dynamics

On January 20th 2009 the United States inaugurated President Obama as their new President. The expectations are that President Obama will move troops from Iraq into Afghanistan, but the actual level of troops in the area throughout 2009 will remain the same. The war in Afghanistan/Pakistan will be quite different than the hostilities in Iraq, and here again we believe because of the sensitivity of Pakistan that communications equipment and “intelligence” will play a greater role in this engagement.

Additionally, homeland security will only be enhanced under the Obama administration, and all the new equipment will be heavily dominated by communication paraphernalia. We do believe that traditional defense will be cut somewhat as it traditionally is under most Democratic Presidents. It was reduced on a budget percentage basis under both Clinton and Carter. The priority of the traditional Democratic Base is to emphasize domestic spending in contrast to defense spending. However, having said this: we are arguing that while the perception will be for a reduction, communication defense will be completely spared, and in fact will likely fill in for some of the shortfall from traditional defense, making passage easier in the House and Senate.

For the past four years we have been toying with the idea of initiation coverage on both HRS and LLL, but each time we think about it we have concluded that there are more important areas for an investment of our energy. Again we are at this cross road and we are ambivalent. We believe that our analysis will turn out to be correct and feel comfortable with our conclusions. At this juncture we always ask what

will be the value added of initiating coverage except publicity. We feel strongly that our value added here is in the analysis, and we have been all over these nuances for several years now. We continue to like HRS and LLL at this juncture as both a safe component for any portfolio, as well as an area that is likely to outperform the market, certainly as the markets continues to struggle though the first part of this year.

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