

Capital Goods

Aerospace & Defense

Sector Strategist

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Underweight Defense

Stocks Mentioned:

General Dynamics (GD)
Lockheed Martin Corp. (LMT)

Northrop Grumman Corp. (NOC)
Raytheon Co. (RTN)

Key Points:

- **We are Reversing our Overweight on the Defense Aircraft & Parts Sector** and are calling for a reduction in those positions. We believe the next few months can be very volatile and believe that it is possible that during that period these stocks will underperform the market.
- **The Commerce Department reported** new orders for manufactured durable goods in March increased 3.4% m/m.
- **Defense Capital Goods new orders however were:** down - 22.4% m/m.
- **Defense Aircraft and Parts new orders were:** down - 48.8% m/m.
- **Congress has passed the Defense Supplemental Appropriations Bill** with restrictions forcing a withdrawal of troops from Iraq.
- **President Bush has threatened** to veto the supplemental appropriations bill.
- **New Orders for Large ticket items like Defense Aircraft and Parts are declining** with the possibility that the Department of Defense is slowing new orders for big ticket items to assure that there is enough money to continue the war effort, until congress and the white house can agree on an appropriations bill.
- **Irrespective of this interpretation it is clear from the data that:** new orders for large ticket military items have slowed, and we believe this will continue until a new appropriation bill is signed into law.

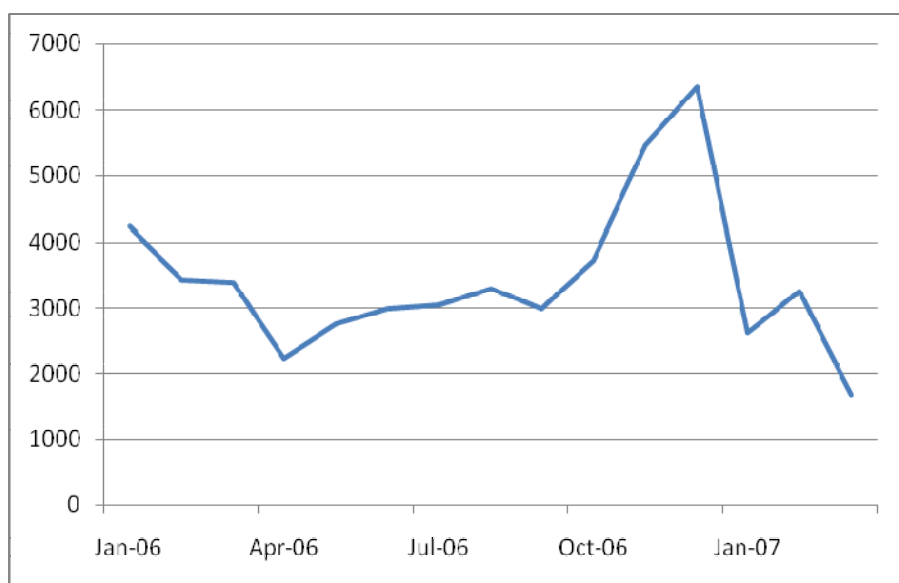
Analysis

We are reversing our Overweight on the Defense Aircraft & Parts Sector and are calling for a reduction in those positions. We believe the next few months can be very volatile and believe that it is possible that during that period these stocks will underperform the market.

The commerce department on April 25, 2007 released its “Advanced Report on Durable Goods” for the month ending March 2007. The most striking aspects of the report was the steep decline in new orders for Defense aircraft and parts which were down - 48.8% m/m, and the more general category of defense capital goods were down - 22.4% m/m. Irrespective of the fact that this measure is often a very volatile indicator, it nevertheless appears to be a significant decline in new order.

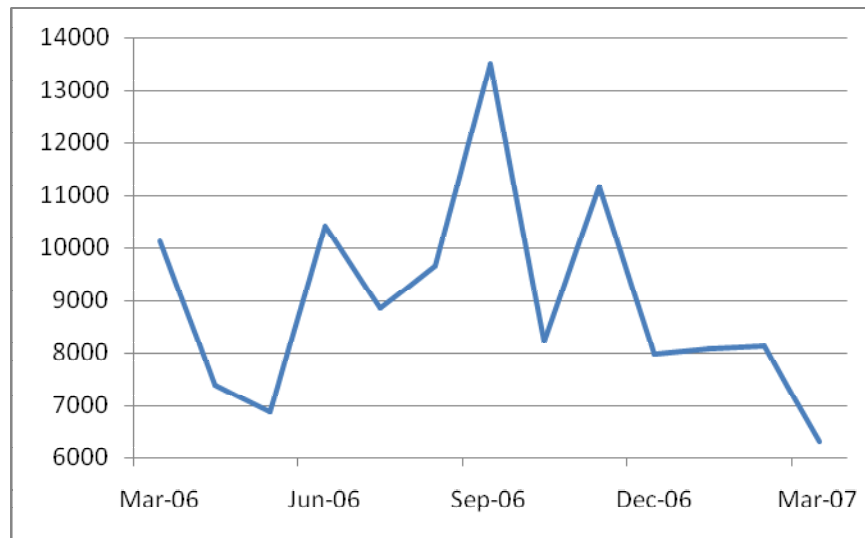
Tables I and II respectively present the two month moving average of new orders for Defense Aircraft and parts, and new orders for Defense Capital Goods. We have selected to use a two month moving average to take advantage of some smoothing but not to dilute the significant decline in the last month's number.

**Table I: Dollar New Orders for Defense Aircraft and Parts:
March 2006 through March 2007**



Source: Department of Commerce Advance report on Durable Goods Manufacturers' and SIS Research.

**Table II: Dollar New Orders for Defense Capital Goods:
March 2006 through March 2007**



Source: Department of Commerce Advance report on Durable Goods Manufacturers' and SIS Research.

We know that since the 2006 election when the Democratic Party took control of both houses of congress, there has been a continuous push to set a date for withdrawing the troops from Iraq. The Democratic Party is likely to push through their version of the supplemental appropriations bill this week with some provision for the removal of troops. The Bush administration has threatened a veto of such a bill. We expect that the supplemental appropriations bill will pass both houses of Congress later this week and that President Bush will veto that Bill early next week. The consequence of that action is the need for money to support the troops and the war in Iraq.

We believe that the low level of new orders for the large ticket item of defense aircraft and parts may be a consequence of the uncertainty regarding future funding for the war in Iraq. It is highly likely that the Department of Defense is slowing its acquisitions of large ticket items to juggle resources between those items and the need for money to continue the war effort, at least until a new appropriations bill is signed into law.

The data indicates that there have now been several months of reduced new orders. We believe that it is still too early to assert a new trend, but it is possible that we now have at least a plausible explanation for the downturn. However, irrespective of the viability of this explanation for the downturn, we nevertheless observe that new orders for defense aircraft and parts have declined, and it appears likely that revenue will begin to be affected by this shortfall.

It would appear that since the decline for defense aircraft and Parts is greater than the decline for Defense capital goods, the companies most likely to be affected are: General Dynamics (GD); Lockheed Martin Corp. (LMT); Northrop Grumman Corp. (NOC); and Raytheon Co. (RTN).

Precautionary Notes: This research report is based on a review of the April 24, 2007 release by the Department of Commerce in a very volatile sector, and as a consequence is limited by this fact. Also even if the explanation for this occurrence is correct the political situation that may be responsible for these events are rapidly changing and an agreement between Congress and the White House could be reached at any minute. This analysis in addition, assumes that the somewhat protracted dispute will continue and that it will last into the early summer.

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1 – Recommended List – The stock has our highest recommendation and is expected to outperform the average equal weighted expected total return of the overall Market irrespective of sector. Our investment horizon is 12 – 18 months except as specified by the reporting analyst.

2 – Overweight – The stock is expected to outperform the equal weighted expected total return of the sector coverage. Our investment horizon is 12 – 18 months except as specified by the reporting analyst.

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3 – Neutral – The sector fundamentals and valuations are flat with the second derivative close to zero or with a neutral slope.

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Price Chart:

A price chart, with changes of ratings and price targets in prior periods, is included above, for all securities covered in this report.

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