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OVERBERG MARKET REPORT

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Global Report

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Defence stocks are defensive

Since 2020, global defence spending has grown at an annualised rate of 4.4%, up approximately fourfold from pre-pandemic levels. World military expenditure reached $2.72 trillion in 2024, an increase of 9.4% from 2023, the steepest year-on-year increase since at least the end of the Cold War.

Geopolitical fragmentation between US aligned countries and those aligned to China and Russia is gathering momentum. Trade barriers are being lifted between the geopolitical blocks, and the world is entering a new arms race. A new Cold War era has begun. After years of neglect, the West must catch up with, on the one hand, China's rapid militarisation in the Pacific and on the other, Russia's massive wartime spending in Europe. The post-Cold War era of disarmament is shifting into one of arms proliferation. China reportedly already has a bigger navy than the US and the Pentagon expects its military to have 1500 nuclear warheads by 2035, up from about 200 in 2020. Meanwhile, Russia is spending an eye popping 7% of GDP on its defence.

The West needs to dramatically increase spending just to rebuild inventories, which have been depleted by three years of war in Ukraine, but to keep up much more is needed. A large and long-term step-up in spending is required to modernise military capabilities. Technological advancements and the Ukraine war have highlighted the advent of new military systems. These include combat drones, unmanned robots, satellite sensors, lasers, hypersonic missiles, electronic and cyber warfare, which all hinge on critical technologies. Trump's "Golden Dome" missile shield will include sensors able to capture the entire globe in real time, generative AI models that can analyse complex data sets, and space-based interceptors such as lasers capable of destroying missiles seconds after launch. The project, which Trump wants completed during his term in office aims to offer protection against new generations of hypersonic missiles.

World defence spending is expected to accelerate over the next 10 years. European defence policy is at a turning point, triggered by the combination of Russia's threat and waning support from the US. Trump has demanded that all Nato allies commit to raising their defence spending to 5% of GDP over the next decade, a level that US officials say will "equalise" the burden of defending Europe. Germany took a momentous decision this year to loosen its fiscal rules to allow for a rise in defence spending and other European countries have also pledged to raise spending. Nato secretary general Mark Rutte is assuming Nato defence spending of 5% of GDP, with 3.5% on pure defence and 1.5% on broader security related items, in line with Trump's demands, compared with 2% at present. The UK has just completed its 10-year Strategic Defence Review, billed as one of the biggest overhauls of the UK armed forces in a century, comprising an increase in defence spending to 2.5% of GDP from 2.3% currently, and to 3% in the next parliament.

The US's Pacific allies are being pressured to lift defence spending in the same way as its European allies. US Defence Secretary Pete Hegseth, while warning that threats to Taiwan from China "could be imminent", urged Asian allies to spend more on defence. He said at the latest annual defence related Shangri-La Dialogue in Singapore that: "It doesn't make sense for countries in Europe to do more on defence while key allies and partners in Asia spend far less in the face of a far more formidable threat, not to mention North Korea." Allied defence spending is already picking up. New Zealand plans to double its spending. Japan, South Korea, Vietnam, the Philippines, India and Australia are all boosting their budgets.

The Golden Dome shield is budgeted by the Trump administration to cost about $175 billion over coming years, but the Congressional Budget Office has issued rough estimates as high as $831 billion, and some say its costs could run into the trillions. US military spending budgets have traditionally been the largest item in the federal budget but are expected to get even bigger under Trump. He has requested a record $1 trillion for defence in the "big beautiful" budget bill and his wish will probably be granted. There is a surge in popular support across Western democracies for increased defence spending, and while the US has prioritised the Asia Pacific region, and urged European countries to spend more, it does not appear that it will reduce its own commitments in Europe. The US is doubling down in Northern Europe to deter Russian aggression along its borders with Finland, Norway, Estonia, Latvia and Lithuania.

Overberg Asset Management has recently added two defence ETFs to its global private client share portfolios. The VanEck Defence UCITS ETF provides diversified exposure to global defence companies, including those in defence technology and cybersecurity, spanning firms across the US, Europe and Asia. The WisdomTree Europe Defence UCITS ETF tracks the performance of European defence companies, offering a pure play exposure to the region's surging militarisation. A total 23 Nato countries now meet the prior 2% GDP defence spending threshold, compared to just 5 in 2021, and targeted to reach 5% under the new push for rearmament.

Defence stocks have performed well, especially technology related stocks and European defence stocks. On a trailing P/E basis valuations may appear stretched over the near-term, but we expect earnings will deliver. As the world pivots from Arms Control to Arms Proliferation, the need to modernise military capabilities after years of neglect and the rapid change in defence technology will require long-term spending commitments for at least a decade or more. The structural shift demands exposure to the sector in global investment portfolios.

As well as enhancing potential investment returns due to the structural shift in defence spending, defence exposure also reduces portfolio risk. Defence spending is relatively inelastic, which means that regardless of economic cycles, governments will continue to allocate large budgets to it. **Defence spending does not depend on consumer spending or business confidence and will remain constant during recessionary conditions. Investment in defence will also act as a hedge against geopolitical instability.** Moreover, many of the firms represented in the ETFs, beneficiaries of large increases in government R&D spending and technological advancements, will enjoy long-term growth prospects beyond traditional military applications.

Local Report

Werner Erasmus

Interest rates and inflation: What every investor should know.

Introduction

Whether you're saving money, paying off a loan, or investing, interest rates affect all your financial decisions. Interest rates are interlinked with inflation and central banks often change interest rates to manage inflation and stimulate growth. For investors, understanding the mechanics of interest rates is essential, as they directly affect asset valuations, capital flows, and portfolio strategy. Beyond personal finance, interest rates also play a big role in shaping the broader economy.

Interest rates are the cornerstone of macroeconomic policy and financial market dynamics. From a macroeconomic standpoint, interest rates serve as a lever to manage aggregate demand. Higher interest rates tend to suppress consumption and investment, thereby cooling inflationary pressures. Conversely, lower interest rates stimulate borrowing and spending, supporting economic expansion often leading to higher asset prices. This cyclical adjustment mechanism is central to monetary policy and the broader business cycle.

Interest rates, inflation and the South African Reserve Bank (SARB's) new 3% inflation target

In South Africa, the SARB uses the repurchase (repo) rate as its primary tool to influence currency stability, economic growth and inflation. The SARB has recently proposed to adopt a point inflation target of 3%, replacing the current 3%-6% range that has been in place since 2000. Compared to other countries, South Africa's current inflation target is above the developed market average of 2% and the emerging market peer group average of 3%. The adoption of this lower inflation target, according to the SARB, will over time lead to lower inflation and lower interest rates. Furthermore, it can also reduce the government's high cost of debt, particularly over the long term. However, the trade-off between inflation and economic growth is complex. The SARB noted that growth might be lower at first but then improve later. This short-term cost might be difficult to swallow given South Africa's current low growth environment and weak fiscal position. Nevertheless, a lower inflation target will noticeably change the investment landscape in South Africa and have multiple benefits in the medium-to-long term.

Impact of a lower inflation target and resulting interest rates on investors and asset classes

If, however, the SARB can adopt and implement a 3% inflation target successfully, the lower target and resulting lower interest rates will impact investors and asset classes in the following ways:

Impact on investors:

- *Greater predictability:* A lower and more credible inflation target (like SARB's 3%) reduces uncertainty. Investors can better forecast real returns, especially for long-term investments like bonds and retirement portfolios.
- *Lower risk premium:* With inflation expected to remain low, investors demand smaller compensation for inflation risk. This can reduce yields on bonds and borrowing costs for companies, potentially boosting equity valuations.
- *Shift in portfolio strategy:* Lower inflation leads to lower interest rates, often pushing investors to seek higher returns in riskier assets such as equities, property, and emerging market assets. Income-focused investors may need to adjust their allocations to maintain their yield.

Impact on asset classes:

- *Equity*: Lower interest rates reduce the discount rate used in valuation models, increasing the present value of future earnings, which leads to higher prices. Growth stocks benefit more in such an environment due to their long-duration cash flows. The caveat, however, is that if low rates signal weak economic growth, earnings expectations may be subdued.
- *Bonds:* Lower inflation and interest rates support bond prices, especially long-duration bonds. However, future returns may be lower, especially for newly issued bonds with lower yields. Inflation-linked bonds may underperform if inflation expectations fall in line with the new target.
- *Cash and money market instruments*: Nominal returns on cash and short-term deposits will decline. If inflation declines in line with interest rates, real returns will stay the same.
- *Property:* Lower interest rates reduce mortgage costs, supporting demand and valuations. Commercial property may benefit from lower cap rates, which in turn increases property values.

Conclusion

Interest rates are a fundamental variable in both macroeconomic management and investment decision-making. For South African investors, understanding the interplay between interest rates, inflation, and the business cycle is crucial for navigating portfolio management.