Assessing Winners and Losers in the Global Financial Markets if China Invades Taiwan

written by Matt Bohlsen | May 8, 2023

In recent months China has escalated tension over Taiwan. An example of this came last month when CNN reported: "Military exercises suggest China is getting 'ready to launch a war against Taiwan,' island's foreign minister tells." CNN quotes Taiwan's Foreign Minister Joseph Wu stating, "They seem to be trying to get ready to launch a war against Taiwan. Look at the military exercises, and also their rhetoric, they seem to be trying to get ready to launch a war against Taiwan."

Taiwan's Foreign Minister would be better informed than most and he clearly feels a China invasion is a very real near-term threat.

It should also be noted that President Biden has said that the U.S. would defend Taiwan militarily if China were to attack.

Potential losers if China invades Taiwan

In the short term, most stocks globally would be hit if China invades Taiwan. The biggest loser would likely be Taiwan stocks and the Taiwan currency.

Taiwan's leading stock Taiwan Semiconductor Manufacturing Company ("TSMC") (TWSE: 2330 | NYSE: TSM) would be the largest concern for Western investors. If the business was forced to shut down, it could cause havoc globally with the semiconductor industry.

CNBC reported in 2022:

> *“If China were to invade Taiwan, the most-advanced chip factory in the world would be rendered “not operable”, TSMC Chair Mark Liu said. … Liu said that if Taiwan were invaded by China, the chipmaker’s plant would not be able to operate because it relies on global supply chains.”*

TSMC produces approximately 60% of the world’s semiconductor foundry market, essentially the chips that are then used by companies in products such as smartphones, PCs, autos, and military hardware.

In 2022 the U.S. passed the Chips and Science Act, to provide billions of dollars in incentives to build semiconductor factories in the USA. The problem is that new USA semiconductor factories take time, expertise, and billions of dollars to establish.

This potentially means an invasion of Taiwan with TSMC inoperable, would lead to severe semiconductor shortages and massive global supply chain upheaval, especially across the electronics, telecommunications, auto, and defense & space sectors.

The good news is that the U.S-China trade war and then Covid-19 led to decisions to decouple supply chains and build up U.S. self-sufficiency, especially in semiconductors. Intel Corporation (NASDAQ: INTC), GlobalFoundries Inc. (NASDAQ: GFS), Samsung Electronics Co. (KOSE: A005930), Texas Instruments Incorporated (NASDAQ: TXN), and TSMC are all building new semiconductor factories in the USA.

TSMC is building a US$12 billion factory in Arizona, USA and

Intel is outlaying US$40 billion on chip facilities in the USA. The CHIPS Act will pump an estimated US$52 billion into new US-based chip fabrication factories. By 2025 the USA will be in a much stronger position.

Companies that rely on semiconductors heavily in their products such as Apple Inc. (NASDAQ: AAPL) would also potentially be badly impacted.

FIGURE 1: The Nimitz Carrier Strike Group with aircraft carriers, like the one below, is operating in the vicinity of Taiwan in the Philippine Sea (April 2023)

Source: istock

Potential winners if China invades Taiwan

Cash should be the safest asset class, ideally in USD currency.

In terms of stocks, the non-Taiwan-based semiconductor foundries such as Samsung Electronics (13% global market share) and GlobalFoundries could benefit.

Military stocks could likely be the clear winners. Some examples would be Lockheed Martin Corporation (NYSE: LMT), Northrop Grumman Corporation (NYSE: NOC), General Dynamics Corporation (NYSE: GD), Raytheon Technologies Corporation (NYSE: RTX), and The Boeing Company (NYSE: BA).

Closing remarks

Generally speaking, a Taiwan-China war would be very negative for most technology stocks. Taiwan, Hong Kong, and China's equity markets would be hit the hardest. U.S. stocks that rely on TSMC's semiconductors would also likely take a hit as would those sectors that rely on semiconductors the most, such as aerospace, automotive, consumer electronics, defense, and telecommunications.

The few winners would likely be those semiconductor companies that can gain market share and achieve higher pricing due to chip shortages. The other obvious winner would be the military stocks. Cash and other safe-haven assets, such as gold and treasury bills, could also be expected to outperform.

We all hope that wars never happen, but it is wiser to be prepared just in case it does.

The Ukraine War and Equities: Surprising Findings on Defense, Commodities, & Tanker Stocks

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As we mark the somber first anniversary of Russia's invasion of Ukraine, I thought it would be interesting to have a look at what equities have been impacted by this brutal and very unnecessary war. My first thought was that defense or drone stocks would be slam-dunk outperformers. I also figured there would be several resource companies that may have done well if they produce key commodities where Russia was a dominant player, assuming the company in question wasn't actually operating in Russia where it likely would have had to forego its assets. What I found surprised me.

Defense and Drone Companies

I first looked at the biggest U.S. defense and drone stocks and did not find what I expected at all. Let's start with Raytheon Technologies Corporation (NYSE: RTX), and Lockheed Martin Corporation (NYSE: LMT) because not only are they two of the largest market cap defense contractors (US$145 billion and US$122 billion, respectively) but they also count as two of the biggest manufacturers of military drones. Excluding dividends, Raytheon is actually down 3.5% over the last year, while Lockheed Martin rose 10.5%. Granted a positive 10.5% return over the last year did materially outperform the S&P 500, which was down 9% over the comparable time period, I was expecting a much better return.

Given the ever-increasing use and impact of drones in Ukraine, I thought I'd look at a company that was almost exclusively focused on this sector alone to see if there was any difference in performance from the multi-faceted defense names. I choose Kratos Defense & Security Solutions Inc. (Nasdaq GS: KTOS). Not only because of the name but the Company has contract ties to the U.S. Department of Defense, and roughly 25% of Kratos' revenue comes from its "Unmanned Systems" division. This all sounds good on paper but the Kratos share price saw a dismal 40% loss over the last 12 months. Even with that pummeling, Capital IQ has the stock trading at 33.2x Forward P/E. I don't think I'll be putting this name on my list as a hedge against the war in Ukraine dragging on for a lot longer.

(Note: An Unmanned System (US) or Unmanned Vehicle (UV) can be grouped into four primary types: (1) in the air, as Unmanned Aerial Vehicle or System (UAV or UAS), commonly known as a "drone"; (2) on the ground, as Unmanned Ground Vehicle (UGV); (3) on the water surface, as Unmanned Surface Vehicles (USV); and, (4) in the water, as Unmanned Underwater Vehicles (UUV).)

Commodity Stocks

Time to change gears and start looking at commodities. Despite oil, natural gas, and refined products accounting for Russia's largest value of exports, I chose platinum as the first place to look given Russia's Norilsk Nickel (MISX: GMKN) accounts for 10-12% of the world supply, which is a higher percentage of global market share than oil or natural gas. For reference, Nornickel, as it is also known, is also the world's largest palladium and refined nickel producer, plus a top-ten producer of copper as well. The best platinum/palladium surrogate I could find was Sibanye-Stillwater (NYSE: SBSW), another of the world's largest primary producers of platinum and palladium. This stock is down an abysmal 57% over the last 52 weeks. With platinum prices down 10% year-over-year and palladium down 41%, it appears the market isn't reeling from the impact of Russian supply disruptions in these particular metals.

Early in the conflict, natural gas was making a lot of headlines, with European prices spiking to unimaginable heights and all the subterfuge around the two Nord Stream pipelines. The leading European benchmark is Dutch TTF Gas and it is priced in Euro per megawatt hour (€/MWh). Despite this benchmark price peaking in late August 2022 at €339, it is currently trading below €50, even lower than it was trading before this whole mess began. Meanwhile, Henry Hub gas prices in the U.S. also peaked in August at US$9.71/MMbtu (Metric Million British Thermal Unit) but iscurrently transacting around US$2.70, also below year-ago levels. Thus, it will probably come as no surprise that big natural gas producer ARC Resources Ltd. (TSX: ARX) in Canada and EOG Resources, Inc. (NYSE: EOG), a leading gas producer in the U.S., are trading at pretty much the same price they were last year at this time. Or maybe it is a surprise as one might think they'd be down year over year based on the commodity price.

Oil and Refined Products Companies

The question is, did anyone's share price benefit from this unfortunate event? There were a few that I found and they were all oil and refined products related. The most well know name of the bunch is Exxon Mobil Corp (NYSE: XOM) which returned an impressive 41% excluding dividends over the last year. We all know Exxon is a behemoth, and there could be lots of reasons other than Russian supply disruptions that could have influenced the share price but other integrated global giants like Shell PLC (formerly Royal Dutch Shell) (LSE: RDSA | NYSE: SHEL) and BP plc (LSE: BP | NYSE: BP) all had similar one-year performances. Albeit they all had setbacks of some form in the last year due to the fact that they had to write off or choose to sell (for essentially zero) some Russian assets. Regardless, the large integrated oil companies outperformed the rest of the sector for the most part.

Tanker Stocks

But the big outperformers were the oil and refined product tanker stocks. The returns in this category were what I would have expected from the defense stocks, which as we discussed above, were relatively disappointing. There are many to choose from but I looked at two that I have traded in the past but did not have the foresight to continue holding them. The first company is Scorpio Tankers Inc. (NYSE: STNG), a Monaco-based international transporter of refined petroleum products with a fleet of 113 vessels. This stock returned a whopping 255% over the last 12 months.

The second company is Frontline Ltd. (NYSE: FRO) a Bermuda-based company providing marine transportation of crude oil and oil products with a fleet of roughly 70 tankers. Frontline returned 97% excluding dividends since the end of February 2022. This quote from Scorpio's Q4, 2022 results pretty much sums up why this sector has performed as well as it has:

> *"…the volatility brought on by the ongoing conflict in Ukraine, which has resulted in the implementation of sanctions on the export of Russian crude oil and refined petroleum products, has continued to disrupt supply chains for crude oil and refined petroleum products, changing volumes and trade routes, and thus increasing ton-mile demand for the seaborne transportation of*

refined petroleum products."

Scorpio's Q4/2022 vessel revenue increased 211% as a result and needless to say, the market paid attention even though I did not.

Today I've only scratched the surface of what ramifications the Russian invasion of Ukraine has had on markets and stocks around the world. What I truly hope is that I won't be doing this again a year from now.

Under the Hood in the Defense Sector

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As more and more vile images of atrocities are coming out of Ukraine, one can be reasonably assured that defense spending is heading in one direction in the near term – up, way up. Even Canada finally got its head out of it's you know where and committed to buying some new fighter jets. The exact same jets that the Justin Trudeau led Liberal party won a majority government in 2015 in part on a campaign promise to not buy the F-35, even though Canada had been actively involved in the Joint Strike Fighter (F-35) project since 1997, committing $100's of millions to the development of the fighter jet. But not to worry, I'm sure those same jets that Canada committed to buy back in 2010, for initial delivery in 2016 won't cost the taxpayers anymore money, I say with a heavy dose of sarcasm and disappointment.

My personal rant aside, we are seeing nations around the world become increasingly unsettled by Putin's actions and are making commitments to increase defense spending. In February, the German government announced it had decided to supply [€100 billion for military investments](#) from its 2022 budget, more than double what it allocated in 2021. News like this has seen the shares of F-35 manufacturer, Lockheed Martin Corp. (NYSE: LMT), and many of its peers, rally as much as 15% since late February. But not every defense stock has rallied, especially if most investors aren't even aware that a particular stock is in the defense sector. Today we are going to take a closer look at a Canadian company that is the third largest landing gear company worldwide, with 70% of its sales coming from the defense segment. It also happens to be trading at virtually the same price it was in late February and only slightly higher than a year ago.

Héroux-Devtek Inc. (TSX: HRX) is an international company specializing in the design, development, manufacture, repair and overhaul of aircraft landing gear, hydraulic and electromechanical actuators, custom ball screws and fracture-critical components for the Aerospace market. The Corporation supplies both the commercial and defense sectors with production facilities in Canada, the United States, the United Kingdom and Spain. Approximately 90% of the Corporation's sales are outside of Canada, including about 55% in the U.S. and 28% in the UK/Europe. Note that all production and virtually all its sales are in politically stable, West-friendly jurisdictions. An increasingly important factor in today's world.

The numbers coming out of the Company are equally stable. Excluding a one time, non cash impairment charge related to goodwill as a result of a reduction in expected demand for commercial aerospace products due to COVID-19, sales, EBITDA and income have been pretty stable for the past 5 years:

Source: Héroux-Devtek Quarterly Investor Fact Sheet

The Company trades at a P/E of 20x based on 12 month trailing income and roughly 1x sales but that includes a couple of disappointing quarters that were a result of supply chain and production system disruptions related mostly to the Omicron variant. Héroux-Devtek expects to recover these sales over the coming quarters, and that doesn't include any upside resulting from increased global defense spending. Additionally, as the pent-up demand to get back on commercial airlines start to gain traction, there could be an added tailwind to the Company's civil business segment.

Another metric I like about Héroux-Devtek is that it is a free cash flow (FCF) machine. Over the last 2 years, the Company has a combined stock buyback and net debt reduction of $143 million. Current net debt to Adjusted EBITDA ratio is 1.8:1, with $86 million in cash at the end of 2021. Then there is the tight share structure, with only 34.6 million shares outstanding after the Company repurchased 2.2 million shares through its NCIB in the first 9 months of Fiscal 2022. All of this sets up very nicely for a quarterly result that could surprise to the upside. Albeit there is no certainty that will be the next quarter reported, but you can see a company that is in good shape for a solid quarterly beat in the not too distant future. Along those lines, in October 2021 Héroux-Devtek announced it had entered into an agreement with the aforementioned Lockheed Martin for the development of landing gears for its next generation of defense aircraft.

All in all, it appears that Héroux-Devtek has a decent forward outlook and may simply be suffering from a mild case of anonymity. Next quarterly results are scheduled for May 19^{th} if you want to wait and see if supply chain issues have been laid to rest. But with one NATO country after another announcing increased or renewed defense spending, it may only be a matter of time before the market discovers this defense stock that hasn’t participated in the recent rally.

Top picks in defense, aviation, and related ETFs for 2022

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As we start 2022 one area of concern is global geopolitical uncertainty. In particular, Russia continues to threaten Ukraine, and China threatens almost everyone. The biggest Chinese threat, for now, is probably to Taiwan. Then there is always the threat posed by North Korea. Given the increasing global tensions, it is not surprising that many countries are boosting their defense spending. This leads to an opportunity for investors who want to be ahead of the game just in case a war or conflict breaks out.

Furthermore, it is starting to look like 2022 will see some recovery in the civilian aviation sector, assuming we are near the end of the COVID-19 pandemic, or at least getting back to more normal living.

Research groups also see a recovery ahead for U.S aerospace and defense. Fitch stated in December 2021: “Fitch Ratings views the 2022 Aerospace & Defense (A&D) sector outlook as improving following a bottoming out in early 2021 and a moderate improvement in 2H21.” Deloitte also forecasts a recovery in 2022.

Below are three defense or aviation stocks/ETFs to consider in 2022.

Defense stocks can offer some safety to a portfolio especially if we get any conflicts in 2022

iShares U.S. Aerospace & Defense ETF

The iShares U.S. Aerospace & Defense ETF (ITA) seeks to track the investment results of an index composed of U.S. equities in the aerospace and defense sector. The advantage of using the ITA ETF is the broad exposure to the U.S aerospace & defense sectors, which are sure to gain if there are any global breakouts of hostilities.

The current top 5 holdings are:

- Raytheon Technologies Corporation. (NYSE: RTX) (20.83%)
- The Boeing Company (NYSE: BA) (18.38%)
- Lockheed Martin Corporation (NYSE: LMT) (5.27%)
- Northrop Grumman Corporation (NYSE: NOC) (4.71%)
- TransDigm Group Inc. (NYSE: TDG) (4.66%)

The ITA ETF trades on a PE ratio of 26.59, with a dividend yield of 0.9%pa.

An alternative to the ITA ETF is the SPDR S&P Aerospace & Defense ETF (XAR) with a key differentiator being that XAR takes an equal weighted approach. XAR describes its approach as an “equal weighted index which provides the potential for unconcentrated industry exposure across large, mid and small cap stocks". XAR trades on a weighted average PE of 24.75.

Northrop Grumman Corporation (NYSE: NOC)

Northrop is one of the world's largest weapons and military technology providers. It is also a large U.S military aircraft manufacturer. What I like about Northrop is that it is well diversified and provides products and services across the air, land, sea, space, and cybersecurity sectors. Over the years Northrop has grown organically but also via takeovers, including that of Orbital ATK Inc., a global aerospace and defense systems company. This has enhanced Northrop's capabilities especially in the area of Ground-Based Interceptor ('missile') products.

In March 2021 it was reported that Northrop had won a US defense contract for up to $3.9 billion to design the next-generation interceptor for the U.S. missile defense network. The report stated: The new interceptors would be a part of the Ground-based Midcourse Defense (GMD) system here, a network of radars, anti-ballistic missiles and other equipment designed to protect the United States from intercontinental ballistic missiles (ICBMs). Northrop's stock rallied on the news, but there is still the possibility of a contract extension or expansion as Reuters stated: "The next-generation interceptor program could be worth as much as $10-$12 billion over its lifetime as the contractor works to make the technology capable of defeating current threats and future technological advances from countries like North Korea and Iran." There is also the next possibility of a space based defense system (read "a space-based sensor layer for ballistic missile defense").

Northrop trades on a market cap of US$62 billion and has a current PE ratio of 16.1. Not bad when you consider the U.S S&P 500 PE is currently 33.8.

The Boeing Company (NYSE: BA)

When it comes to U.S companies with massive exposure to defense, aerospace and civilian aviation there is none bigger than Boeing. I like Boeing in 2022 as it stands to benefit both as the aviation industry recovers post-COVID-19, and if we get any rise in the defense stocks due to global conflicts.

Boeing is an aerospace company that manufactures commercial jetliners and defense, space and security systems. Its products, and tailored services, include commercial and military aircraft, satellites, weapons, electronic, and defense systems, launch systems, advanced information and communication systems, and performance-based logistics and training.

Boeing trades on a market cap of US$125 billion and has a 2022 PE ratio of 32.8. Not cheap but remember Boeing is potentially at the early stage of an earnings recovery as global airlines look again to open their airline order books. One example of this is today's news of U.S. carrier Allegiant Air rumored to be buying 50 Boeing 737 MAX jets valued at US$5 billion.

Closing remarks

We never know when the next terrorist attack or a global conflict will breakout. Given the tensions building after a tough two years enduring the COVID-19 global pandemic, it would not be surprising to see a geopolitical event spark in 2022. Will it be Ukraine, Taiwan, North Korea, the South China Sea, the Middle East, a terrorist attack on Western soil, or an unforeseen black swan event? It is hard to predict, but one thing is certain, and that is that buying up some 'defense' stocks as insurance, early at very reasonable market valuations, makes a lot of sense as we enter 2022.

Finally, the aviation sector looks poised to come out from its worst-ever downturn caused by COVID-19 in 2020 and 2021.

It now looks like it is time to book a seat and invest back into the defense, aerospace and aviation sectors in 2022. Fasten your seat belt and enjoy the ride, hopefully with much less turbulence in 2022.