

Europe's rearmament is a project for decades

Europe's limited defense capabilities may remain so for some time. This is not a comforting realization, but it means funds could be flowing into the defense sector for a long time.

A more than 500% price increase in the index¹ in five years. Can one remain positive about European defense stocks after such a rally? There are price explosions that can implode just as fast. Think of the beneficiaries of the Covid lockdown period, for example. The booming stocks of the artificial intelligence (AI) wave, meanwhile, still show little sign of weakness even after three years, because AI's potential is seen as being so great. And European defense? We believe that as long as governments believe that the threat to Europe will persist, they could be more willing to invest in the region's defenses.

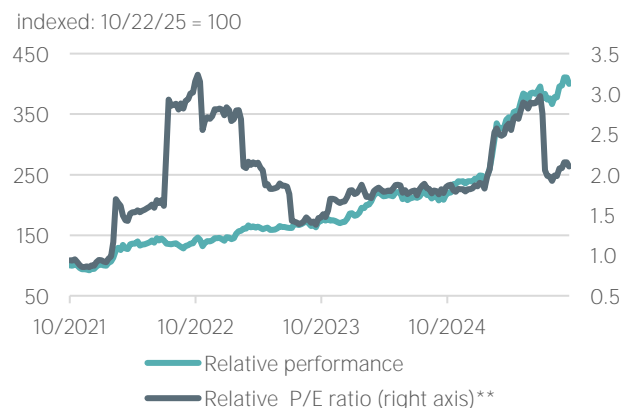
The state of the European military can be summarized in appropriate staccato: Since the fall of the Iron Curtain there have been 30 years of underinvestment. Europe left defense to the Americans. The attack on Ukraine and clear signals from the White House that Europe must defend itself have changed that. Russian drones on European NATO territory are a further spur. A major political rethink has taken place. Defense budgets are rising sharply, especially in Germany, Northern and Eastern Europe. The budget difficulties faced by France, Spain, and Italy make progress slower. Further, military production capacities cannot be created overnight.

And so there may be some near-term disappointment on the march to stronger European defense. But we are convinced that European rearmament represents a structural change that may provide the sector with a strong tailwind for many years to come. Investors now may wish to evaluate which defense stocks they buy, however. Madeleine Ronner, Senior Equity Portfolio Manager at DWS, comments: "One year ago you could buy practically anything related to defense and beat the market. Now, you have to be much more selective. And, even then, the valuations of our favorite stocks look quite challenging. However, given the current growth outlook, they may be able to grow into these valuations."

The chart shows this dynamic. The defense sector has performed significantly better than the overall market over the past five years, building since 2021 a steadily rising valuation premium. Measured by earnings over the past twelve months, it is now twice as expensive as the overall market. At its peak, however, in July this year, it was three times as expensive.

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Europe's defense sector relative to the market*



* Bloomberg Europe Defense Index relative to Stoxx Europe 600

** Price-to-earnings (P/E) ratio

Sources: DWS Investm. GmbH; Bloomberg Finance L.P. 10/17/25.

We think, however, that the sector's appeal, remains strong. It might offer: 1. Long-term, relatively predictable, government-financed revenues. 2. High economies of scale through capacity expansion with high operational leverage due to high fixed costs. 3. Potentially higher expected profit growth for several years. If the sector is valued based on assumed profits over the next three to five years, its valuation premium quickly melts away again.

These forecasts are based on the following assumptions: Europe's defense spending will rise from the current 2% of gross domestic product (GDP) to 3% by 2030,² with the prospect of rising to 3-4% of GDP. At the same time, spending on equipment is currently falling in relation to spending on manpower. According to the International Institute for Strategic Studies (IISS),³ around half of the spending is expected to benefit European suppliers, which Europe's politicians want to strengthen.

As the war in Ukraine shows, warfare technology and tactics are changing rapidly. This calls for a selective approach, as not all companies are equally prepared for this challenge. It also requires considering the entire value chain and related industries, such as aircraft and cybersecurity. Nevertheless, we believe that the defense sector is likely to remain buoyant as long as Europe doesn't feel safe.

Footnotes

¹ Bloomberg Europe Defense Index

² Oxford Economics, "Europe's defence splurge will help industry – but by how much?" March 25, 2025. According to the European Commission, "Preserving Peace - Defence Readiness Roadmap 2030," as of October 16, 2025, to reach the new core defence spending target of 3.5% GDP by 2035 (not including spending for protection of critical infrastructure) would require sustained expenditure in the next decade of at least additional EUR 288 billion each year. This, in turn, is in the same ballpark of the annual investment budget for AI infrastructure of the four major hyperscalers Meta, Alphabet, Amazon, and Microsoft alone (CNBC, "Tech megacaps plan to spend more than \$300 billion in 2025 as AI race intensifies," as of February 8, 2025).

³ International Institute for Strategic Studies (IISS), "Building Defence Capacity in Europe: An Assessment," as of November 2024

Glossary

Artificial intelligence is the theory and development of computer systems able to perform tasks normally requiring human intelligence

The **Bloomberg Europe Defense Index** tracks the performance of European defense companies that are focusing on developing new technologies to keep pace with advancements and changing threats. The Index includes companies in Modern Global Defense ecosystem from Bloomberg Intelligence (BI) and Aerospace & Defense sector according to Bloomberg Industry Classification Standard

Economies of scale are the cost advantages that enterprises obtain due to their scale of operation

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Hyperscalers are large cloud service providers, which can provide services such as computing and storage at enterprise scale.

The **Iron Curtain** was the political and physical boundary that divided Europe from the end of World War II in 1945 until the end of the Cold War in 1991.

NATO is a Western military alliance with currently 30 member states

The **Stoxx Europe 600** is an index representing the performance of 600 listed companies across 18 European countries.

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

A **valuation premium** is the excess a buyer is willing to pay for one asset relative to other assets.

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