



PERSPECTIVES Special

Defence in a fragmented world

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Key takeaways

- Defence spending around the world is likely to increase further, at a time of profound transformation in the nature of warfare itself.
- Recent conflicts have exposed significant vulnerabilities within global defence supply chains, including around advanced integrated circuits and rare earth elements.
- Aerospace and defence companies have outperformed in recent years, outperforming broad equity markets. Earnings are expected to keep growing strongly, especially for European companies.
- Defence spending is increasingly supporting not only traditional defence contractors, but also a broader ecosystem of digital defence capabilities, including AI, cybersecurity, communications, semiconductors and autonomous systems.
- The sector's outlook depends on continued political support for higher defence spending. Fiscal pressures, shifting government priorities and changes in defence commitments could affect the pace of future expenditure.



01

Geopolitics and defence spending

The global security environment has now entered a new phase. The resurgence of high-intensity conflict, the erosion of long-standing deterrence frameworks and the gradual shift towards a more fragmented and multipolar international order have moved defence back to the centre of government priorities.

As a result, defence spending is no longer being treated as a residual budget item – after other domestic spending needs had been addressed – but increasingly as a structural necessity.

The need for a change in approach was underlined by, first, Russia's full-scale invasion of Ukraine in February 2022 and, second, by the conflict in the Middle East which started in February this year. The first prompted a profound reassessment of threat perceptions, defence readiness and deterrent frameworks across advanced economies; the second highlighted the vulnerability of critical infrastructure, energy supply routes and allied military assets to asymmetric threats, including ballistic missiles, drones and cyber-enabled warfare.

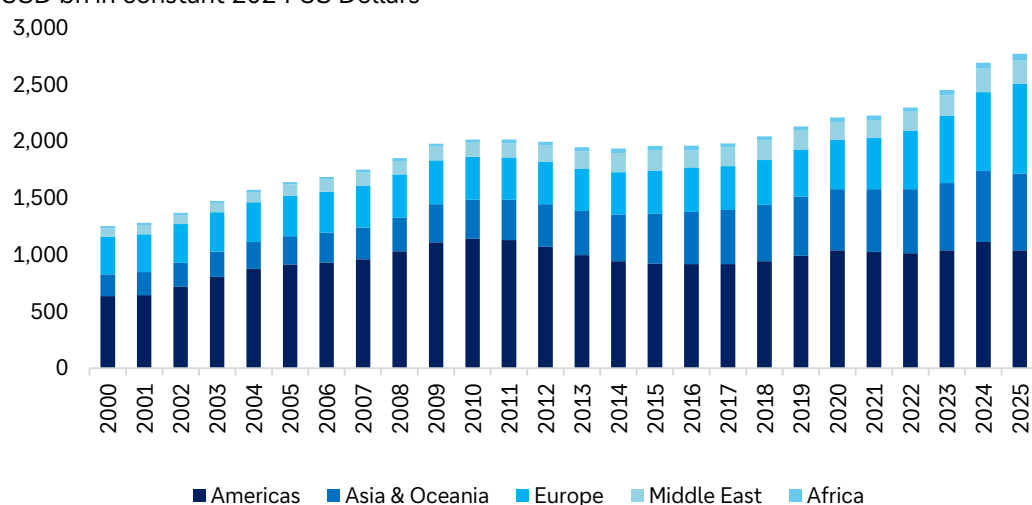
Recent conflicts have also underscored the growing cost-intensity of modern warfare and the need for sustained investment in air and missile defence, intelligence, surveillance and reconnaissance (ISR), and advanced command-and-control systems.¹

Uncertainty around the future trajectory of transatlantic security arrangements has increased in recent years.² The post-Cold War era – characterised by US primacy – is already giving way to a more fragmented and multipolar order marked by intensifying strategic competition and weaker multilateral coordination, providing a further incentive to countries to rebuild their military capabilities.

Structural fragmentation supports the view that higher defence spending around the world will become a persistent feature of the global landscape rather than a temporary response to current shocks. Global defence expenditure reached a new historical high of USD2.9tn in 2025 (Figure 1), marking the eleventh consecutive year of growth and equivalent to approximately 2.5% of world GDP. Based on the past five years, when defence budgets expanded by an average of 4.7% annually, the UN now projects global military expenditure to climb to USD3.5tn by 2030 and beyond USD4.4tn by 2035.³

Figure 1: Military expenditure reached a new record in 2025

USD bn in constant 2024 US Dollars



Source: SIPRI Database, Deutsche Bank AG. Data as of October 9, 2026.

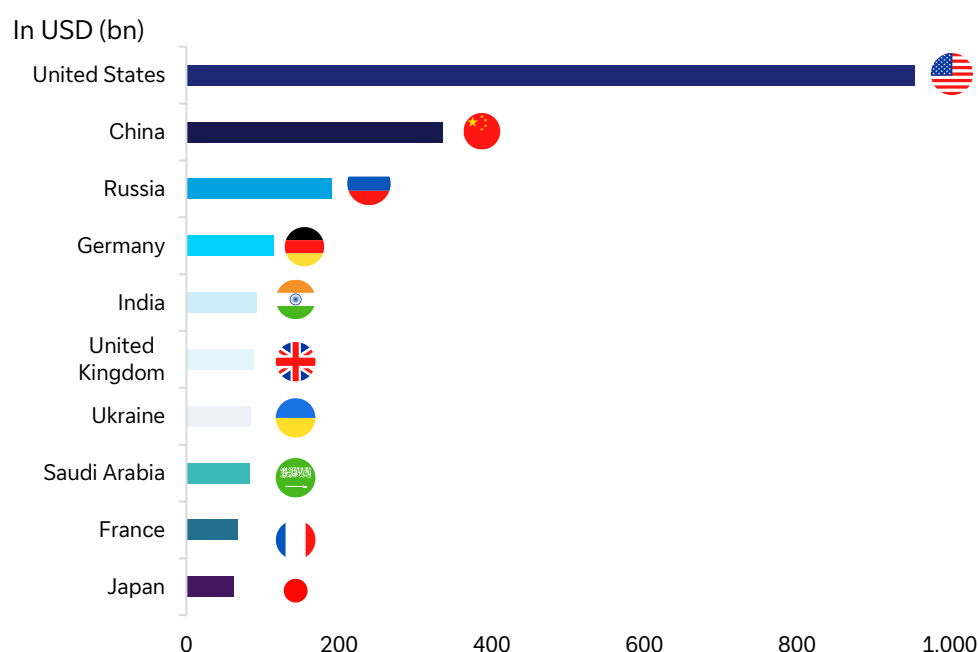


Increases in **European and Asian defence spending** in 2025 more than offset a decline in US spending. European spending is likely to rise further: the EU's "Readiness 2030" framework, part of the broader ReArm Europe plan launched last year, aims to mobilise more than EUR800bn in defence investments up to 2030, strengthening the European defence industrial base and accelerating procurement across priority areas including air defence, drones and cyber capabilities.

SIPRI figures represent estimated actual military expenditure during the calendar year in constant prices and may therefore differ from US budget authorisations or appropriations, including supplemental funding, owing to differences in scope, timing and measurement.

NATO has also redefined its spending ambitions. In 2025, member states agreed to raise defence spending to 5% of GDP by 2035, including 3.5% dedicated to core military expenditure: the previous long-standing target had been 2%. This is a difficult time to raise spending, with higher energy prices adding to fiscal pressures across Europe, but a reversal of the upward trend seems unlikely.

Figure 2: Top 10 countries for defence spending



Source: SIPRI, Deutsche Bank AG. Data as of October 9, 2026.

The **US** FY2027 budget proposal points to a significant increase in defence resources, with total funding requests approaching USD1.5tn when including both discretionary and additional allocations – again, aimed at strengthening the defence industrial base, accelerating procurement and supporting next-generation defence capabilities.

Asia has emerged as a key pillar of global defence spending, with military expenditure in the region rising by around 8% YoY in 2025. **China** is the world's second-largest military spender after the US with expenditure estimated at USD336bn in 2025, as shown in Figure 2. **Japan** is set to grow its military capacity significantly under the Takaichi administration, with the defence sector among the "17 strategic sectors" the Japanese government is intended to concentrate public-private support with directed investments.



Increased defence spending comes at a time of severely stretched **public balances** across the advanced economies: G7 gross debt-to-GDP is projected to exceed 115% by the end of 2026. This has revived the classic “Guns vs. Butter” macroeconomic dilemma (the trade-off governments face between allocating resources to defence spending and civilian priorities such as healthcare, education, and social welfare). At the same time, defence financing has become increasingly tied to financial measures arising from conflicts, most notably the freezing of approximately USD300bn in Russian sovereign assets and the use of windfall profits from these assets for defence funding.⁴ The precedent this has set, for asset expropriation, may have contributed to a structural diversification away from G7 fiat reserves and elevated levels of central bank gold purchases. Such a gradual shift toward a “multipolar reserve regime” in which gold, real assets, and non-aligned currencies increasingly serve as hedges against jurisdictional risk, could alter structural term-premia and increase structural borrowing costs for traditional reserve-issuing G7 nations.

02

Technological change and its implications

Defence spending is increasing at a time when there is also a profound transformation in the nature of conflicts themselves. The extensive use of drones, real-time intelligence gathering, autonomous systems and networked command structures in recent conflicts has demonstrated how relatively low-cost but technologically sophisticated capabilities can challenge traditional military superiority.

Figure 3 helps to assess how the nature of warfare has evolved significantly since World War II, when conflict was characterised by mass mobilisation, industrial firepower and territorial conquest. In the post-war decades, the emergence of nuclear deterrence reduced the likelihood of direct confrontation between major powers and shifted military competition towards proxy wars, regional conflicts, hybrid warfare and technological rivalry. The Cold War accelerated innovation in missiles, satellites, jet aircraft and computing technologies, laying the foundations for modern command-and-control systems. The first Gulf War marked then another turning point, demonstrating the effectiveness of precision-guided munitions, stealth technologies and network-centric operations.

More recent conflicts have reinforced the importance of drones, missile defence systems, electronic warfare capabilities and cyber operations. The impact of **drones** is clearly visible in Ukraine's defence procurement. During the first half of 2026 alone, Ukraine signed drone-related contracts worth more than UAH333bn (EUR7bn). Drones could therefore account for over 15% of Ukraine's total 2026 security and defence budget of UAH4.367tn (EUR91bn) and 30% of the country's total 2026 procurement budget (UAH2.297tn, EUR48bn). Drones are now a central pillar of modern military planning and expenditure.

The flip side of this is growing spending on **air-defence systems**. In August 2026, the European Commission approved an additional EUR6.1bn for Ukraine covering air- and missile-defence systems, missiles, ammunition and radars, to combat the growing intensity of ballistic-missile and drone attacks. The ability to detect, track and intercept incoming threats has become one of the most strategically important areas of defence spending.



Figure 3: The rise of technology-driven warfare

Aspect	World War II (1939–1945)	Modern Warfare (21st Century)
Information Warfare	Code-breaking (e.g. Enigma), human espionage	Cyberattacks, AI surveillance, social media manipulation
Battlespace	Land, sea, air	Land, sea, air, cyber, space
Technology	Tanks, propeller aircraft, early radar	Drones, satellites, AI, autonomous systems, hypersonic missiles
Troop Deployment	Mass conscription, large armies	Small, agile units; special forces; PMCs; proxy forces
Air Power	Manned bombers and fighters	Unmanned drones, precision airstrikes
Cyberwarfare	Non-existent	Central to conflict – sabotage, data theft, critical infrastructure attacks
Command & Control	Radios, runners, paper maps	Real-time digital networks, satellites, encrypted systems
Defence Systems	Anti-aircraft guns, bunkers	Missile defence shields, AI-guided interceptors, lasers
Actors Involved	Nation-states, formal alliances	States, non-state actors, PMCs, cyber groups
War Declaration	Formal declarations common	Informal, hybrid, undeclared or proxy conflicts

Source: SIPRI Database, Deutsche Bank AG. Data as of October 9, 2026.

Drones also highlight **asymmetries in warfare costs**. Interceptor missiles costing USD1mn-4mn are frequently used to neutralize drones costing as little as USD10,000-50,000, something that may prove financially unsustainable in a war of attrition. Procurement strategies are therefore examining Directed Energy Weapons (DEWs), such as tactical lasers and high-power microwave systems, which may offer a much lower marginal cost-per-use.



Information itself has become a battlefield. Military and state actors increasingly employ cyberattacks, artificial intelligence and digital information campaigns to influence public opinion, disrupt opponents and obtain real-time intelligence. **Cyber warfare** can target critical infrastructure, communications networks and government systems from thousands of kilometres away, often below the threshold of conventional military confrontation.

As a result, **cybersecurity** capabilities are becoming an integral component of national defence strategies. For FY2025, the US Department of Defense requested more than USD64bn for Information Technology and Cyberspace Activities, while cyber-related programmes represented approximately 23% of the department's overall IT budget. Cybersecurity, digital networks, cloud infrastructure and information dominance has become an increasingly important component of modern defence spending alongside more traditional military capabilities.

Space has also become a critical military domain. Modern armed forces rely extensively on satellites for communication, navigation, intelligence gathering, surveillance and missile guidance. Concern about the vulnerability of space-based infrastructure has contributed to growing investment in sovereign satellite capabilities, for example the EU's IRIS² constellation and the US Starshield initiatives. China's reported progress in on-orbit satellite refuelling could enable persistent "hunter" satellites, making space logistics as strategically important as space launch itself.⁵

Artificial intelligence (AI) is already playing an increasingly important role, with systems now deployed for battlefield monitoring, intelligence analysis, logistics optimisation, threat detection and autonomous systems. Over time, decision-making processes may become increasingly data-driven, reducing reaction times and enhancing operational effectiveness but also creating new resource requirements e.g. computing power, data infrastructure and reliable access to electricity.

The defence sector is increasingly evolving towards a **hybrid military-industrial ecosystem**. Many of today's most important defence capabilities are built on a dual-use foundation, whereby technologies originally developed for civilian applications are adapted for military use and vice versa: AI, semiconductors, cloud computing, communications systems, satellite technologies and advanced software are already relevant to both the commercial and defence markets.

This convergence has blurred the distinction between **traditional defence contractors** and **technology companies**. Large technology firms are becoming increasingly involved in defence activities through cloud infrastructure, cybersecurity services, battlefield analytics and AI-enabled platforms. Conversely, established defence firms are investing heavily in cyber capabilities, autonomous systems and space technologies to remain competitive in an increasingly digital operating environment.

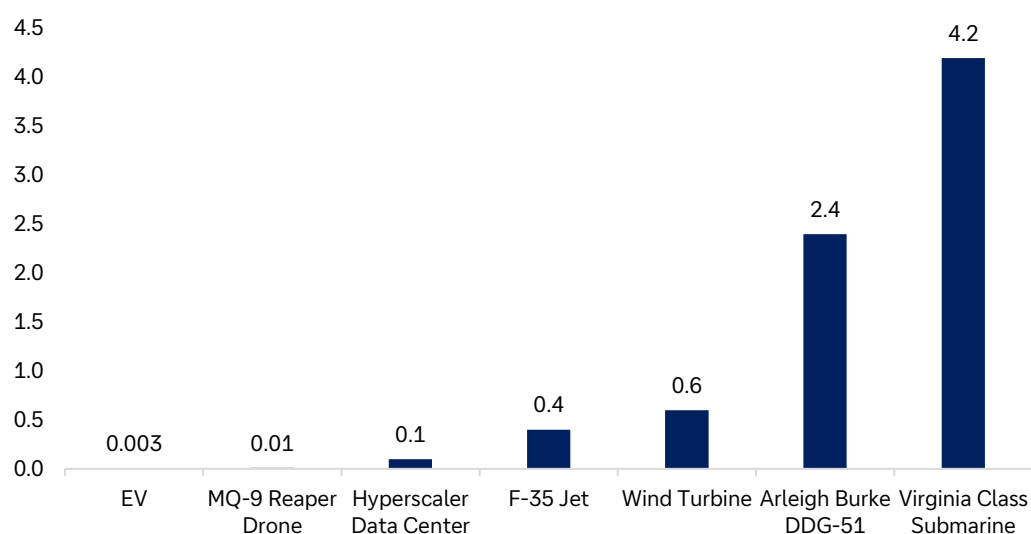
Recent conflicts have exposed significant vulnerabilities within global **defence supply chains** and highlighted the importance of industrial capacity as a strategic national asset. Many Western countries have discovered that their production capabilities for ammunition, missile interceptors, drones and electronic systems are insufficient to support prolonged periods of high-intensity warfare.⁶ Some more fundamental **bottlenecks** have also emerged, for example related to the concentration of advanced chip manufacturing in a limited number of countries and suppliers, or supplies of **rare earth elements (REE)** and critical minerals.



Rare earth elements (REE) have become indispensable inputs for modern defence technologies (e.g. through high-performance permanent magnets used in a wide range of military systems) and many of these applications are dual-use, serving both civilian and defence markets, placing them in competition for limited supplies. (The same magnet technologies that enable precision manufacturing robots, fibre-optic networks and commercial aircraft, for example, are also deployed in missile guidance systems, military aircraft actuators, sonar systems and naval propulsion technologies.) Figure 4 illustrates, showing REE demand in specific military and civilian uses.

Figure 4: REE demand in defence and other applications

REE demand per unit, thousand tonnes



Source: US Department of War, MIT, Rare Earth Exchanges, Deutsche Bank AG. Data as of October 9, 2026.

With China currently accounting for nearly all global processing capacity, securing access to many REE has become a growing strategic priority for governments seeking to strengthen defence-industrial resilience. This has driven policies focused on **domestic mining, processing capacity, strategic stockpiling and supply-chain diversification**. Problems here may get worse: the US Department of Commerce estimates that the Pentagon's demand for highly specialised defence magnets could increase from around 3-4 thousand tonnes annually now, to as much as 10 thousand tonnes by 2030.

There are other potential shortages. The rapid expansion of drone production has also created growing demand for batteries, advanced sensors, optical systems and specialised electronic components. At the same time, shortages of skilled engineers, software developers and advanced manufacturing capabilities are increasingly constraining production growth across both North America and Europe.

These vulnerabilities are encouraging governments to pursue **reshoring initiatives, strategic stockpiling programmes and broader industrial policy measures**. Policy efforts are no longer focused solely on military procurement of finished weapons but also on securing access to critical technologies, strengthening domestic production capabilities and enhancing supply-chain resilience.



This growing overlap between **defence policy, industrial policy and national security** is shaping a new strategic framework. Governments are increasingly using public investment programmes, procurement strategies, export controls and targeted incentives to support key technologies and industrial capabilities. Technological leadership, industrial resilience and manufacturing capacity are becoming critical pillars of national security alongside traditional military capabilities.

03

Investing in defence

Over the past few years, renewed investor attention in the defence sector has translated into a **strong re-rating of Aerospace & Defence (A&D) companies**, with the sector significantly outperforming broad equity markets. Over the last 5 years, the MSCI World Aerospace & Defence Index has gained more than 120% compared to less than 80% for the MSCI World Index (Figure 5).

Figure 5: Returns of global A&D stocks vs. overall market

Total return performance (indexed to 100 = October 7, 2021)



Source: LSEG Datastream, Deutsche Bank AG. Data as of October 9, 2026.

In 2025, aggregate revenue for the top 100 global A&D companies crossed the USD1tn threshold for the first time, rising by 14% year-on-year, with profits increasing by 46% to a record USD124.4bn. As shown by a PwC study, this earnings boom was however heavily concentrated, with nearly 40% of the profit expansion driven by the four major engine manufacturers.⁷

In Europe, the MSCI Europe Aerospace & Defence Index has gained more than 210% since October 2021, far outperforming the MSCI Europe Index's 58.4% return. However, the sector has underperformed the broader market so far in 2026 (-11.1% versus -1.5% year-to-date as of October 9). Figure 6 overlays the European A&D index's relative performance compared to the broader European market over the last five years with the relative trend in earnings per share (EPS, 12-months forward), which has also move upwards.

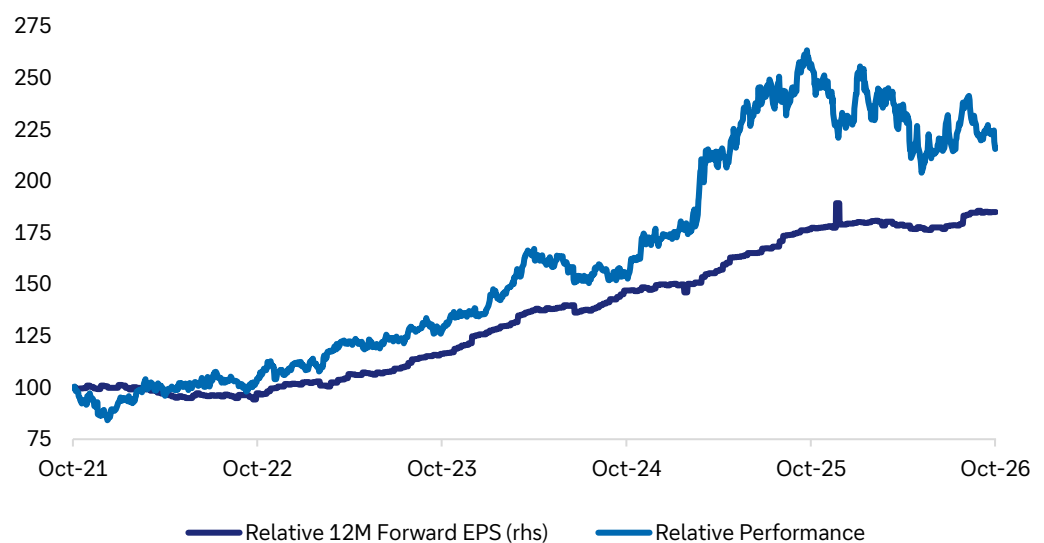


Some European defence contractors have been particularly strong performers over this period, while so-called US primes (a small group of large companies holding major US Department of Defense contracts) have delivered steadier, more defensive growth but faced greater margin pressure due to legacy fixed-price contracts. Nonetheless, US primes have traditionally traded at a historical valuation premium to their European peers due in part to much higher **state-subsidized innovation**. According to the US Department of Defense, the US FY2025 budget allocated a record USD143.2bn specifically to Research, Development, Test, and Evaluation (RDT&E).⁸ By contrast, total European defence R&D spending across all European Defence Agency (EDA) member states was just EUR13bn in 2024. R&D represented 4% of the EU defence budget vs 16% for the US.⁹

This funding asymmetry has forced European firms in the past to heavily self-fund innovation out of retained earnings or operate under highly fragmented, national-scale programmes, depressing their return on invested capital (ROIC) relative to US peers. However, with increasing European defence spending accompanied by greater public support for R&D costs, this structural ROIC gap could narrow, suggesting that European primes could get closer to US peers' valuations.

Figure 6: European A&D stocks: relative index performance vs. relative EPS expectations

MSCI Europe Aerospace & Defense / MSCI Europe (indexed to 100 = October 7, 2021)



Source: LSEG Datastream, Deutsche Bank AG. Data as of October 9, 2026.

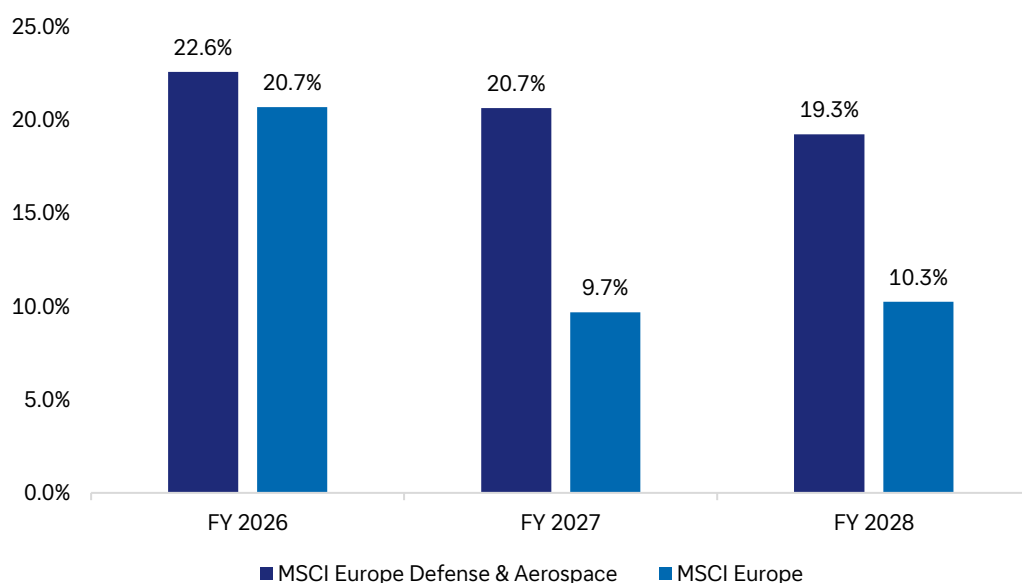
With European defence budgets expected to rise over the coming years, consensus expectations point to a CAGR of approximately 20% EPS growth for the MSCI Europe Defense and Aerospace index for the period 2026-28 compared to 13.5% for the MSCI Europe Index (Figure 7).

Headwinds exist. Despite ongoing conflicts in Ukraine and the Middle East, defence stocks erased part of the past years overperformance versus the broader market in recent months. The initial market enthusiasm surrounding the move towards higher NATO spending targets has marginally faded, as investors increasingly scrutinise the implementation and fiscal sustainability of announced spending plans.



Elevated public-debt burdens and higher global bond yields are reinforcing this scrutiny, while the 2026 energy shock has increased competing demands on government budgets and could delay some procurement programmes. Several European governments were forced to devote additional fiscal support to households and businesses and higher electricity and fuel costs are already directly adding pressure across defence supply chains, given the energy-intensive nature of much defence manufacturing. At a broader level, the AI investment theme continues to capture investors' attention and capital flows.

Figure 7: European A&D companies: expected EPS growth vs. overall index



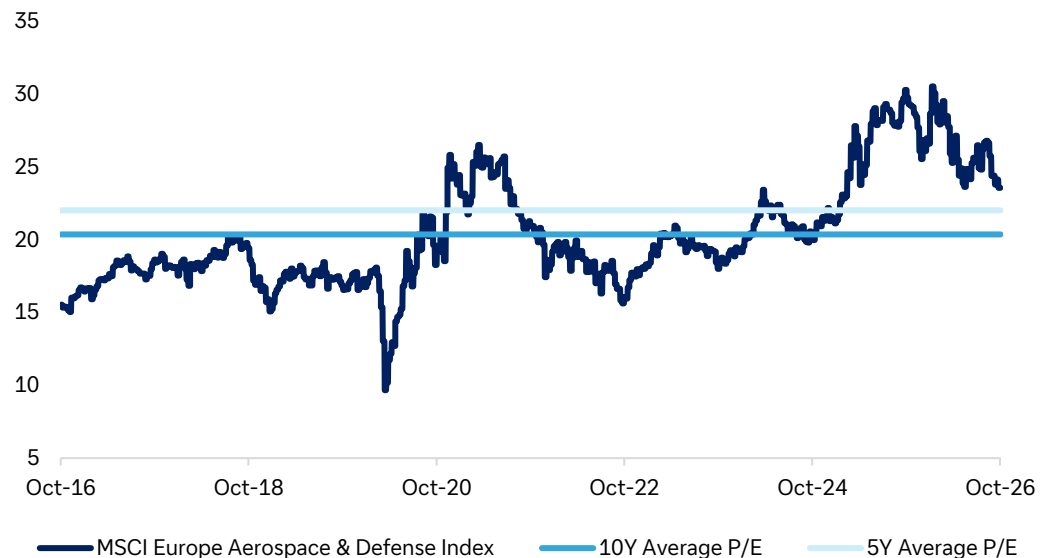
Source: LSEG Datastream, Deutsche Bank AG. Data as of October 9, 2026.

In our view, the current geopolitical backdrop will benefit the A&D sector. For US companies, the passage of the FY2027 defence budget could provide an important near-term catalyst. We nevertheless maintain a neutral view on the US defence sector, reflecting a potentially lower likelihood that the proposed USD1.5tn package will be approved in full in case the Democrats gain in the polls ahead of the mid-term elections. The timing and final scale of funding also remain subject to the congressional appropriations process and broader fiscal negotiations. By contrast, we retain a more favourable view on European A&D companies, supported by stronger expected earnings growth and continued revenue visibility from rising defence budgets and robust order books. Recent stock price volatility appears to reflect a valuation adjustment rather than a deterioration in long-term demand, or the underlying earnings outlook.

From a bottom-up perspective, most companies remain well positioned, although constrained production capacity means that investor attention is increasingly shifting from order intake towards execution, particularly the ability to expand capacity, manage supply-chain bottlenecks and convert growing backlogs into profitable deliveries and cash flows.



Figure 8: European A&D valuation multipliers remain elevated but below recent peaks



Source: LSEG Datastream, Deutsche Bank AG. Data as of October 9, 2026.

As of October 9, 2026 the European A&D sector still traded at a historically high **valuation**, with a 12 months forward P/E of 23.6x. This is above the average multiples of the last five and ten years (Figure 8) but 22.8% below its peak reached during Q3 2026. Considering that, as of October 9, the MSCI World Aerospace & Defence Index, which is composed of approximately 66% US companies by market capitalisation, traded on a 12-month forward P/E of 25.3x, there seems to be some room for European companies to further close their valuation gap vs. US peers.

The current **fragmentation of the European defence industrial base** will also create opportunities for cross-border mergers and acquisitions (M&A), potentially providing an additional tailwind to the sector's performance. While the US market has largely consolidated into a small number of very large prime contractors, Europe remains highly differentiated, manufacturing 17 different types of main battle tanks and 20 distinct fighter aircraft platforms.¹⁰ According to PwC's Aerospace & Defense Report¹¹, global defence M&A transaction values rose to a record USD29bn in 2025, from USD25bn in 2024, driven heavily by mid-cap consolidations in Europe. Further consolidation activity can be expected going forward.

An additional consideration for investors is that an increasing share of defence innovation is taking place outside public markets. Many of the companies developing next-generation capabilities in areas such as drones, autonomous systems, AI, cybersecurity, space technologies and advanced sensors remain privately held, venture-backed businesses. This trend is particularly visible in Europe, as discussed in our recent special report, [Venture Capital: Assessing the European Market](#).

Investor preferences within the sector are also evolving. Sentiment towards traditional platforms, including main battle tanks and other heavy equipment, has moderated, while recent conflicts have reinforced the importance of air defence, drones and ammunition.



Nevertheless, traditional land-based platforms remain strategically important to national defence, providing protected mobility, operational reach and a visible contribution to deterrence and force readiness. New technologies, including drones, sensors and autonomous systems, are likely to complement rather than replace these platforms, supporting continued investment in their protection, connectivity and integration within broader defence capabilities.

At the same time, defence-tech companies exposed to autonomous systems, AI, cybersecurity, advanced sensors and software-defined capabilities are attracting growing interest.

Drones may be of particular interest. According to Deutsche Bank Research, the **global military drone market** is projected to increase from around USD17bn in 2025 to more than USD50bn by 2035, a CAGR of approximately 11%, while the counter-drone market is expected to grow from roughly USD2bn to USD15bn over the same period. The drone industry is characterised by a fragmented and innovation-driven competitive landscape. Ukraine, for example, has developed a large domestic drone industry in only a few years, with domestic companies producing systems ranging from low-cost drones to more sophisticated long-range platforms. This decentralised production model is, in turn, reshaping defence procurement, as military demand shifts towards scalable, lower-cost and rapidly upgradeable systems.

However, the investment opportunity extends beyond aerial drones. **Unmanned ground vehicles, autonomous surface vessels and uncrewed underwater systems** are also attracting increasing attention, reflecting their potential use in areas such as logistics, surveillance, reconnaissance, mine clearance and the protection of critical infrastructure. Rather than displacing traditional warfare platforms, these systems are likely to be deployed alongside them, increasing the importance of interoperability, secure communications and integrated command-and-control capabilities.

This evolution should not be seen as a shift away from traditional defence segments. Conventional platforms, including aircraft, naval vessels, armoured vehicles, air-defence systems and ammunition, will remain central to military capability and deterrence. Rather, the opportunity increasingly lies in **integrating these platforms with autonomous systems, sensors, software and secure connectivity**, benefiting both traditional A&D contractors and defence-tech companies.

For investors, drones serve as one reminder that a growing share of future defence spending may be captured by a **broader universe** of companies than has historically been the case. As discussed in the previous chapter, modern military capabilities increasingly depend on an ecosystem encompassing AI, cybersecurity, semiconductors, satellite infrastructure, advanced manufacturing, communications systems and critical materials. These technologies are often developed outside the traditional defence industry and have significant civilian and military dual-use applications.

This broader perspective is increasingly reflected in the composition of listed companies exposed to defence spending. New military capabilities increasingly rely on technologies and expertise supplied by companies operating in areas such as industrial equipment, specialised services, software, electronic equipment, semiconductors, communications equipment and IT services. As these capabilities become more deeply integrated into modern defence systems, a growing share of these companies' revenues may be linked directly or indirectly to defence expenditure.

As a result, the defence investment universe is becoming increasingly difficult to define through conventional sector classifications alone. For investors, the key question is therefore no longer limited to which defence companies may benefit from higher military budgets, but rather **which parts of the broader security ecosystem, including many other sectors, are best positioned to capture this long-term structural trend.**



04

Sustainable investment and defence

Historically, the defence sector was widely excluded from sustainable investing frameworks, due to its association with weapons production and other ethical concerns. The evolving geopolitical environment and, in particular, the Russia-Ukraine conflict, has however prompted a more nuanced debate.

At its core, the argument in favour of allowing some parts of the defence sector within sustainable investment frameworks is that, in a more fragmented and unstable world, defence and security capabilities can help protect democratic institutions, critical infrastructure and economic resilience. **Defence investments** – particularly those linked to resilience, cybersecurity and dual-use technologies – may play a necessary role in supporting broader social stability.

This shift in view is reflected in investor sentiment. As we discussed in a [recent publication](#), most respondents to our 2026 client survey thought that higher levels of defence investment would be necessary; they were also highly pessimistic on geopolitical stability, trade and resource competition.

Ongoing **policy and regulatory discussions** also suggest a change in attitude. In Germany, a National Security and Defence Industrial Strategy¹² paper has argued, for example, that ESG considerations must be reconciled with the sector's need for access to financing and capital markets. The European Commission has also clarified that the EU sustainable finance framework does not impose explicit restrictions on financing and investing in conventional defence activities.¹³ But concerns remain, with the Dutch financial regulator cautioning against counting defence as part of a sustainable investment and stressing the importance of clear and transparent client disclosures.

We do not expect a full reclassification of defence as “sustainable” but expect moves towards a more **flexible and pragmatic approach**, where ESG frameworks are adapted to incorporate security-related considerations without abandoning core ethical and governance principles and with certain weapons categories (e.g. cluster munitions, landmines, biological/chemical weapons) remaining generally incompatible under ESG standards for Article 8 and 9 funds.

Among banks and asset managers, while the traditional model of blanket exclusion still exists, it is giving way to more granular frameworks, where investors continue to exclude specific defence activities on ethical or client-mandated grounds.

Investors may also still adopt tighter **standards** than regulators. For example, while the EU's Sustainable Finance Disclosure Regulation (SFDR) imposes disclosure requirements regarding controversial weapons (via Principal Adverse Impact indicators), the broader legislative and regulatory framework (as noted above) does not deem investments in the defence sector as inherently incompatible with ESG criteria. In theory, this permits investment into conventional – and in some cases, nuclear – weapons, provided that stringent disclosure, governance, and “Do No Significant Harm” criteria are met. In practice, however, many financial institutions maintain stricter internal standards than those legally mandated. For example, the Norges Bank Exclusion List, a widely recognized global benchmark, excludes many defence firms due to their involvement with nuclear weapons, despite the current European regulations not explicitly mandating the exclusion of nuclear arms makers from sustainability funds. In practice, most sustainability funds have their own rules to exclude controversial weapons according to international treaties and conventions – such as those covering anti-personnel mines or cluster munitions.



Changing perceptions around defence are increasingly reflected in **actual portfolio allocations**. According to research from Morningstar Sustainalytics,¹⁴ European ESG investors have significantly increased their exposure to Aerospace & Defence companies since Russia's full-scale invasion of Ukraine. Between late 2021 and early 2025, the average exposure of actively managed European ESG equity funds to the sector increased from approximately 0.5% to 1.9% of portfolio assets, while exposure among passive ESG strategies rose from around 0.2% to 0.6%. (By comparison, defence exposure in non-ESG European equity funds rose to approximately 2.3% among active strategies and 1.7% among passive strategies over the same period.)

According to Morningstar, approximately 43% of European ESG equity funds now hold some exposure to Aerospace & Defence companies, compared with around 56% among non-ESG funds. The increase has been largely concentrated among Article 8 funds, while Article 9 funds (as might be expected, given their explicit sustainable investment objectives) remain substantially more restrictive in their approach to defence-related investments. Morningstar Sustainalytics estimates that 92% of Article 8 funds continue to apply exclusions on controversial weapons, although only 31% exclude military contracting more broadly.

A profound technical hurdle however remains largely unaddressed: the tension between increasing defence exposures and meeting **portfolio decarbonization targets**. Conventional military hardware is inherently carbon-intensive, and the defence sector is one of the most difficult to align with Paris Agreement pathways to reduce carbon emissions. This is encouraging a selective focus, amongst some sustainable investors, on defence firms that are actively developing dual-use transition technologies, such as hybrid tactical propulsion and sustainable aviation fuels (SAF) for military transport.

Conclusion

The investment case for defence rests on an increasingly fragmented global landscape marked by strategic competition, geopolitical uncertainty and growing concerns over economic and technological sovereignty.

Against this backdrop, defence spending is increasingly being treated as a **structural policy priority** rather than a cyclical budget item. Global military expenditure has risen for eleven consecutive years and reached USD2.9tn in 2025, with Europe emerging as one of the fastest-growing regions.

The transformation of warfare is also **expanding the defence ecosystem** into areas such as AI, cybersecurity, semiconductors, satellite infrastructure, communications systems, advanced manufacturing and critical materials providing investment opportunities across a much broader set of industries, many of which operate on a dual-use basis serving both civilian and military markets.

Traditional European A&D companies remain however at the centre of the current rearmament cycle, with consensus forecasts currently suggesting they could deliver **earnings** growth of around 20% annually between 2026 and 2028, substantially above the broader European equity market. The sector's recent consolidation appears to have been driven primarily by multiples rather than a deterioration of the underlying outlook.

The debate surrounding **sustainability** and defence is also evolving, with a growing belief that security should be considered a prerequisite for long-term social and economic stability and thus not seen as inherently incompatible with sustainable investing frameworks.

In short, the defence sector and the wider security ecosystem it supports appear well positioned to benefit from sustained public investment, continued technological innovation and a growing recognition of security as a cornerstone of economic resilience and long-term prosperity.

05



Appendix

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Appendix

Glossary

- Aerospace & Defence (A&D)** covers the industries that develop aircraft, spacecraft and military systems.
- Artificial intelligence (AI)** refers to computer systems that perform tasks associated with human intelligence.
- Compound annual growth rate (CAGR)** is the annualised rate of growth over a period longer than one year.
- Directed Energy Weapons (DEWs)** use focused energy, such as lasers or microwaves, against a target.
- Earnings per share (EPS)** is a company's profit attributable to each outstanding share.
- Environmental, social and governance (ESG)** describes factors used to assess a company's non-financial risks and practices.
- European Defence Agency (EDA)** supports cooperation among European countries on defence capabilities.
- European Union (EU)** is a political and economic union of European member states.
- Fiscal year (FY)** is the annual reporting period used for a government or company budget.
- Gross domestic product (GDP)** is the total value of goods and services produced in an economy.
- Intelligence, surveillance and reconnaissance (ISR)** covers the collection and analysis of information for military decisions.
- Mergers and acquisitions (M&A)** are transactions that combine companies or transfer ownership of a business.
- North Atlantic Treaty Organization (NATO)** is a defence alliance of member countries in Europe and North America.
- Price-to-earnings ratio (P/E)** compares a company's share price with its earnings per share.
- Principal Adverse Impact (PAI)** refers to negative effects of investments on sustainability factors under EU disclosure rules.
- Rare earth elements (REE)** are a group of metals used in magnets and other advanced technologies.
- Research and development (R&D)** is work undertaken to create or improve products, processes or technology.
- Research, Development, Test and Evaluation (RDT&E)** is a US defence budget category for developing and testing new capabilities.
- Return on invested capital (ROIC)** measures the return a company earns on capital invested in its operations.
- Sustainable aviation fuel (SAF)** is aviation fuel made from eligible non-conventional feedstocks to reduce lifecycle emissions.
- Sustainable Finance Disclosure Regulation (SFDR)** sets EU disclosure requirements for financial products and sustainability risks.
- Ukrainian hryvnia (UAH)** is the national currency of Ukraine.
- US Dollar (USD)** is the currency of the United States and a major global reserve currency.
- Year on year (YoY)** compares a measure with the same period in the previous year.
- Year to date (YTD)** covers the period from the start of the calendar year to the stated date.



Appendix

Historical performance

	11.10.21 – 11.10.22	11.10.22 – 11.10.23	11.10.23 – 11.10.24	11.10.24 – 11.10.25	11.10.25 – 11.10.26
MSCI World	-20.0%	24.7%	31.2%	15.6%	19.0%
MSCI World Aerospace & Defence Index	-8.9%	20.8%	42.0%	45.0%	-2.9%
MSCI Europe	-11.1%	20.8%	18.6%	11.4%	15.4%
MSCI Europe Aerospace & Defence Index	-8.3%	45.8%	38.6%	80.5%	-3.7%
Gold	-4.9%	11.9%	42.1%	50.8%	4.4%

Source: Deutsche Bank AG, Bloomberg Finance L.P., LSEG Datastream; Data as of October 11, 2026.



Appendix

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