INVESTING IN EUROPEAN DEFENCE

iShares by BlackRock

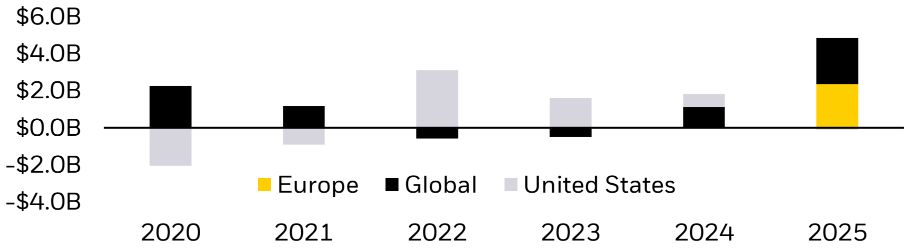
May 2025

Quick read

We see a strategic opportunity today in European defence, with the sector poised for structural growth despite a strong showing YTD. Yet a selective approach is key, in our view, to unlocking access to potential winners across the European defence equity stack.

The European defence sector has been in focus this year, against a backdrop of geopolitical fragmentation and positive policy tailwinds. Events in 2025 have accelerated a departure from decades of steadily-rising globalisation, with blocks and regions increasingly prioritising national security and resilience over economic efficiency. This has played out in the European defence space, where a shifting geopolitical landscape and continuing conflict in Russia and Ukraine have supercharged moves to increase the region's strategic autonomy – including the introduction of major fiscal packages. This stimulus is one reason investors have been reallocating to European equities – including strong flows into European aerospace and defence ETPs, with a record $2.6B added YTD.

Chart 1: Investors surge into European defence
Cumulative flows into aerospace and defence ETPs by region, 2020-2025



Source: BlackRock and Markit, as of 23 May 2025.

Investing in defence...

...in Europe

DFEU	**iShares Europe Defence UCITS ETF**

...with our broader range

DFND	**iShares Global Aerospace & Defence UCITS ETF**
LOCK	**iShares Digital Security UCITS ETF**

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Defence has been the best-performing sector in Europe since the Ukraine war began in February 2022, but it firmly stepped into the spotlight this year – returning 71.5% YTD, outperforming the global sector by 39.9% and US defence by a historic 55.1%. This has come against a backdrop of elevated equity volatility with little compensation in 2025 – global returns have been flat, and the VIX hit its highest level since March 2020 in April (though levels have since normalised).[1]

Defence stocks have rerated significantly since 2022 – currently trading at 32.3x P/E – albeit from a low base, given decades of underinvestment in the sector. In May, European defence stock prices returned to March highs on positive rearmament newsflow. Yet the surge has come with higher growth: EPS has risen 50%, vs. just 10% for the broader market.[2] Our Fundamental Fixed Income team notes that the bottom-up case validates rising prices: companies in the sector see revenue growth of 4-5x over the next 3-5 years – a scale-up that aligns with even the most conservative estimates of future government spend.[4] Coupled with fiscal capacity (see below), this supports the view that the rally to date is grounded in reasonable estimates. As we gain clarity on how recently-announced European defence funding will be allocated, we could see derating on materially higher EPS expectations.

While potential for a Russia-Ukraine ceasefire could lead to some profit taking in the near term, we do not expect a significant reduction in headline geopolitical risk. Any tactical pullback may thus offer an opportunity to add structural allocations, as rising defence spending will remain a catalyst.

Policy tailwinds

The case for greater defence spending across individual European nations varies, with Germany and Poland best-positioned to significantly boost defence budgets, according to our Fundamental Equity team. Yet broader Europe has come under increasing pressure to spend more on defence, with widespread acknowledgement that NATO's current 2% of GDP target for member states is insufficient.

[1] **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** See p.3 for 5Y annualised returns. Source: Bloomberg, as of 28 May 2025. [2] Source: Bloomberg, Barclays, May 2025. [3] Source: Barclays Research, as of 12 March 2025. [4] Source: BlackRock Fundamental Equities, as of 19 May 2025.

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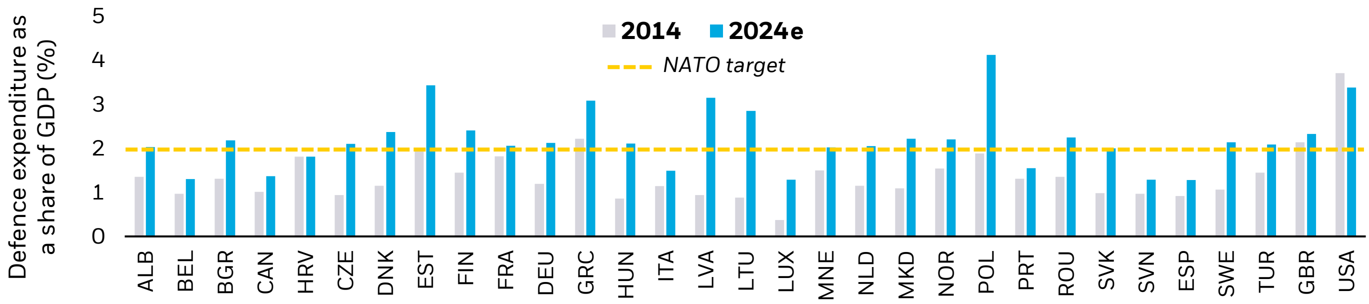
Chart 2: An upward shift in defence spending

NATO member states – defence spending as a share of GDP, 2014 & 2024e (%)



Source: NATO, as of 12 June 2024. Note: figures for 2024 are estimates.

Nearly all NATO member states' defence expenditure has trended higher over the past decade (see chart 2) – and we see room to run. A potential increase in the spending target is on the agenda for June's NATO summit, and could be a further tailwind for the sector. In May, NATO Secretary-General Mark Rutte proposed raising the target to 3.5% of GDP, alongside a further 1.5% to broader security-related spending – which aligns with the latest projections from our Fundamental Equity team. An increase to 3.5% spending levels in Europe, with equipment expenditures rising from 32% to 40%, could mean c.$140B of additional equipment spend – a 110% uplift.[5]

Moves to raise spending will be supported by major fiscal packages announced this year by the EU and Germany. In March 2025, the European Commission introduced Readiness 2030, aiming to mobilise up to €800B to enhance the EU's defence capabilities and boost Europe's strategic autonomy. Among other measures, the plan includes temporarily suspending EU budget rules to allow member states to increase defence spending without breaching debt limits and Security Action for Europe (SAFE), a €150B loan instrument that will help countries invest jointly in defence initiatives. The recent EU-UK security and defence pact, announced in May, paves the way for UK defence names to benefit from this fiscal impulse. Germany has also enacted a historic fiscal rewiring this year, which included exempting defence spending above 1% from the country's debt brake and raising the annual defence budget from €52B to over €60B from 2025 for at least five years.

These fiscal packages support sustained investment in European defence on a strategic horizon, alongside decreasing international spillage across the defence stack as supply chains and procurement rewire.

Investing in Europe for the long term

We see a strong opportunity to invest in European defence - but selectivity and granularity will be key. Our flagship European defence ETF, the **iShares European Defence UCITS ETF** (**DFEU**), offers Europe-only, specialised exposure to the companies driving European defence via the STOXX Europe Targeted Defence Index, including notable allocations to Rheinmetall, BAE Systems, Leonardo, Saab, and Dassault – key suppliers of European countries that have recently increased defence expenditure, such as Germany, France, Sweden and the UK, as well as high spenders such as Poland. DFEU's tiered revenue screening index methodology ensures at least 65% of constituents derive high revenues (51-100%) from military equipment and services.

Defence has historically been a catalyst for innovation in engineering and technology – and we see this trend at play today, with cutting-edge defence and cybersecurity tech coming online in Europe. While the US still leads in defence innovation, our Fundamental Equity team notes that European investment is growing, particularly in areas like autonomous vehicles and underwater technologies. The STOXX Europe Targeted Defence Index's methodology includes companies with a market capitalisation of €200m+, for a diversified blend of exceptional large-, mid-, and small-cap allocations. This allows DFEU to provide exposure to companies at the forefront of innovation (such as autonomous defence systems and robotics from QinetiQ) as well as established household names (like aerospace and weapon systems from Leonardo and Thales). This approach may also help to 'future-proof' the exposure, adding flexibility to include other sectors, for a more comprehensive and dynamic defence allocation.

DFEU may also be used to help close a gap in European portfolios. Despite the strong flows we've seen into defence ETPs so far this year, our analysis of EMEA client portfolios shows that nearly 82% are underweight defence relative to MSCI Europe.[6] Given the opportunity set in European defence today, we see scope to increase these levels through an allocation to targeted strategies such as DFEU.

The landscape of defence investment and investment restrictions is rapidly developing across Europe as the region focuses on its strategic autonomy. To enable investors to stay invested in the sector as it evolves, DFEU applies screens for controversial weapons and ensures holdings are aligned with UNGC criteria.

Investing in defence with iShares

Investors can build exposure to the aerospace and defence sector using our **iShares Global Aerospace & Defence UCITS ETF** (**DFND**) or take a complementary digital lens on defence with our **iShares Digital Security UCITS ETF** (**LOCK**), which is Article 8, suited to investors with sustainable investment objectives.

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[5] Source: Barclays Research, as of 12 March 2025. [6] Source: BlackRock, Morningstar, 187 EMEA moderate risk multi asset portfolios tracked through Q1 2025, with holdings as at 31 March 2025.

5Y annualised returns (%)

	2020	2021	2022	2023	2024	2025 YTD
European defence	-22.33	10.55	27.27	44.99	45.67	71.47
Global defence	-16.20	9.18	12.36	17.27	16.68	31.61
US defence	-17.59	11.45	15.50	5.09	12.39	16.38
Global equities	15.90	21.82	-18.14	23.79	18.67	5.08

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Source: Bloomberg, as of 28 May 2025. Based on net total returns for the STOXX® Europe Total Market Defense Capped (European defence), S&P Developed BMI Select Aerospace & Defense 35/20 Capped (global defence), S&P Aerospace & Defense Select Industry (US defence) and MSCI Daily TR Net World (global equities) indices.

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Concentration Risk, Counterparty Risk, Equity securities, ESG risk (benchmark screening)

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Concentration Risk, Counterparty Risk, Emerging Markets Risk, Equity securities, Investment in Technology Securities Risk, Liquidity Risk, Smaller Companies

iShares Global Aerospace & Defence UCITS ETF USD (Acc)
Concentration Risk, Counterparty Risk, Equity securities

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Emerging markets are generally more sensitive to economic and political conditions than developed markets. Other factors include greater 'Liquidity Risk', restrictions on investment or transfer of assets, failed/delayed delivery of securities or payments to the Fund and sustainability-related risks.

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The value of equities and equity-related securities can be affected by daily stock market movements. Other influential factors include political, economic news, company earnings and significant corporate events.

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