

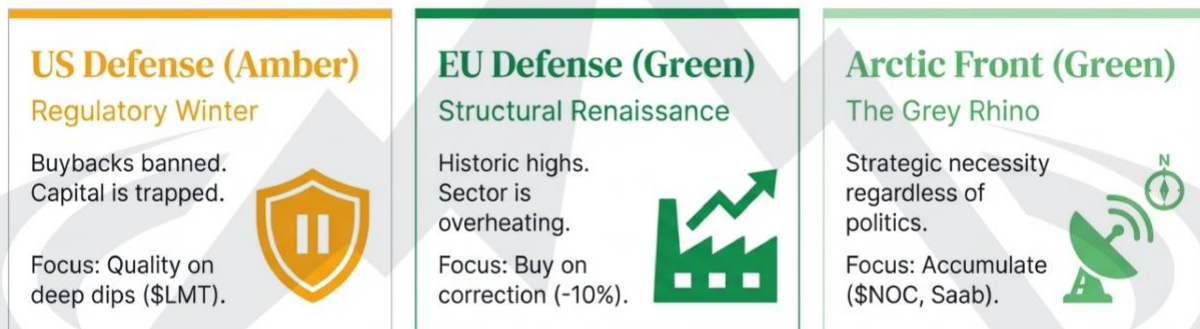
The Great Divergence: Why Europe’s Defense Sector is Winning Where America Is Faltering

MoatPeak — Independent Research

1. Executive Summary

At MoatPeak Research, we see a tectonic shift unfolding in the global defense industry—a shift that is driving a clear divergence between the fortunes of American and European defense contractors. We believe understanding this change is essential for anyone allocating capital to the sector over the next decade. (see Figure 1)

Executive Summary: The Decision Engine View



The MoatPeak Take: The easy money in the 'War Trade' is over. Capital is rotating. We are moving from a cycle of broad accumulation to a cycle of precision: avoiding US political noise and capitalizing on European infrastructure and the Arctic frontier.

Figure 1. Executive summary: the decision-engine view on US vs. EU defense and the Arctic Front

Key takeaway: We see a structural split forming: US defense faces policy-driven constraints, while Europe’s rearmament cycle is becoming secular.

This divergence came into sharp focus after a series of Truth Social posts by former President Trump on January 7, 2026, which culminated in a policy directive that directly targeted the capital return policies of U.S. defense companies. In our view, that decision fundamentally altered the investment case for the U.S. defense sector. (see Figure 2)

The Catalyst: January 7, 2026

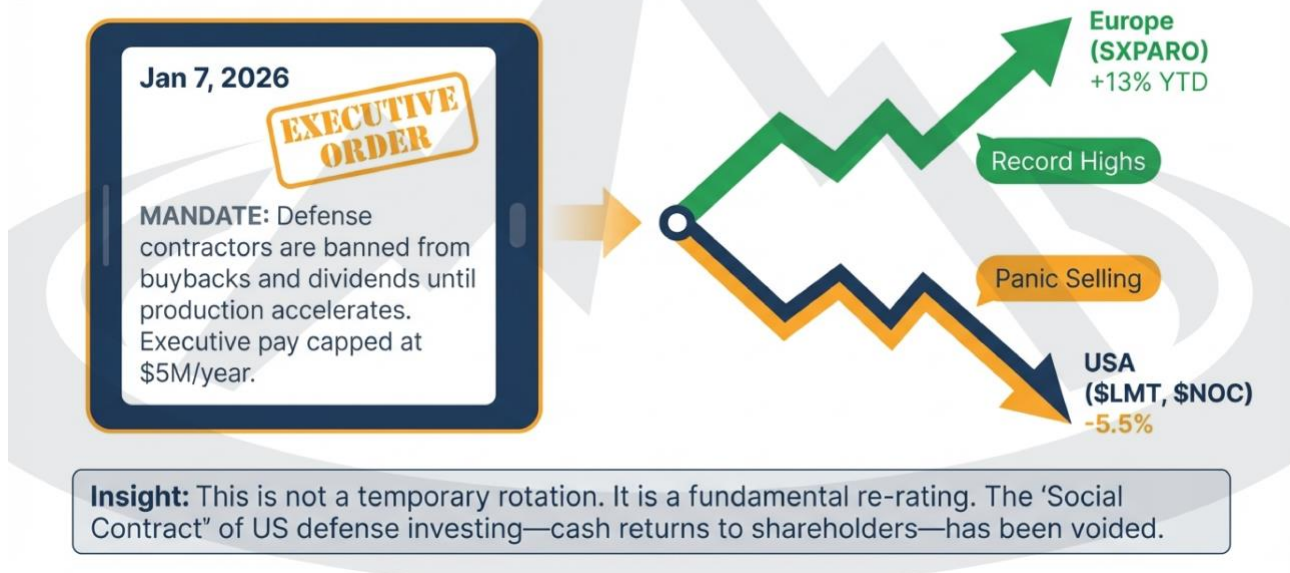


Figure 2. The catalyst (Jan 7, 2026): policy shock drives US selloff and EU defense outperformance

Key takeaway: The market reaction was immediate: US primes were repriced on capital-return restrictions, while Europe extended a structurally supported rally.

The market’s response was instant and emphatic. In the very next session, U.S. defense bellwethers such as Lockheed Martin (LMT), Northrop Grumman (NOC), and Raytheon (RTX) sold off sharply. At the same time, the STOXX Europe Aerospace & Defense index (SXPARO) surged to a record high, extending a rally that has lifted it more than 260% since February 2022. In this report, we unpack the structural forces behind this divergence and share MoatPeak’s framework for navigating the new landscape.

At the core of the U.S. story lies what we call the paradox of the **“Dream Army.”** On paper, the Pentagon is proposing a historically large budget of **\$1.5 trillion**. Yet that headline number is now tied to strict limits on share buybacks and dividends—the very tools that have made U.S. defense contractors a cornerstone for income-focused institutional investors. If left unchanged, this approach risks turning these companies into **quasi-state-owned enterprises with private risks**, alienating the capital base that has supported them for decades. (see Figure 3)

The US Trap: The Paradox of the ‘Dream Army’

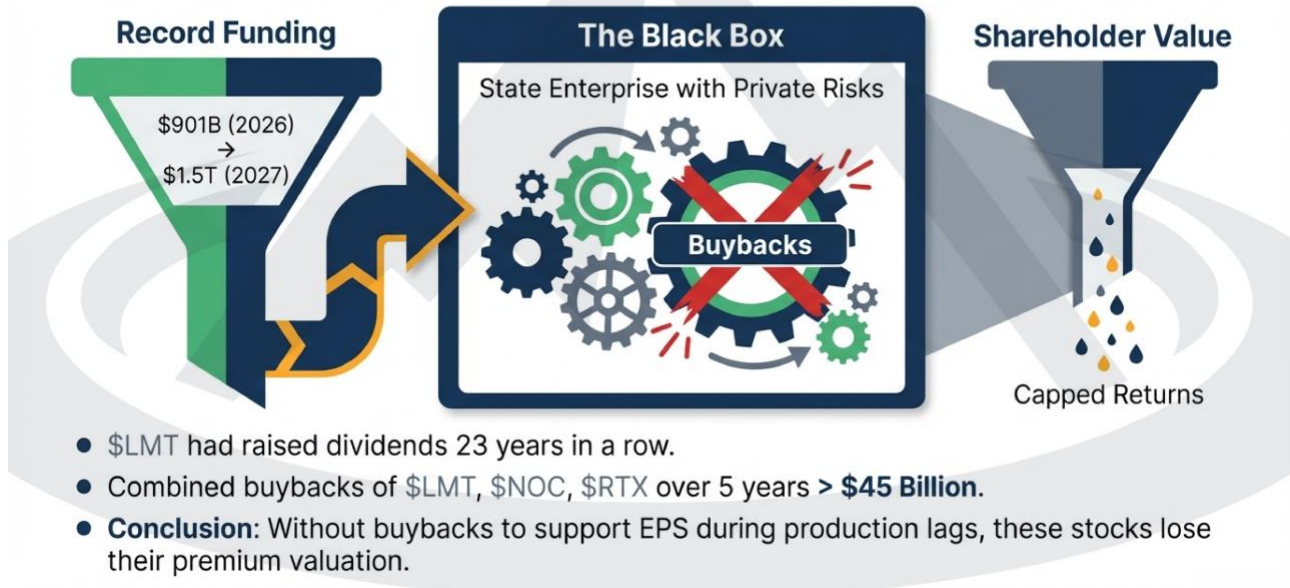


Figure 3. The US trap: record funding paired with capped shareholder returns

Key takeaway: A larger Pentagon budget does not guarantee shareholder value if buybacks/dividends are constrained and production risk rises.

In sharp contrast, Europe is in the midst of a structural transformation. The war in Ukraine and newly formalized NATO spending targets have shifted defense from a cyclical line item to a long-term strategic priority. We see this as a secular rearmament cycle—one underpinned by broad political consensus—that is creating a multi-decade tailwind for the European defense industry.

Rheinmetall (RHM) has become the flagship symbol of this European renaissance, boasting a formidable order backlog and an aggressively expansionary growth plan. However, we believe its current valuation reflects extreme optimism and offers an important case study in the risks of blindly chasing momentum.

We also introduce what we call the “**Arctic Front**”—an underrated but durable geopolitical theme that, in our view, will generate substantial demand for specific defense capabilities and create opportunities on both sides of the Atlantic.

Our goal in this report is to provide a clear, practical framework that investors can use to identify those opportunities and manage the growing risks in an increasingly complex and divergent global defense market.

2. The Impact on U.S. Markets: A Golden Cage

From our perspective, the current U.S. defense landscape is a textbook example of a critical principle: **a record budget does not automatically translate into higher shareholder returns**. Instead, the new political reality has created what we describe as a “**golden cage**” for American contractors—unprecedented spending paired with policies that fundamentally erode their appeal to investors.

The “**Dream Army**” **paradox** sits at the center of this dilemma. A proposed **66% increase** in the U.S. defense budget to **\$1.5 trillion** would, under normal circumstances, be a powerful catalyst for the sector. Yet this top-line growth is accompanied by severe restrictions on capital returns. Under the new policy, any company receiving Pentagon contracts is barred from buying back its own shares or paying dividends until it both accelerates production and reduces the cost of weapons. On top of that, top executive compensation is capped at **\$5 million** a year.

We see this as the creation of a new and highly unattractive paradigm: a “**state-owned enterprise with private risks**”—companies enjoying record contracts while their shareholders are denied the traditional financial upside.

The market recognized the implications immediately on January 7. Investors swiftly repriced the sector:

Lockheed Martin (LMT): Fell 4.8% Northrop Grumman (NOC): Fell 5.5% Raytheon (RTX): Fell 2.5%

To put that into perspective, Lockheed Martin alone shed roughly **\$6 billion** in market capitalization in a single session. We do not read this as a routine pullback; we see it as a fundamental reassessment of the sector’s risk and reward profile.

Historically, the investment appeal of U.S. defense names has rested on the reliability of their capital return programs. They have been stalwarts of **dividend growth and aggressive share repurchases**:

Lockheed Martin has raised its dividend for 23 consecutive years and deployed about **\$20 billion** on buybacks over the last five years. Northrop Grumman has spent roughly **\$15 billion** on repurchases in the same period. Raytheon has returned over **\$10 billion** via buybacks in the last five years. General Dynamics (GD) has built a long record of consistent dividend growth.

In our view, the new policy effectively ends the “**era of financial engineering**” for the U.S. defense sector. By constraining the primary mechanisms for returning excess cash to shareholders, the administration has drastically reduced the sector’s appeal for income-focused institutions. Revenue may grow, but the **pathway to shareholder value has been deliberately narrowed**—especially when we compare it with the far more investor-friendly setup now emerging in Europe.

3. The European Renaissance: From Cyclicity to Structural Growth

While U.S. contractors wrestle with political and regulatory drag, we see Europe’s defense industry entering a **decade-long structural upcycle**. Our analysis leads us to believe this is not a transient spike driven by a single conflict. Rather, it is a **profound strategic realignment** that provides a powerful and durable tailwind. (see Figure 4)

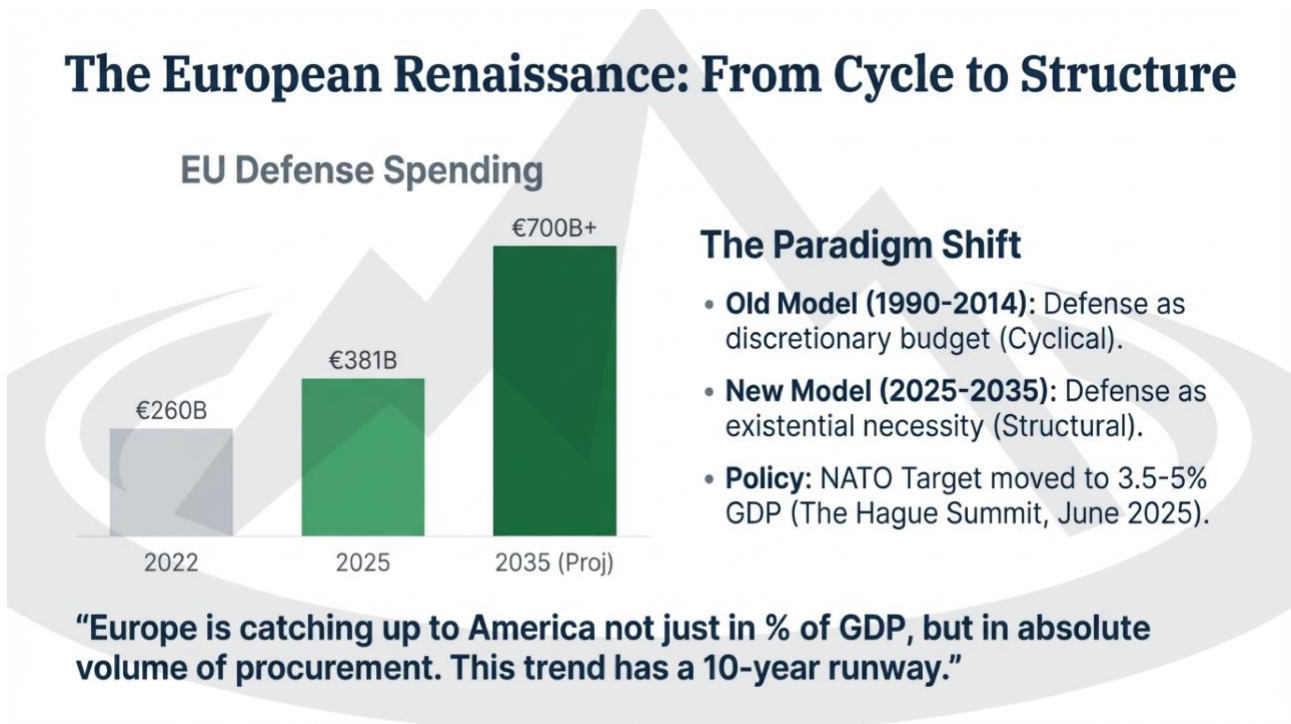


Figure 4. Europe’s defense renaissance: spending shifts from cyclical to structural

Key takeaway: We view Europe’s rearmament as a multi-decade tailwind, anchored by formalized targets and political consensus.

Market performance already reflects this shift. The **STOXX Europe Aerospace & Defense index (SXPARO)** has recently reached a fresh all-time high of **3,029 points**. Its performance has been remarkable:

+73% over the last 12 months. Over +260% since Russia’s full-scale invasion of Ukraine in February 2022.

Behind this rally is a tectonic change in how European governments think about security. For decades after the Cold War, defense spending was treated as a **cyclical and discretionary expense**, often drifting down toward **1.4–1.5% of GDP**. The war in Ukraine has decisively ended that mindset. We estimate European defense spending has already climbed from **€260 billion in 2022** to about **€381 billion in 2025**.

We believe this is still only the beginning. In June 2025, NATO members agreed on a new target: **5% of GDP on defense and related infrastructure by 2035**. This breaks down into **3.5%** for nuclear and combat capabilities, and **1.5%** for infrastructure, resilience, and the defense industrial base. If realized, this implies a potential **doubling of European defense outlays** over the next decade, to an annual budget in the **€700–800 billion** range.

This long and visible investment cycle is something we have not seen in generations. Just as important, it is anchored by a **broad and durable political consensus**. Germany, Poland, Denmark, and the Baltic states, among others, are embedding higher defense outlays into their long-term fiscal frameworks. For us, this confirms that Europe's rearmament is **structural, not cyclical**, and it stands in sharp contrast to the policy-driven uncertainty now weighing on the U.S. sector.

4. Sector Deep Dive: Key Players and Emerging Fronts

To truly benefit from the great divergence we are describing, we believe investors must move beyond index-level exposure and examine how individual companies and emerging geopolitical themes are positioned. In this section, we highlight the most prominent players and the critical new fronts we see shaping the industry.

4.1 Rheinmetall (RHM): The Right Company at the Wrong Price

Rheinmetall has become the **go-to vehicle** for investors looking to ride the European defense boom. Operationally, the company's momentum is impressive. In the first nine months of 2025, revenue grew **20%**, its order backlog reached a record **€64 billion**—equivalent to roughly **seven years of current revenue**—and management has set out a bold plan to grow revenue fivefold to **€50 billion by 2030**, implying a **37.2% compound annual growth rate**. (see Figure 5)

Deep Dive: Rheinmetall (\$RHM)

The Business (Bull)



Backlog: €64 Billion (7 years visibility).



Expansion: 13 new plants (Lithuania, Romania, Hungary).



Growth Target: €50B revenue by 2030 (CAGR 37.2%).

The Price (Bear)



P/E Ratio: 100.4x (Sector median 22.5x).



EV/EBITDA: 55x.



Valuation Gap: Fair Value ~€718 vs Price €1,889.

MoatPeak Verdict

Great company, wrong price. Avoid buying at the top of the hype cycle. Wait for the dip (€1,400-1,600 zone).

Figure 5. Rheinmetall deep dive: growth momentum versus valuation and execution risk

Key takeaway: Rheinmetall's operational momentum is real, but today's valuation leaves limited margin of safety if execution slips.

However, when we look at the valuation, we see a much more sobering picture. The market is paying a substantial premium for this growth story:

Metric	Rheinmetall (RHM)	Sector Median
Trailing P/E Ratio	100.4x	22.5x
EV/EBITDA	55.0x	14.0x
PEG Ratio (Forward)	2.24x	4.0x - 7.0x (U.S. peers)

Our conclusion is that **RHM is an outstanding business currently trading with no margin of safety.** The share price assumes near-flawless execution of an extraordinarily ambitious expansion plan that includes building **13 new factories at once.**

Our DCF work suggests a fair value of around **€718 per share**, which implies a potential downside of roughly **-62%** from the recent market price of **€1,889** if any material execution missteps occur. At today's levels, we see an unattractive risk/reward profile for fresh capital. In our view, a more compelling entry zone is likely to emerge in the **€1,400-€1,600** range, once an inevitable correction takes some of the froth out of the name.

4.2 The Arctic Front: The Geopolitical Theme You’re Overlooking

We believe the **strategic militarization of the Arctic** is one of the most durable—and underappreciated—themes in global defense today. As climate change opens new shipping routes and access to untapped natural resources, the Arctic is rapidly becoming a new arena of great-power competition. (see Figure 6)



Figure 6. The ‘Arctic Front’: geography-driven demand for surveillance and defense capabilities

Key takeaway: We view the Arctic as a durable, regime-agnostic demand theme that can drive sustained procurement regardless of the political cycle.

Key locations such as **Greenland’s Pituffik Air Base**—home to a critical U.S. early-warning radar—and the **GIUK Gap** (the maritime chokepoint between Greenland, Iceland, and the UK) are gaining outsized strategic importance in this evolving theater.

Russia has already been investing heavily in Arctic infrastructure, including new bases, airfields, and naval assets. In response, NATO is reinforcing its northern flank. Denmark alone has committed **\$8.77 billion** to Arctic defense, which includes new vessels, drones, and an expanded fleet of **F-35 fighter jets**.

We see this as the beginning of a **multi-decade demand cycle** for specialized capabilities. Among the key corporate beneficiaries, we would highlight:

- Lockheed Martin (LMT) as the manufacturer of the F-35.
- BAE Systems, Saab, Kongsberg, and Thales as critical suppliers of radar, missile defense, and naval systems.

- Northrop Grumman (NOC) as a prime contender for contracts tied to early warning systems under the proposed “Golden Dome” missile defense architecture. This modern program carries a total budget of \$175 billion, with \$25 billion already earmarked in the 2026 budget. (see Figure 7)

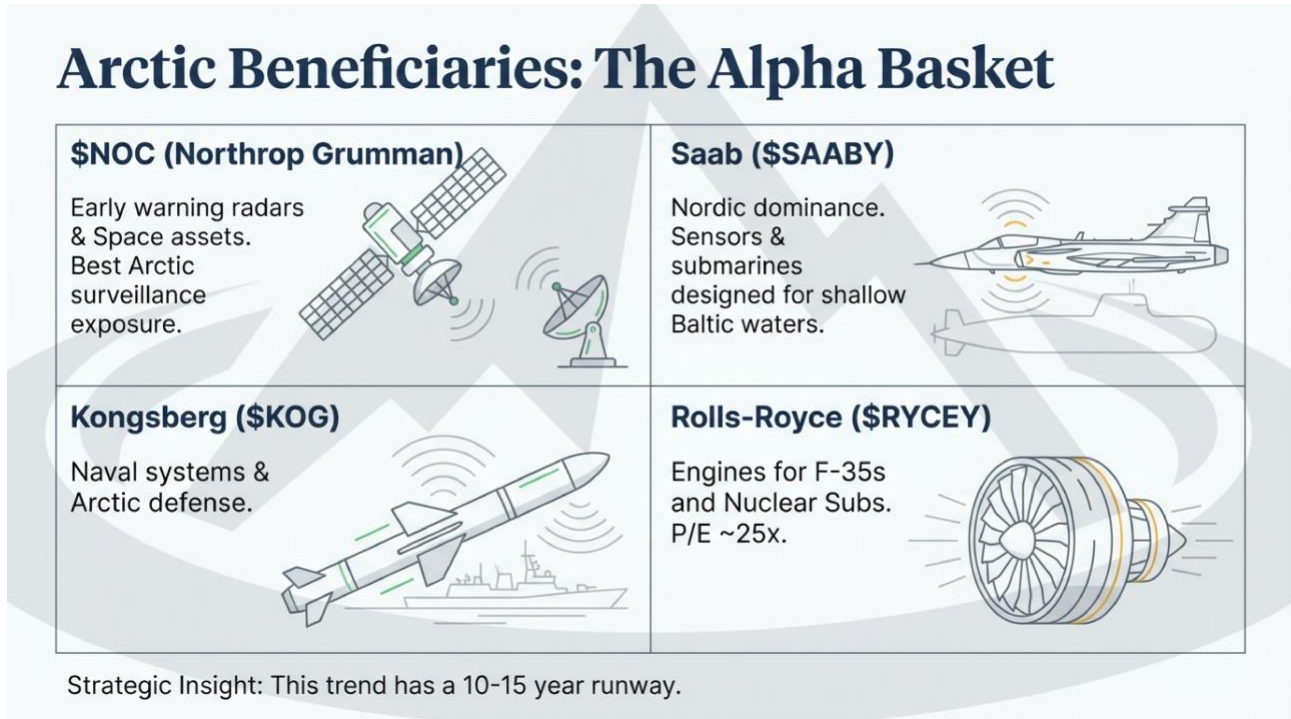


Figure 7. Arctic beneficiaries: a focused basket for surveillance, naval systems, and propulsion

Key takeaway: Exposure is best expressed through beneficiaries with direct ties to radar/early warning, naval systems, and platform propulsion demand.

4.3 U.S. Incumbents: Navigating Political Headwinds

Even beyond the executive order on capital returns, we see the U.S. defense sector wrestling with deeper structural issues—most notably **skilled labor shortages** and the legacy of decades of **over-consolidation**, which has reduced competition and eroded flexibility. (see Figure 8)

Structural Friction in the US Industrial Base

Why an Executive Order cannot print engineers.

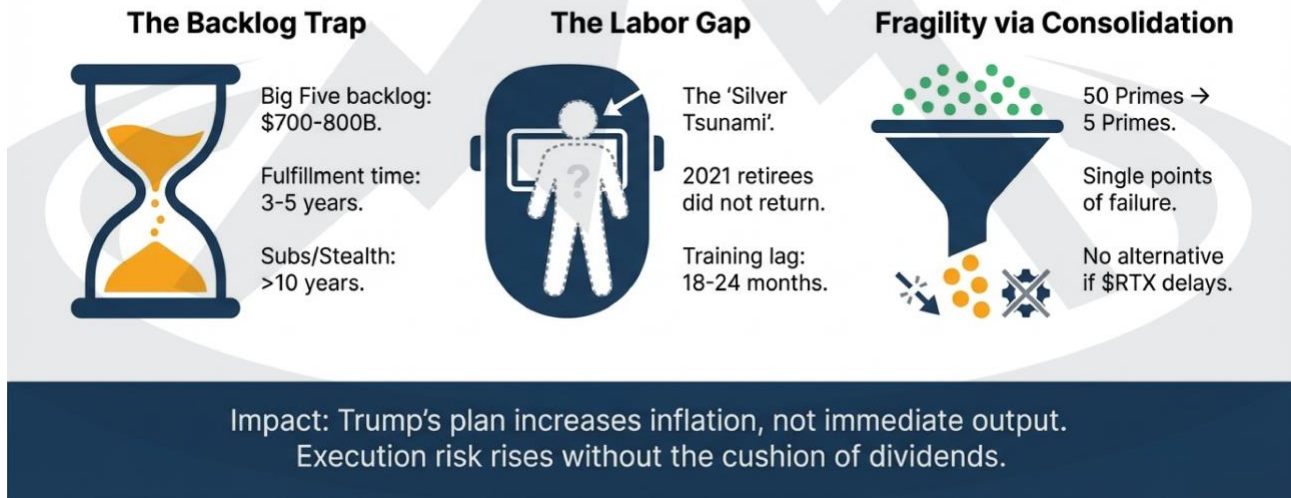


Figure 8. Structural friction in the US industrial base: backlog, labor constraints, and consolidation risk

Key takeaway: Execution risk rises when output must accelerate into bottlenecks; constraints in labor and supply chains can lengthen delivery timelines.

Our current views on the major U.S. primes are as follows:

- Raytheon (RTX), in our assessment, looks the most exposed in the near term, having been singled out publicly by the administration and placed directly in the political firing line.
- Lockheed Martin (LMT) remains a high-quality long-term compounder with an attractive dividend. We believe the most effective approach is to accumulate on weakness, especially during bouts of peak political noise.
- Northrop Grumman (NOC) offers, in our view, the most favorable risk/reward among the U.S. large caps, supported by a more reasonable valuation and strong positioning in structurally attractive segments such as space and missile defense.

5. “Gray Rhinos”: What the Market Is Currently Ignoring

We use the term “**Gray Rhino**” to describe a threat that is both highly probable and high impact, yet often underappreciated until it is suddenly upon us. In a sector that can oscillate between euphoria and panic, we believe recognizing these risks is essential for responsible capital allocation.

At MoatPeak, we currently see five such Gray Rhinos that could disrupt the prevailing defense investment narrative: (see Figure 9)

Risks & Invalidation Points



RSI Overheating

EU Stocks (SXPARO) at RSI 75+. Historically precedes a 10-20% correction.



Execution Risk

Can \$RHM actually build 13 factories on time? Logistics stretch is high.



Peace Talks (The Ukraine Factor)

A ceasefire causes an immediate -15% correction in EU defense stocks. “Buy the rumor, sell the peace”.



The China Shock

Supply chain dependency. Asian semiconductor shock would paralyze EU production.

Figure 9. Risks and invalidation points: overheating, execution, geopolitics, and supply-chain shocks

Key takeaway: We see a meaningful risk of near-term drawdowns in Europe and idiosyncratic execution shocks—position sizing and patience matter.

European Sector Overheating. Technical signals indicate that European defense equities are stretched. The **RSI for the SXPARO index near 70–75** has historically preceded corrections. We see a **10–20% near-term pullback** as highly likely as investors lock in profits—an environment that would, in our view, offer far more attractive entry points for long-term buyers.

Rheinmetall’s Execution Risk. Orchestrating the simultaneous build-out of **13 new plants across multiple jurisdictions** is a formidable operational challenge. A delay at even a single critical facility—whether due to permitting issues or labor constraints—could undermine the company’s growth guidance and spark a **20–30% correction** in the share price.

The China Factor. A military crisis over Taiwan would represent a dual shock. On the one hand, it would unleash a powerful surge in global demand for munitions and advanced systems. On the other, it would almost certainly cause a **severe supply chain disruption**, especially in semiconductors and other critical components sourced from Asia. For European contractors, that combination of booming orders and constrained inputs could paralyze production for months.

E.U. Political Fragmentation. The current pro-defense consensus in Europe is broad, but not immovable. Upcoming elections in major economies such as Germany and France carry the risk of ushering in coalitions that are more fiscally conservative or less committed to high defense outlays. A policy reversal in Berlin or Paris alone could materially undermine the entire European growth story.

A “Frozen” Conflict in Ukraine. A ceasefire or frozen conflict in Ukraine—however temporary—would likely be interpreted by markets as a reduction in immediate threat. We would expect to see a rapid rotation out of defense and into more cyclical or growth sectors, potentially resulting in a **swift, sector-wide drawdown of up to 15%**.

6. Our Scenarios & Probabilities (2026–2028 Horizon)

As investors, we try to resist the temptation to search for certainty. Instead, we work in probabilities. For the next 24–36 months, we map the defense sector through three primary scenarios, each with its own catalysts and portfolio implications. (see Figure 10)

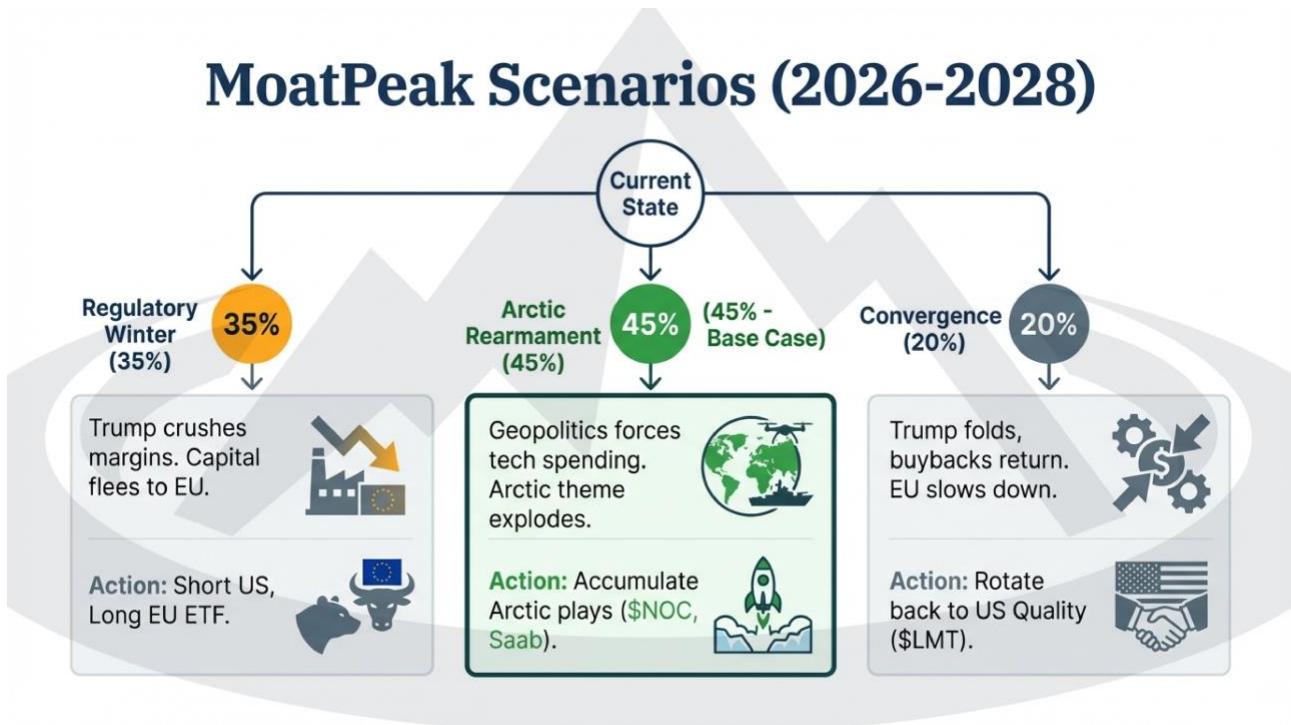


Figure 10. Scenario map (2026–2028): base case, regulatory winter, and convergence

Key takeaway: Our base case assumes Arctic-linked rearmament persists; tails are defined by US policy escalation or a European slowdown.

Base Case: “Arctic Rearmament” (45%)

In our base scenario, rising tensions in the Arctic—for instance, a high-profile incident involving a Russian submarine—drive urgent demand for new defense systems across NATO. This incremental geopolitical pressure partly offsets the negative impact of Trump-era restrictions on capital returns, and markets begin to focus more on top-line growth than on payout constraints. Key milestones would include the **NATO Steadfast Defender 2026** exercises and the formal launch of the “**Golden Dome**” program.

In this environment, we would hold a **neutral weighting in U.S. defense overall**, while **overweighting Arctic-focused beneficiaries** such as **NOC, Saab, and Kongsberg**, and using dips below **\$520** to add to **LMT**.

Alternative 1: “Regulatory Winter in the U.S.” (35%)

In a colder scenario, the Trump administration follows through fully on its threats—blocking buybacks and dividends for major contractors and escalating public confrontations with industry leaders. A highly visible incident, such as **the revocation of a major RTX contract** or a televised clash between the White House and a defense CEO, could accelerate a broad-based exodus of institutional investors from the U.S. defense complex.

Here, we would look to **underweight U.S. primes** and increase exposure to **European defense ETFs** such as **WisdomTree Europe Defence UCITS (WDEF)** or the **Future of Defence UCITS ETF (NATO)**, as we expect capital to continue flowing across the Atlantic.

Alternative 2: “The Great Convergence” (20%)

In our third scenario, political realities in Washington force a partial rollback of the harshest restrictions, allowing capital returns to resume at more modest levels. Simultaneously, Europe’s rearmament wave encounters fiscal constraints and slows. As a result, the valuation gap between U.S. and European contractors begins to close.

A ceasefire in Ukraine or a new German government prioritizing debt limits could act as key catalysts. In such a setup, we would look to **take profits on richly valued European names** and **reallocate into high-quality U.S. contractors on weakness**, prioritizing reliable dividend payers like **LMT and NOC**.

7. Our Core Thesis: Invest in Structure, Not the Cycle

After reviewing the data, policy dynamics, and company fundamentals, we arrive at a central conviction: **Europe’s defense sector has entered a multi-decade structural growth phase, while the U.S. sector is trapped in a politically induced cycle that undermines its long-term appeal.**

On the surface, simple trailing P/E comparisons might suggest U.S. names are cheaper. Yet, when we look through a forward lens—especially through the **PEG ratio**—we see a very different story. **Rheinmetall’s PEG of 2.24x** is, despite its elevated headline multiples, meaningfully more attractive than the **4x–7x range** we see for U.S. peers, whose growth is forecast to be in the low single digits. In our view, the critical question is not **“Is Rheinmetall expensive?”** but **“Can Rheinmetall execute its plan?”** If it can, we believe its premium valuation will be justified. (see Figure 11)

The Tale of the Tape: US vs. EU Giants

Metric	Lockheed Martin (\$LMT)	Rheinmetall (\$RHM)
P/E Ratio	30.2x	100.4x
Dividend Yield	2.46%	0.43%
Backlog Visibility	~5.2 Years	~7 Years
PEG Ratio	High (Low Growth)	2.24x (High Growth)

The Trade-Off:

- **US = Value Trap?** (Cheap but capped returns).
- **EU = Priced for Perfection?** (Expensive but high growth).

Note: \$RHM's PEG ratio suggests it may be cheaper relative to growth, despite the high P/E.

Figure 11. US vs. EU giants: valuation trade-offs between capped returns and priced-for-perfection growth

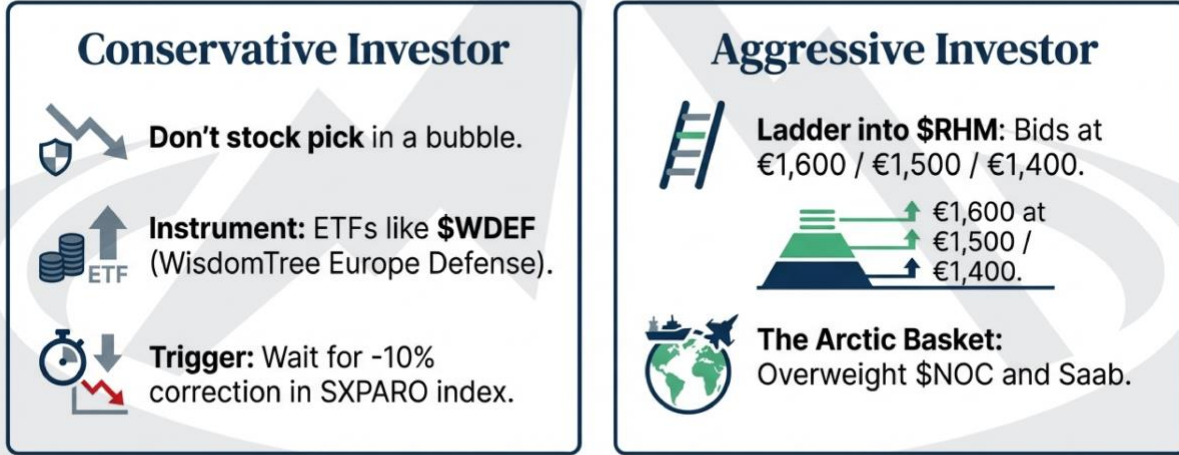
Key takeaway: The opportunity is in dispersion: US quality may be discounted on politics, while Europe is rewarded for structural growth but can be overextended.

This is where the most compelling opportunities often lie: at points of pronounced divergence. Today's market is characterized by **overpriced momentum in Europe** and **undervalued quality in the U.S.**, with the latter weighed down by what we see as transitory political risk. By disentangling **structural trends** from **cyclical noise**, we believe investors can position themselves to benefit from both sides of this great divergence.

8. What This Means for Your Portfolio

In this final section, our objective is to convert our institutional research into a clear, usable roadmap for portfolio construction. We frame our guidance around different investor profiles while keeping one unifying principle in mind: let structure, not headlines, drive your decisions. (see Figure 12)

The Synthesis: How to Allocate Capital



AVOID: \$RTX (Raytheon). Specifically targeted by Trump; too much political risk.

Figure 12. Portfolio synthesis: implementation framework by investor profile

Key takeaway: We prefer staged entries—buy Europe on correction, add US quality on fear—and keep an Arctic allocation as a structural theme.

For the Conservative Investor. If you prefer to avoid single-stock risk, we see **diversified ETFs** as the most prudent route. Our preference is to wait for a **10–15% correction in the SXPARO index** before initiating a position in a European-focused vehicle such as the **WisdomTree Europe Defence UCITS (WDEF)**. As a blended alternative, the **Future of Defence UCITS ETF (NATO)** offers roughly **60% U.S. and 40% European** exposure, smoothing regional risk while still capturing the core themes we have outlined.

For the Growth-Oriented Investor. Rheinmetall (RHM) offers one of the most compelling growth stories in the sector—but, in our view, **timing matters enormously**. We would resist the temptation to chase the stock at elevated levels. Instead, we advocate building a position gradually during a correction, aiming for an **average entry near €1,500** to tilt the risk/reward balance more decisively in your favor. For those seeking European growth with **less valuation stretch**, we see **Hensoldt and Saab** as attractive alternatives, given their lower multiples and strong exposure to high-demand radar and sensor technologies.

For All Investors.

We believe three universal principles apply regardless of risk profile:

- **Maintain Arctic Exposure.** The militarization of the Arctic is, in our view, a durable, multi-decade theme. We recommend maintaining exposure through a diversified basket of companies such as NOC, Saab, and Rolls-Royce.

- Be Patient with U.S. Stocks. Treat periods of peak political tension and negative headlines as a source of opportunity, not just risk. Use those moments to add high-quality names like LMT and NOC when their long-term value is temporarily obscured by short-term fear. (see Figure 13)

The Watchlist

Ticker	Status	Action Level
\$LMT	WATCH (Value Trap)	Buy < \$520 (Yield Support)
\$NOC	BUY (High Conviction)	Accumulate at current levels (Arctic Play)
\$RHM	WATCH (Overbought)	Wait for €1,500-1,600
\$SAABY	BUY	Market price (Strategic positioning)
\$RTX	AVOID	Political uncertainty
\$RYCEY	BUY	Value play (P/E 25x)

Focus on Structure, ignore the Noise.

Figure 13. Tactical watchlist: action levels and positioning bias across key tickers

Key takeaway: The playbook emphasizes discipline: define levels for adds/trims and avoid names in the direct political firing line.

If we were to distill our entire thesis into a single strategic message, it would be this: **Buy Europe after a correction, buy the U.S. on fear, hold the Arctic for the long term, and avoid low-quality names caught in between.** And above all, do not obsess over perfect timing. In our experience, investors are better served by **building positions in stages**, using volatility as a tool rather than treating it as a threat. (see Figure 14)

Invest in Structure, Not Cycle.

The US defense sector is currently a hostage of political theater. The European sector is a beneficiary of historical necessity. We do not chase green candles. We wait for the correction in Europe, and we position ourselves in the Arctic—the one front where geography dictates strategy.

Figure 14. Conclusion: invest in structure, not cycle

Key takeaway: In our view, structure—not headlines—should drive allocation: patience on entry and selectivity in exposures are decisive.

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