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INVESTMENT STRATEGY

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US Policy Pulse

Defense on the Fiscal Front Line

In this report, we discuss the evolving defense policy landscape and what it may mean for the economy and financial markets.

Key Insights:

- The US defense budget has grown at a 4.7% annualized rate since 1961 and will account for about 47% of discretionary spending in 2026.
- US defense outlays reached an estimated $954 billion in 2025, more than the next six countries combined and roughly 2.8 times China's spending.
- Still, the US defense budget has not kept pace with the economy. Defense spending has fallen from 6% of GDP in 1975 to 3.1% currently.
- President Trump's $1.5 trillion fiscal year 2027 request represents roughly a 50% increase in defense spending. The House-passed National Defense Authorization Act (NDAA) would raise spending by about 28% from 2026.
- Higher defense spending has historically provided a modest economic boost, and there is a positive correlation between defense spending and the defense industry's market performance.
- Elevated defense stock valuations suggest geopolitical risk and new spending may be priced in, creating a higher bar for execution and adding exposure to post-spending surge normalization, as well as potential post-midterm legislative risks.
- That said, higher procurement, research and development (R&D) and readiness spending may broaden the opportunities beyond prime contractors to software, electronics, shipbuilding, advanced manufacturing and infrastructure providers.

The first two years of the second Trump administration have been largely influenced by the shifting geopolitical landscape and a rise in US military engagement abroad. When layered against the backdrop of rapidly developing technological shifts, supply chain reorganization and growing energy needs, the definition of what is captured in defense spending is expanding. The record budget request from the White House totaling $1.5 trillion for defense and national security reflects not just the current administration's policy priorities but also the expectation for continued geopolitical pressure. This suggests that heightened US defense spending is likely a durable trend.

Furthermore, defense spending is also on the rise globally, with the EU, Russia and China notably increasing outlays in the past five years. Because of this evolution, we will discuss the status of defense spending globally, the 2027 National Defense Authorization Act (NDAA) and explore what spending may mean for the economy and financial markets.

Defense Spending: A New Baseline

Bipartisan congressional support has helped push the US defense budget steadily higher for more than six decades. From 1961 through 2026, defense spending grew at a 4.7% annualized rate, rising from $43.5 billion to $891 billion, accounting for roughly 47% of discretionary appropriations today. The US also remains the world's largest defense spender by a wide margin. According to research from the Peter G. Peterson Foundation, US defense outlays reached an estimated $954 billion in 2025, more than the next six countries combined and roughly 2.8 times China's spending (see Exhibit 1).

Exhibit 1: The US Spends More on Defense Than the Next Six Biggest Spenders

Source: Stockholm International Peace Research Institute (SIPRI), Peter G. Peterson Foundation, Morgan Stanley Wealth Management Global Investment Office as of Aug. 28, 2026

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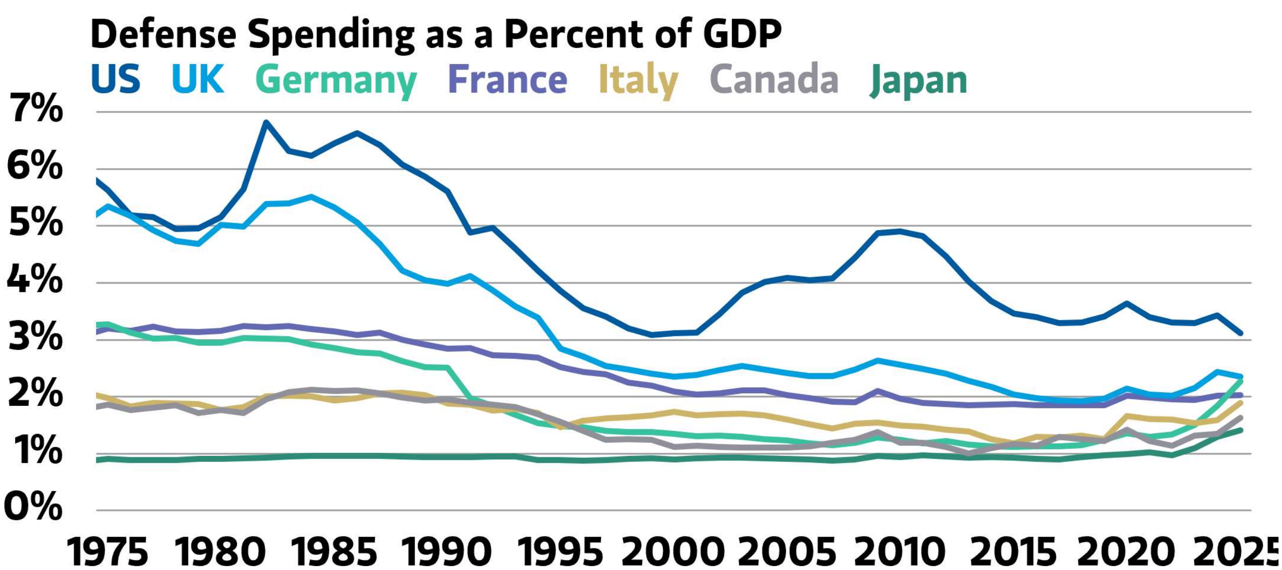
The size of the US defense budget looks different when measured against the broader economy. Defense spending has fallen from roughly 6% of GDP in 1975 to about 3.1% in 2025, even as the US devotes a larger share of GDP to defense than other G7 countries (see Exhibit 2). The current policy proposals would begin to reverse that decline. Morgan Stanley & Co. Research estimates that fulfillment of the president's $1.5 trillion FY2027 request, a 50% year-over-year increase, could lift defense spending back toward roughly 5% of GDP. The House-passed NDAA alone would represent an approximately 28% increase from FY2026, but when combined with supplemental spending it could reach similar levels as the initial budget request.

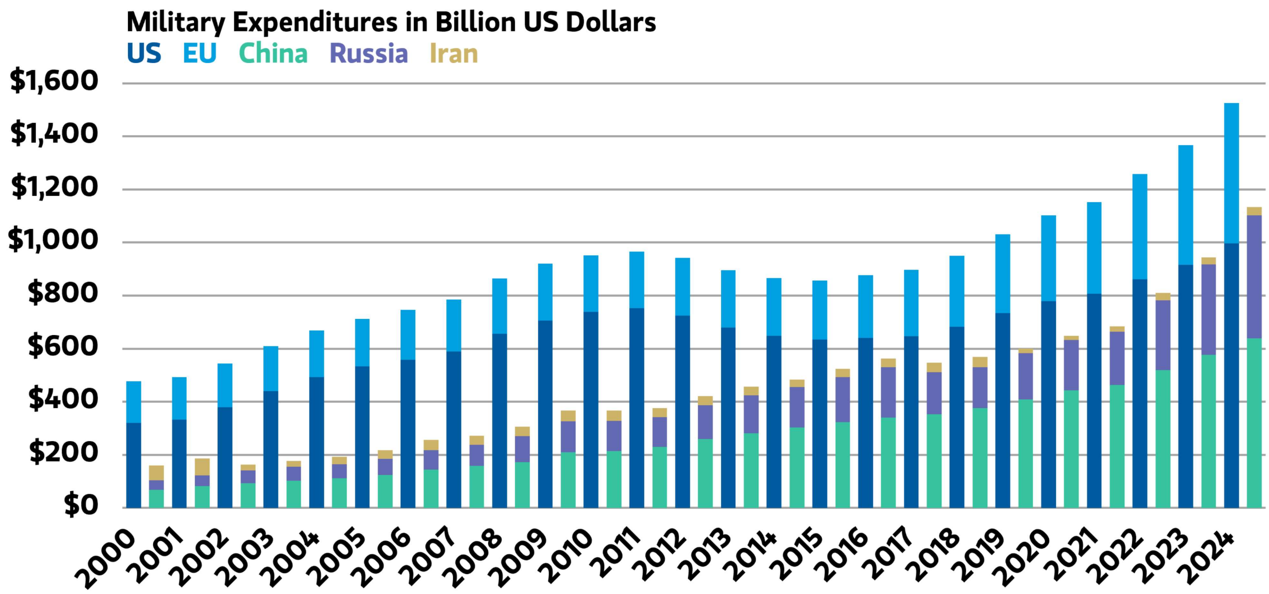
Exhibit 2: US Defense Spending as a Percent of GDP Exceeds Other G7 Countries



Source: Stockholm International Peace Research Institute (SIPRI), Morgan Stanley Wealth Management Global Investment Office as of Aug. 28, 2026

The case for a higher spending baseline also reflects rising domestic and strategic demands. Operational requirements, munitions replenishment, procurement, R&D and an aging defense infrastructure are all competing for resources. The Government Accountability Office (GAO) estimates DoD's deferred-maintenance backlog reached roughly $285 billion in 2025, with deteriorating facilities and equipment contributing to higher costs and a lower level of readiness. At the

Exhibit 3: Pace of US Defense Spending Has Slowed in Recent Years



Source: World Bank, Morgan Stanley Wealth Management Global Investment Office as of Aug 28, 2026

While the US still spends more on defense than any other country, its relative advantage has eroded as defense has declined as a share of GDP, strategic competitors have accelerated investment and domestic modernization needs have grown. These shifts help explain the scale of the current policy response and support our view that higher defense spending represents a structural shift rather than a temporary trend. Defense is also central to our broader "multipolar world" theme. In our January 2025 *AlphaCurrents Macro*, "The New Arms Race," we explored how Great Power competition, technological innovation and defense-industrial-base investment could create opportunities well beyond traditional contractors.

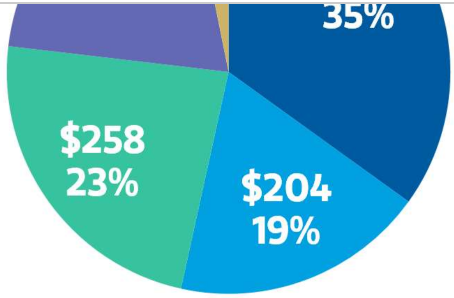
From Defense Spending to Fiscal Impulse

President Trump's FY2027 request would raise total defense funding to roughly $1.5 trillion, including about $1.15 trillion in base discretionary spending and $350 billion through reconciliation. The House has already moved partway toward that level, passing a roughly $1.1 trillion defense authorization, about 28% above FY2026, approaching levels for an annual increase not seen since World War II.

The Senate Armed Services Committee has advanced its own version, but full Senate consideration and eventual House-Senate reconciliation still lie ahead. Importantly, we expect a final version to include marginal changes to the spending bottom line.

Importantly, the House increase is not evenly distributed. The Congressional Budget Office (CBO) estimates that procurement authorization rises by 58% to $258 billion, research and development increases by 52% to $220 billion, operation and maintenance and revolving funds by 16% to $385 billion, and military personnel by 6%, reaching $204 billion. The spending mix is therefore shifting disproportionately toward equipment, next-generation capabilities and rebuilding industrial capacity (see Exhibit 4).

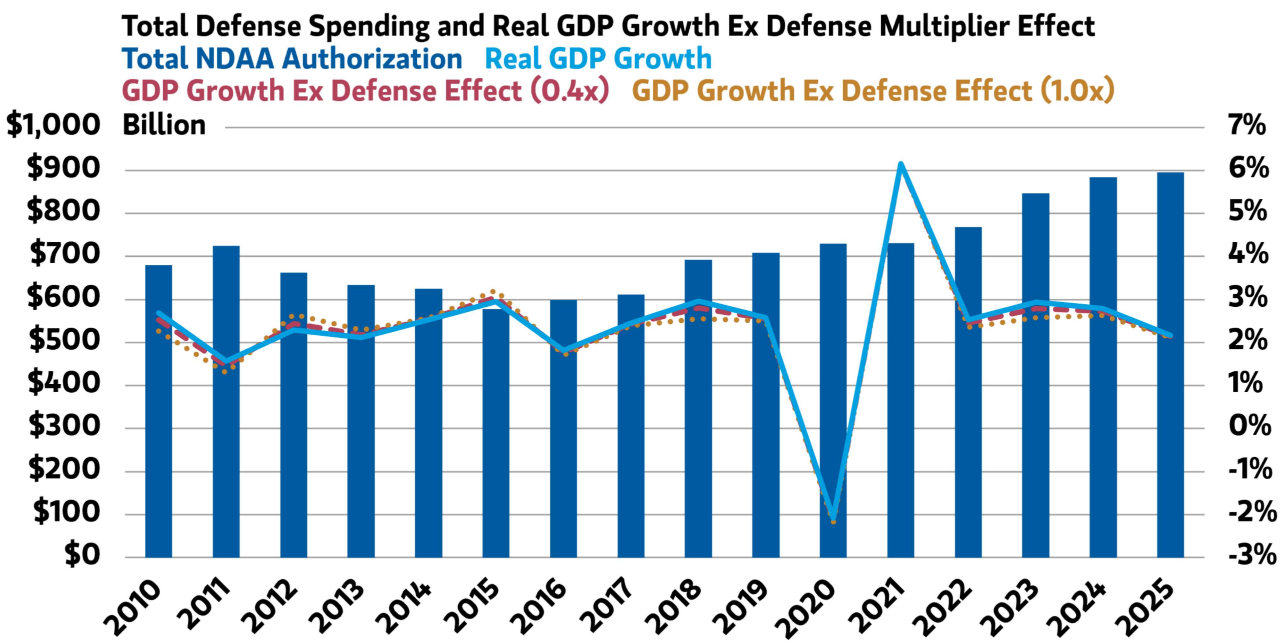
Exhibit 4: The House NDAA Proposal Reaches Historic Spending Levels



Source: Congressional Budget Office (CBO), Peter G. Peterson Foundation, Morgan Stanley Wealth Management Global Investment Office as of Aug. 28, 2026

The economic impact of the bill depends on how quickly authorizations translate into actual outlays. Procurement, R&D and military construction allocations are often spent over several years, spreading the fiscal impulse beyond the initial budget year. Estimates of government or defense spending multipliers vary, but a range of roughly 0.4x to 1.0x provides a useful sensitivity framework. Our analysis suggests defense spending has historically contributed only a few tenths of a percentage point to annual real GDP growth, even during periods of relatively rapid budget expansion (see Exhibit 5). That said, the proposed FY2027 increase is unusually large and the CBO estimates that 89% of associated outlays will occur within the first three years of passage. This suggests a more visible near-term boost to defense-related manufacturing, investment and broader economic activity.

Exhibit 5: Defense Spending Economic Multiplier Is Modest



Source: World Bank, Congressional Research Service, Morgan Stanley Wealth Management Global Investment Office as of Aug 28, 2026

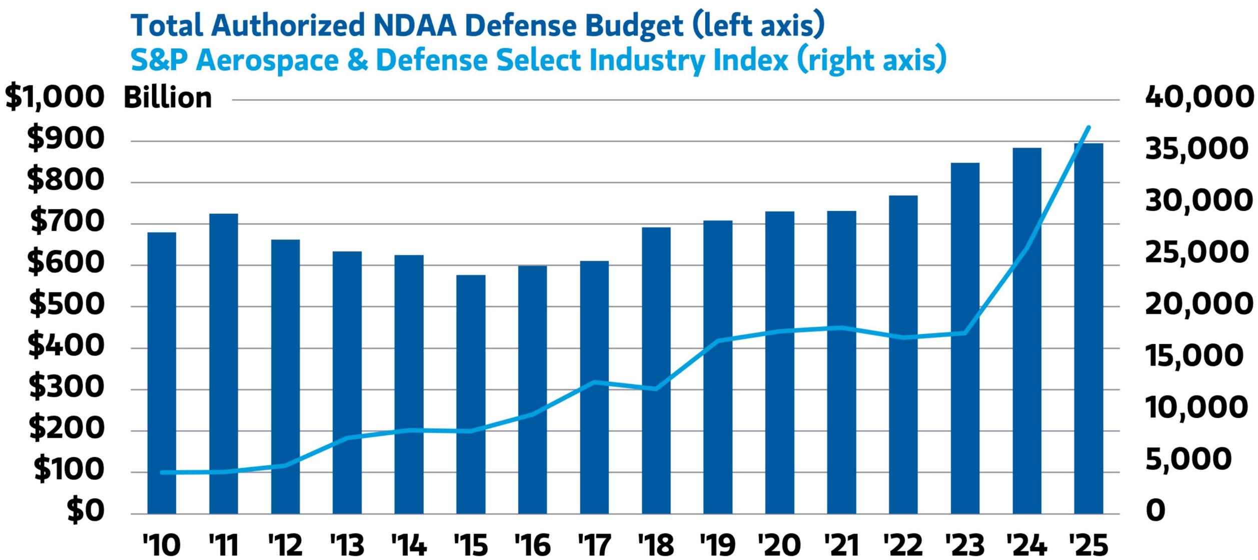
The US enters this defense spending cycle with elevated debt and deficits. Gross federal debt exceeded $40 trillion in August, while the CBO projects the federal deficit at roughly $1.9 trillion, or 5.8% of GDP, in FY2026, rising to $3.1 trillion by 2036. Net interest costs are also projected to rise from roughly $1 trillion today to more than $2 trillion by 2036. While higher defense spending can provide a muted but positive near-term fiscal impulse, the resulting increase in Treasury supply may pressure longer-dated yields and add to bond term premiums (the amount of compensation in the form of yield required by investors to take on related risk).

For investors, that leaves defense spending with two competing macro effects: a positive near-term fiscal and industrial impulse, but a potentially higher long-term cost of capital due to larger deficits, greater Treasury supply and rising debt-service burdens.

provided a more sustained tailwind for sector performance than one-time supplemental appropriations. With FY2027 proposals pointing to a higher spending baseline, the investment focus shifts to where incremental dollars are being sent, which parts of the defense ecosystem stand to benefit most and whether current valuations already reflect that policy support.

Steady bipartisan support for the defense budget has historically helped limit volatility around annual funding cycles. Our analysis of NDAA defense budget spending and the S&P Aerospace & Defense Select Industry Index (SPSIAD) reinforces that relationship, showing a 0.79 correlation between government defense spending and the industry's market performance. Importantly, the analysis excludes contingency appropriations and other supplemental funding tied to wars or national emergencies, suggesting that the more persistent signal for investors has come from growth in the underlying defense budget rather than one-off infusions (see Exhibit 6).

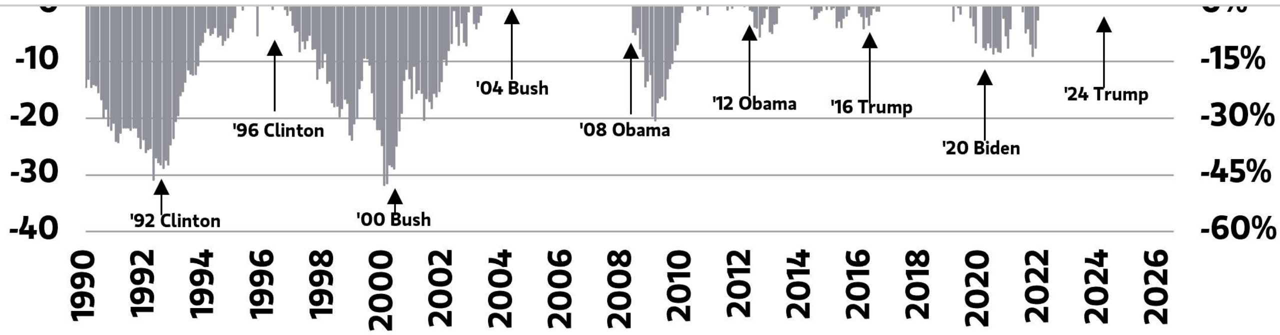
Exhibit 6: Increases to the Defense Budget Support Market Performance



Source: Bloomberg, Congressional Research Service, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2025

While the policy backdrop remains favorable as the FY2027 spending baseline moves higher, the market has already begun to reflect that policy tailwind. Currently, the sector now trades at a notable premium to the S&P 500 on a 12-month price/earnings basis, a reversal from the discounts experienced through much of the 1990s, early 2000s and parts of the 2010s (see Exhibit 7). According to Morgan Stanley & Co. Research, the defense stock premium has surged to 49% from 17% at the beginning of the second Trump administration, indicating that geopolitical risks and additional defense spending may be priced in to performance. While history suggests that relative valuations often remain elevated during periods of sustained defense investment, the current high valuation raises the bar for further gains while also creating opportunities for upside should supplemental spending exceed expectations. The key question now is whether higher defense spending can drive enough demand and stronger earnings to justify current higher valuations.

Exhibit 7: Defense Stocks Now Trade at a Premium to the Market



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Aug 28, 2026

That said, we believe selectivity remains important as investors assess where higher defense spending may have the greatest impact. Procurement, R&D and operation and maintenance account for the largest year-over-year increases in the House-passed defense bill, directing more resources toward equipment recapitalization, next-generation technologies and military readiness (see Exhibit 8). This broadens the opportunities beyond traditional prime contractors to include industries that support the defense supply chain, including software, electronic systems and components, shipbuilding, advanced manufacturing and infrastructure.

Exhibit 8: The Expanding Defense Spending Opportunity Set

House FY2027 NDAA Spending Category	Sector/Industry Beneficiaries
Procurement $258.3 Billion	Missiles and munitions; air and missile defense interceptors; combat aircraft; naval shipbuilding and submarines; unmanned aerial systems; radar and fire-control systems; secure communications hardware; satellite terminals; rocket motors; navigation components; energetic materials; explosives
R&D $219.5 Billion	AI-enabled defense software; drones and counter-UAS; hypersonics; missile-defense technology; space-based sensing; satellite payloads; electronic warfare; advanced radar; secure communications; next-gen propulsion; semiconductors; microelectronics
Operation & Maintenance $384.6 Billion	Aircraft maintenance, repair and overhaul; naval maintenance and repair; depot services; logistics and distribution; IT modernization; cybersecurity services; communications-network support; training and simulation; military-base operations; facilities maintenance

Source: Congressional Budget Office, Morgan Stanley Wealth Management Global Investment Office as of Aug. 28, 2026

While the unusually large FY2027 increase may make another comparable step-up less likely next year, the 2026 midterm elections could add further uncertainty to the spending outlook. A split Congress would make increases meaningfully above the defense budget's historical annual growth rate more difficult to advance and would likely raise the hurdle for supplemental funding. In that scenario, we believe the FY2028 NDAA could remain relatively flat to FY2027 as lawmakers balance national-security priorities against growing fiscal constraints. Importantly, a flatter NDAA would represent a normalization in the pace of authorization growth rather than a reversal in the broader defense investment cycle, with procurement, R&D and readiness needs likely to remain supported within the base budget.

Investment Conclusion

The defense investment story is increasingly shifting from a conflict-driven trade toward a broader capital investment cycle. Geopolitical pressure, depleted inventories, aging infrastructure and rapidly changing military technology have contributed to an unusually large FY2027 fiscal policy response. The House-passed NDAA is increasing authorization by approximately 28% and directing disproportionate gains toward procurement, R&D and operation and maintenance. Historically, sustained increases to the underlying defense budget have mattered more for markets than one-time market, fiscal pressures are rising as federal debt exceeds $40 trillion and the 2026 midterms could make another outsized increase more difficult to achieve. A split Congress could result in a relatively flat FY2028 NDAA and raise the hurdle for supplemental funding, but we would view that as a normalization in the pace of spending rather than a reversal in defense priorities. In our view, this backdrop favors investor selectivity, particularly across industries positioned to benefit from continued procurement, next-generation technology and industrial investment.

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