

Europe: The centre of a global arms race in power, defence and AI

Research & Insights

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For years, the US market has led global equity growth, but soaring valuations now suggest much of the upside is already included in prices. Meanwhile, Europe, having been in the growth doldrums, is stepping into the spotlight with fresh government spending and attractive valuations, fuelling new opportunities. Ausbil's Global Small Cap Team argues that shifting focus to select European companies could unlock unrecognised earnings growth.

10 minute read

Key points

- The US market has dominated global returns for years, driven by low interest rates and large fiscal stimulus post-COVID. We believe Europe is poised for a stronger relative growth.
- US valuations are now elevated, with much of the growth already priced in.
- Europe presents a potentially compelling opportunity due to strong government spending commitments on defence, infrastructure, and power initiatives.
- Local sourcing mandates and geopolitical factors supports the relative growth potential of some European companies, many of which have delivered stellar earnings growth but we believe has been under appreciated by the market.
- Consequently, we have been shifting focus from the US towards Europe to seek to capture this unrecognised earnings growth opportunity.
- Three companies we think provide significant potential in Europe are: R&S Group (Switzerland), AQ Group (Sweden) and Warehouses De Pauw (Belgium).

The US market has been the clear winner for many years, both after the Global Financial Crisis (GFC) and more recently since the COVID-19 pandemic. The low-interest rate environment of the 2010s supported the US market, particularly US technology. Following COVID, significant fiscal spending programs were introduced in the US, including the Infrastructure and Jobs Act (2021), the Inflation Reduction Act (2022), and the CHIPS Act (2022). These initiatives injected substantial fiscal support into the US economy, underpinning investment themes such as US onshoring, artificial intelligence and data centre capital expenditure, and the expansion and up-grading of electricity grids.

We conducted comprehensive analyses of these fiscal spending packages when announced, evaluating their impact on many companies within our market. We focused on companies where we identified strong earnings growth potential at valuations that were still very attractive — what we refer to as unrecognised earnings growth. While the strategy benefited from the growth coming out of the US, the recent geopolitical climate has sparked change across Europe that we believe represents signs of renewed European growth momentum following almost a decade of dormant growth in Europe.



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A shift in direction: Europe reawakening

Ausbil’s view of the US economy is that tariffs will have a downward drag on growth in the near term before growth begins to build again at the end of 2025, and into 2026. We think that the chance of a US recession is lower than the market is ascribing given the mitigating factors discussed below. With the hard monetary tightening undertaken by global central banks in 2022 and 2023, monetary authorities have significant room to stimulate should this be needed. Of course, we will keep a watchful eye on this and make any necessary adjustments as events unfold.

We have analysed three potential tariff scenarios, including a base, mid and severe case. Our base case for which we currently ascribe a 65% probability sees the US economy avoid recession, though suffering a materially weak June quarter of stalling growth, before growth begins to strengthen as the tariff shock is absorbed, and countries negotiate better outcomes. Underpinning this view is a number of assumptions that we think the market has ignored, including faster tariff relief through bilateral negotiation, the US tax reduction and the ‘One Big Beautiful Bill Act’, Federal Reserve rate cuts to support the economy, and targeted assistance through tariff exemptions for key industries critical to the defence sector as part of the industrial military complex.

As illustrated in Table 1, tariffs were the catalyst for Ausbil to lower 2025 growth forecasts for the US to 1.7% (from 2.2%) and global growth to a range of 3.0%-3.3% (from 3.5%). The higher tariff situation confronting China will see the authorities ‘forcibly’ deploy additional expansionary policy measures in meeting their resolute 5% growth target and to alleviate the expected drag to export facing industries. For context, Ausbil still sees Chinese growth at 4.6% for 2025 (unchanged from our forecast made in 2024).

Table 1: Global growth – slower in 2025, improving growth profile into 2026

Real GDP year average %	Long run average 2010 to 2019 (pa)	2025 Ausbil (f)	2026 Ausbil (f)
United States	2.3	1.7	2.1
Japan	1.2	1.1	0.8
Europe/Area	1.4	1.6	1.8
China	7.7	4.6	4.5
India	7.0	6.5	7.0
Australia	2.6	2.0	2.8
Global GDP	3.7	3.0 to 3.3	3.2 to 3.5

Source: FactSet, Ausbil, as at August 2025, (f) denotes forecast.

In the background there are several longer-term structural drivers that are offering growth opportunities that may contribute to new value supply chains across sectors. These include an increased commitment to military spending globally (as the US withdrawal of support for Ukraine and others has sparked an upward shift in defence spending in Europe, Scandinavia and other countries); increased investment in infrastructure to accommodate the growth in artificial intelligence; ongoing investment to secure independent energy security; and the increase in demand for electricity from the electrification of our daily lives. Carbon free energy sources, primarily from renewables, are expected to become the dominant force in global energy systems, reducing reliance on fossil fuels.

About Ausbil Investment Management

Ausbil is a leading Australian based investment manager. Established in April 1997, Ausbil’s core business is the management of Australian and global equities for major superannuation funds, institutional investors, master trust and retail clients. Ausbil is owned by its employees and New York Life Investment Management a wholly-owned subsidiary of New York Life Insurance Company. As at 31 August 2025, Ausbil manage over \$21.5 billion in funds under management.

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The tariff complication. At this stage, the threat of higher tariffs weighs on Europe. Ausbil is still considering a number of scenarios. Our 'baseline scenario' is that the US leaves the current status quo of 10% tariffs in place. This assumes tariffs to remain at the May 2025 level of 10% (except for China at 40%) and that the EU does not retaliate, while China retaliates symmetrically. Ausbil's house analysis of the macro impact shows lower inflation in 2025 and 2026, whilst Real GDP is largely changed.

Our 'mild scenario' is for lower tariffs and a faster unwinding of trade policy uncertainty, and assumes that by the September quarter of 2025 the EU and the United States would reach a deal on eliminating bilateral tariffs. The US would further reduce its tariffs on China, while China would remove all of its retaliatory tariffs against the US, leading to an effective US tariff rate of 13% on all goods and services (China 10%, EU 0%, Canada and Mexico 25% for non-USCMA goods, rest of the world 10% and worldwide sectoral tariffs). In this scenario, the United States and China experience a small impact on growth and inflation. Euro area, GDP growth would be stronger in 2025-26, reflecting the drop in trade policy uncertainty. Inflation would be higher than in the baseline in the latter part of the projection horizon, reflecting stronger activity.

Our final 'severe scenario' would see higher tariffs and more persistently elevated trade policy uncertainty. The severe scenario assumes that US tariffs would return to the elevated levels announced on 2 April and that the EU would retaliate by imposing tariffs on imports of US goods. China tariffs would be at 120% with an effective US tariff rate on goods and services of 28%. The macro impact of this scenario would see US inflation increases by 0.5ppts in 2025-26. US real GDP growth lower by 0.7ppts relative to the baseline in 2026. Euro growth and inflation would be weaker. Euro real GDP would come in at around 0.5% in 2025, 0.7% in 2026 and 1.1% in 2027, cumulatively about 1% below GDP growth in our baseline case, with inflation at 1.8% in 2027 compared with 2.0% in the baseline.

Overall, we expect larger EU defence, larger infrastructure spending and larger fiscal deficits to spur a much stronger recovery path for Europe than expected by the market. This will be supported by modest rate cuts, and our base case scenario for tariffs.

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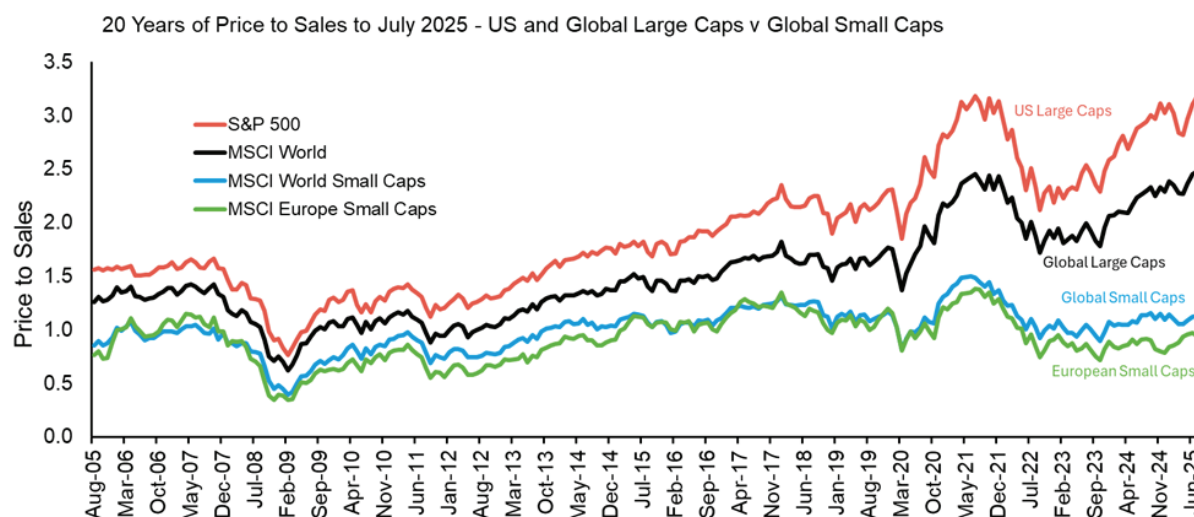
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Transition from Unrecognised to Recognised Earnings Growth

Over the last few quarters, however, valuations in the US have risen to elevated levels relative to both the rest of the world and their own historical averages. While we continue to anticipate robust earnings growth in the US, we now see significantly more potential for unrecognised earnings growth emerging from the European region. For instance, Price-to-Sales valuations for the S&P 500 are near all-time highs (Chart 1), suggesting that much of the robust earnings growth is already priced into US large-cap stocks. Global large caps are also elevated in valuation, both MSCI World and the S&P 500 priced well in excess of MSCI World Small Caps on price-to-sales valuations.

Chart 1: Global small caps show significant potential for a valuation rerate



Source: Ausbil, Bloomberg, data to end July 2025.

Shifting from US to Europe

Toward the end of last year and earlier this year, we began trimming positions and taking profits in US companies that had performed well over recent years. The capital freed up was redeployed into several European companies with strong projected earnings growth. Europe appears compelling when compared to the US for several reasons. First, valuations in the European Union and the UK remain comparatively attractive, especially as US valuations have continued to climb (Chart 1). Second, European governments are now making clear and quantifiable commitments to increase fiscal spending, a significant shift after many years of conservative fiscal policy. This includes significant increases in defence spending, and in related areas like energy, information technology and industrials.

For example, Germany's new government, under Chancellor Friedrich Merz, has initiated a major policy shift aimed at revitalising the economy and enhancing global competitiveness. This strategy combines pro-business reforms with substantially increased fiscal spending. Measures include corporate tax relief amounting to a new EUR 46 billion package, investment incentives, and reductions in bureaucratic hurdles to improve the business climate. Notably, Germany has amended its constitution to relax its stringent "debt brake" rules, allowing for greater public spending. Defence expenditures exceeding 1% of GDP are now exempt from borrowing limits, facilitating increased investment in national security. Additionally, a €500 billion extrabudgetary fund has been created to finance infrastructure projects over the next 12 years, focusing on transport, healthcare, energy, education, research, and digitalisation. Of this, €100 billion is allocated for climate-related investments to support Germany's objective of achieving climate neutrality by 2045. These policy initiatives were passed with a two-thirds majority in the Bundestag, reflecting strong political consensus.

In parallel, European NATO countries, including the UK, have pledged significantly higher defence spending targets in response to ongoing Russian aggression and pressure from the US to boost military expenditures. NATO's new defence spending commitment targets 5% of GDP by 2035, a substantial increase from current spending levels, which typically range from 1% to 2.5%. Of this, 3.5% will be dedicated to core defence expenses such as personnel, equipment, and operations, while 1.5% will support related areas like cybersecurity, infrastructure resilience, and strategic initiatives. The UK, specifically, has committed to reaching the 5% GDP defence spending goal by 2035, with a rapid increase to 4.1% by 2027.

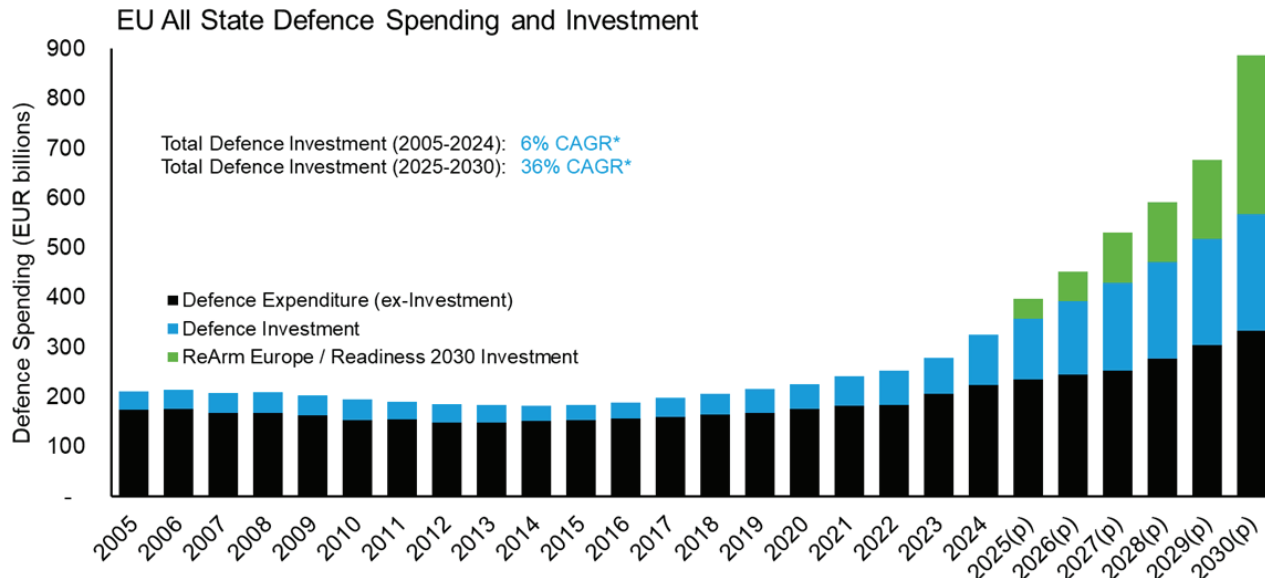
Defence spending and investment by the European Union has been accelerating over many years and is at record levels (Chart 2). Defence spending by EU states increased by more than 30% since 2021, and is expected to increase by at least 30% gain by 2027, or over EUR100 billion. In terms of growth, for the 20 years from 2005 to 2024, defence spending rose at a compound annual growth rate (CAGR) of 2.3%. Though defence spending was contracting between the GFC in 2008/9 and around 2014, it began accelerating again as Russia increasingly became isolated from other developed nations. Since the invasion of Ukraine by Russia in 2022, defence spending by the EU has shown a CAGR of 9.9% based on the projected growth in defence spending to 2027.

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Chart 2: EU defence spending is growing rapidly in the face of threats



Source: European Council, as at 5 August 2025. Note: European Council, as at 5 August 2025. Retrieved from <https://www.consilium.europa.eu/en/policies/defence-numbers/#cooperation>. Projections for defence spending for EU states are EU data but have been applied on a straight-line assumption. Projections for EU defence investment are Ausbil's based on the assumption that the average annual growth rate calculated from between 2021 and 2024 will persist (covering the period of the Russian invasion of Ukraine). The additional EUR800bn for ReArm Europe / Readiness 2030 is apportioned from 2025 to 2030 on an assumed profile for illustrative purposes.

Building on the Versailles declaration of March 2022, and on new defence priorities agreed by the European Council in March 2025, the EU has presented a ReArm Europe plan / Readiness 2030 that will see a surge of an additional EUR800bn in defence spending. This new spending aims to ensure that the "European defence industry can produce material at the requested speed and volume and facilitate the rapid deployment of military troops and assets across and beyond the EU." This is in addition to the spending by EU states.

Opportunities in an emergent Europe

Given the macro backdrop, the outlook for stronger growth in Europe, and more fiscal and defence spending sees Europe at the centre of a global arms race in power, defence and AI. Increases in fiscal and defence spending will have a multiplier effect, delivering positive impacts on the wider European economy and on some European companies in particular. Industrial sectors such as engineering, aerospace, shipbuilding, electronics, logistics and IT stand to benefit significantly. Furthermore, much of the fiscal spending is mandated to remain within European borders wherever possible, which should boost local industries such as steel production, truck manufacturing, and logistical engineering.

Three companies that we think are positioned to benefit as Europe builds out its defences, its electrical grid and energy independence, and its AI and data centre capacity include R&S Group (Switzerland), AQ Group (Sweden) and Warehouses De Pauw (Belgium).

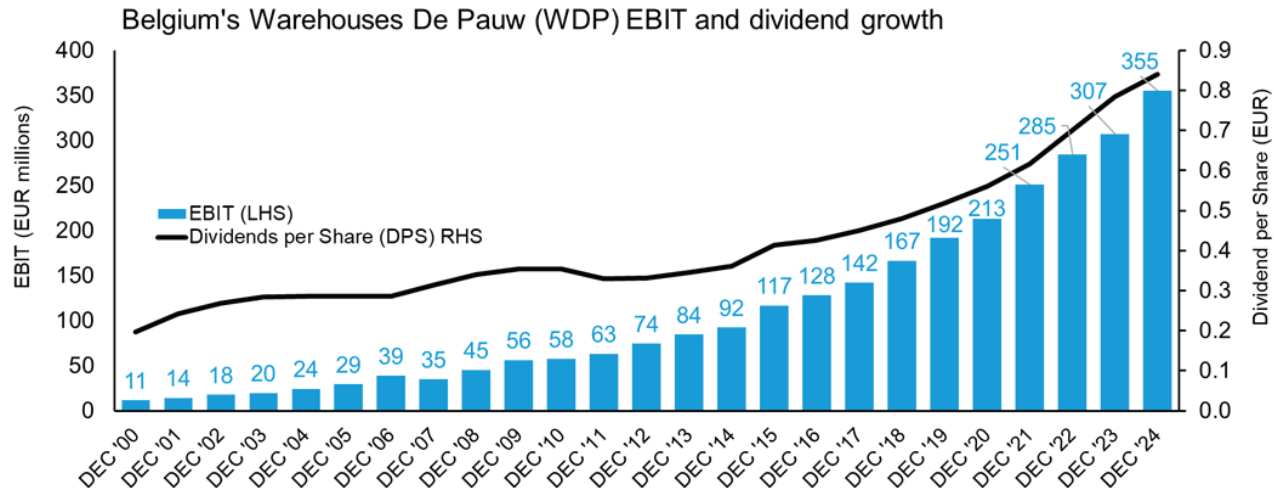
Logistics and warehousing in environment of rising growth

Warehouses De Pauw (WDP) is a real estate investment trust, which engages in the development and leasing of logistic and semi-industrial real estate properties across Europe (Belgium, The Netherlands, France, Germany, and Romania). Real estate investment trusts had a punishing 2022-2024 with restrictive monetary policy and slow growth, however, with the European Central Bank in an easing cycle and the economy rebounding, leaders in logistics like WDP are set to capture upside in business activity and investment. Moreover, lower rates correspond with tighter cap rates which is an additional tailwind for valuations for companies like WDP.

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Chart 3: WDP has a strong track-record of earnings growth



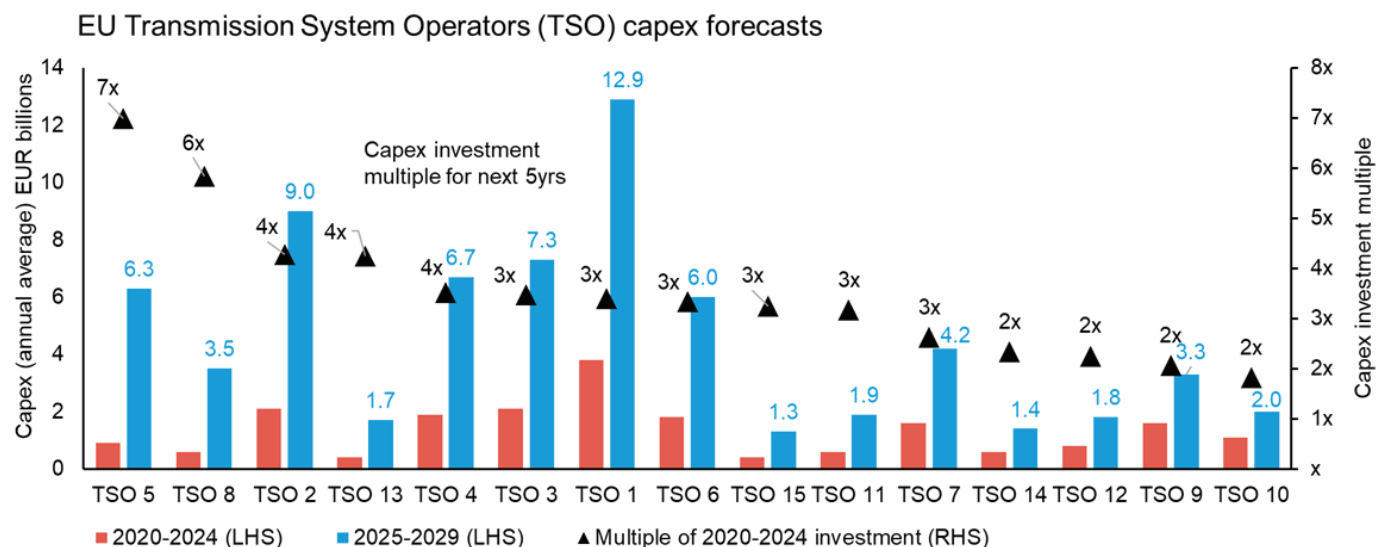
Source: Ausbil, Bloomberg, WDP, as at end June 2025. *CAGR for full years from 2000 to 2024 (does not include 6 months to June 2025). Past performance is not an indicator of future performance.

WDP has produced consistent positive earnings surprises over the last year, and is relatively cheap for the quality of the business, having been neglected by sell-side analysts during the monetary contraction. WDP has generated earnings growth at a CAGR of 15% since 2000, a remarkable achievement. However, with a strong earnings growth outlook in an economy that will spend more, WDP is underappreciated by the market and ripe to generate growth as Europe's GDP expands into 2026.

Power and AI driving secular investment

The EU is witnessing major investment in the electrical transmission network across Europe, with capex investment in the coming five years (2025-2029) at multiples of the level undertaken in the last five years (2020-2024), ranging from 2x to 7x the amount invested previously (Chart 4). This capex spend by EU transmission system operators (TSOs) will benefit companies across the value chain in electrical engineering, services, transformers, transmission and technology.

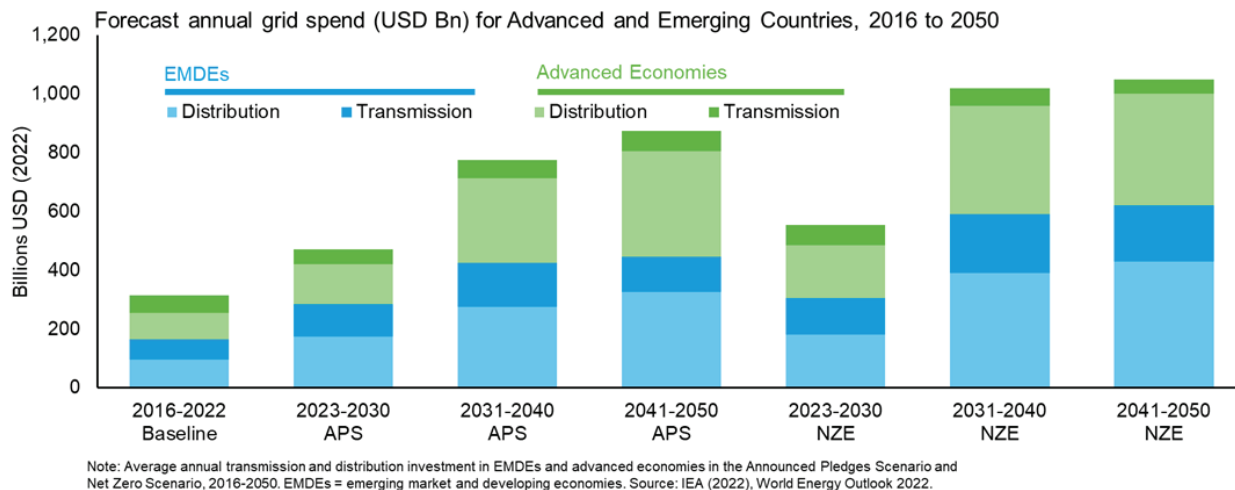
Chart 4: Investment in EU transmission to increase 2x-7x over the next 5-years



Source: Ausbil, S&P Capital IQ, TSO company filings as at end 2024.

Globally, grid expansion for the electrification of things is a major secular growth opportunity (Chart 5). Capex and resources investment on the world's electrical distribution and transmission infrastructure will cost between US\$750 bn to over US\$1 trillion annually, depending on the energy scenarios that play out, in order for the world to meet Net Zero targets. Underpinning the demand for efficiency and electrification is the demand that AI and cloud computing has added to energy demand and transmission capacity.

Chart 5: Global electricity grid investment is an enormous opportunity



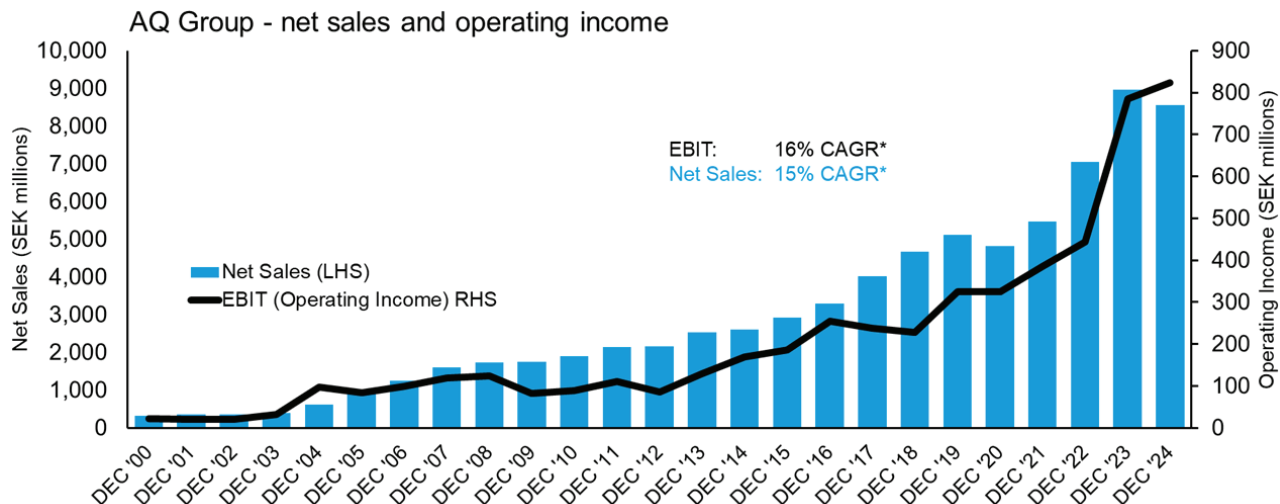
Source: IEA (2022), World Energy Outlook 2022.

Two companies that we have found at that potentially benefit from this boom in capex spend are R&S Group and AQ Group. R&S Group, based in Switzerland, provides electrical infrastructure product, and engages in the business of power distribution transformers, and the supply of components like cast resin and power transformers and medium and high voltage switching devices. R&S also offer specific railway electrification products and industrial electrical connectors, an area that we are seeing as a major beneficiary of increased global trade and activity not just in Europe but also in the US. We see R&S as a major beneficiary of the rebuild in Europe, in fiscal and defence spending.

We believe AQ Group in Sweden is another beneficiary of the re-emergence of European growth. AQ Group engages in the manufacture of components and systems for industrial customers. Their component segment offers transformers, cabling, mechanical solutions, sheet metal processing, and injection moulded thermoplastics. The system segment produces systems, automation, and power solutions, as well as complete machines in close cooperation with customers. AQ Group is another case where we have identified unrecognised growth in a company that has a history of delivering strong earnings growth (16% CAGR since 2000, Chart 6).

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Chart 6: AQ Group, another unrecognised growth story



Source: Ausbil, Bloomberg, to end June 2025. *CAGR for full years from 2000 to 2024 (does not include 6 months to June 2025). Past performance is not an indicator of future performance.

While markets are inherently uncertain, our research and analysis point to strong opportunities for high-quality European businesses that are niche leaders in their respective industries (such as WDP, R&S and AQ Group cases in point). The combination of attractive valuations, robust government spending commitments, and a heightened focus on defence and security provides compelling reasons that support our ethos of being overweight in European equities. Moreover, as we have addressed above, the macro-economic outlook suggests a rerating of a newly unified Europe that is bound by the common need to spend more on defence, to trade more together as a block to counter the assault of Trump's tariffs, and to work towards energy independence given their reliance in the past on external energy providers like Russia. Currently, we believe market valuations do not reflect these new opportunities, and companies like those we have covered may benefit from valuation rerates with the European Union collectively working to deliver strong future growth for the first time in over a decade.

More information

For more information on Ausbil Global SmallCap Fund and to view our investment returns, visit www.ausbil.com.au.

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