Confluence Investment Management

Bi-Weekly Geopolitical Report

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The New Era of Higher Defense Budgets

The Russia-Ukraine war has transformed the world in the blink of an eye. We think the war and its aftermath will reverse much of the economic globalization of recent decades and cleave the world into two or more blocs with only limited interplay. We believe sanctions on Russia will discourage many central banks from seeing the U.S. dollar as their preferred reserve currency. We see an isolated Russia being forced into an even tighter relationship with China, where it will be the junior partner.

Now that it's easier to see the geopolitical and military threats from authoritarian leaders in China, Russia, and beyond, we believe the war has also ushered in a new era of high defense spending. We expect that countries around the world will now invest much more in national defense than they have in decades. This report examines the implications of higher defense spending within NATO and the potential ramifications for investors.

Defense Spending and Economic Growth

As countries respond to the war by hiking their defense outlays, we expect a reprise of the "guns versus butter" debate that raged during the Cold War from the late 1940s to 1989. The debate stems from a thesis that military spending requires giving up needed civilian goods and services, and that higher defense spending impedes economic growth.

In reality, authoritative analyses over the decades have found a modest positive correlation between defense spending and economic growth. Studies by the Central Intelligence Agency late in the Cold War suggested military spending only slows economic growth when it exceeds about 10% of a country's gross domestic product. At the time, the CIA estimated that the Soviet Union was spending 15% to 18% of its GDP on the military. Such a high "defense burden" helps explain why the CIA was warning about economic and political instability in the country several years before its demise in 1991.[1]

High defense spending may be associated with high economic growth (if the defense burden remains below 10%), but it's hard to prove that it ***causes*** better growth. Still, we think it can do just that. After all, defending the nation against a clear and imminent threat can justify investments that otherwise wouldn't get made, including in dual-use goods that have both military and civilian applications and purely military goods that have positive spill-over effects for the broader civilian economy. One example is the Interstate highway system, which President Eisenhower justified in part by arguing that it was essential for wartime mobilization (its formal name is the "National System of Interstate and Defense Highways"). Another example is the internet, which was first developed as a way for defense researchers to communicate among themselves. In any case, we think

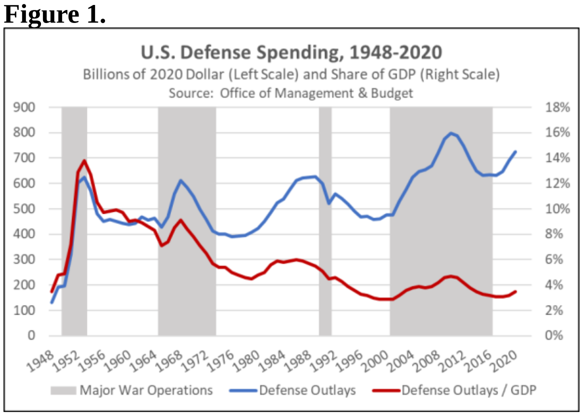
[1] In full disclosure, the author worked from 1989 to 1994 in the CIA office that analyzed Soviet military spending and defense industries.

the defense spending increases discussed in this report would be compatible with continued good economic growth in the U.S. and its NATO allies. We don't believe defense burdens will get large enough to hinder their economic growth.

Recent Defense Spending Trends

To understand how NATO defense spending could grow in the coming years, it may be helpful to review how it fluctuated during the Cold War. Since the U.S. has always dominated NATO defense spending, we begin with the U.S. defense budget. As shown in Figure 1, inflation-adjusted U.S. defense outlays trended higher for most of the last eight decades as the country worked to preserve global peace and protect its position as global hegemon. Still, U.S. defense spending has fluctuated wildly during wartime. It reached $798.1 billion in 2010, at the height of the War on Terror, before falling back to $724.6 billion in 2020.

Figure 1.



As a share of the economy, U.S. defense spending has trended downward ever since the Korean War and the military buildup of the early Cold War. Ignoring the temporary surges during the Vietnam War, the Reagan buildup, and the War on Terror, the long downtrend in the U.S. defense burden reflected the calmer U.S.-Soviet relationship after the two countries reached nuclear parity and had a near-death experience during the Cuban Missile Crisis. Fast economic growth also allowed the U.S. to keep boosting its military with a smaller share of its resources. Following the end of the Cold War, politicians thought lower tensions would justify less defense spending and produce a "peace dividend" that could fund higher outlays on civilian priorities or tax cuts.

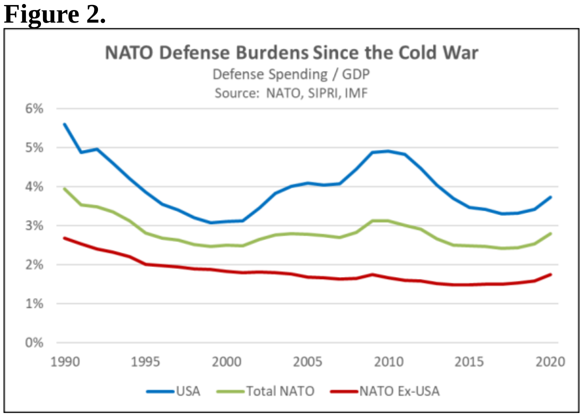
- As we've written before, the West's victory in the Cold War convinced corporate managers that a long era of world peace and security was at hand, so they could safely extend their supply chains to wherever production costs were lowest. Managers were also seduced into thinking they could dispense with costly "surge capacity" in their factories, safety cushions in their inventory levels, and all but their most essential workers.

- The U.S. applied the same ethos of "lean" operations and "just-in-time" resources to its armed forces. A case in point was the cap on U.S. troop levels during the War on Terror and the need to send soldiers on multiple tours of duty in Iraq and Afghanistan. That dynamic can be seen as simply a military version of private firms' focus on minimizing inventories and boosting inventory "turns."

- As a result, the U.S. defense burden averaged just 3.9% of GDP from 2001 to 2020, even as the War on Terror raged. That was less than half the average burden of 9.1% of GDP during the peacetime years of 1956 to 1965.

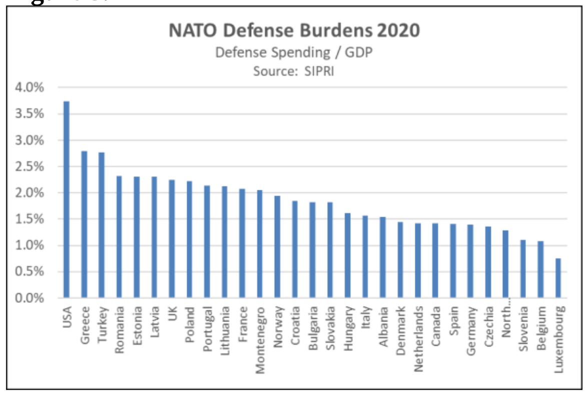
In data from NATO and the Stockholm International Peace Research Institute (SIPRI), we see similar trends for the whole alliance since the end of the Cold War. As shown in Figure 2 on the next page, the U.S.'s NATO partners continually cut their defense burdens over a quarter century, from a GDP-weighted average of 2.7% in 1990 to less than 1.5% in 2015. Even the allies' contributions to the War on Terror in Afghanistan did little to affect the trend. Another notable aspect of Figure 2 is that the average defense burden among the allies is far lower than the U.S. defense burden. Of course, none of the allies has the same global interests and commitments that the U.S. has as the global hegemon. Nevertheless, U.S. officials have long been irritated by their relatively low spending and the sense that they aren't pulling their own weight in the alliance.

Figure 2.



Despite the political tensions brought on by the allies' low spending, Figure 2 does demonstrate a recent change. The chart shows that both the U.S. and its NATO allies had started to increase their defense investments by the late 2010s. In the U.S., that partly reflected concerns that the military had been hurt by fiscal austerity in the years after the Great Financial Crisis. Among the U.S.'s NATO partners, some of the increase reflected strong pressure for more spending from President Trump. Importantly, it also reflected a growing sense of vulnerability in Europe after Russia's 2014 annexation of Crimea and incursion into Ukraine's Donbas region. As shown in Figure 3, more than one-third of the NATO countries were spending more than the alliance's target of 2% of GDP by 2020, although many key countries continued to lag that standard badly.

Figure 3.



What Happens Now?

Despite its long decline in military outlays, NATO still spends an enormous amount on defense. Total spending by NATO members in 2020 came to $1.103 trillion, including U.S. spending of more than $700 billion and the non-U.S. members' spending of more than $300 billion. Nevertheless, Russia's invasion of Ukraine has profoundly unsettled policymakers throughout the alliance. Even European policymakers have abandoned their prior reluctance to invest in their military forces. Indeed, we've seen many dramatic instances in which U.S. and European policymakers have made an about-face regarding their plans for defense.

- ***United States.*** The final federal budget for the year ending in September 2022 hikes U.S. defense spending by 5.6%, marking the seventh straight fiscal year in which U.S. defense spending has increased. The hike in FY 2022 will allow for major new acquisitions and increased activities for the Army, Navy, and Air Force. President Biden hasn't yet released his budget for FY 2023, but the Democratic chairman of the House Armed Services Committee said in early March that there's "no doubt" U.S. defense outlays will need to be bigger than expected before Russia's invasion.

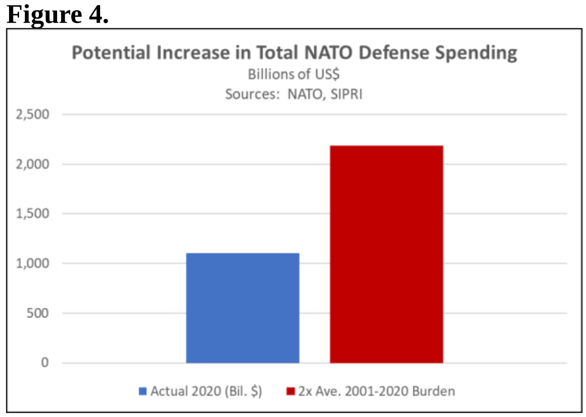
- ***Germany.*** The most stunning change has come in Germany, long the poster child for timid European defense efforts. After paying the huge cost of post-Cold War reunification and suffering a related spike in consumer price inflation in the 1990s, German leaders for two decades had maintained exceedingly tight fiscal spending on programs ranging from infrastructure investment to defense. However, just days after Russian troops entered Ukraine, Chancellor Scholtz announced a huge €100 billion fund to modernize the Bundeswehr and vowed that Germany would finally meet its NATO commitment to spend 2% of GDP on defense. Coupled with its taboo-breaking decision to send weapons to Ukraine and shut the Nord Stream 2 gas pipeline from Russia, Germany's about-face on defense spending shows a new concern for national security that isn't likely to dissipate soon.

- ***Italy.*** Even before Russia's invasion, lawmakers in Italy had passed a series of big defense budget increases, including a 24% hike in weapons purchases last year alone. As the Russian invasion unfolded, they signed off on yet another big procurement budget for the upcoming year, including purchases of new destroyers, amphibious ships, and armored vehicles.

- ***Others.*** The invasion has also boosted defense spending plans elsewhere in Europe, including Poland and France (where President Macron has long advocated for strong, autonomous European defense forces). Non-NATO nations, such as China, are also hiking their outlays. This is a reminder that higher defense spending in one country can prompt its rivals to respond in kind, potentially sparking a global arms race.

Based on these swift policy shifts and the menacing character of Russia's rhetoric and war operations in Ukraine, we believe the NATO countries could boost their defense spending as a share of GDP to something approaching the levels from the mid-1950s to the mid-1960s, i.e., up to 2x each country's average burden from 2001 to 2020. In such a scenario, we estimate total NATO defense spending could roughly double to $2.186 trillion and stay there for half a decade or more (see Figure 4). Our assumption implies that U.S. defense spending would rise to 7.9% of GDP from an average of 3.9% in 2001 to 2020. Defense spending in the rest of NATO would rise to 3.2% of GDP from 1.6%.

Figure 4.



Where Will the Money Go?

It's not enough to know that NATO military spending looks set to increase. To gauge what economic sectors and companies could benefit, we need to know what the money will be spent on. In this regard, it's important to understand that the U.S. defense budget, which accounts for more than two-thirds of NATO defense spending, has a much different structure than that of most other alliance members.

Since U.S. national income is so high, the country has long channeled more of its resources into procuring advanced, costly weapons systems like aircraft carriers, submarines, stealth bombers, spy satellites, and world-leading battle tanks. To keep upgrading those systems, the U.S. also spends large amounts on military-related research, development, testing, and evaluation (RDT&E). Operating those systems around the world means the U.S. must spend large amounts on military operations and maintenance (O&M). As shown in Figures 5 and 6, U.S. defense spending is therefore far different than that of the other NATO allies.

Figure 5.

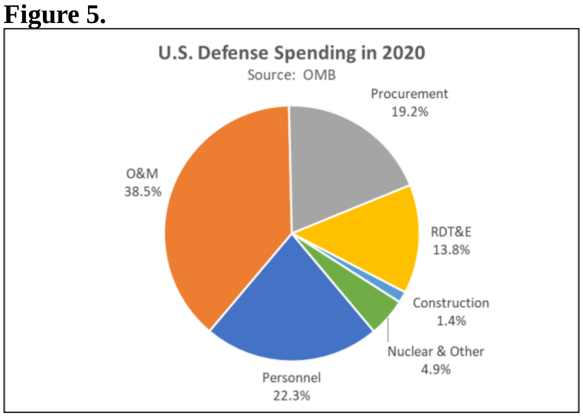
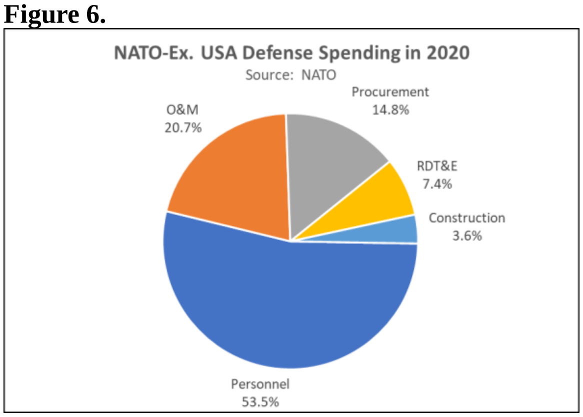


Figure 6.



In our scenario in which each NATO nation hikes its defense spending as a share of GDP to double its average from 2001 to 2020, these structural differences suggest that not only will U.S. defense spending rise the most, but it will also lead to much bigger increases in procurement, RDT&E, and O&M than among the other NATO allies. Of course, the structure of defense budgets can change over time. As the other NATO members try to modernize their armed forces and catch up to U.S. capabilities, they may have to increase their emphasis on new weapons and more expensive operations. However, for purposes of this analysis, we assume that the structure of defense spending in all the NATO countries will remain similar to what it has been in the recent past.

- If defense budgets remain anything like their recent structures, doubling each country's defense burden would mean the U.S. might hike its annual weapons procurement and RDT&E spending by $282.9 billion. The other NATO nations would hike theirs by only $50.0 billion (see Tables 1 and 2, next page).

- On the other hand, our scenario suggests that while annual U.S. spending on military personnel might rise by about $191.1 billion, personnel outlays by the other NATO members might rise by a similarly large $120.6 billion.

Ramifications

To reiterate, the figures calculated here probably reflect the upper range of new NATO defense spending that could persist for several years if alliance officials now become as worried about Russian aggression as they were at the start of the Cold War. Even with these increases, military spending in the NATO countries would probably not impede economic growth. Funding these spending increases may require cutting civilian programs or raising taxes, but that could be at least partially offset by added investment in manufacturing facilities, the development of new technologies, and higher demand for military and dual-use goods and services. In Europe, where unemployment has long been a challenge, increased military recruitment and spending on personnel could be especially stimulative.

Table 1.

Potential Increases in U.S. Defense Spending
At 2x Average Defense Burden in 2001-2020

	2020 Shares	2020 Budget (Bil. $)	New Amount (Bil. $)	Diff. (Bil. $)
Personnel	22.3%	173.4	364.5	191.1
O&M	38.5%	299.5	629.6	330.1
Procurement	19.2%	149.3	314.0	164.6
RDT&E	13.8%	107.3	225.5	118.2
Construction	1.4%	10.9	23.0	12.0
Nuclear & Other	4.9%	37.9	79.6	41.7
Total	100.0%	778.2	1,636.1	857.9

Table 2.

Potential Increases in NATO-Ex. USA Defense Spending
At 2x Average Defense Burden in 2001-2020

	2020 Shares	2020 Budget (Bil. $)	New Amount (Bil. $)	Diff. (Bil. $)
Personnel	53.5%	173.6	294.2	120.6
O&M	20.7%	67.0	113.6	46.6
Procurement	14.8%	48.0	81.3	33.3
RDT&E	7.4%	24.0	40.7	16.7
Construction	3.6%	11.8	20.0	8.2
Nuclear & Other	0.0%	.0	.0	.0
Total	100.0%	324.3	549.7	225.4

We believe the coming spending hikes on procurement and RDT&E will be channeled mostly into traditional "defense industry" firms, boosting their revenues, profits, and stock prices. Since modern weapons involve a lot of advanced data processing, the spending hikes will probably also benefit makers of dual-use information technology products and services. Firms such as semiconductor manufacturers and cybersecurity software providers could therefore see their stock prices rise. Meanwhile, bigger military forces and higher O&M spending will likely give a boost to a range of other businesses that support the defense sector, including the makers of vehicles and spare parts, fuel providers, uranium miners, and the like. All these industries could enjoy a prolonged period of good sales if defense spending hikes spark a global, self-reinforcing arms race. Of course, increased defense spending could lead to bigger government budget deficits, falling bond values, and higher interest rates, but we still think the new era of high defense spending will create opportunities in some sectors of the stock and commodities markets.

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