

More Than Meets the Eye

The Underlying Strength of the Aerospace & Defense Industry



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Near-Term Pullback Amid Record Backlogs, Demand, Secular, and Structural Drivers

The aerospace and defense sector's pullback in the third quarter has been driven largely by near-term political and sentiment factors. Specifically, uncertainty around the upcoming midterm elections and growing "peak defense" concerns that higher spending could face congressional gridlock, delayed appropriations, or reduced momentum if control of Congress shifts. These worries have prompted pullback across the group even as operational backlogs remain at or near record levels.

Near-Term Sentiment Drivers

Investors caution has centered on two interrelated themes:

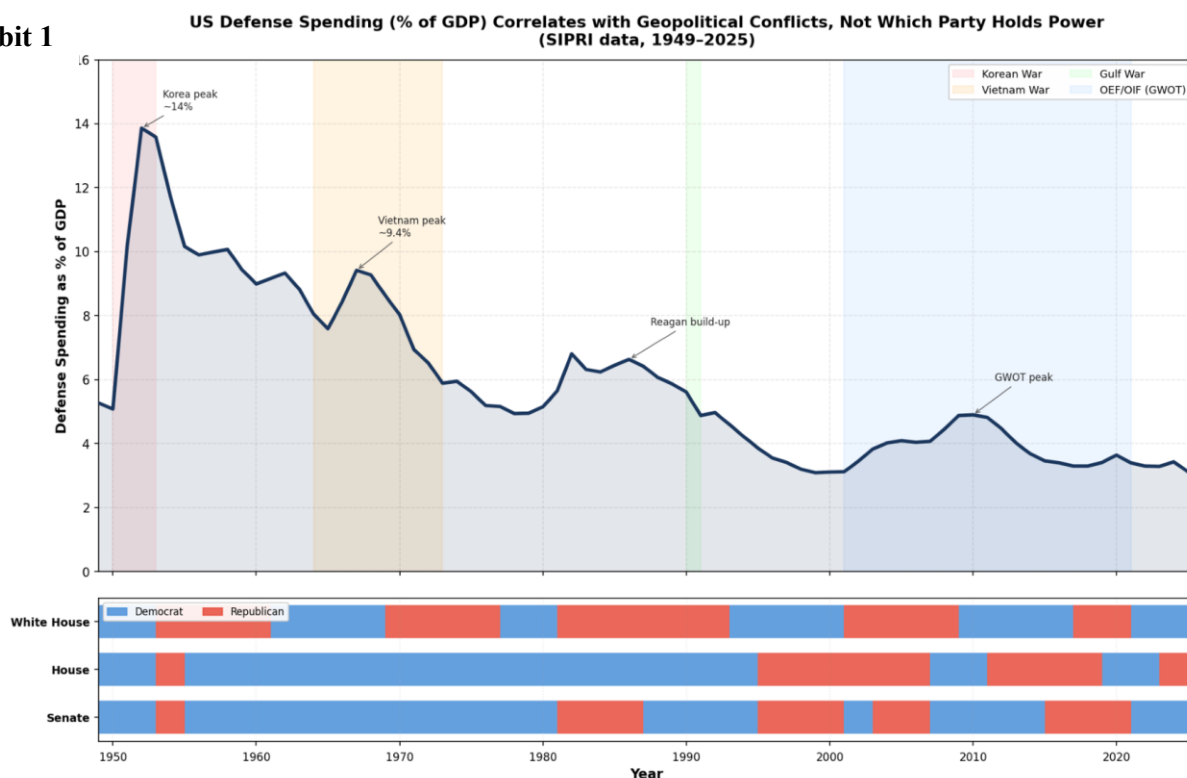
- Midterm election uncertainty and the potential shifts in congressional control that could complicate the appropriations process.
- "Peak defense" narrative that multi-year growth in outlays may slow or face greater scrutiny, leading to delayed funding or reduced program momentum.

These factors have weighed on valuations across the sector despite continued strength in order books, production ramps, and multi-year visibility on key platforms.

Operational Reality: Backlogs and Stockpile Replenishment

In reality, U.S. defense spending is fundamentally driven by geopolitical volatility and the need to replenish depleted munition stockpiles and modernize forces against peer and near-peer threats. Operational backlogs across major primes and suppliers remain at or near historic highs, providing multi-year revenue visibility independent of near-term appropriation timing.

Exhibit 1



Source: SIPRI Military Expenditure Database

Source: SIPRI Military Expenditure Database. Conflicts shaded. Political control approximate by presidential term and congressional majority periods.

Recent operations have underscored the urgency of inventory rebuilding. During Operation Epic Fury (February – April 2026), U.S. inventories of precision munitions and interceptors were consumed well in excess of replacement rates. Key systems experienced significant drawdowns:

Table 1

Munition	Pre-War Inventory	Depletion	% of Inventory	Depleted Value
Tomahawk	3,100	1,000	32.3%	\$2.60B
SM-3	410	130	31.7	3.73
SM-6	1,160	190	16.4	1.01
THAAD	360	~202	56.1	~3.13
Patriot (PAC-3)	2,330	~1,430	61.4	~5.58
Total	7,360	~2,952	40.1%	\$16.05B

Source: CSIS April 2026 Estimates, Gabelli Estimates

The Army Requirements Oversight Council had already raised the PAC-3 MSE acquisition objective substantially prior to the conflict. FY27 requested deliveries represent multiples of current production rates for Patriot, THAAD, Tomahawk, SM-6, and SM-3 systems, with replenishment timelines extending three-to-five years. Capacity constraints at primes and across the supply chain mean that requested volumes will take years to fully materialize, supporting sustained production growth.

Historical Spending Context

Current U.S. defense outlays represent roughly 3% of GDP, well below the long-term post-World War II average (which has historically run closer to 6%) and a smaller share of the overall federal budget than was typical for much of the Cold War and post-9/11 eras. This provides both fiscal room and strategic rationale for elevated investment to address peer competition, munitions shortfalls, and force modernization.

Allied demand remains robust as European and Indo-Pacific partners increase spending in response to the same threat environment. Combined with domestic requirements, this supports a multi-year demand backdrop that is not solely dependent on any single annual appropriation cycle.

Aftermarket Overreaction

Since July 1, 2026, aerospace aftermarket stocks have fallen ~26%, well behind the rest of the aerospace and defense sector. The selloff has been driven largely by rising fuel prices. We believe that view is misplaced and that these companies remain well positioned for growth.

Fuel costs hit airlines directly, but aftermarket companies depend on different drivers. Boeing and Airbus are still working to raise production, and until that ramp is sustainable, airlines must keep their existing fleets flying longer. Older aircraft need more maintenance, repair and overhaul (MRO), which drives demand for aftermarket parts and services.

Demand for flying remains intact. Excluding Middle East carriers, IATA reported that global RPKs rose 0.6% year-over-year in August, with international traffic up 1.3%. Continued traffic growth on an aging fleet means more maintenance per flight hour and sustained demand for the aftermarket. As high-margin businesses in a supply-constrained market, aftermarket companies are better positioned than their recent share prices suggest.

Structural Drivers Remain Intact

With multi-year program backlogs at historic highs, ongoing requirements to rebuild inventories, and sustained demand from both the U.S. and allies, the structural drivers of defense investment remain intact irrespective of short-term election-related dynamics. Key considerations include:

- Geopolitical volatility continues to drive requirements for air and missile defense, precision strike, and space-based capabilities.
- Munitions inventories, particularly interceptors and long-range strike systems, remain well below desired levels following recent high-intensity use.
- Production capacity expansion across solid rocket motors, seekers, and airframes is underway but will take years to fully scale, locking in elevated activity.
- International orders and FMS pipelines provide additional diversification and visibility beyond U.S. domestic budgets.

Investment Implications

The recent pullback has created a disconnect between near-term sentiment and the multi-year operational outlook. Companies with exposure to missile solutions, air and missile defense, and related supply chains are positioned to benefit from sustained production ramps as inventories are rebuilt and force structures are modernized. The aftermarket companies have seen an overreaction to the rise in oil prices for how they will be impacted. While election-related noise may continue to influence near-term price action, the underlying demand drivers; geopolitical threat environment, depleted stockpiles, and historic backlogs are independent of short-term political cycles.

We continue to view the aerospace and defense sector as fundamentally supported by structural requirements that are unlikely to be reversed by midterm election outcomes or temporary appropriation delays.

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