Morgan Stanley
INVESTMENT MANAGEMENT

BIG PICTURE

Mapping Europe's Barbell

BIG PICTURE | 3Q 2026

Europe is undergoing its most significant economic policy shift since the creation of the euro. After decades in which economic policy prioritized fiscal restraint, globalization and market efficiency, eurozone governments are prioritizing economic security, strategic autonomy and industrial resilience. This is more than merely increased public spending. Capital is being reallocated to defense, energy and digital infrastructure, advanced manufacturing and critical technologies.

For investors, Europe is directing capital toward areas systematically underinvested for much of the post-Cold War era. Its longstanding problems of weak productivity, unfavorable demographics, expensive energy and institutional fragmentation remain, but the direction of policy and capital allocation has changed sufficiently to create a different investment opportunity set.

DISPLAY 1
Europe by Region

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WESTERN EUROPE

The End of the Old Model

Germany is the catalyst for this transformation. In the 1990s, Germany was dubbed the "sick man" of Europe, as reunification proved far more costly than anticipated, saddling the new economy with uncompetitive industry, rising unemployment and chronic fiscal strain. The model looked broken.

The Hartz labor reforms of 2003–2005 under Chancellor Schröder helped Germany emerge from the post-reunification malaise through wage restraint, industrial reform and the competitive advantages conferred by the euro.

Germany became the model of disciplined, export-led capitalism: low debt, current account surpluses and a manufacturing base of unparalleled quality. Its post-Cold War success rested on three pillars: inexpensive Russian energy, insatiable Chinese demand for capital goods and an American security umbrella that allowed defense spending to remain minimal. Germany went from the sick man to an indispensable engine of European growth. That model proved extraordinarily successful. It is now fractured.

The war in Ukraine exposed a fundamental miscalculation: the elimination of baseload nuclear capacity, as insufficient investments in grid and storage and structural dependence on Russian gas as the marginal price setter left European industry with electricity costs materially higher than in the U.S. or China. European Union (EU) electricity prices are still an acute competitive handicap. Eurozone industrial output is 3% below its 2021 level and chemicals capacity is down 9% since 2022. China's evolution from customer to competitor has been equally consequential. Chinese demand plateaued as its manufacturers learned to build what Germany once had a monopoly on selling to them. The American security umbrella is being held up for renegotiation by an administration that views burden sharing in transactional terms.

While energy security and sanctions dominated the immediate response to Russia's invasion of Ukraine from the EU, led by Germany, the policy agenda has broadened considerably. It is now centered on reducing strategic dependencies on Russian energy, Chinese supply chains and American technology, while strengthening industrial resilience. The consequence is a historic change in German fiscal policy. The country is abandoning fiscal orthodoxy in favor of a €500 billion investment in infrastructure, defense, energy resilience, industrial capacity and digital sovereignty. Because Germany sits at the center of Europe's industrial ecosystem, its transformation is reshaping investment priorities across the continent.

Germany therefore matters beyond its equity market. Its fiscal pivot is potentially the transmission mechanism for a broader European CapEx (capital expenditure) cycle spanning industrials, power, defense, construction, automation and digital networks.

France presents the sharpest contrast between industrial strength and macroeconomic fragility. Its fiscal position is concerning: a deficit above 5%, pension reform that triggered the collapse of two governments and the 2027 presidential election looming with credible paths for both the far right under Marine Le Pen and a resurgent left coalition. Neither would pursue fiscal consolidation, arguing for stock-level selectivity rather than broad French equity exposure.

France's industrial champions in defense, aerospace, electrification and industrial automation are beneficiaries of European rearmament, AI investment and the energy transition. The French defense budget is set to rise 13% in 2026 and 11% in 2027, backed by a new six-year program creating multi-year revenue visibility. France's nuclear fleet, the largest in Europe, gives it an energy cost advantage, as data center demand accelerates and baseload power becomes a critical resource.

The opportunity in France is not with the country itself; it is in specific companies. More broadly, France illustrates an important distinction for European investors: sovereign risk, domestic macroeconomic conditions and corporate fundamentals need not all point in the same direction.

The remaining Western European economies offer more targeted opportunities. **The Netherlands** is home to ASML, the sole producer of the extreme ultraviolet lithography equipment on which every advanced semiconductor depends. **Switzerland**, outside the EU fiscal framework and insulated from eurozone political risks, offers exposure to industrial and healthcare champions, with the added defensive characteristics of a hard currency balance sheet.

NORTHERN EUROPE

Power, Defense and Digital Infrastructure

The **Nordic economies** entered this cycle from a position of strength that most of Western Europe cannot match. Fiscal positions are sound and labor markets are flexible. Proximity to Russia has concentrated political attention on defense and energy security, translating directly into industrial investment. Sweden's NATO accession, and Finland's and the Baltics' borders with Russia, have made the region's defense industrial base significant and unlocked domestic political consensus for sustained defense spending. Sweden and Denmark plan to increase defense expenditure to more than 3% of GDP by 2030.

Beyond defense, the Nordics' combination of cheap renewable power, cold climate for natural cooling and political stability is attracting hyperscaler data center investment at scale. More than 90% of electricity generation in Norway and Sweden comes from low-carbon sources. With the AI-driven investment cycle increasingly constrained by the availability of power, the region's energy abundance is becoming an economic asset rather than simply an environmental advantage.

Norway's sovereign wealth fund, the largest in the world, also provides a stabilizing fiscal backdrop that insulates the region from the sovereign debt pressures felt in Southern and Western Europe. Its Government Pension Fund Global has assets of roughly $2 trillion, making it the world's largest sovereign wealth fund.

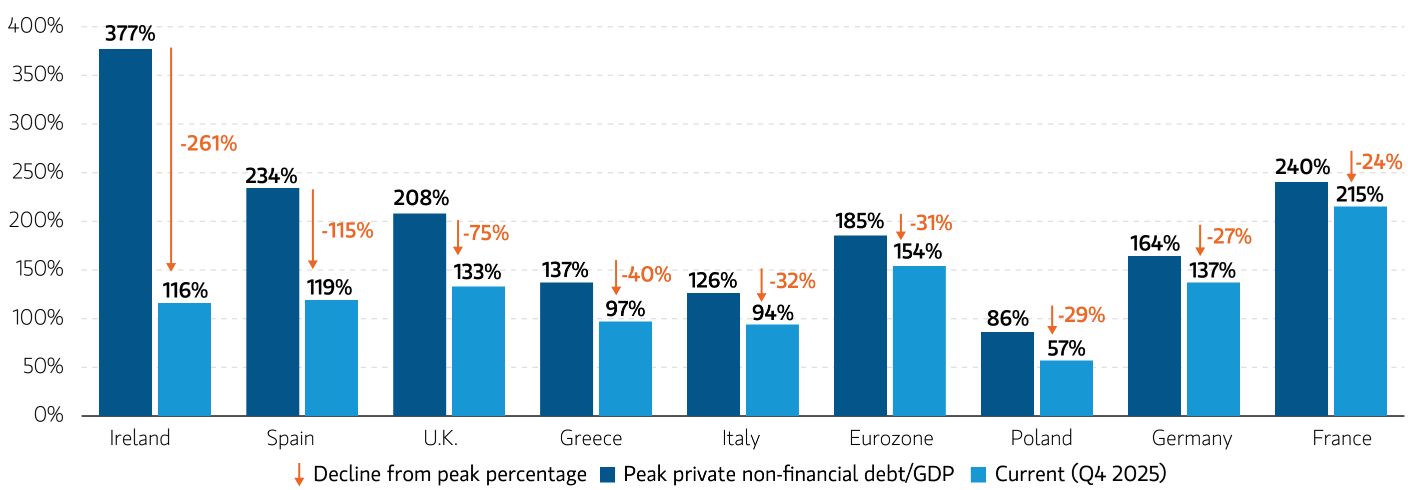
Ireland is the outlier in Northern Europe. Its investment story is not about defense or energy, but rather pharmaceutical manufacturing, technology services, the deleveraging of its credit cycle and its role as a U.S. multinational tax domicile. Apple, Google, Meta and Microsoft all have significant operations in Ireland, making it more sensitive to U.S. corporate tax policy and domestic credit than European geopolitical dynamics (Display 2).

Britain, the second largest equity market in Europe, also illustrates the widening gap between domestic macro conditions and global competitiveness. Its economy faces genuine structural headwinds: anemic productivity growth, constrained fiscal headroom and a housing market that limits labor mobility. But the investment opportunity is in global industrial champions. Britain's defense industrial base is among the most capable in NATO and benefits directly from the commitment to raise defense spending toward 2.5% of GDP and beyond. The opportunity for Britain, like France, lies in selected global champions rather than broad index exposure.

DISPLAY 2

A Decade of European Bank Deleveraging

Private non-financial debt/GDP from peak to current



Source: Bank for International Settlement. As of 12/31/2025.

SOUTHERN EUROPE

From Periphery to Growth Engine

Countries that spent the 2010s under International Monetary Fund (IMF) programs enduring brutal austerity and capital flight, namely Greece, Portugal and Spain, have fully recovered and outgrown the core Eurozone economies in the post-pandemic era. Several appear positioned to sustain that outperformance into the next decade.

The countries at the center of eurozone crisis spent much of the last decade deleveraging private debt, rebuilding external balances and recapitalizing banks. As a result, they entered the current expansion with more fiscal and financial flexibility than their core counterparts, an extraordinary reversal of pre-2012 dynamics.

Spain is the continent's most compelling macro story. GDP growth has consistently outpaced the eurozone average, driven by a combination of factors that are unlikely to reverse quickly: immigration from Latin America has boosted labor supply without the social integration complexity that characterizes migration from other regions, meaningfully improving Spain's dependency ratio relative to Germany and France. Next Generation EU fund absorption has been among the highest in Europe. Services diversification, particularly technology and tourism, has reduced the economy's vulnerability to manufacturing cycle volatility. Spain's renewables buildout has also created a genuine energy cost advantage relative to Northern and Central European industrial competitors.

Portugal, Italy and Greece follow similar patterns. Deep deleveraging has created room for robust lending growth. EU structural fund absorption provides a vast pipeline of investment relative to economic size that few regions globally can match. Banking sectors that were existentially stressed in 2012 are now among the most profitable in the eurozone, benefiting from rising net interest margins and improving credit quality (Display 3).

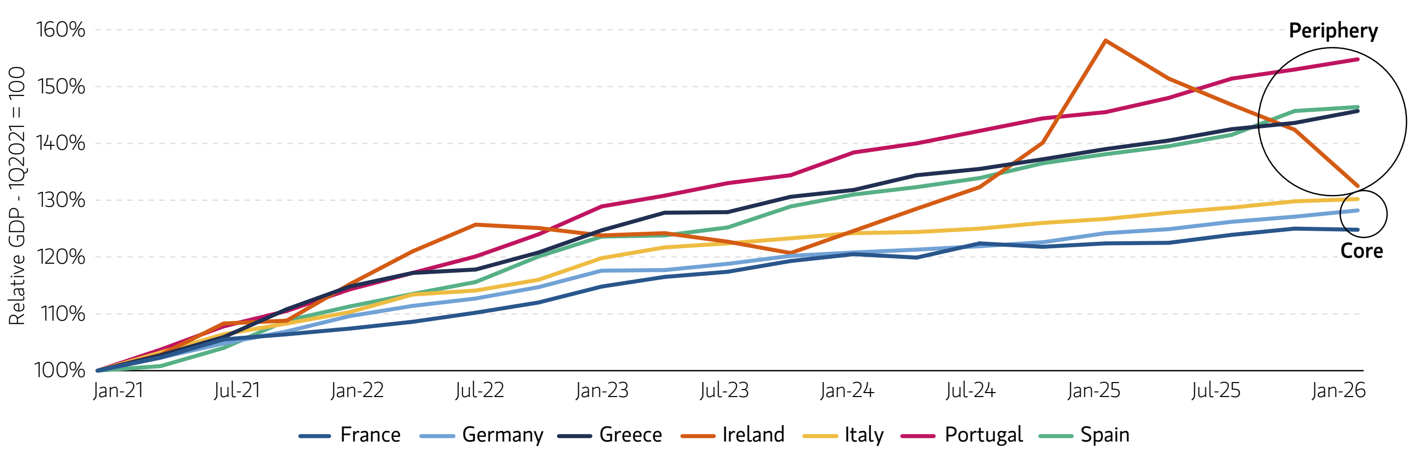
Greece was written off as an investment destination for most of the past decade, but it now offers a combination of improving fiscal metrics, with EU fund inflows equivalent to approximately 10% of GDP, tourism-driven services growth and a banking sector that has been comprehensively restructured. The investment grade restoration has served as a catalyst.

The investment story in Southern Europe is one of healthier balance sheets, improving credit creation, favorable relative growth and large public investment pipelines.

DISPLAY 3

The Periphery Leads Growth

Nominal GDP in Southern Europe has outpaced the core this decade



Source: Haver. As of 1/31/2026.

EASTERN EUROPE

Europe's New Industrial Frontier

If Southern Europe represents Europe's macroeconomic reversal, Eastern Europe represents its industrial one.

Industrialization is shifting eastward and Eastern Europe stands to be one of the principal beneficiaries of Europe's strategic transformation. The region offers what Western Europe increasingly cannot: competitive energy costs, skilled engineering labor, available factory capacity and geographic proximity to the defense supply chains that NATO is urgently rebuilding. As energy-intensive German industry contracts, the production base is migrating east, while intellectual property and engineering leadership remain in Germany.

2026 is set to be a year of substantial EU fund inflows into Central Europe, driven by a combination of three key factors. First, member states face the deadline for deploying Recovery and Resilience Facility (RRF) resources before the program expires. Second, the EU's new Security Action for Europe (SAFE) initiative for defense-related investment is in place. Third, absorption of cohesion funds from the 2021–27 budget cycle is gathering pace. Together, these programs should provide one of the strongest impulses the region has experienced for a long time. For years, Eastern Europe's case rested on a familiar macroeconomic framework where inflation would decline, central banks would cut interest rates and bonds and currencies would rally accordingly. Today the drivers are structural: industrial convergence, defense investment, infrastructure spending and EU-funded capital investment.

Poland remains the region's economic anchor and the clearest illustration of this shift (Display 4). It is likely to remain a principal beneficiary of Europe's defense buildout and industrial expansion with RRF and SAFE seen as the country's primary sources of funds in 2026. Although RRF funds can only be disbursed by the European Commission through end of this year, Poland may plan to spend the money over a longer period, transferring funds to beneficiaries later in 2027.

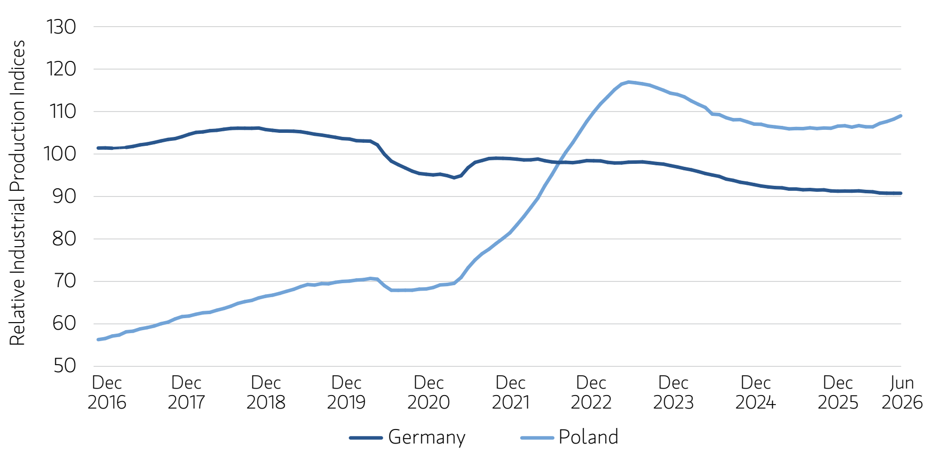
Should relations with the European Union improve, the release of suspended funds could make **Hungary** a convergence story rather than a macro-stabilization trade, reducing sovereign risk premiums and improving the outlook for domestic assets. Political developments therefore have the potential to become an important catalyst for both fixed income and equity markets, boosting growth, easing fiscal pressures and increasing banking sector liquidity and FX reserves.

Across the region's **smaller emerging and frontier markets,** three tailwinds are evident. The first is improving political stability and reform momentum, which have reduced risks that previously deterred international investors. The second is the transformation of the banking sector. The inflation shock of 2021–23, while painful, fundamentally improved the profitability of the region's predominantly deposit-funded banks by lifting net interest margins after years of ultralow interest rates. Strong capital positions, resilient earnings and the prospect of increased credit demand associated with infrastructure investment should continue to support the sector. The third is the scale of EU funding. RRF allocations amount to approximately 11% in Croatia, 6% in Romania and 3% in Slovenia. Relative to the size of these economies, this represents a sizeable pipeline of investment in infrastructure, digitalization and the energy transition that few regions globally can match.

DISPLAY 4

Industrial Power Moves East

Poland rises as Germany contracts



Source: Haver. As of 6/30/2026.

A Regime Change, not a European Renaissance

Europe is mobilizing, though it has not yet solved its structural problems. This distinction is critical to the investment case for Europe.

The EU has not produced a global-scale platform company in a generation. Venture funding remains a fraction of U.S. levels. The cumulative unrealized corporate R&D gap since 2012 has reached approximately €740 billion, a number representing forgone innovation, productivity, employment and tax revenue. Fragmented capital markets that cannot fund scale, rigid labor markets that prevent creative destruction and regulation calibrated across 27 jurisdictions raise the cost of growth.

A shrinking working-age population, rising pension costs and a hardening political consensus against non-EU migration all serve to create a labor supply constraint that no industrial policy can directly address. Spain's immigration-driven labor supply boost, drawing on Latin American workers with language, cultural and qualification advantages, is the exception.

EU electricity prices are materially higher than those in the U.S. or China. Gas sets the marginal price of European electricity despite accounting for only 18–20% of generation, leaving the industrial base exposed to geopolitical volatility.

Nearly two years after the 2024 Draghi and Letta reports that diagnosed Europe's competitiveness issues, implementation remains narrow. Deregulation faces institutional resistance. Capital markets integration requires forms of tax harmonization that member states have resisted; the banking union requires deposit insurance that creditor states remain reluctant to fund. The near unanimity requirement across 27 member states is a load-bearing structural constraint that has consistently prevented Europe from delivering reform at speed and scale.

The geopolitical shocks of the past four years have finally created a political coalition broad enough to act and a looser fiscal framework. Europe has not solved its underlying problems, but it has changed the trajectory. For investors with a longer-term time horizon, the continent is entering a multi-year capital expenditure cycle in defense, AI and industrial modernization, offering a different return profile than in the last decade.

FROM GEOGRAPHY TO PORTFOLIO

Where Countries and Themes Become Investable

We believe a European portfolio is best constructed by understanding individual countries and structural themes that transcend any single country. The key for investors is determining when the country itself is the investment thesis, and when a broader dominant cross-country theme matters more than any one market (Display 5).

The matrix on the following page maps each country's weight in the MSCI Europe Index against its sector composition, helping to distinguish where country-specific catalysts dominate and thematic exposure across borders offers the better investment. This distinction matters as much for risk management as it does for return generation.

In France, Germany, Britain, the Netherlands and the Nordics the strongest opportunities cut across borders and are better captured through specific companies and themes, where the European capital cycle matters more than any single country's growth rate.

Defense rearmament and industrial automation make for a compelling story in France, Germany, Sweden, Britain and increasingly Poland. No single country allocation captures the whole theme. Power infrastructure and electrification run from the Netherlands through Germany to Spain, France, the Nordics and Eastern Europe. This is a continent-wide CapEx cycle rather than a sector bet within a single market.

Europe is unlikely to challenge the U.S. in consumer-facing frontier AI platforms. Perhaps its comparative advantage lies instead in the industrialization layer of AI: the picks and shovels of the build-out including semiconductor capital equipment, grid transformers, gas turbines and industrial automation.

Europe's push for data sovereignty and reduced dependence on non-European technology creates an additional opportunity in sovereign compute (resources for training and deploying AI), cloud and cyber infrastructure. Much of this buildout remains in private markets, broadening the opportunity set for asset owners beyond listed equities.

European financing remains predominantly led by banks, unlike the U.S. landscape dominated by capital markets. Banks are not simply a beneficiary of economic expansion but they are one of its principal transmission mechanisms.

The same logic applies across parts of Southern Europe. In Spain, Greece and other former peripheral economies, stronger relative growth, healthier private-sector balance sheets and improving credit creation flow directly into domestically-oriented financials and cyclicals. Here, unlike in France

DISPLAY 5

What's Inside Each Market?

Sector percent by country of the MSCI Europe Index

COUNTRY	TECHNOLOGY	FINANCIALS	INDUSTRIALS	DISCRETIONARY	MATERIALS	HEALTH CARE	STAPLES	ENERGY	COMMS	UTILLITIES	REAL ESTATE	TOTAL
Britain	0.2	6.2	2.9	0.8	1.8	2.9	3.2	2.5	0.4	1.1	0.1	**22.2**
France	0.5	2.1	4.7	1.8	1.1	1.3	1.3	1.2	0.4	0.6	0.2	**15.2**
Switzerland	0.1	3.1	1.9	1.0	0.9	5.4	2.1	0.0	0.1	0.0	0.1	**14.7**
Germany	2.0	3.1	4.1	1.0	0.7	1.0	0.2	0.0	0.8	0.7	0.1	**13.5**
Netherlands	5.7	1.5	0.3	0.4	0.2	0.1	0.7	0.0	0.3	0.0	0.0	**9.2**
Spain	0.0	3.0	0.6	0.7	0.0	0.0	0.0	0.2	0.2	1.4	0.0	**6.1**
Sweden	0.3	1.3	2.4	0.1	0.2	0.1	0.1	0.0	0.7	0.0	0.1	**5.3**
Italy	0.0	2.7	0.5	0.5	0.0	0.0	0.0	0.4	0.1	0.9	0.0	**5.2**
Denmark	0.0	0.3	0.7	0.1	0.2	1.3	0.1	0.0	0.0	0.1	0.0	**2.7**
Finland	0.4	0.6	0.3	0.0	0.1	0.1	0.0	0.1	0.0	0.1	0.0	**1.8**
Belgium	0.0	0.4	0.0	0.0	0.0	0.6	0.5	0.0	0.0	0.0	0.0	**1.7**
Norway	0.0	0.2	0.1	0.0	0.1	0.0	0.1	0.3	0.1	0.0	0.0	**0.9**
Ireland	0.0	0.3	0.2	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	**0.6**
Austria	0.0	0.5	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	**0.6**
Portugal	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.1	0.0	**0.3**
MSCI Europe Index Total	9.3	25.2	18.8	6.3	5.3	12.8	8.6	4.8	3.2	5.0	0.6	**100**
Sector percent of the MSCI All Country World Index (ACWI) and MSCI U.S. Index												
MSCI ACWI	30.7	15.9	10.8	9.1	3.7	7.9	5.0	4.1	8.6	2.5	1.7	**100**
MSCI U.S. Index	36.4	12.2	8.9	9.4	1.9	9.1	4.6	3.4	10.1	2.2	1.8	**100**
Sector percent by country of the MSCI EFM Central and East Europe and CIS Index												
Eastern Europe/Frontier												
Poland	2.2	47.1	1.8	13.0	8.5	0.0	5.6	16.8	3.2	1.8	0.0	**100**
Hungary	0.0	75.6	0.0	0.0	0.0	11.9	0.0	12.5	0.0	0.0	0.0	**100**
Czech	0.0	43.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	56.9	0.0	**100**
Romania	0.0	30.3	0.0	0.0	0.0	2.8	0.0	30.1	5.0	29.7	2.0	**100**
Croatia	0.0	0.0	55.9	8.3	0.0	0.0	12.3	0.0	23.5	0.0	0.0	**100**
Greece	0.0	70.7	5.6	8.6	0.0	0.0	0.0	0.0	4.8	10.2	0.0	**100**
Slovenia	0.0	35.3	4.6	11.8	0.0	46.1	0.0	0.0	2.2	0.0	0.0	**100**
Lithuania	0.0	40.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	59.6	0.0	**100**
Estonia	0.0	62.0	25.1	0.0	0.0	0.0	12.9	0.0	0.0	0.0	0.0	**100**

Source: Bloomberg. As of 6/30/2026. Index definitions can be found on page 9.

or Britain, the domestic macro thesis and the corporate earnings thesis can reinforce one another.

Eastern European convergence lives largely outside the benchmark. Eastern European banks, predominantly deposit-funded, provide a particularly direct expression of that cycle. A decade of deleveraging has restored credit capacity, just as public investment and industrial relocation are stimulating private credit demand.

It is our view that a resulting portfolio has a natural barbell with country convergence and continental themes. On one side are targeted country exposures where domestic macroeconomic improvement is expected to be the return driver, particularly in Southern and Eastern Europe. On the other are cross-border themes, specifically rearmament, electrification, automation and AI infrastructure, that we believe are best constructed bottom-up across markets, rather than through broad country allocations.

The same regime change extends beyond equities into sovereign and corporate credit, infrastructure and private markets. For asset owners, Europe's new capital cycle is inherently multi-asset.

Conclusion

Europe has not solved its structural problems. But it has changed its trajectory.

Geopolitics, fiscal policy and the push for greater strategic autonomy are driving a capital cycle in defense, energy, infrastructure and industrial modernization after decades of underinvestment. The opportunity is neither uniform nor well captured by the MSCI Europe Index benchmark: in Southern and Eastern Europe, the country itself can be the investment thesis; elsewhere, the better expression lies in companies exposed to structural themes that transcend national borders. The last decade rewarded investors for looking past Europe. The next may reward them for looking beneath the index.

Risk Considerations

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The **MSCI Europe Index** is a free float-adjusted market capitalization index that is designed to measure developed market equity performance in Europe. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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The **MSCI EFM Central and East Europe and CIS Index** captures large and mid cap representation across 3 Emerging and 7 Frontier Markets countries. The Index covers approximately 85% of the free float-adjusted market capitalization in each country.

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