From Bonds to Arms?
Capital Rotation Between Government Bonds and Defense Equities
During Geopolitical Shocks, 1990–2025

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Abstract

This paper investigates whether major geopolitical shocks trigger measurable capital rotation from sovereign government bonds into defense-sector equities. Although a growing body of literature demonstrates that geopolitical risk positively affects defense stock performance (Zhang et al., 2022; Gheorghe & Panazan, 2024; Panazan & Gheorghe, 2025) and influences sovereign bond markets (Aslam & Newaz, 2025), the cross-asset relationship between these markets remains largely unexplored. The paper develops the Bond-to-Defense Capital Rotation Hypothesis, which posits that periods of elevated geopolitical risk induce investors to reallocate portfolios away from traditional sovereign fixed-income assets toward defense-sector equities that are expected to benefit from sustained increases in military expenditure. Like other equities, defense stocks are vulnerable to short-term price declines following increases in geopolitical risk, reflecting investors' initial flight to quality during periods of heightened uncertainty. Over longer horizons, however, defense stocks exhibit a positive movement with geopolitical risk, consistent with a "flight-to-arms" effect, as investors begin to price in expectations of higher defense spending and sustained security demand. Major geopolitical-risk spikes appear to prolong the initial flight-to-quality phase before the flight-to-arms effect materializes. Conversely, easing geopolitical tensions does not generate an immediate short-term return-to-risk effect. Although a negative "return-from-arms" effect eventually emerges, it does so only with a delay. These findings contribute to the literature on sectoral differences in geopolitical-

risk exposure and show that defense stocks should not be viewed as short-term hedges against geopolitical shocks, but rather as contingent long-term plays on geopolitical and defense-spending cycles. Overall, the evidence suggests that defense stocks are not immediate safe-haven assets during geopolitical shocks, but rather conditional long-horizon beneficiaries of persistent geopolitical risk and anticipated increases in defense expenditure.

To test this proposition, we employ an event-study framework covering four major geopolitical shocks: the Gulf War (1990), the September 11 terrorist attacks (2001), the NATO intervention in Libya (2011), and Russia's full-scale invasion of Ukraine (2022). The analysis combines cumulative abnormal returns (CARs) for leading U.S. and European defense companies with movements in sovereign government bond yields. Geopolitical uncertainty is measured using the Caldara–Iacoviello Geopolitical Risk (GPR) Index, while structural break techniques are applied to determine whether the strength of capital rotation has changed over time.

The study is motivated by a profound transformation in the global security environment. Russia's invasion of Ukraine initiated the largest European military rearmament since the Cold War, while defense expenditures across NATO have reached historically unprecedented levels. European defense spending increased substantially between 2020 and 2025, and the proposed United States Fiscal Year 2027 defense budget reflects a transition from the post-Cold War "peace dividend" to a prolonged period of elevated military investment. These developments suggest that financial markets may increasingly perceive defense spending not as a temporary wartime response but as a structural component of long-term fiscal policy.

This paper contributes to the literature in four important respects. First, it introduces a cross-asset framework that jointly analyses sovereign government bonds and defense-sector equities rather than examining each market independently. Second, it provides a long-term empirical analysis spanning thirty-five years, thereby capturing multiple geopolitical regimes and security environments. Third, it employs structural break analysis to identify whether investor behaviour changed following major geopolitical turning points, particularly after September 11, 2001, and Russia's invasion of Ukraine in 2022. Finally, it offers a comparative assessment of U.S. and European financial markets, highlighting differences in fiscal responses, defense-industrial capacity, and investor behaviour across the Atlantic.

This research offers important policy and practical implications for institutional investors, sovereign wealth funds, pension funds, and policymakers seeking to understand portfolio allocation under conditions of persistent geopolitical uncertainty. As geopolitical competition increasingly becomes a defining feature of the global economy, examining capital flows

between sovereign debt instruments and defense-related equities provides new insight into how financial markets adapt during periods of structural security transformation. By clarifying the relationship between geopolitical risk, safe-haven demand, and defense-sector investment, the study contributes to a deeper understanding of cross-asset allocation strategies in an era of heightened security and economic fragmentation.

Keywords: Defense equities; Government bonds; Geopolitical risk; Capital rotation; Event study; Structural break analysis; Caldara–Iacoviello Geopolitical Risk Index.

JEL Classification: G11; G14; G15; H56; F51.