May 24, 2022 04:01 AM GMT

US Public Policy

Mapping Out Midterms for Markets

It's time to start thinking about midterm elections. In collaboration with analysts across 12 research disciplines, we present our guide for investors, focusing on outcome drivers, resulting 'plausible policy paths', and fundamental impacts. While implications will be more sectoral than macro, more is at stake than you may have considered.

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Contents

Mapping Out Midterms for Markets

You need a plan – more is at stake than meets the eye: Market volatility and a consensus view that Democrats will lose at least one chamber of Congress suggest complacency around the US midterm election as a market driver. This is precisely the reason investors should have a plan for this event. Tax, healthcare, and tech regulation are among policy variables that could hinge on the outcome. Adding to the uncertainty is the history of markets misinterpreting policy impacts and the potential for another 2020-like delay in knowing the outcome. Hence, we present our "plausible policy paths" as a signal amidst the noise.

A 'Blue Do-Over' would have the most impact, but it is not the only outcome that will matter to investors. Democrats maintaining majorities in both houses of Congress creates the greatest potential for transformative change, creating headwinds for IT hardware, internet, telecoms, and pharma through increased potential for higher taxes, prescription drug pricing reforms, and tech regulation. Yet this outcome could benefit banks by improving the chances for crypto regulation that levels the playing field with FinTechs, and clean tech by improving the chances for passage of a "Build Back Better"-like bill. It would also blunt the impact of a recession in our economists' bear case by keeping the fiscal reaction function by Congress proactive. Divided government outcomes could still yield market consequences, such as benefits for pharma through reduced chances of drug pricing legislation.

Take cues from inflation, polls, and key races: These factors are a means for investors to assess the relative likelihood of outcomes ahead of the election. Combining these indicators with our "plausible policy paths" and analysts' assessments of the fundamental impact of those paths, we present a guide for linking changes in election outcome indicators to market outcomes.

What else is inside?

- State of the Race: A Primer on Key Outcome Drivers
- Tax Policies in Play : How & When Taxes Are Going Up
- Impact Assessments: Across 12 Sectors, the US Economic Outlook, and Asia Equity Markets

Methodology note: While there are viable legislative efforts in process in Washington, DC regarding energy, taxes, and competitiveness with China, for this report we've assumed they remain unresolved before the election. This is not a prediction of non-passage (in fact, we continue to expect passage of a China competition bill before year-end), but rather an effort to ensure we deliver investors a comprehensive assessment of election-contingent policy paths and market impacts given near-term legislative uncertainty.

Executive Summary – Plan Beats No Plan

Michael D. Zezas, C.F.A., Ariana Salvatore

That 2022 is an election year may not have drawn too much attention from investors. After all, they've been dealing with substantial equity and bond market volatility driven by a hard-to-predict inflation path, rapidly evolving monetary policy, and lingering questions about the interaction of the COVID pandemic and the global economy. As if that wasn't enough, Russia invaded Ukraine, accelerating key geopolitical trends with major ramifications for global supply chains, energy, and long-term inflation. By comparison, a US midterm election, particularly one where the consensus so strongly believes the outcome is already fated (i.e., ~90% prediction market implied probability that Democrats lose at least one house of Congress) may seem a faint market risk factor.

Yet this complacency is precisely the reason we think investors need to plan now for the midterm elections as a potential market catalyst. Elections have consequences, often ones that defy consensus and catch investors off-guard. This can be a result of consensus thinking being wrong about the outcome (i.e., the high conviction in a Clinton win in 2016) or the policy path resulting from that outcome. Consider the 2016 election outcome, where a sharp market selloff following Trump's election night victory was quickly followed by a meaningful rally once the reality of a high probability of a tax-cut stimulus set in. 2020 was a similar head fake, where our pre-election survey showed investors assumed a Biden win and Democratic sweep would lead equities lower, but the opposite happened the outcome unlocked substantial economic stimulus.

To that end, in this report we once again develop a midterm election plan for investors by applying our 'plausible policy path' framework. Here are three key takeaways from our assessment.

1 - More than you think is at stake for markets

While the macro effect of fiscal policy was the variable most clearly in focus for markets in the 2016, 2018, and 2020 elections, 2022 has a decidedly more sectoral flavor, in our view. That may cause some investors to overlook the election. We would advise against this. Policy variables may deliver substantial tailwinds or headwinds to important market sectors (e.g., tech, financials, energy).

Consider the transformative policies that could result from Democrats maintaining control of both the House and Senate ('Blue Do-Over'). Such an outcome still likely results in slim control of both chambers, and hence the need for Democratic initiatives to hew toward the preferences of moderates and, for Republican non-starters like tax increases, be tailored to the budget reconciliation process (i.e., 'The Rule of 2 Joes'). Still, within these constraints, Democrats would have a fighting chance at boosting clean energy spending, raising corporate taxes, and introducing tech and digital currency regulations. Expanding traditional energy exploration as a trade-off for moderates' support may also be required. Getting a China competition bill across the finish line, if not passed before the midterms, should be an easy lift and in a stricter form. In short, boosting the probability of enactment of this set of policies creates headwinds for IT hardware, internet, telecoms, and pharma through increased potential for higher taxes, prescription drug pricing reforms, and tech regulation. Yet this outcome could benefit banks, by improving the chances for crypto regulation that levels the playing field with FinTechs, & clean tech, by improving the chances for passage of a "Build Back Better"-like bill. It would also blunt the impact of a recession in our economists' bear case by keeping Congress' fiscal reaction function proactive.

A divided outcome narrows the plausible policy path, but could still deliver some key impacts. Divided government outcomes could still yield market consequences, such as benefits for pharma through reduced chances of drug pricing legislation. The fiscal reaction function of the US government would, however, be reactive. Hence, in our economists' bear case for the US, a recession would largely play out before Congress provided aid.

Exhibit 1: Sector Impact of Legislation by Outcome Scenario

		D Senate / D House		D Senate / R House R Senate / D House		R Senate / R House	
Policy Area	Provisions	Climate for Enactment	Impact	Climate for Enactment	Impact	Climate for Enactment	Impact
Tech Regulation	Limited tech regulation: data privacy, transparency	🟢	(+) Banks & Consumer Finance (-/=) Internet (-) IT Hardware	🟡	(+) Banks & Consumer Finance (=/-) Internet (-) IT Hardware	🟡	(+) Banks & Consumer Finance (=/-) Internet (-) IT Hardware
	Broader tech regulation: data portability, content moderation	🟢	(+) Banks & Consumer Finance (-) Internet	🔴	(+) Internet (+) IT Hardware	🔴	(+) Internet (+) IT Hardware
Crypto Regulation	Congressional designation of agency control/authority	🟢	(+) Banks & Consumer Finance	🟡	(+) Banks & Consumer Finance	🟡	(+) Banks & Consumer Finance
	Baseline stablecoin regulation	🟢	(+) Banks & Consumer Finance	🔴		🔴	
Prescription Drug Pricing	Limitations on annual drug price increases; transparency around pricing	🟢	(-) Pharmaceuticals	🟡	(=/+) Pharmaceuticals	🔴	(+) Pharmaceuticals
	Government to partially negotiate under Medicare Part D and B	🟢	(-) Pharmaceuticals	🔴	(+) Pharmaceuticals	🔴	(+) Pharmaceuticals
"All of the Above" Energy Investment	Clean energy tax credits	🟢	(+) Metals & Mining (+) Clean Tech	🟡	(+) Metals & Mining (+) Clean Tech	🔴	(=) Metals & Mining (-) Clean Tech
	Incentives for buying/producing clean energy (wind, solar, nuclear)	🟢	(+) Metals & Mining (+) Clean Tech	🔴	(-) Clean Tech	🔴	(=) Metals & Mining (-) Clean Tech
	Investments in R&D related to clean energy	🟢	(+) Metals & Mining (+) Clean Tech	🔴	(-) Clean Tech	🔴	(=) Metals & Mining (-) Clean Tech
Tax Increases	Corporates	🟢	(-) IT Hardware (-) Telecom Services (-) Consumer Staples (-) Banks & Consumer Finance	🔴	(+) IT Hardware (+) Consumer Staples (=) Telecom Services	🔴	(+) IT Hardware (+) Consumer Staples (=) Telecom Services
	Individuals	🟢		🔴		🔴	
China Competition	Make it in America Act: incentivize domestic manufacturing; R&D	🟢	(+) Metals & Mining (+) Banks & Consumer Finance (+) Semiconductors (+) IT Hardware	🟢	(+) Metals & Mining (+) Banks & Consumer Finance (+) Semiconductors (+) IT Hardware	🟢	(+) Metals & Mining (+) Banks & Consumer Finance (+) Semiconductors (+) IT Hardware

Source: Morgan Stanley Research

2 - Don't sleep on Democrats

Consensus is that Democrats are very likely to lose control of at least one chamber of Congress in this election. And, to be clear, there's plenty of evidence to support that prediction. Republicans currently hold a 2.4ppt lead in the generic ballot poll as of 5/20, which historically has had a strong correlation with the midterms' national vote share. They also have, as they have for several election cycles, a favorable House map. And historically the party not controlling the Presidency tends to pick up seats in the midterm elections. Hence, it's quite rational that as of 5/20 prediction markets imply the Republicans have a ~90% chance of taking control of at least one chamber of Congress.

But while we're not arguing that Democrats are likely to keep Congressional control, we do think this consensus is likely too complacent, opening the door to volatility in the pockets of the market that we've flagged as sensitive to election outcomes. For example, in a surprise outcome, the redistricting process actually netted Democrats an extra "safe" House seat, whereas many expert observers had expected they would lose 10-15 seats through this process. Further, the Democrats have a somewhat favorable Senate map this year. And, of course, the contrarian in us feels obligated to point out that a ~10% chance of Democrats holding Congress may be too low, and could rise in the run-up to the election on any number of "October" surprises (i.e., the Supreme Court Roe v. Wade draft decision motivating Democratic turnout). And even if such a surprise doesn't catalyze a Democratic win, as any Fed-sensitive bond market investors can tell you, improving the odds of an outcome from very low levels can of course move markets, in this case to price in higher probability of Democratic policy outcomes and resulting sector impacts.

Another reason you need a plan: Election night could again turn into 'election week', with early results sending a distorted picture of the outcome to investors. As in 2020, increased vote by mail and early voting being further codified in many states could delay vote tallying. Because Republicans tend to vote more in person and on Election Day than Democrats, initial vote counts are likely to show strength in their direction. Whether that strength endures may take days to know. Hence, an initial market reaction to price out the impacts of a Democratic win could give way to volatility as the uncertainty of election outcomes would, counter-intuitively, grow greater for a time.

Exhibit 2: Tale of the Tape: Which Party Has the Advantage?

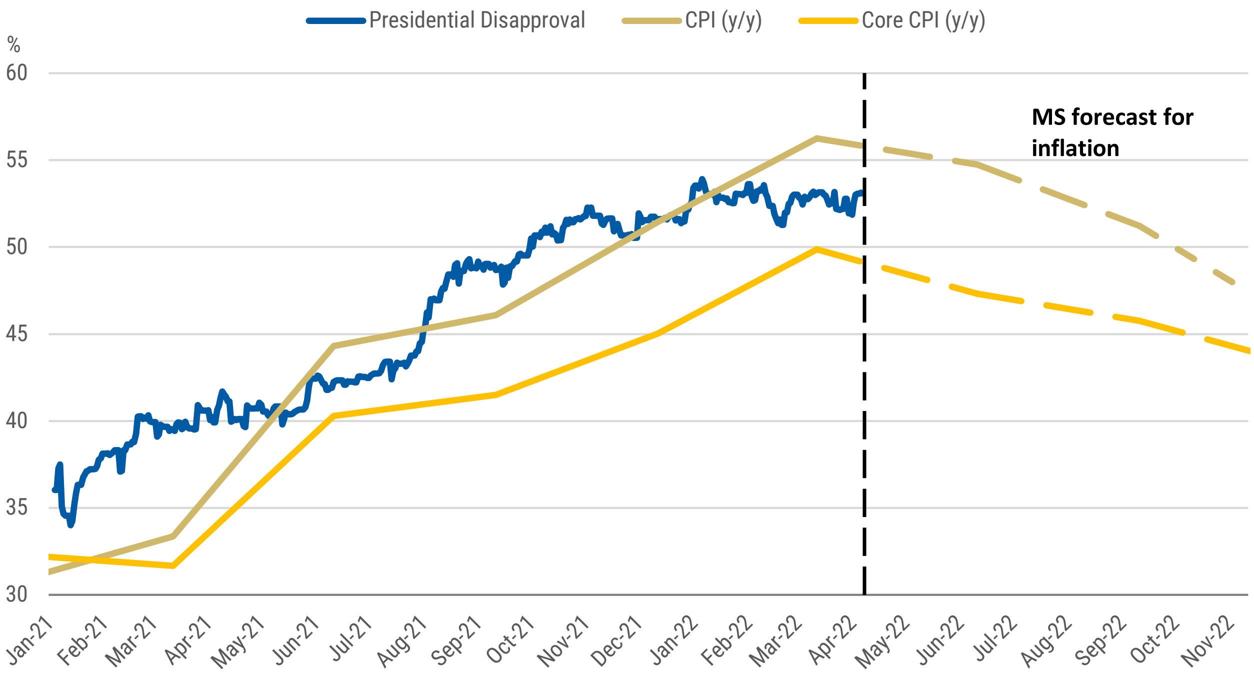
	Republican	Democrat
Historical Precedent	✓	
Generic Ballot	✓	
House Map	✓	
Senate Map		
Redistricting		✓

Source: Morgan Stanley Research

3 - Take cues from inflation, polls, and prediction markets

In the run-up to the election, we think investors can take cues about the relative likelihood of certain outcomes from the trajectory of inflation, the generic ballot poll, and, in the weeks immediately preceding the election, prediction markets. Inflation has been closely tracking with President Biden's approval rating, hence, an abatement of inflation could correlate with improved Democratic prospects. The generic ballot, currently favoring Republicans, has a solid predictive track record for midterm outcomes, and hence Democratic improvement there could auger a better November outcome. And in the weeks immediately preceding the election, prediction markets may fare even better as a predictor of the outcome, as they did in 2020.

Exhibit 3: Inflation tracks closely with President Biden's disapproval rating



Source: FiveThirtyEight, Morgan Stanley Research

Exhibit 4: Key Indicators to Watch and Sector Impact

↗ positive impact – neutral ↘ negative impact

Variable	Inflation	Generic Ballot	Prediction Markets	Key Race Polling
Direction	*Higher*	*Favors Republicans*	*Favor Republicans*	*Leans Republican*
Sector Impact				
Banks & Consumer Finance	↘	↘	↘	↘
Clean Tech/Energy	↘	↘	↘	↘
Consumer Staples	↗	↗	↗	↗
Internet	– / ↗	– / ↗	– / ↗	– / ↗
IT Hardware	– / ↗	– / ↗	– / ↗	– / ↗
Metals & Mining	–	–	–	–
Pharmaceuticals	↗	↗	↗	↗
Semiconductors	– / ↗	– / ↗	– / ↗	– / ↗
Telecom Services	– / ↗	– / ↗	– / ↗	– / ↗

Source: Morgan Stanley Research

What's at Stake? Policy Paths & Market Impacts

Michael D. Zezas, C.F.A., Ariana Salvatore

Tech, Energy, Pharma, Taxes, and China Are Key Policy Variables

Note: While there's viable legislative efforts in process in Washington, DC regarding energy, taxes, and competitiveness with China, for this report we've assumed they remain unresolved before the election. This is not a prediction of non-passage (in fact, we continue to expect passage of a China competition bill before year-end), but rather an effort to ensure we deliver investors a comprehensive assessment of election-contingent policy paths & market impacts given near-term legislative uncertainty.

Legislation dealing with tech regulation, cryptocurrency, prescription drug pricing, tax increases, and China competition will, in our view, have varying degrees of likelihood of passage by the end of 2023, contingent on the outcome of the midterm elections. Why? Because these are areas where policymakers and voters of both parties are interested in action.

Exhibit 5: Plausible Policy Paths by Legislation

Policy Area	Voter Support	Policymaker Support	Climate for Enactment		
			D Senate / D House	D Senate / R House R Senate / D House	R Senate / R House
Tech Regulation	✓	✓	🟢	🟡	🟡
Crypto Regulation	✓	✓	🟢	🟡	🟡
Presecription Drug Pricing	✓	✓	🟢	🟡	🔴
"All of the Above" Energy Investment	✓	✓	🟢	🟡	🔴
Tax Increases	✓	✓	🟢	🔴	🔴
China Competition	✓	✓	🟢	🟢	🟢

Source: Morgan Stanley Research. Note: green indicates environment is most favorable for enactment, red indicates least favorable for enactment.

Consider the following:

- **Tech regulation:** There is significant lawmaker consensus on the need for further scrutiny of tech companies on both sides of the aisle: as we note in our Tech Regulation insight, polling indicates that voters of all stripes support tougher regulation on large tech companies, and bipartisan support exists in Congress for some baseline consumer protections for areas like transparency and data privacy, as we explain in our Policy Edge episode "The Policy Edge: The Tech Regulation Risk."
- **Crypto regulation:** Policymakers in both Democratic as well as Republican camps have expressed frustration with the status quo in terms of crypto regulation, arguing that stricter government oversight is needed to address a variety of concerns, most notably around consumer protection. Similarly, polls indicate that nearly a quarter of adults believe there aren't enough regulations currently on cryptocurrency, relative to 16% who believe the "right amount" of regulation exists, and 8% who responded that there are "too many" regulations.
- **Prescription drug pricing:** Drug pricing has been a priority for both sides for quite some time, reflecting public opinion. Proposals to cap drug costs were included in the original Build Back Better legislation debated in 2020-2021, and Republican lawmakers have co-sponsored similar measures. While progressive Democrats in Congress tend to support acting on health care more broadly, drug-pricing reform might be the "low-hanging fruit" that both parties can agree to pursue following the 2022 midterms, in our view, In the case of a split government scenario.
- **'All of the above' energy investment:** Energy-related investments have been an integral component of the Build Back Better agenda since it was introduced in 2020. Those provisions, including climate-related tax incentives and infrastructure-related climate investments, garnered substantial support from Democrats. Similarly, some Republican lawmakers have expressed interest in pursuing a less expansive version of the Democrats' agenda – in particular clean energy tax credits – in a bipartisan bill. These measures reflect public

opinion polling, which suggests individuals are concerned about climate change and believe the government should do more to address the issue.

- **Tax increases:** Since the 2020 campaign, President Biden – and the broader Democratic party – has argued that wealthier individuals and corporations should "pay their fair share" and rectify what they view as the failures of the 2017 Tax Cuts & Jobs Act. Voters share this view. According to Morning Consult, 58% of voters support higher taxes on the wealthy and corporations to fund investments.
- **China competition:** We have long cited China as an "independent policy vector" in DC, meaning that it is one of the few areas where Democrats and Republicans have been able to come together and enact significant legislation. The US ICA, now known as the Make It in America Act, and the Bipartisan Infrastructure Bill are two examples of legislation furthering this goal. Both passed in the Democrat-controlled Senate with significant support from lawmakers of both parties. The bipartisan support behind this bill is parallel to public sentiment, as voters in both parties report an increase in criticism of China in recent polls.

Impacts by Scenario: Markets Most Sensitive to a 'Blue Do-Over'

In our view, markets' sensitivity to different electoral outcomes will be a function of 1) the sectoral impact of policies in play; and 2) what that outcome implies for the probability of enactment of these policies. Later in this report, our sector analysts cover the first point in detail, which we summarize in the table below.

To flesh out point 2, we assess the outcome-contingent probability of policy outcomes using our "plausible policy path" approach. A few quick reminders about the boundaries set by that approach:

- Legislation of a more moderate flavor is more likely to receive approval regardless of party control. That's because the Republican and Democratic caucuses effectively have to solve for the preferences of their most moderate members in order to gain a sufficient consensus to enact legislation.
- Furthermore, any bipartisan compromise (and, hence, legislation that passes in a DR/RD outcome) will likely be more moderate in nature to appease both conservative Republicans and liberal Democrats.
- Conversely, we expect the legislation to be most severe in a DD outcome, but still bounded by certain constraints such as the limitations of process and the "Rule of 2 Joes," or the notion that any legislation passed in a DD outcome (Democrat Senate/Democrat House) must still solve for the gap between progressive and moderate members of the cohort, assuming majorities remain as slim as they are right now.

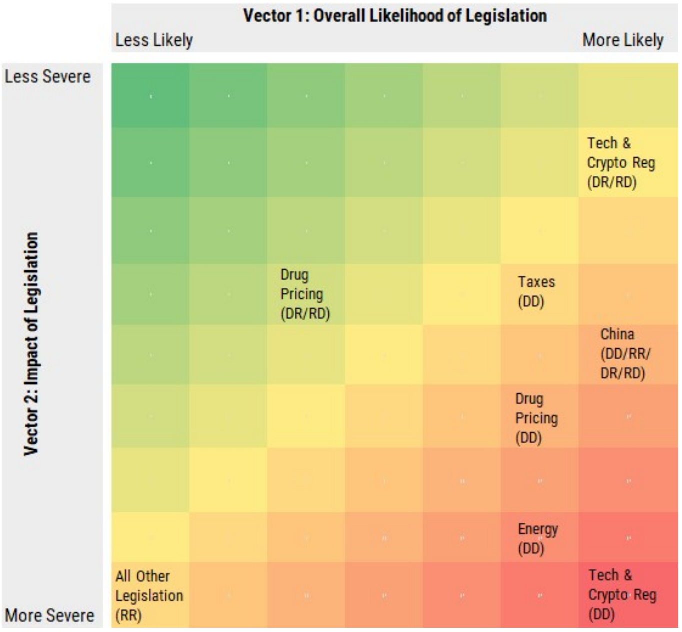
Putting points 1 and 2 together, we stylize the relative likelihood of these different pieces of legislation, as well as the "impact" of the content, by election outcome, in the matrix below. We define "impact" in terms of the market impact of the content: for example, drug pricing is less "severe" according to our framework, relative to full-scale health care reform. We formulated these placements based on our key legislative priors, which we introduced in our 2020 election framework. In short:

Exhibit 6: Detailed View: Sectoral Impact of Legislation By Outcome Scenario

Policy Area	Provisions	D Senate / D House Climate for Enactment	D Senate / D House Impact	D Senate / R House, R Senate / D House Climate for Enactment	D Senate / R House, R Senate / D House Impact	R Senate / R House Climate for Enactment	R Senate / R House Impact
Tech Regulation	Limited tech regulation: data privacy, transparency	•	(+) Banks & Consumer Finance (-/=) Internet (-) IT Hardware	•	(+) Banks & Consumer Finance (=/-) Internet (-) IT Hardware	•	(+) Banks & Consumer Finance (=/-) Internet (-) IT Hardware
	Broader tech regulation: data portability, content moderation	•	(+) Banks & Consumer Finance (-) Internet	•	(+) Internet (+) IT Hardware	•	(+) Internet (+) IT Hardware
Crypto Regulation	Congressional designation of agency control/authority	•	(+) Banks & Consumer Finance	•	(+) Banks & Consumer Finance	•	(+) Banks & Consumer Finance
	Baseline stablecoin regulation	•	(+) Banks & Consumer Finance	•		•	
Prescription Drug Pricing	Limitations on annual drug price increases; transparency around pricing	•	(-) Pharmaceuticals	•	(=/+) Pharmaceuticals	•	(+) Pharmaceuticals
	Government to partially negotiate under Medicare Part D and B	•	(-) Pharmaceuticals	•	(+) Pharmaceuticals	•	(+) Pharmaceuticals
"All of the Above" Energy Investment	Clean energy tax credits	•	(+) Metals & Mining (+) Clean Tech	•	(+) Metals & Mining (+) Clean Tech	•	(=) Metals & Mining (-) Clean Tech
	Incentives for buying/producing clean energy (wind, solar, nuclear)	•	(+) Metals & Mining (+) Clean Tech	•	(-) Clean Tech	•	(=) Metals & Mining (-) Clean Tech
	Investments in R&D related to clean energy	•	(+) Metals & Mining (+) Clean Tech	•	(-) Clean Tech	•	(=) Metals & Mining (-) Clean Tech
Tax Increases	Corporates	•	(-) IT Hardware (-) Telecom Services (-) Consumer Staples (-) Banks & Consumer Finance	•	(+) IT Hardware (+) Consumer Staples (=) Telecom Services	•	(+) IT Hardware (+) Consumer Staples (=) Telecom Services
	Individuals	•		•		•	
China Competition	Make it in America Act: incentivize domestic manufacturing; R&D	•	(+) Metals & Mining (+) Banks & Consumer Finance (+) Semiconductors (+) IT Hardware	•	(+) Metals & Mining (+) Banks & Consumer Finance (+) Semiconductors (+) IT Hardware	•	(+) Metals & Mining (+) Banks & Consumer Finance (+) Semiconductors (+) IT Hardware

Source: Morgan Stanley Research. Note: green indicates environment is most favorable for enactment, red indicates least favorable for enactment

Exhibit 7: Plausible Policy Paths Under Each Outcome Scenario, Plotted by Impact and Likelihood.



Source: Morgan Stanley Research. Note: DD indicates Democrats control both chambers (RR indicates the inverse). RD indicates Republicans control the Senate and Democrats control the House, and DR indicates Democrats maintain control of the Senate and Republicans control the House.

This assessment drives the following observations:

'Blue Do-Over' is the easiest path to market-impactful legislation. A scenario in which Democrats maintain control of both the House and the Senate (which we call the DD scenario) following the midterms holds the most potential for change, in our view. In the event that Democrats hold all their current Senate seats and pick up any additional ones, leadership would have more flexibility to maneuver policy through that chamber than the current situation allows. While legislation would likely still have to hew to preferences of the moderates in the caucus to gain widespread support, veto power would not be as concentrated in the hands of one or two senators as it is right now. Potential policy action:

- **Fiscal reaction:** While we are currently in the 'stability' quadrant in our framework (below), we believe a DD outcome - in which Democrats control both the Senate and House - unlocks potential for horizontal movement, toward proactive expansion. We expect the delivery of additional fiscal stimulus would come in the form of the enactment of the Build Back Better agenda. The ultimate scope and deficit impact of the legislation would be a function of the majority that Democrats hold in both chambers: in a situation reflecting the current power distribution, we expect a package acceptable to moderates would reflect a slimmed-down version of the initially proposed $3.5 trillion.
- **Tax hikes/Build Back Better:** We expect that, given a healthier margin, Democratic leadership will once again take up the tax hikes proposed in the President's Build Back Better Agenda. These hikes – on corporations and the wealthy, as we've outlined most recently here – have widespread support from both Democrats in Congress and the public. Most notably, Sen. Manchin and Sinema have both expressed support for tax hikes of some kind. We believe that these hikes can plausibly be paired with the most popular pieces of the rest of the Build Back Better Act: while the entire initial proposal would likely not have sufficient support, popular provisions such as climate funding are likely to be pursued in a DD scenario.
- **Tech regulation:** Democratic lawmakers have emphasized a need to regulate technology/internet companies, as evidenced by the Senate Judiciary Committee's bipartisan approval of a package of anti-competitive legislation and in particular Democratic lawmakers' comments around antitrust regulation of large tech companies. We anticipate that in a DD scenario, a larger margin than the current one (in particular, the 50-50 split in the Senate) would allow leadership more flexibility to enact stricter legislation, placing it on the bottom right corner of our matrix.
- **Crypto regulation:** We expect that in a DD outcome lawmakers would pursue stricter regulation of cryptocurrencies. In our framework, this involves Congress passing legislation that assigns various agencies jurisdiction/control over different aspects of crypto as well as baseline stablecoin regulation.
- **Drug pricing:** Democrats in a DD scenario would likely work off the legislation proposed as part of the Build Back Better plan, which as of December 2021 included allowing the government to negotiate the prices for certain high-cost prescription drugs covered under Medicare Part D and Part B after the drugs have been on the market for a fixed number of years; imposing an excise tax on drug manufacturers that refuse to negotiate pricing with Medicare; requiring rebates to limit annual drug price increases in Medicare and private insurance; and limiting cost-sharing for insulin products, among other provisions.

Split Control Scenarios - Republican Senate/Democratic House (RD) or Democratic Senate/Republican House (DR) - result in less impactful legislation, though we see potential for narrow bipartisan efforts. Any other outcome would not result in unified control of government given that Democrats still control the White House. Therefore, any policy that makes it into law would require the consent of both President Biden and Republicans in Congress. While that universe of legislation that occupies that overlap may be small, we thinks it exists. While relatively less likely compared to a DD scenario, there is scope, in our view, for bipartisanship on some key issues that both parties want to address. This bipartisan action will likely be more limited in reach than what is possible under a unified government outcome, narrowing lawmaker ambitions as well as potential market impact.

- **Fiscal reaction:** As we've noted in the past, the fiscal reaction function becomes tougher in a split government control scenario. In any of these instances, we would expect fiscal expansion to come only as a reaction to deteriorating economic conditions or an exogenous shock to the economy, as we saw with the CARES Act and subsequent fiscal aid packages in response to the pandemic in 2020. As we show in the gray box below, these scenarios represent movement from 'stability' to 'reactive expansion.'

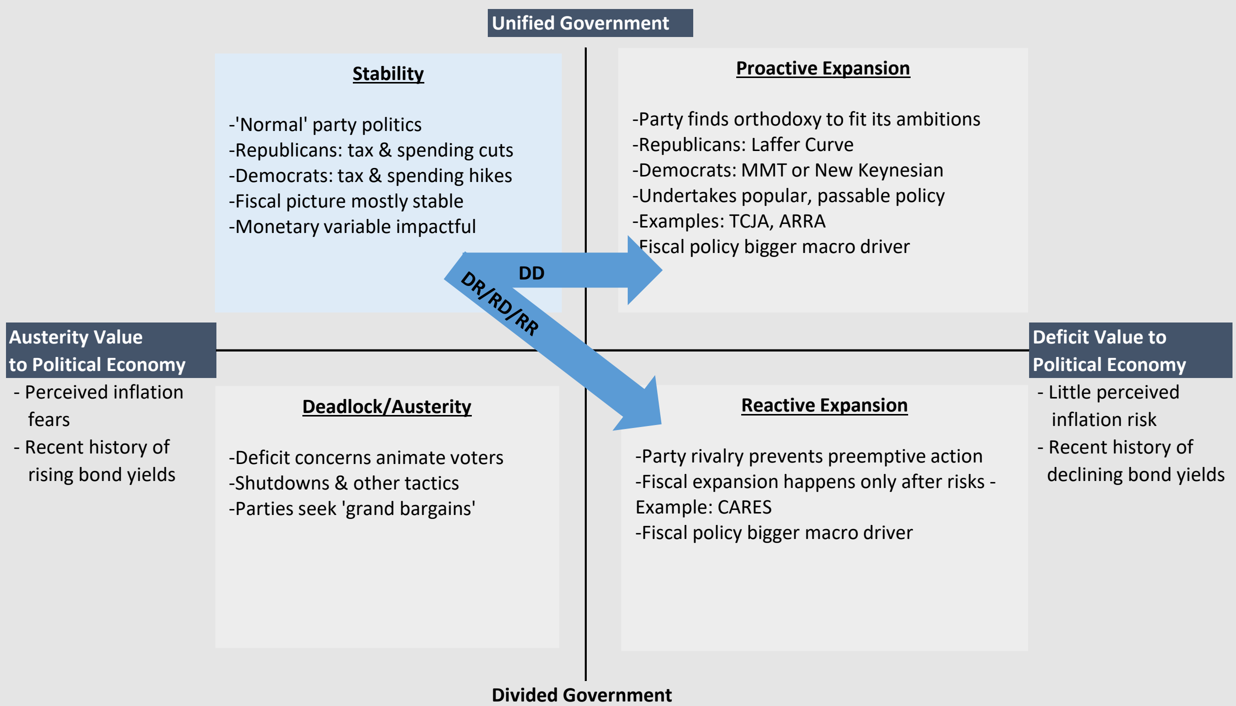
- **Tech regulation:** As we note in our Tech Regulation Insight, a scenario of split control of government would narrow lawmaker ambitions, given that both parties agree on the need for tech regulation but have opposing positions on the underlying issues as well as the best way to address them. This means, in our view, that legislation likely focuses on the 'low-hanging fruit' of tech regulation – namely, some federal protections around data privacy or transparency – and avoids more challenging areas like anti-competitive practices.
- **Crypto regulation:** Given broad-based support from lawmakers in both parties for acting on crypto regulation, we expect that even in a split-control scenario Congress is able to pass legislation designating control/jurisdiction over certain areas of the crypto space. However, in this scenario as opposed to a DD outcome, we believe lawmakers would be unable to find sufficient support for baseline stablecoin regulation.
- **Drug pricing:** We expect the scope of any drug pricing legislation passed in a bipartisan fashion to be reduced substantially from other unilateral proposals. There are two recent bills that we believe can form the basis for a bipartisan approach to drug pricing reform assuming divided control of government in 2023. First is the Grassley-Wyden bill, which among other items caps seniors' out-of-pocket drug costs in Medicare and limits Medicare drug price increases to the rate of inflation. The bill however does not include a major objective for Democrats: allowing Medicare to negotiate prices. Separately, Senators Collins and Casey introduced legislation late last year to improve transparency in drug pricing. The Prescription Drug Pricing Dashboard Act aims to provide the public with basic information on what Medicare and Medicaid spend on prescription drugs and on what consumers pay, according to a summary of the legislation.

'Republican Redux' (RR) yields little, as legislative gridlock becomes the status quo. In this scenario, certain legislative priorities are immediately off the table - like tax increases or investments in clean energy - while others become much more difficult to achieve, but still possible, in our view. The items encompassed in this universe are things that Democrats and Republicans are close to agreement on, like the China competition bill currently making its way through Congress. We also see potential for tech or crypto regulation, though much narrower in scope relative to what could be considered in other scenarios.

Fiscal Reaction Function: 'Blue Do-Over' Is the Only Outcome that Makes Proactive Expansion Possible, Expect Reactive Policy in a Split-Control Scenario

We outlined fiscal policy as a key debate going into 2021, in particular arguing that fiscal expansion was a function of both motive and opportunity for whichever party is in power in Washington DC. We visualize our framework below: motive is represented on the x-axis, and is a function of there being a political benefit to fiscal expansion; opportunity is represented on the y-axis, and is a function of whether one party has control of the major policymaking powers in Washington. We believe we are currently in the "stability" category, given the state of the economy and inflation concerns. This could change depending on the election outcome as we would expect a DD outcome to be the most conducive to further fiscal expansion, and all other scenarios lead to a "reactive" stage. More detail can be found on an outcome-by-outcome basis above.

Exhibit 8: Fiscal Path According to Outcome. Only a DD outcome results in proactive fiscal expansion.



Source: Morgan Stanley Research

State of the Race – What Investors Need to Know

Michael D. Zezas, C.F.A., Ariana Salvatore

Democrats are Down, but Not Out

Investors looking at prediction markets might see Democrats losing control of at least one chamber of Congress as a fait accompli. And while we can't argue with the logic that the Democrats are underdogs when it comes to the prospects of the party retaining majorities in Congress, we don't think investors should behave as if their fate is sealed. There's still plenty of time for Democrats' headwinds to abate (e.g., what if inflation drops quickly?) and surprises to emerge (e.g., could SCOTUS overturning Roe v. Wade boost Democratic turnout?). Furthermore, as we detail in this section, the drivers of the race are generally favorable to Republicans, but not universally so. **Accordingly, investors need understand these drivers because their ebb and flow could shift outcome probabilities and, hence, reactions of key market sectors.**

Exhibit 9: Tale of the Tape: Which Party Has the Advantage?

	Republicans	Democrats
Historical Precedent	✓	
Generic Ballot	✓	
House Map	✓	
Senate Map		
Redistricting		✓

Source: Morgan Stanley Research

Exhibit 10: Prediction market-implied probabilities as of 5/20

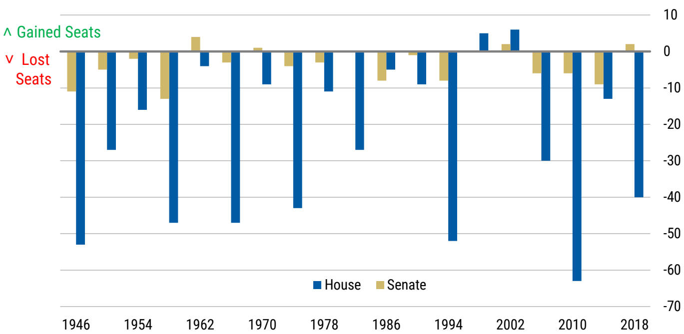
Scenario	Prediction Market Implied Probabilities
R Senate, R House	74%
D Senate, R House	19%
D Senate, D House	11%
R Senate, D House	4%
Outcome	
Democrats Hold Both Chambers	10%
Democrats Lose One or Both	**90%**

Source: Morgan Stanley Research, PredictIt

1) History - Advantage Republicans: Historical precedent suggests that the president's party tends to underperform in the midterm elections in the House of Representatives. Going back to midterms since 1946, the president's party has only improved upon its share of the popular vote in the House once (the exception here was the surge of popularity for George W. Bush and the Republican party in 2002 following the September 11 attacks). FiveThirtyEight notes that "overall, in the post-World War II era, the president's party has performed an average of 7.4 points worse in the House popular vote in midterm elections than it did two years prior." Given the slim majority that Democrats won in the 2020 election (3ppt), history would indicate that the party would be facing a deficit in 2022 if the historical precedent holds. Most recently, this dynamic was on display with losses for the parties of Presidents George W. Bush in 2006, Obama in 2014, and Trump in 2018.

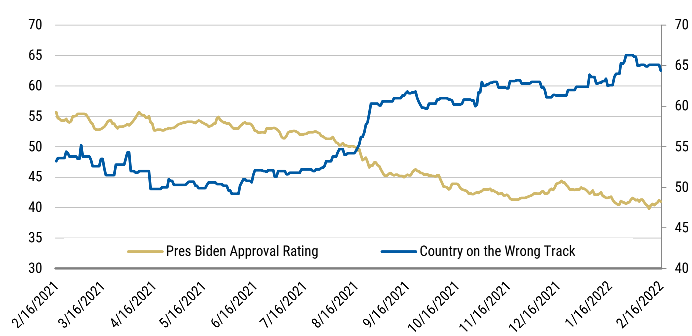
Why does this pattern occur? Two factors that could explain the trend: 1) moderate voters – even those who voted for the party in power – sometimes switch their preferences to provide a balance or check to the power held by the White House, and 2) myriad studies have shown that more voters tend to turn out to vote against a candidate rather than for him or her. In an environment in which turnout is likely to be lower than it is in presidential elections (though there are some state-by-state vote-by-mail changes that could provide a counterbalancing force; more in the gray box in the next section), the voters voicing their frustration with the status quo are more likely to be heard in House midterm elections than voters who are in favor of it.

Exhibit 11: The president's party tends to lose ground in Congress during midterm election cycles



Source: Morgan Stanley Research, Ballotpedia

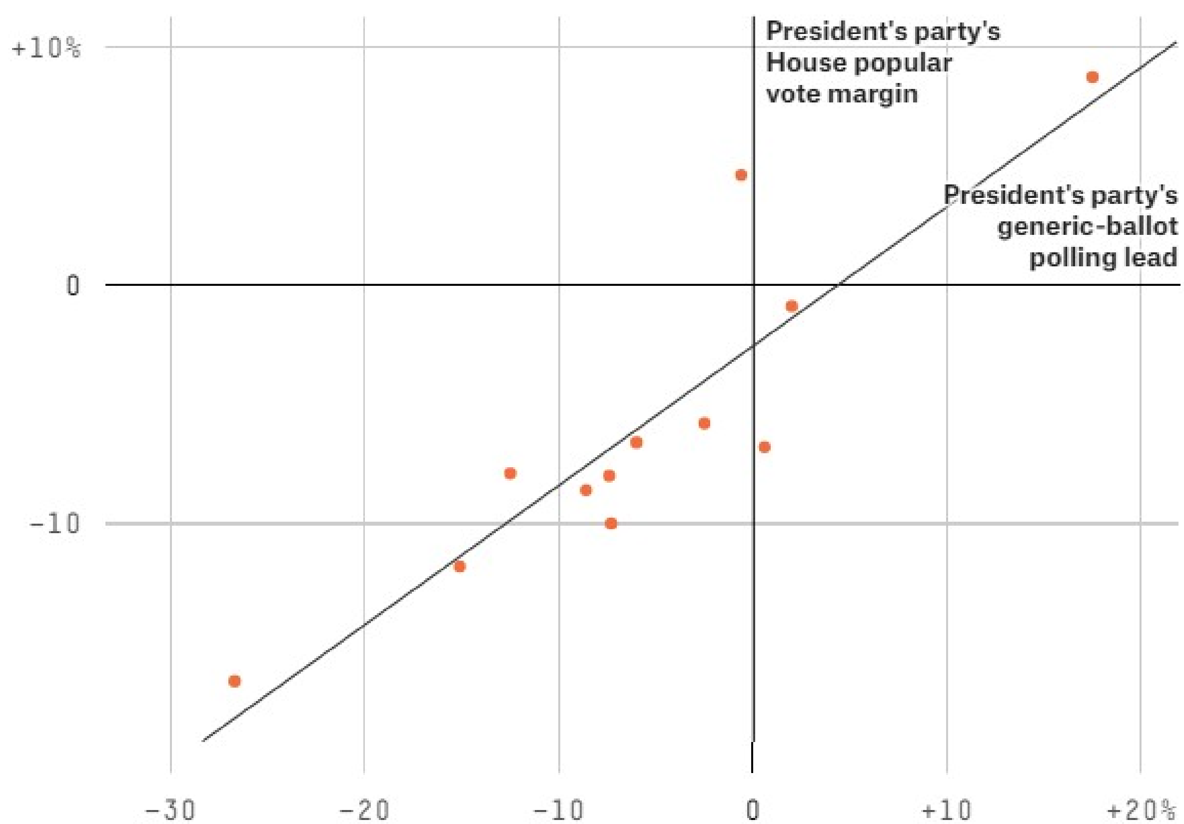
Exhibit 12: President Biden's declining approval rating could indicate that voters are holding him accountable for the state of the country, which most believe is 'on the wrong track' by a margin of ~43ppt as of 5/20



Source: RealClearPolitics, Bloomberg, Morgan Stanley Research

2) Generic Ballot – Current Advantage Republicans: We have long referenced the generic congressional ballot, an aggregate of various polls asking respondents if they would rather have Democrats or Republicans in Congress, as a reliable prior heading into an election. FiveThirtyEight references it as the best single indicator of the national political mood, citing a strong correlation between the generic ballot polling average on Election Day and the national House popular vote for that election:

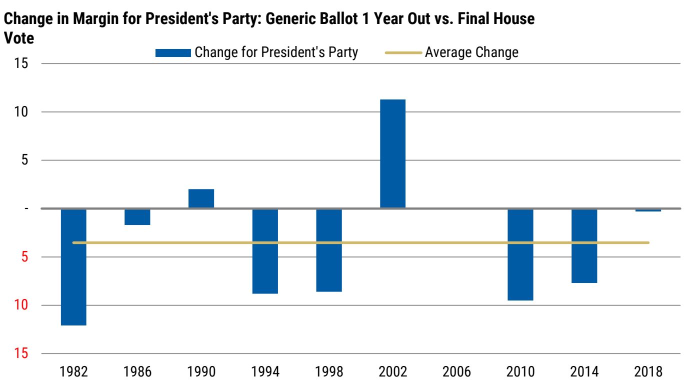
Exhibit 13: The generic congressional ballot on Election Day vs. House popular vote margin for midterm elections since 1974



Source: FiveThirtyEight

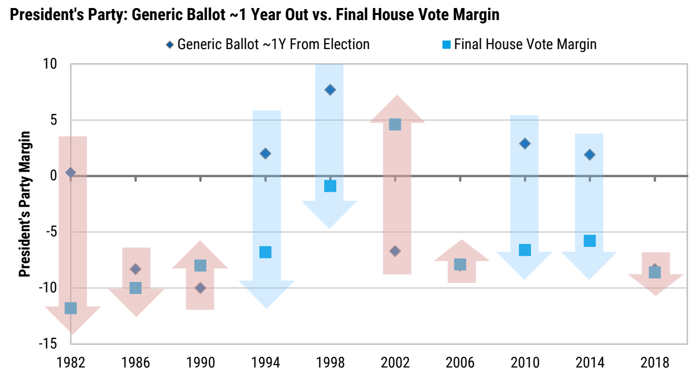
The below charts compare generic ballot polling approximately a year out from the election with the final election result in the House. In most instances, the lead that the president's party holds approximately a year out from the election tends to weaken as voting gets closer (or the deficit tends to get larger as the party loses ground). On average, looking at elections back to 1982, the lead weakens – or the deficit widens – by ~3.5ppts. Going back to 1982, there was only one instance – 2002 under President George W. Bush – in which the president's party went into the midterm elections with unified control of government and maintained control of both chambers.

Exhibit 14: Change in generic ballot ~1 year out vs. final House vote margin for president's party in midterm elections: in most instances, the incumbent party loses ground in the year leading up to the election.



Source: Morgan Stanley Research, FiveThirtyEight

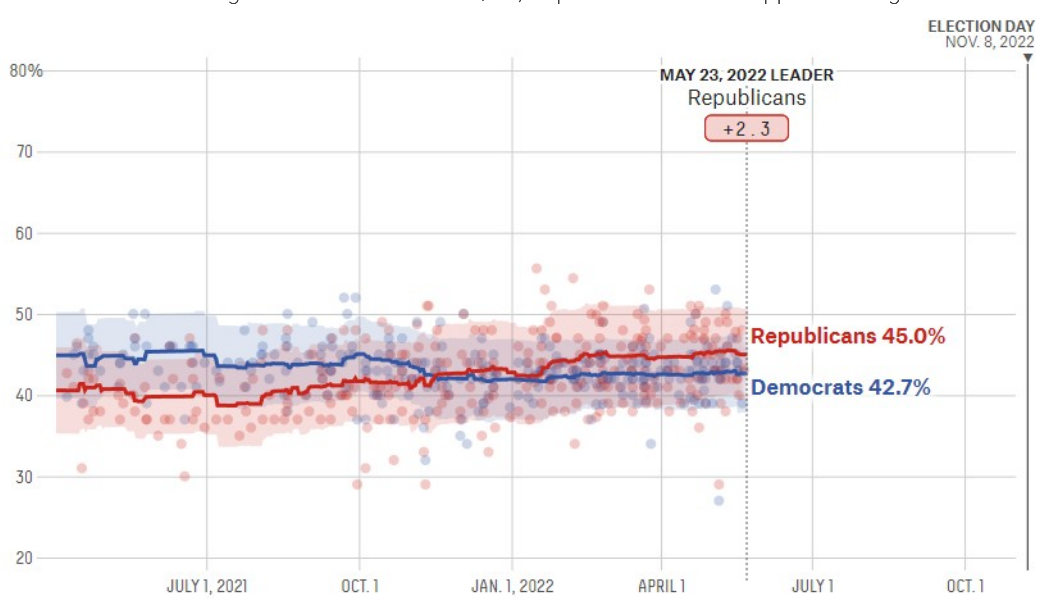
Exhibit 15: The president's party tends to lose ground when comparing the margin it holds in the generic ballot ~1 year out from the election vs. final result in the House elections



Source: FiveThirtyEight, Morgan Stanley Research. Note: Color of arrow indicates party of the president at the time of the midterm elections.

Currently, the generic ballot is showing Republicans with a three-point edge relative to Democrats, in a pattern that has held relatively steady since flipping from net Democrat favorability in November 2021.

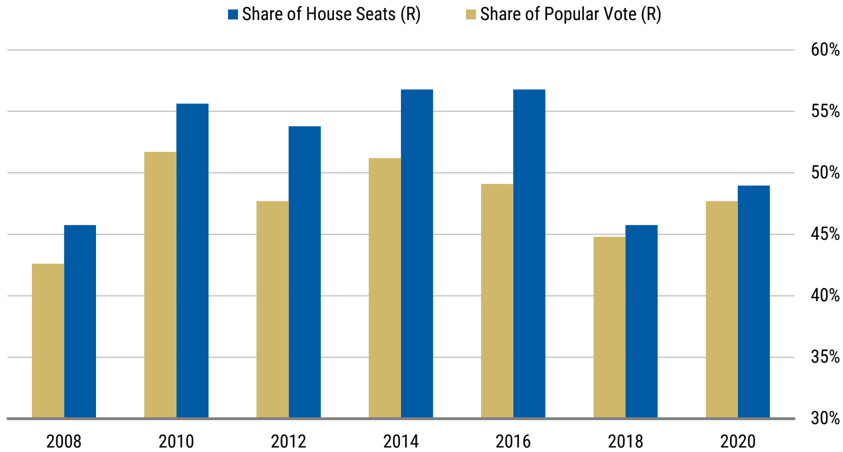
Exhibit 16: Generic congressional ballot: as of 5/23, Republicans hold a ~2ppt advantage



Source: FiveThirtyEight

3) House Map – Advantage Republicans: Although the most recent redistricting process appears to have slightly favored Democrats, overall the House district map presents a favorable dynamic for Republicans. This is best evidenced by the difference in the popular vote share and the percent of seats won by Republicans. In most recent cycles, Republicans won a greater share of House seats than their share of the popular vote.

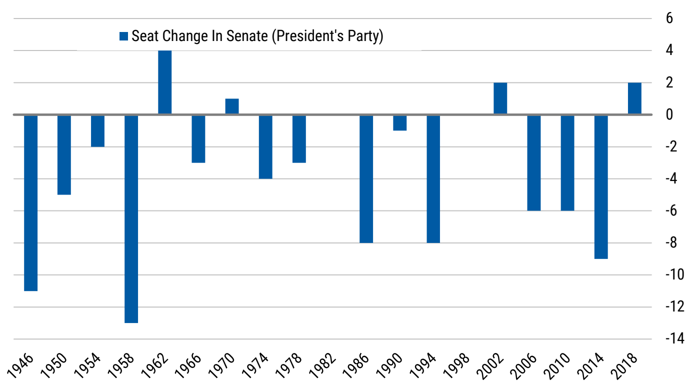
Exhibit 17: Republicans' share of seats in the House has exceed the party's share of the popular vote in recent election cycles



Source: Ballotpedia, Morgan Stanley Research

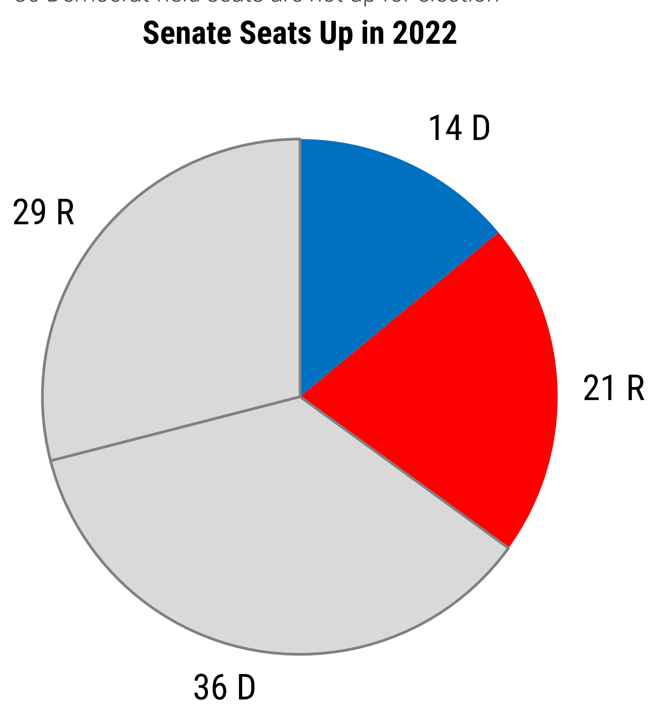
4) Senate Map – Push: History sends a strong message about how the president's party tends to do in the midterms with regard to the House, but less so about the Senate. FiveThirtyEight cites six instances (out of 19 post-WWII midterm election cycles) in which the president's party has either gained Senate seats on net or at a minimum avoided losing ground. This is partially attributable to the Senate's election cycle, which is less in tune with the national sentiment as only approximately a third of seats are up in any given midterm election. Similarly, the longer terms that senators serve allow them to build a more formidable brand with their constituents and be slightly more insulated from the trend.

Exhibit 18: Seat changes for presidents' party in Senate



Source: Ballotpedia, Morgan Stanley Research

Exhibit 19: Senate seats up in 2022: 29 Republican-held and 36 Democrat-held seats are not up for election



Source: Morgan Stanley Research

That said, with each party currently controlling half the Senate seats, having fewer "at-risk seats" can be a meaningful advantage. However, it seems each party is equally vulnerable here. Among both Republicans and Democrats, there are five Senate seats that are rated by independent watchers as "tossup" or "lean."

Exhibit 20: Democrats currently hold 48 seats. Of those, 14 are up for election, and 9 are considered 'solid' according to Cook Political. There are two Independents who caucus with Democrats, and neither seat is up for election. Republicans currently also hold 50 seats, of which 21 are up for election. Of those, 16 are considered 'solid', according to Cook Political

	Senate		House	
	Democrat	Republican	Democrat	Republican
Not Up for Election	36	29	-	-
Solid	9	16	150	181
Likely	1	0	13	14
Lean	1	3	11	6
Toss-Up	5		27	

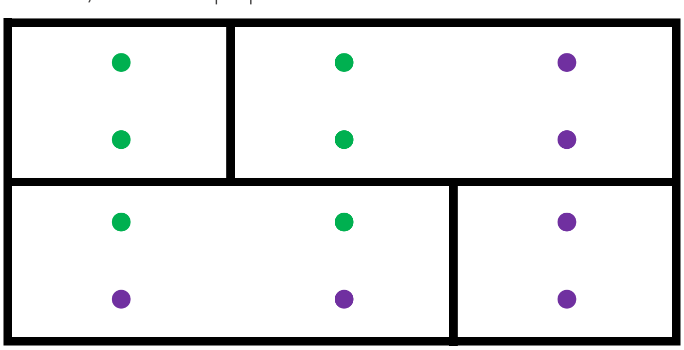
Source: Morgan Stanley Research, Cook Political. Note: The seats in the House do not sum up to the total number of candidates running because some states have yet to formally complete their redistricting processes. Ratings as of 5/20.

3) Redistricting – Advantage Democrats: Redistricting occurs every ten years, after a new census is complete, and updates Congress on population totals, demographics, and perhaps most importantly, geographic shifts. The new data allows lawmakers in some state legislatures to redraw congressional maps with the intention of more accurately reflecting the population distribution. These maps have a meaningful impact to subsequent election cycles, as the new legislative districts will not be redrawn for another ten years. Hence, third parties have been closely tracking the advantage that one political party or the other is set to gain from the process. Although not all states have completed their process yet, FiveThirtyEight's tracker as of this writing cites a net advantage for Democrats, despite the fact Republicans maintain control over redrawing of 187 congressional maps relative to the 75 held by Democrats. The redistricting process so far has created a net gain of 6 seats for Democrats and 6 fewer highly competitive seats.

Understanding "Gerrymandering"

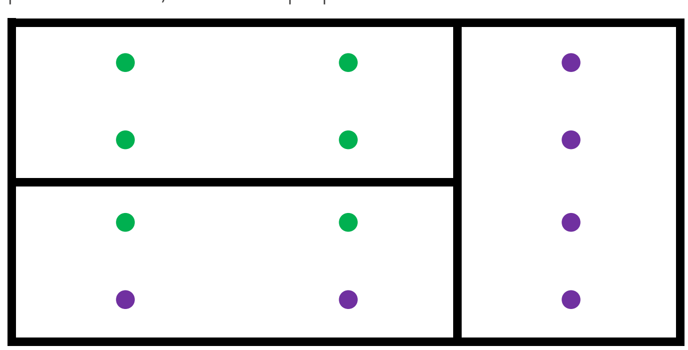
A large part of the redistricting process is parties in state legislatures attempting to solidify the seats within their control. In the end, this results in fewer competitive seats over time. As of this writing, there are 77 competitive districts, down 11 from the 2020 election. How does that happen? In essence, lawmakers are both spreading out the voting power of the opposing party's supporters across many districts ("cracking"), while also solidifying their base by consolidating the opposing party's voting power in one district to reduce their voting power in other districts ("packing"). Overall, as both parties in engage in this process, the end result is a smaller amount of toss-up districts over time, meaning that fewer and fewer elections will be responsible for determining the balance of power in the House of Representatives. A helpful visual follows:

Exhibit 21: A balanced map: 1 safe green district, 2 competitive districts, and 1 safe purple district



Source: Morgan Stanley Research

Exhibit 22: A "gerrymandered" map: 1 safe green district, 1 competitive district, and 1 safe purple district



Source: Morgan Stanley Research

Putting It Together – An Election Playbook for Investors

Michael D. Zezas, C.F.A., Ariana Salvatore

Having laid out the market ramifications of various outcomes, and the fundamental drivers of those election outcomes, we now combine those insights to provide an investor guide. **As coverage of the midterms ramps up in both traditional and financial media, we believe this guide will help cut through the noise and keep focus on the easiest-to-track indicators of the election outcome and the most likely to endure market impacts that would result.** This guide could be at its most valuable on and after Election Day, given that more relaxed early and mail-in voting rules could lead to a repeat of the multi-day outcome uncertainty that characterized 2020 (see grey box at the end of this section). As such, we intend to update this guide as necessary in between now and Election Day.

We summarize our guide in the exhibit that follows, and subsequently detail the rationale of the indicators (with the exception of the "Generic Ballot", whose predictive value was previously detailed).

Exhibit 23: Summary: Sector Impact By Outcome Scenario

	(+) Impact	Neutral	(-) Impact
D Senate / D House	Banks & Consumer Finance Clean Tech Metals & Mining		Internet IT Hardware Pharmaceuticals Telecom Services Consumer Staples Tobacco
D Senate / R House R Senate / D House	Pharmaceuticals Consumer Staples Tobacco	Internet IT Hardware Metals & Mining	Banks & Consumer Finance
R Senate / R House	IT Hardware Consumer Staples Tobacco	Internet Metals & Mining	Banks & Consumer Finance Clean Tech

Source: Morgan Stanley Research

Exhibit 24: Key Indicators to Watch and Sector Impact

↗ positive impact – neutral ↘ negative impact

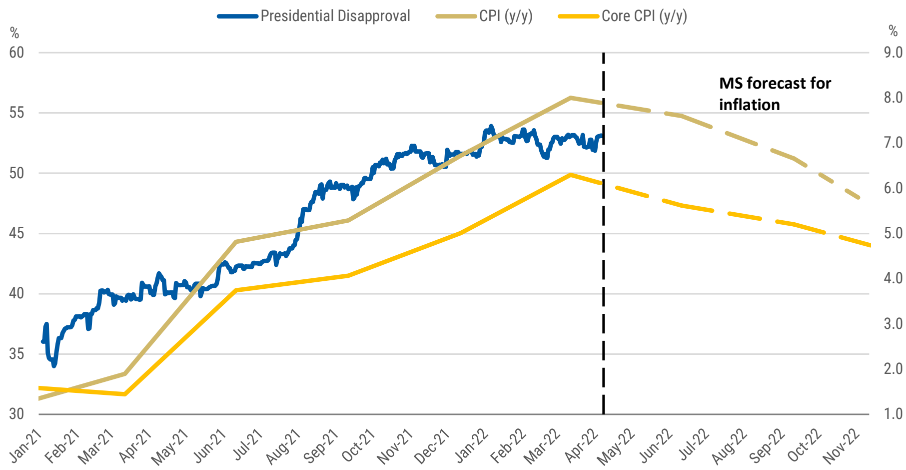
Variable	Inflation	Generic Ballot	Prediction Markets	Key Race Polling
Direction	*Higher*	*Favors Republicans*	*Favor Republicans*	*Leans Republican*
	Sector Impact			
Banks & Consumer Finance	↘	↘	↘	↘
Clean Tech/Energy	↘	↘	↘	↘
Consumer Staples	↗	↗	↗	↗
Internet	– / ↗	– / ↗	– / ↗	– / ↗
IT Hardware	– / ↗	– / ↗	– / ↗	– / ↗
Metals & Mining	–	–	–	–
Pharmaceuticals	↗	↗	↗	↗
Semiconductors	– / ↗	– / ↗	– / ↗	– / ↗
Telecom Services	– / ↗	– / ↗	– / ↗	– / ↗

Source: Morgan Stanley Research

Democrats' Favorability Is Tracking with Inflation

Since his inauguration in January 2021, President Biden's disapproval rating has tracked closely with monthly CPI readings, as demonstrated in the chart below (Exhibit 24). The association does not surprise us, as many voters tend to hold presidents accountable for current economic conditions, and as any market participant is aware, inflation has been sustained at elevated levels relative to pre-Covid conditions. Inflation is one of the main concerns for voters going into the polls in November, with 50% of people citing inflation and the economy as the most important issue for the President and US Congress (WSJ). Inflation is particularly pertinent for lower income, fixed wage, and rural residence individuals, who were the critical swing votes that secured the 2020 election for Biden. According to a CNN poll, 7 in 10 Americans think the government is not doing enough to reduce inflation. In addition, an ABC News/Ipsos poll found that only 30% approve of Biden's handling of inflation. Hence, elevated inflation levels over the past year (and voters' continued indication that inflation/economic concerns are a top issue) have likely contributed to President Biden's steadily climbing disapproval rating.

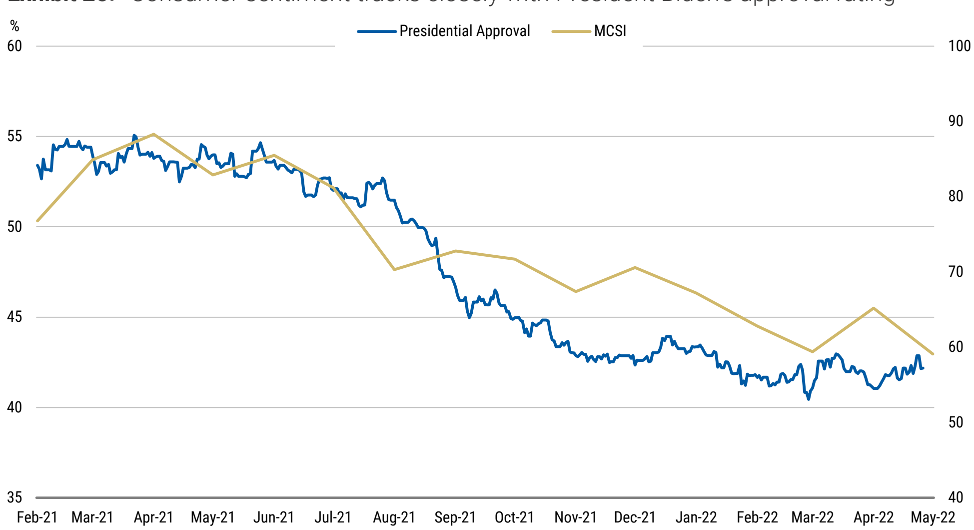
Exhibit 25: Inflation tracks closely with President Biden's disapproval rating



Source: FiveThirtyEight, Morgan Stanley Research

Given that relationship, it is worth noting that inflation could provide more downside, or upside, to Democrats' midterm prospects. Our economists' forecast suggests that inflation peaked in 1Q22 at 8% and will fall to 6.7% in 3Q22, when voters head to the ballot box. Consumer sentiment – another indicator that tracks closely with presidential disapproval (Exhibit 25) could also be an important factor to watch as the elections inch closer. Consumer sentiment is currently near an 11-year low, largely driven down by worries about inflation and pandemic recovery. Voters' negative economic outlook could be a challenge for Democrats to overcome in November.

Exhibit 26: Consumer sentiment tracks closely with President Biden's approval rating



Source: University of Michigan Surveys of Consumers, Morgan Stanley Research

Key Races to Watch

There are a few key races in both the House and Senate that we believe are worth keeping a closer eye on than the broader landscape. In the Senate, we believe control comes down to about a handful of critical races. Given that every seat in the House of Representatives is up for election (and the total is ~ 4x the number of seats in the Senate), each individual race indicates less about the final outcome. That being said, given a high number of Democratic representative retirements and redistricting outcomes shifting the landscape, there are about 20 races (according to third parties such as Politico and Cook Political Report) that will be critical in the 2022 midterms.

The Senate races that we think can deliver control of the chamber to one party or another are summarized in the table below:

Exhibit 27: Key Senate Races: 2022 Midterm Elections

Key Senate Races: 2022 Midterm Elections				
State	Reasons to Watch	Incumbent	538 Most Recent Poll	538 Partisan Lean
Arizona	· Kelly won narrowly in a special election · Close state in the 2020 election · AZ has voted more Republican than the national popular vote in the last two elections	Mark Kelly	D+2	R+7.6
Georgia	· Warnock won narrowly in a special election · Closest state in the 2020 election · Opponent Walker backed by Trump and much of GOP establishment · Comparable fundraising levels between both candidates	Raphael Warnock	D+5	R+7.4
Nevada	· First term incumbent · Likely opponent is Trump-endorsed former state AG	Catherine Cortez-Mastro	D+8	R+2.5
Pennsylvania	· Incumbent retiring · Close state in 2020 election · R won Senate seat but Biden carried the state in 2020 · Republican primary crowded and competitive	Pat Toomey (retiring)	D+2	R+2.9
Wisconsin	· Close state in 2020 election · R won Senate seat but Biden carried the state in 2020	Ron Johnson	D+4	R+4.1
North Carolina	· Incumbent retiring · Republican primary crowded and competitive	Richard Burr (retiring)	D+4	R+1

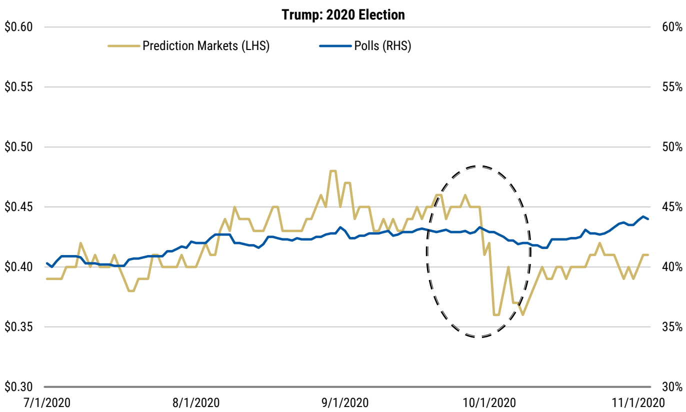
Source: Morgan Stanley Research, FiveThirtyEight, Politico, Cook Political Report

Prediction Markets - Potential for Insight Close to Election Day

We've long tracked various sources (third-party models, polling data, and prediction markets among them) to get a read on the state of the race in the months leading up to the election. As a result of this practice over the past few election cycles, we began to notice that prediction markets generally track polls early in the race, but start to break from them as the election draws closer. However, on a more local level, prediction markets tracked well throughout the race with battleground state polls. Looking at the 2020 election results, our question then became: did prediction markets have a better read of the 2020 outcome than polls did closer to the election? In short, there's some evidence that prediction markets were a more reliable indicator of the final election outcome closer to the election, though this pattern only broke out ~1 month out from Election Day.

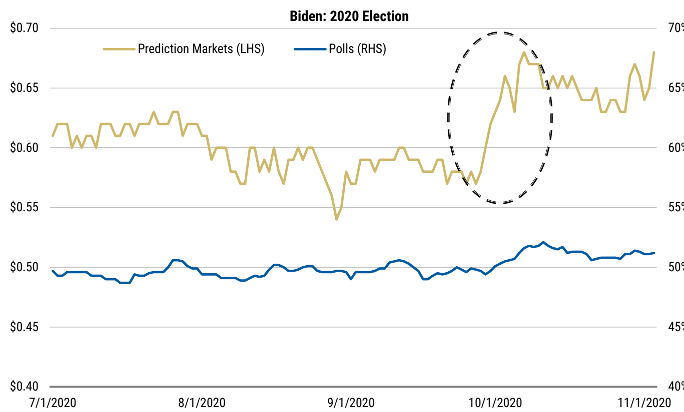
Prediction markets appear to move more than polling data. For example, national polls were relatively consistent for both Trump and Biden throughout the race, while prediction markets tended to fluctuate more with race developments: for example, the chart below highlights the prediction markets' assigning Trump a lower chance of winning in early October 2020, immediately following the first presidential debate, which was held on September 29. Polls, conversely, remained steady over the same time period.

Exhibit 28: During the late summer/early fall, prediction markets flagged a decline in support for the incumbent President...



Source: PredictIt, Real Clear Politics, Morgan Stanley Research

Exhibit 29: ...while prediction markets continued to assign Biden a higher probability of winning, but in particular saw a surge in early October following the debate.



Source: PredictIt, Real Clear Politics, Morgan Stanley Research

Hurry Up & Wait: We Could See 'Election Week' Part Two

Some states have codified more permissive voting changes after the pandemic, an event which we expect has the potential to delay the delivery of the results in a similar way as 2020. As we explored in depth ahead of the 2020 election, the Covid pandemic and concerns around in-person gatherings underscored a preference for a large segment of the population to vote either early in person or by mail. States responded by expanding access to alternate methods of voting, including no-excuse absentee voting or adding drop boxes. Some states pursued these as temporary measures, while others sought to make the changes permanent to facilitate voting in future elections. Some relevant changes codified since the 2020 election that might alter the way individuals vote in the future:

- Nevada and Vermont switched during the pandemic to universal mail voting (mailing ballots to all active registered voters) for all elections going forward.
- Kentucky locked in changes that allow in-person early voting, adding three days of in-person early voting and allowing counties to establish "voting centers" where any voter can go to vote rather than at a single local precinct.
- Six states (Connecticut, Delaware, Illinois, Maine, Nevada, and New York) enacted automated voter registration laws.
- In total, 25 states have enacted legislation aimed at creating more expansive voting provisions, including things such as expanding early voting opportunities, facilitating mail voting, easing voter registration, and expanding mail ballot drop box access or locations, according to the Brennan Center.

These changes could lead to a delay in delivering the election outcome, resulting in an "Election Week" as we saw in the 2020 election, though likely not at the same scale.

Although Covid cases have been declining and the world is slowly returning to normal, we expect that a significant amount of voters will continue to take advantage of these new methods of voting. Hence, while we do not anticipate a delay of the same magnitude as the one that occurred two years ago, it's possible that some states could be slower to count ballots and struggle to announce results the same night of the election. As mentioned, we do not expect the delay to be as severe as it was in 2020 (it took nearly a week for the final result) for a variety of reasons, including 1) scale of the surge, as fewer people overall are likely to vote via alternate methods relative to 2020, and 2) improved practices, as states were by and large unprepared for the magnitude of ballots during that election and likely have developed better processes around managing and counting mail-in ballots since then. To the extent the data is available, we plan to monitor states' databases as the election gets closer to map out how many voters (on a % basis) in each state anticipate voting via alternative methods to get a better sense of the potential delay. The exhibit below outlines the way that we determine the path toward various outcome delivery scenarios: "Silent Night," "Election Week," and "Election Month."

Exhibit 30: Our 2020 framework for predicting lag of the election results

	Outcome Scenario			
	Silent Night	Election Week		Election Month
Polling: Close Race?				
Note: "Close Race" = within margin in sufficient battleground states such that Electoral College outcome could swing either way				
Yes		✓		✓
No	✓		✓	
Early Vote Totals Indicate Significant Increase in Vote By Mail				
Yes		✓	✓	✓
No	✓			
There Is A Partisan Skew Among Those Willing to Vote By Mail				
Yes	✓	✓	✓	
No				✓
In Which Direction Does It Skew?				
Party Behind in the Polls	✓	✓		
Party Ahead in the Polls			✓	

Source: Morgan Stanley Research

US Economics

Julian M. Richers

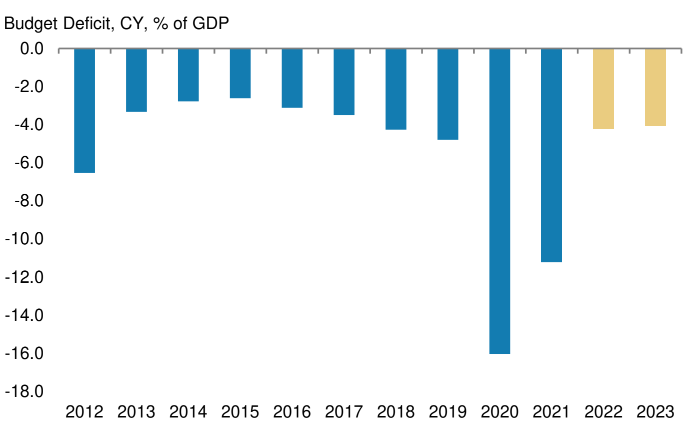
Key Takeaways

1. Deficit expansion remains the key variable to watch for the near-term growth outlook, both unconditionally and conditional on a worsening of the economic outlook.
2. In a scenario in which Democrats hold both houses, we believe increased spending is likely to be offset by tax increases, we do not expect a major positive growth impulse in the near term even if major spending initiatives were to be announced. Long-term economic growth could benefit however, and the re-institution of the Child Tax Credit (CTC) would boost household incomes and consumption.
3. In our bear case of a growth recession, fiscal support is least likely in a divided-government scenario.

Through the first half of 2022, fiscal policy has mostly been a drag on economic growth, but to a much lesser extent than feared. **In line with our expectations, the fiscal cliff has largely failed to materialize**. Even though on paper, the fiscal deficit is on track to contract sharply this year (to -4.2% from -11.2% in 2021, Exhibit 31), the negative growth contribution of government spending has been moderate. A large part of last year's deficit spending came in the form of household transfers, most of which did not get converted into spending. Instead, household savings have increased and are now beginning to feed into spending, at least to a limited extent. The expiration of the Child Tax Credit led to a drop in household transfers, but consumer demand stayed resilient, supported by strong wage growth and available household savings. Last year's fiscal spending will therefore continue to support growth even as the direct flow of funds out of government coffers has ceased.

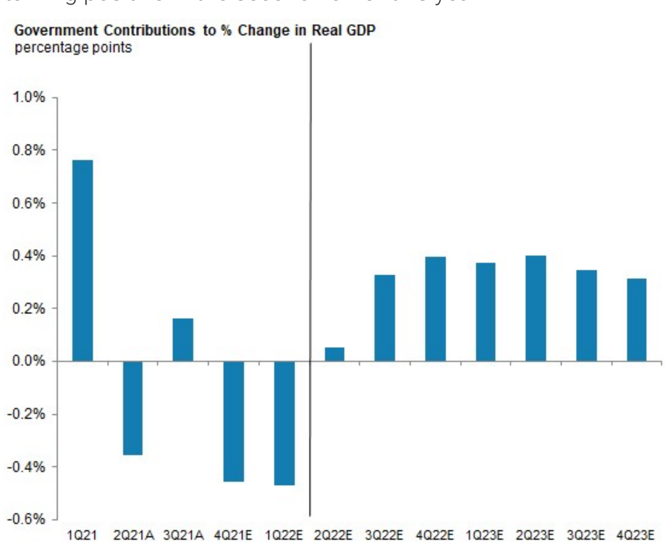
Growth contributions from government spending were a drag in 1Q to the tune of -0.5 ppts of GDP and the growth impulse will remain weak in 2Q. **But into the back half of the year, we expect acceleration to 0.3 ppts in 3Q and 0.4 ppts in 4Q as investments from last year's bipartisan infrastructure plan begin to break ground** (Exhibit 32). The long time lag on government investment is likely to sustain a positive growth impulse from government spending through 2023 as well.

Exhibit 31: The fiscal deficit will decline in 2022 and 2023 but remain sizable



Source: BEA, Morgan Stanley Research

Exhibit 32: The growth impulse from government spending is turning positive in the second half of this year



Source: BEA, Morgan Stanley Research

Under the scenario of Republicans gaining control of one or both chambers, major new spending initiatives are unlikely to materialize. Fiscal policy should also remain reactive rather than proactive, and would only respond to a meaningful slowdown in economic activity. The conflict in Ukraine is likely to boost defense spending, but the increase is likely to be in the low tens of billions relative to our previous baseline, not enough to meaningfully change the spending trajectory.

In the case that Democrats manage to hold on to the control of a unified government, our policy analysts see some probability of more spending such as on green energy and potentially even a return of the Child Tax Credit. But moderates have been steadfast in their demands that more spending be offset by increased revenue. A new spending program would therefore likely be accommodated by higher corporate taxes, offsetting any effects on the deficit. In the event of a more meaningful economic slowdown, fiscal support is likely to be more supportive, though more measured than during the pandemic period.

Tax Policy

Todd Castagno, C.F.A., C.P.A.

Key Takeaways

1. Individual and corporate taxes are headed higher regardless of election outcomes as key features of the TCJA begin to expire and the administration pursues its agenda.
2. If democrats hold both chambers, a renewed Biden agenda would continue to seek to raise revenue from corporations and the wealthy, but the form is evolving and higher corporate rates should be considered.
3. Sectors most exposed to a 15% minimum corporate book tax: diversified financials, banks, telecommunications and utilities
4. Sectors most exposed to a higher corporate rate & international taxes: technology, energy, telecommunications, healthcare and utilities

Under all election scenarios, individual and corporate taxes are likely to headed higher. The key questions are how high and when?

The Biden agenda prominently includes higher taxes on corporations and the wealthy to reform social policies and to fund investments in clean energy. However, given political dynamics of moderate democrats, there are limits on the form and magnitude of tax increases. For instance, the latest iteration of Build Back Better (BBB) legislation primarily aims to raise revenue from wealthy individuals via surtaxes and from corporations via new minimum taxes. Reform of estate taxation, capital gains, and increasing the corporate tax rate were key elements of Biden's campaign, but since been sidelined due to moderate positioning.

We expect more of the status quo if democrats hold both chambers. Inflationary pressures, a slowing economy and moderate *de facto* control of the senate indicates limits on raising taxes will persist. That said, the mix of revenue policies are likely to evolve. For instance, certain moderate democrat objections to raising the corporate income tax rate may become more flexible depending on election outcomes. This would potentially ease reliance on minimum taxes, such as the newly proposed corporate alternative minium 'book tax'. Investors should monitor closely as changes to the tax menu may materially change the impact to certain industries—even if the overall price stays relatively similar.

For instance, we estimate a 15% minium book tax primarily targets **diversified financials**, **banks**, **telecommunications** and **utilities** (see here). If policy makers instead choose to raise the corporate tax rate to say 25% (ceiling in our view), then we estimate **technology**, **energy**, **telecommunications**, **healthcare** and **utilities** are most likely impacted (see here). The current administration is also pursuing an agreement on global tax reform that would address profit shifting and tax minimization that primarily would affect **technology** companies (see The Two-Pillar Tax Overhaul).

We note utilities are largely economically insulated as profits and the rate bases are regulated. The utility industry is also a primary beneficiary of clean energy investment and related tax credits (see Clean Tech/Energy).

Upward tax pressure likely, even in divided government scenarios. Individual and corporate taxes are already set to increase under current law, as we discuss below. The Tax Cuts and Jobs Act (TCJA) is primarily temporary legislation as it was passed via budget reconciliation. Most of the individual provisions are set to expire at the end of 2025. The corporate rate was "permanently" lowered, but other onerous transitions start to take effect this year, including limits on interest deductibility and the amortization of R&D costs.

Congress will be incentivized to address popular bipartisan provisions, such as R&D treatment and extension of child tax credits. In a divided government scenario, these provisions may have enough critical mass to reach bipartisan comprise. Perhaps a reasonable analog is the 2015 PATH Act that enhanced child tax credits while also reforming key elements of business taxation.

In general, we note the individual side of the code typically takes precedence over the corporate side. Given the magnitude of expiring individual provisions, investors should be mindful that corporate effective rates may also be subject to increases.

Key Tax Cuts and Jobs Act (TCJA) Items Scheduled to Expire

The 2017 Tax Cuts & Jobs Act (TCJA) reformed the individual and corporate tax code and permanently reduced the corporate tax rate to 21 percent. In order to pass TCJA within the imposed budget constraints, Congress implemented scheduled phase-outs and offsets.

The Build Back Better bill (BBB), as drafted, planned to extend certain corporate and individual tax provisions. However, following the stalling of BBB, it is unclear how and when Congress will act. The outcome of the midterm election could determine how/if the TCJA provisions are extended. The phaseouts have already begun this year for corporations and barring intervention from Congress, the individual tax reform provisions are scheduled to expire in 2025.

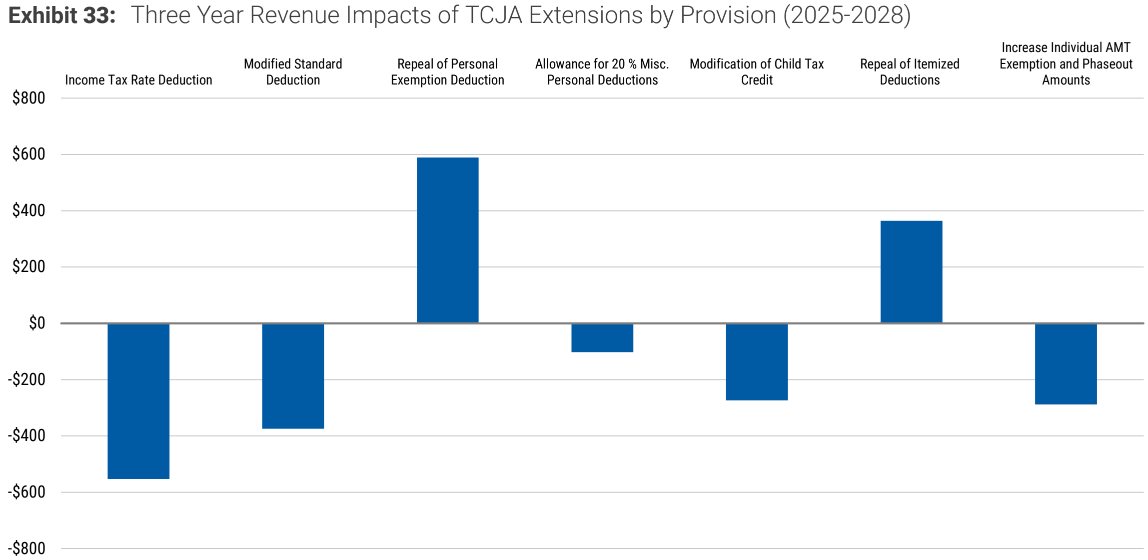
There are 23 provisions relating to individual income taxes that will expire in 2025. Without extension, most taxpayers will see a tax hike. Below is a summary of the most significant individual items scheduled to expire:

- **Reduction of Individual Income Rates**: The individual income tax code is scheduled to return to pre-TCJA levels, including an increased tax rate and the return of personal exemptions, limitations on itemized deductions, uncapped state and local tax deductions, and other miscellaneous itemized deductions.
- **Increased Child Tax Credit**: TCJA increased the credit amount and expanded the qualified thresholds for recipients. Upon expiry, the Child Tax Credit amount will decrease and revert to more restrictive thresholds.
- **Increased Alternative Minimum Tax (AMT) Exemption**: TCJA drastically decreased the number of individuals subject to AMT flings from an estimated 10 million to 1 million. After expiration, a significant amount of individuals will incur AMT liability and owe higher taxes.
- **Increased Standard Deduction**: TCJA nearly doubled the standard deduction, increasing it from $6,500 to $12,000 for single filers and $13,000 to $24,000 for joint filings. The standard deduction will return back to the original amounts after expiration.

We illustrate the budget impacts of extending the main TCJA individual provisions below in exhibit.

A number of important business provisions have already started expiring this year. Notably, corporations are required to amortize R&D and software development costs over 5 years (vs. immediate deductibility and limit interest deductibility to 30% of EBIT (vs. 30% of EBITDA). There will also be a phaseout of immediate capex expensing in 2023-2027 and higher taxes on international income, causing an additional cash flow headwind for corporations. We have highlighted the potential impact from the expiration of these provisions here: US Public Policy | GVAT: Scheduled TCJA Tax Hikes Arrive And Risk Near-Term FCF (13 Jan 2022). *(Author: Todd Castagno)*

Exhibit 33: Three Year Revenue Impacts of TCJA Extensions by Provision (2025-2028)



Source: The Tax Foundation, Morgan Stanley Research

China Equity Strategy

Laura Wang

Key Takeaways

1. United States Innovation and Competition Act (USICA) and inclusion of Accelerating Holding Foreign Companies Accountable Act (AHFCAA) are likely to have the most impact given investors' attention to ADR delisting uncertainty. That said, passage of the bill could take place ahead of midterms with bipartisan support. Broader implications for China are also possible depending on the details of USICA.
2. Most positive outcome: AHFCAA is dropped from the final draft of USICA. This effectively gives one more year of probation period for companies on the SEC's non-compliant list and that could be facing forced delisting after a three-year review period. This will serve as a positive surprise to the market, with the Internet and Consumer sectors benefiting the most. In the DD scenario, alternative energy equipment providers and CDO/CMO could benefit.
3. Most negative outcome: AHFCAA gets officially implemented and effectively brings the delisting schedule for non-compliant ADRs one year forward. Moreover, stricter-than-expected restrictions on trade with, R&D in, and investment in China would weigh further on investors' long-term concern over China's investability and push up the Chinese market's equity risk premium. By sector, IT, Industrials, and Healthcare are likely to be face the most negative impact.

Rationale: China-related legislative efforts likely to gain bipartisan support; ADR delisting risk remains critical to the offshore Chinese equity universe

The US/China geopolitical relationship has remained a "front seat" risk factor in China's equity market since 2018: It startd from direct trade tension but has gradually expanded to multiple non-trade fronts including:

- **Entity List:** Entities and individuals that "are subject to specific license requirements for the export, reexport and/or transfer (in-country) of specified items" due to concerns over "activities sanctioned by the State Department and activities contrary to U.S. national security and/or foreign policy interests."(source: BIS website).
- **Executive Orders:** Executive Order 13959 – "Addressing the Threat From Securities Investments That Finance Communist Chinese Military Companies" – was originally signed by President Trump. It was later replaced by E.O. 14032, signed by President Biden, which addresses "the Threat From Securities Investments That Finance Certain Companies of the People's Republic of China." This E.O. prohibits U.S. persons from investing in Chinese companies identified by the U.S. government as having ties to China's military or surveillance industry. Stocks that had been included in the Executive Order have suffered from loss of US investor allocation, and short-term volatility spike due to forced selling by affected investors.
- **Holding Foreign Companies Accountable Act (HFCAA):** This targets forced delisting from the US equity market of those Chinese stocks that are determined as being non-compliant with US audit inspection requirement by the SEC and the Public Company Accounting Oversight Board (PCAOB). Under current HFCAA stipulation, companies that consecutively fail the annual PCAOB review for three years will face the start of delisting. This Act was signed into law on December 18, 2020 and has been in full effect with 23 companies on the conclusive list and 105 companies on the provisional list for 2021 (first year) inspection as of May 10, 2022 (source: SEC website).

HFCAA is likely to be the one that's the most relevant to this year's midterm election results because Congress would need to vote on a potential amendment of the law: This is because the other US/China geopolitical actions/activities in sight rest more in executive authority, and won't be affected by the midterms. Accelerating Holding Foreign Companies Accountable Act (AHFCAA), which aims at shortening the three-year review period to two years, has been passed by the Senate as a standalone bill and is now integrated into the America Competes Act (HR 4521). The next step will be conferencing with the Senate's Innovation and Competition Act (USICA), which was passed by the Senate in July 2021.

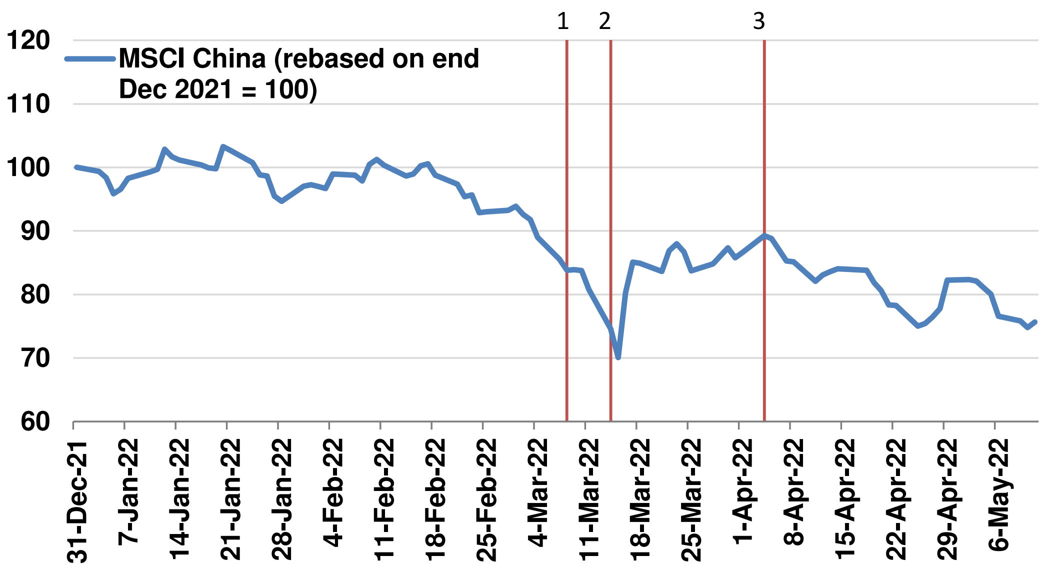
However, we do not view the outcome to be highly uncertain – i.e. inclusion of the AHFCAA in the final draft of USICA is highly likely given its bipartisan support.

Moreover, the chance of USICA being passed before midterms is also quite high.

ADR delisting uncertainty remains a key concern for investors and has been a key factor driving market volatility. MSCI China experienced a major drawdown of 18% between March 9 and March 15 after the first batch of five ADRs got added to the SEC provisional non-compliant list on March 8, US time – see China Equity Strategy: HFCAA Implementation Has Begun – Five ADRs Added to Provisional List (10 Mar 2022).

Broader Chinese sector implications also likely given the nature of USICA's coverage: This includes various fronts – science, manufacturing, R&D, etc. – where China is considered to be directly competing with the US.

Exhibit 34: MSCI China index move (rebased to 100 as of end-December 2021) – down 18% between March 8 and March 15, with the inclusion of five ADRs in the SEC's provisional non-compliant list being a main trigger



Source: Datastream, MSCI, Morgan Stanley research. Data as of May 11, 2022. 1: (Mar 8, 2022): The first batch of 5 Chinese ADRs were added in SEC provisional list; 2: (Mar 14, 2022): Vice Premier Liu He's speech during the Financial Stability and Development Committee meeting; 3: (Apr 3, 2022): CSRC revised Overseas Listing Confidentiality Rules.

Market takeaways: Chinese Internet sector most affected by AHFCAA; Tech and Healthcare likely covered by broader USICA

Most positive outcome: AHFCAA gets dropped from the final draft of USICA. This will serve as a positive surprise to the market because the general consensus is that AHFCAA enjoys bipartisan support. Such an outcome would effectively give one more year of probation period for companies on the SEC's non-compliant list and that could be facing forced delisting after a three-year review period.

Meanwhile, China has been more proactive in trying to achieve an audit dispute agreement with the PCAOB and SEC. The most recent developments include:

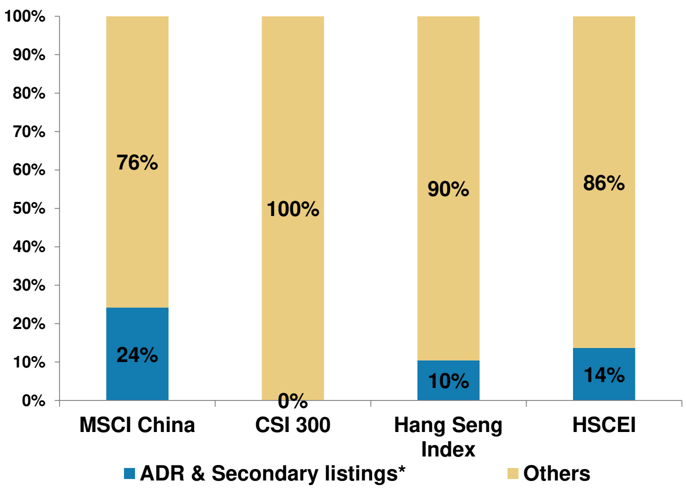
- Vice Premier Liu clarified on March 15 that positive progress has been achieved on the ADR audit dispute front, with detailed collaboration. In addition, ongoing support will be provided for all types of companies for overseas listings. See China Equity Strategy: Policymakers Clarifying Stance – Positive on Sentiment, and More Signs to Watch (16 Mar 2022).
- The CSRC, together with other central government agencies, announced revised confidentiality rules for overseas Chinese listings, signaling that potential achievement of a deal with the PCAOB on audit inspection is one step closer. See China Equity Strategy: CSRC Revising Overseas Listing Confidentiality Rules (3 Apr 2022).

In the event that AHFCAA gets dropped from USICA, together with official announcement of the PCAOB and SEC reaching agreement on audit inspection dispute, the ADR segment of Chinese equities would receive a major boost.

Relatively speaking, A-shares would benefit the least, with zero ADR exposure.

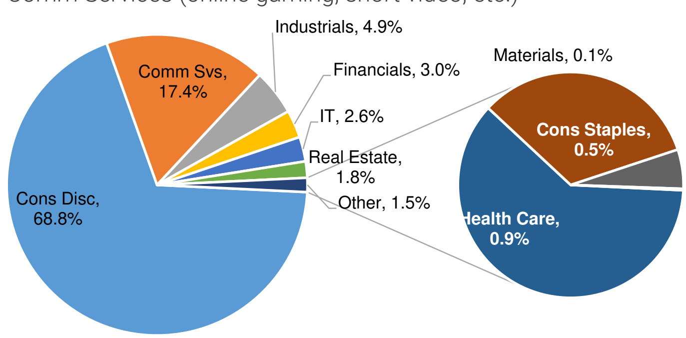
By sector, Internet and Consumer would be likely to benefit the most.

Exhibit 35: Index exposure to ADRs for Chinese equity universe – the MSCI China indez has one-quarter of its weight in ADRs



Source: FactSet, DataStream, MSCI, Shanghai Stock Exchange, Shenzhen Stock Exchange, Hang Seng Index Company, China Securities Index Company, Morgan Stanley Research. Data as of end-March 2022.

Exhibit 36: Breakdown of Chinese ADR universe by sector weight – Consumer (e-Commerce) holds the largest share, followed by Comm Services (online gaming, short video, etc.)



Source: Bloomberg, Factset, Morgan Stanley Research. Data as of end April 2022

Separately in a DD scenario, alternative energy equipment providers could benefit: This reflects the Democrats' emphasis on green energy and a more likely budget expansion outcome. Moreover, drug price reform could also trigger US pharma companies to seek more overseas lower-cost collaborators in drug R&D and testing etc. Whether select Chinese pharma companies would benefit from this remains to be seen, with incrementally more restriction pressure mounting, particularly on the front of competition with China.

Most negative outcome: AHFCAA gets officially implemented, effectively bringing the delisting schedule for non-compliant ADRs one year forward. Moreover, if the final USICA entails stricter-than-expected restrictions on trade with, R&D in, and investment in China, or vice versa, it would weigh further on investors' long-term concern over China's investability and push up the Chinese market's equity risk premium.

By sector, those likely to face the most negative impact include Information Technology, Industrials, and Healthcare.

Exhibit 37: Summary Impact Table

	(+)	(-)
D Senate D House	Alternative energy equipment providers Pharma (CDO, CMO) to a lesser degree ADRs (Internet, Consumer, HC) if AHFCAA gets dropped from USICA	IT, HC, Industrials
D Senate R House R Senate D House	ADRs (Internet, Consumer, HC) if AHFCAA gets dropped from USICA	IT, HC, Industrials
R Senate R House	ADRs (Internet, Consumer, HC) if AHFCAA gets dropped from USICA	IT, HC, Industrials

Source: Morgan Stanley Research

Banks & Consumer Finance

Betsy L. Graseck, C.F.A.

Key Takeaways

1. **We see FinTech regulation as a positive for the bank and consumer finance sector as it could level the playing field between banks and FinTechs and could enable banks to offer stablecoin and crypto products and services.**
2. **Build Back Better or other legislation that supports or accelerates reshoring would be a positive for banks. As supply chains shift to the US, banks would benefit from lending opportunities to the increased corporate investment spending and the trickle-down spending that occurs in those communities.**
3. **Recession risk rises in a divided government as there is less fiscal response to a recession.**
4. **Expect larger student loan forgiveness package under a DD scenario – but a divided government could mean moratorium remains in place beyond YE22.**

1) DD: Most Positive for Banks and Consumer Finance Stocks

Two major changes expected in an empowered and stronger DD government is FinTech regulation and Build Back Better legislation. We view the benefit from FinTech regulation as larger than the expected 4% point higher corporate tax rate.

a) FinTech regulation could level the playing field between the banks/consumer finance companies and the non-banks/FinTechs, a positive for banks and consumer finance companies. The President's Working Group has clearly prioritized regulators on digital assets, stablecoins, and crypto. Legislation could help here in setting rules around stablecoins, which would open the door for banks to be involved in either issuing or servicing stablecoins. Second, legislation could bring crypto into the regulatory purview, enabling banks and regulated consumer finance companies to offer crypto services beyond CFTC-allowed futures and options. Third, legislation might even address the issue of deposit swipe fee arbitrage, in which small banks enable large tech companies to not only offer synthetic banking services like deposits but also generate a larger deposit swipe fee, thanks to the small bank carve-out in the Durbin Bill.

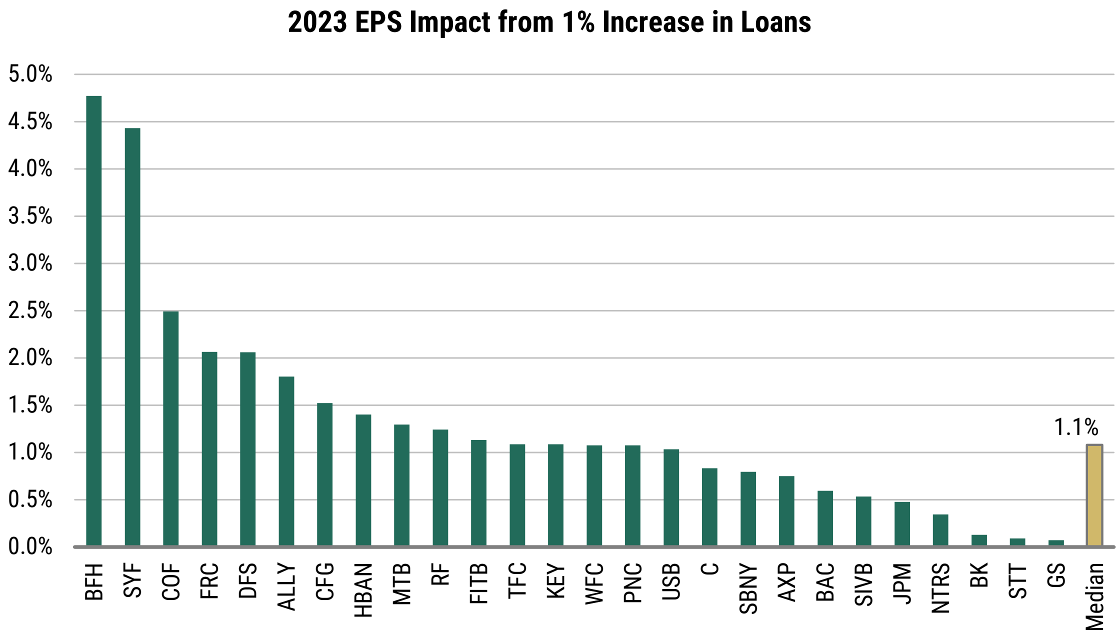
b) Build Back Better would increase onshoring, driving up capex and borrowing demands. One example of this is already playing out in Columbus, Ohio where Intel is putting in a 1,000-acre chip plant, a benefit to Ohio banks like Huntington, FITB, and Key. This type of investment not only helps drive demand for corporate lending but also small business consumer lending in the region as construction brings in workers and the finished plant brings in employees.

c) The drag on EPS from a 4% point hike in the tax rate is a near-term reduction for a much larger long-term benefit that comes from a stronger, more diversified, and resilient economy.

2) Republicans gaining control or a divided government could increase recession risk and magnify the bear case, particularly within consumer finance. Under the scenario of Republicans gaining control of one or both chambers of Congress, the Morgan Stanley economics team's view is that major new fiscal spending initiatives are unlikely to materialize. Fiscal policy should also remain reactive rather than proactive, and would only respond to a meaningful slowdown in economic activity. In our view, this scenario would present a larger potential bear case in the event of a recession, particularly as political appetite for additional consumer stimulus appears weaker following the prior 2+ years of pandemic-related support. This presents a risk for consumer-exposed lenders, particularly those with 1) a higher degree of credit card exposure, and 2) those with more of a subprime tilt. Companies most exposed here would be BFH, SYF, and COF.

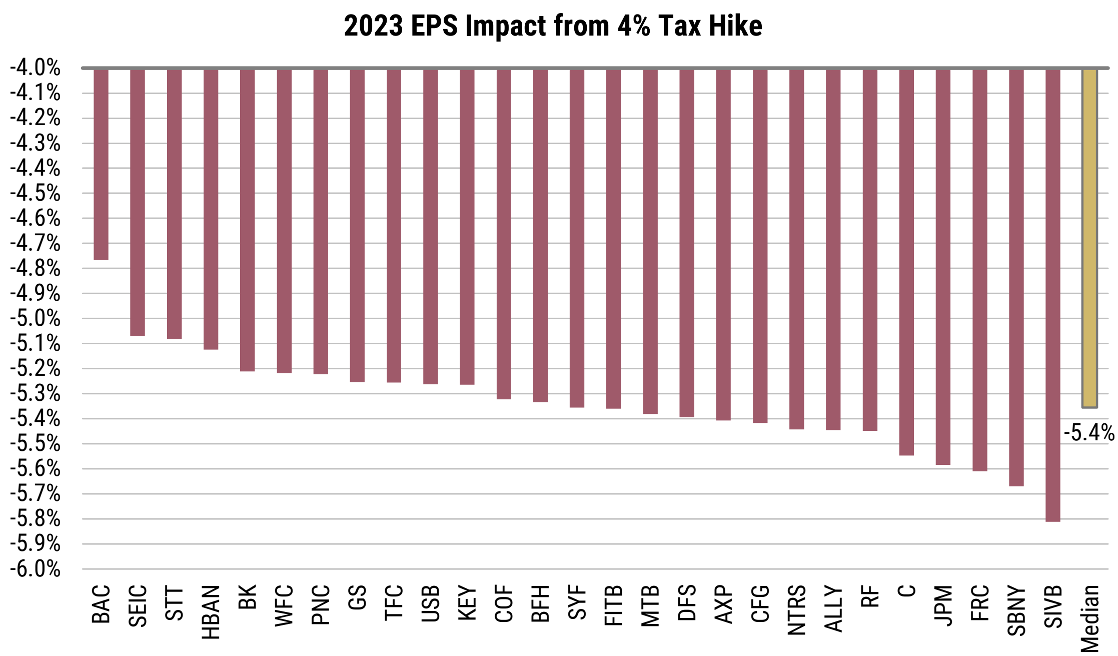
3) Student loan forgiveness issue is a mixed bag: DD positive for consumer finance but negative for student loan refi originators. In the case of a DD scenario, the likelihood of a larger student loan forgiveness package increases, acting as a near-term benefit for consumer lenders given positive implications for the consumer's ability to repay. However, this could be a negative for student loan refi originators, including SOFI, as larger federal student debt forgiveness lowers a significant source of potential student loan refi volume. Under a divided government, the odds of the student loan moratorium continuing could increase, as the President increasingly relies on executive orders to push through his agenda. Under full Republican control of both chambers, one might assume this increases the likelihood of the student loan moratorium ending by YE22, but the President could still rely on executive authority with his veto power, forcing Republicans to come up with a high bar in a 2/3 veto override vote.

Exhibit 38: We estimate a +1.1% benefit to 2023 EPS if we add another 1% to loan growth forecasts



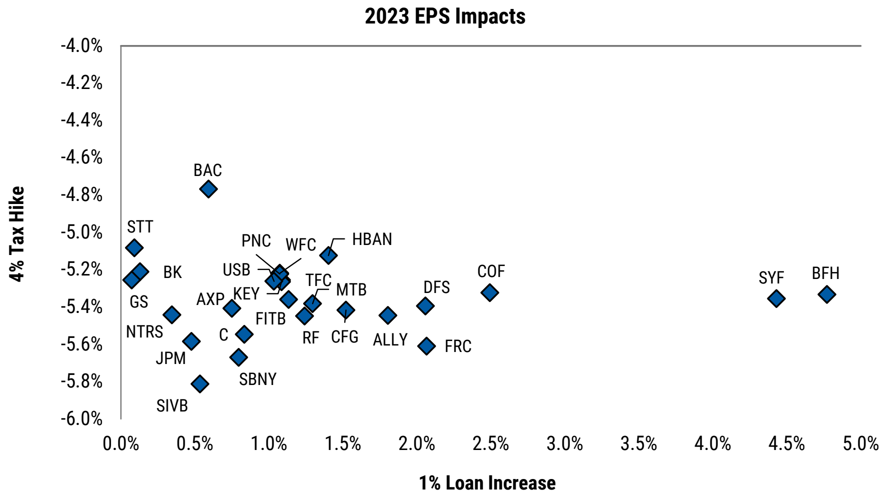
Source: Company Data, Morgan Stanley Research

Exhibit 39: We estimate a -5.4% decrease to 2023 EPS if we increase the tax rate by 4%



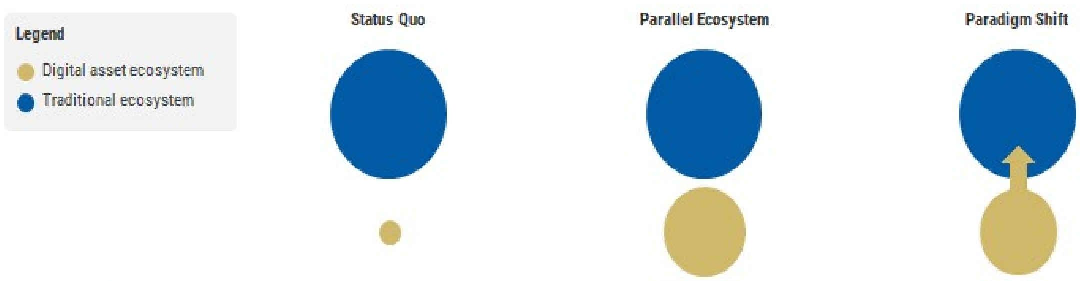
Source: Company Data, Morgan Stanley Research

Exhibit 40: SIVB has the biggest % decline in EPS from a 4% tax hike, while BFH has the biggest EPS benefit from 1% increase in loans



Source: Company Data, Morgan Stanley Research

Exhibit 41: Future evolutionary paths for Wholesale Banks in Digital Assets, 5-year horizon



	Status Quo	Parallel Ecosystem	Paradigm Shift
Institutional Wallet	**$6-7BN**	**$11-13BN**	**$14-16BN**
Wholesale Bank Share	Negligible	$4-5BN	$5-6BN
Key Developments	• Regulatory Stalemate	• Regulatory Shift • Volume Growth • Margin Compression	• Regulatory Shift • Volume Growth • Margin Compression • Bank Operating Model Efficiencies

Source: Industry public information, Oliver Wyman analysis

Exhibit 42: Summary Impact Table

	(+)	(-)
D Senate D House	All Banks	SOFI
D Senate R House **R Senate D House**		BFH, SYF, COF
R Senate R House		BFH, SYF, COF

Source: Morgan Stanley Research

Clean Tech/Energy

Stephen C. Byrd

Key Takeaways

1. Most impactful policy area: climate legislation. The former Build Back Better legislation had several initiatives across multiple clean energy technologies. Taken together, these could accelerate growth and improve margins across a range of industries.
2. Most bullish outcome: Tax credits for solar, wind, battery storage, fuel cells, hydrogen, and nuclear; "direct pay" of tax credits; increased carbon capture, utilization, and storage payments; subsidies for domestic clean energy manufacturing.
3. Most negative outcome: Lack of additional tax incentives along with failure to extend the current solar, wind, and fuel cell tax credits (ITC and PTC).
4. Oil & gas: We are not expecting any meaningful changes in oil & gas directed policy under any midterms outcome.

Multiple clean tech sectors could benefit from potential climate legislation

We see widespread potential benefits across the clean energy space if the climate provisions included in the former Build Back Better legislation were passed into law.

The prior draft bills had numerous supportive clean energy tax credits. Tax credits could be extended for up to ~10 years for solar, wind, and fuel cells, while new tax credits could be implemented for standalone battery storage, transmission, hydrogen, and nuclear facilities. In our view, the hydrogen tax credits were poised to have the most impact, with green hydrogen production receiving a significant tax credit that would meaningfully reduce the net cost of producing the fuel and would make it highly competitive with gray and blue hydrogen, expanding the TAM substantially. Nuclear tax credits would implement economic support for struggling plants and secure a minimum level of profitability and cash flow, thereby reducing downside risk. Battery storage tax credits would improve economics for backup systems, along with the retrofit opportunity in which storage is added to existing renewables facilities.

Beyond tax credits, climate legislation could involve several other beneficial initiatives. Direct pay provisions would enable clean energy project developers to receive cash for tax credits without the need for tax equity financing, potentially lowering financing costs. Subsidies for domestic clean energy manufacturing could drive an onshoring of some solar manufacturing in particular, with several companies indicating their interest in building facilities if incentives came to fruition. Increases in carbon capture, utilization, and storage payments could spur an acceleration in development of this industry by lowering costs and sparking increased demand.

On the broader energy side: We are not expecting any meaningful changes in oil-&-gas-directed policy under any midterms outcome. It is possible there may be some targeted gas infrastructure support that could be tied to climate policy to broaden support for such a bill. Overall, we don't see major pivot points for oil & gas driven by the midterm elections.

A wide set of clean tech stocks would benefit from passage of climate legislation

Our entire clean tech coverage would benefit from passage of comprehensive climate legislation with the above policy initiatives.

- Hydrogen: PLUG and BE
- Nuclear: CEG and PEG
- Solar: RUN, SHLS, AMPS, ARRY, SEDG, FSLR, MAXN, SPWR
- Financing: HASI
- Storage: FLNC, STEM
- Renewable developers: NEE, AES
- Wind: TPIC

Across our Energy / Oil & Gas coverage we see some potential beneficiaries as well:

- Carbon Capture: OXY, XOM, CVX, CLR
- Hydrogen: NFE, XOM, CVX
- Renewable / Low Carbon Fuels: CVX, XOM
- Gas Infrastructure Support: EQT

Exhibit 43: Summary Impact Table

	(+)	(-)
D Senate D House	PLUG, BE, CEG PEG, RUN, FLNC, STEM, SHLS, AMPS, ARRY, SEDG, FSLR, MAXN, TPIC, SPWR, NEE, AES, HASI	
D Senate R House		
R Senate D House		
R Senate R House		

Source: Morgan Stanley Research

Consumer Staples

Dara Mohsenian, C.F.A., Pamela Kaufman, C.F.A., Eric Serotta, C.F.A.

Key Takeaways

1. We are particularly focused on a potential increase in corporate taxes after the midterm elections. Consumer companies generally face less regulatory risk than other sectors. Rising interest rates (following a period of higher inflation), which act as a bond proxy in a low-rate environment, typically are negative for the group. However, we think there is value in consumer companies as the group's strong and durable growth profile is discounted back at higher rates.
2. A Republican House and/or Senate would likely be viewed as a positive for the group, as it would largely eliminate the risk of an increase in the corporate tax rate and in theory temper inflation concerns with limited fiscal spending.
3. A Democratic sweep would be viewed negatively due to increased corporate tax risk, as well as in theory greater inflation risk due to higher fiscal spending.
4. Within tobacco, a Republican House and/or Senate would likely be viewed as a positive outcome as Republican administrations have typically created a more benign tobacco regulatory backdrop and could slow movement on the FDA's rulemaking process for banning menthol cigarettes. A Democratic sweep would likely be viewed as a modest negative, but would largely represent a continuation of the status quo in terms of the government's tobacco policy agenda.

Divided Government the Best-Case Scenario

With no major regulatory impacts expected in the CPG group, a potential increase in corporate taxes would likely be the biggest focus. A divided government with Republican control would likely be viewed as the best outcome, with less risk of rising corporate taxes, as well as more limited fiscal spending, which could limit inflationary pressures. On the other hand, a Democratic sweep would likely be viewed moderately negatively, with worry over higher corporate taxes, and to a lesser extent inflationary fears, but generally limited regulatory implications outside of tobacco.

Within tobacco, the key regulatory initiatives include the FDA's agenda to ban menthol cigarettes. The agency issues a proposed rule in April 2022, which is currently open to public comments. Following the public comment period, the agency will assess feedback and issue a final rule, which we would anticipate in mid-2023 at the soonest. A Republican House and/or Senate could slow the FDA's rulemaking timeline. We expect the tobacco industry to litigate a final rule, with a protracted timeline for litigation/implementation.

Exhibit 44: Summary Impact Table

	(+)	(-)
D Senate D House		
D Senate R House R Senate D House		
R Senate R House	MO, DD	CHD, CLX, KDP, HNST

Source: Morgan Stanley Research

Cryptocurrency

Sheena Shah

Key Takeaways

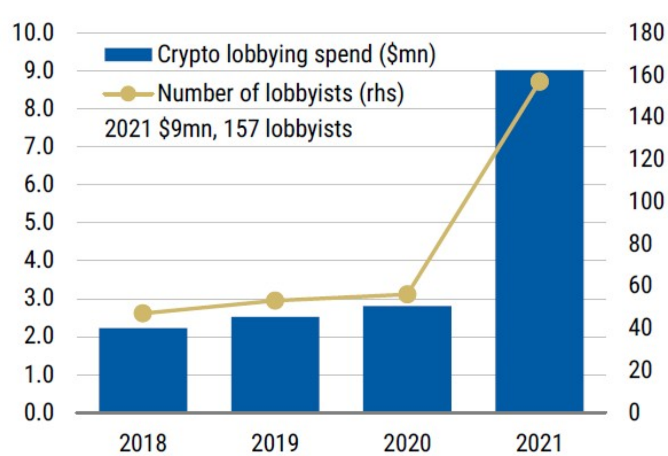
1. Defining cryptocurrency regulation is important for the industry to grow, especially in relation to stablecoins, the crypto products that can be offered, company ownership of crypto, and the possibility of a central bank digital currency. A united government could make it easier for new laws to be agreed upon and to follow the spirit of Biden's executive order, which was to keep the US at the forefront of innovation.
2. Cryptocurrency is having a greater influence on political views on both sides (Republican and Democrat) through political donations and lobbying. $9m was spent on crypto lobbying in 2021, quadrupling over the past three years.
3. A negative outcome for the crypto industry would be an extended period of uncertainty due to disagreement on new legislation, while government agencies such as the SEC, CFTC, and other bodies continue to limit specific crypto offerings from companies.

New cryptocurrency and digital asset regulations are coming – the question is when?

US President Biden's executive order on digital assets asked for various groups to report back on the crypto industry, the future of money and payments, related financial stability risks and the potential for a US dollar central bank digital currency. The first set of reports are due in September 2022, ahead of the November US midterm elections, where we will hear what the US Treasury and other groups see as the future of the payments and fintech industry. It was clear to us that the Biden administration wants to keep the US at the forefront of fintech innovation, meaning they would likely to allow the crypto industry to grow within a new framework of rules.

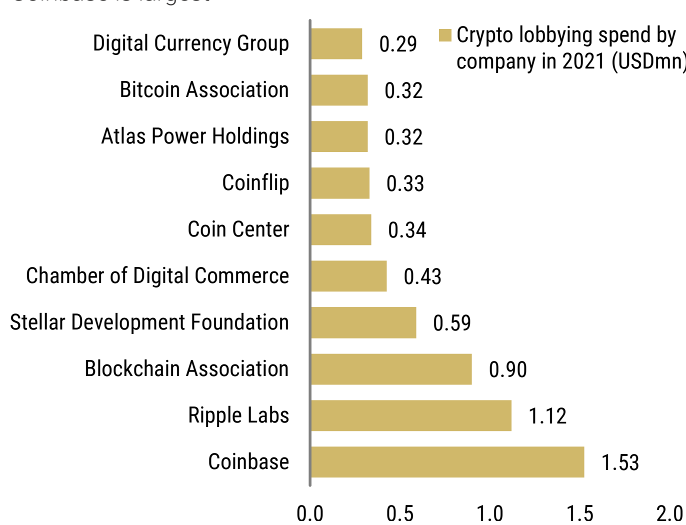
The outcome of the elections could determine how quickly any new crypto regulations as a result of the recommendations in these reports could be implemented, especially if any would require the House and Senate to agree on new legislation. Divided government scenarios could see an extended period of uncertainty but would likely see more of the current rules for banks, payment processors and exchanges be applied to the crypto equivalent businesses.

Exhibit 45: US lobbying spending by the crypto industry rose to $9mn in 2021



Source: Public Citizen, Morgan Stanley Research

Exhibit 46: 10 companies spending the most on crypto lobbying - Coinbase is largest



Source: Public Citizen, Morgan Stanley Research

Cryptocurrency proponents and sceptics on both sides of politics

It is not possible to generalize and say whether the politicians and supporters of either the Democrats or Republicans are pro- or anti-crypto. There are groups on both sides in both parties. The cryptocurrency industry, hoping for a set of favorable regulations, spent $9mn on political lobbying in 2021 (Exhibit 45). The amount may seem small relative to more than $100mn that the securities and investment sector spends on lobbying but the crypto lobbying spend did triple in one year. Among the crypto companies, Coinbase and Ripple Labs spent the most on lobbying in 2021 (Exhibit 46).

Crypto companies and crypto proponents have set up and donate to a number of political action committees (PACs) to support particular candidates ahead of the mid-term elections. Some of these include the Financial Freedom PAC, also called the Bitcoin PAC, Protect Our Future and American Dream Federal Action. The implications for these candidates' support would be two-fold: when Congress may need to vote on bills relating to defining and changing crypto regulation in the coming two years or in local states where crypto industries are being offered incentives to locate their businesses there.

Crypto regulations – what are the key points of debate?

1) Stablecoins - Both Democrats and Republicans have proposed regulating stablecoin issuers and participants and this area is likely to be tackled before other areas of the crypto industry. The key questions are related to whether issuers of fiat/US dollar asset backed stablecoins should be regulated like banks and be limited to owning specific liquid assets and have their reserves audited regularly. The US President's Working Group in November 2021 made some proposals and in view of recent market events, a variety of bills have been proposed. The recent collapse of a crypto backed stablecoin possibly shortened the timeline to implement some stablecoin regulation.

2) Who will have oversight over crypto regulation - SEC, CFTC, OCC, Fed or another new body? The SEC has been the most vocal that they would like to be the lead crypto regulator, stating that most crypto assets are securities. From the outcomes of the US executive order it seems likely that all these bodies are involved in crypto regulation to some extent.

3) Central Bank Digital Currency (CBDC) - Should initial investigations suggest the US should potentially create a CBDC then that would need to be approved by Congress. It is unlikely that type of decision would be presented in the next two years, before the next Presidential election.

Digital assets, sometimes known as cryptocurrency, are a digital representation of a value that function as a medium of exchange, a unit of account, or a store of value, but generally do not have legal tender status. Digital assets have no intrinsic value and there is no investment underlying digital assets. The value of digital assets is derived by market forces of supply and demand, and is therefore more volatile than traditional currencies' value. Investing in digital assets is risky, and transacting in digital assets carries various risks, including but not limited to fraud, theft, market volatility, market manipulation, and cybersecurity failures—such as the risk of hacking, theft, programming bugs, and accidental loss. Additionally, there is no guarantee that any entity that currently accepts digital assets as payment will do so in the future. The volatility and unpredictability of the price of digital assets may lead to significant and immediate losses. It may not be possible to liquidate a digital assets position in a timely manner at a reasonable price.

Regulation of digital assets continues to develop globally and, as such, federal, state, or foreign governments may restrict the use and exchange of any or all digital assets, further contributing to their volatility. Digital assets stored online are not insured and do not have the same protections or safeguards of bank deposits in the US or other jurisdictions. Digital assets can be exchanged for US dollars or other currencies, but are not generally backed nor supported by any government or central bank.

Before purchasing, investors should note that risks applicable to one digital asset may not be the same risks applicable to other forms of digital assets. Markets and exchanges for digital assets are not currently regulated in the same manner and do not provide the customer protections available in equities, fixed income, options, futures, commodities or foreign exchange markets.

Morgan Stanley and its affiliates do business that may relate to some of the digital assets or other related products discussed in Morgan Stanley Research. These could include market making, providing liquidity, fund management, commercial banking, extension of credit, investment services and investment banking.

Internet

Brian Nowak, C.F.A.

Key Takeaways

1. Any changes to US tech regulation remain an investor focus given the potential impact to ad unit pricing and engagement growth across the digital ad names (due to loss of data, lower efficacy, and quality of content).
2. Divided government or Republican sweep would be viewed as a positive/neutral outcome for the industry as we would expect any tech regulation passed to be focused on less restrictive and more widely agreed upon topics including transparency and privacy.
3. A Democratic sweep would be viewed as negative for the industry as more stringent tech regulation may include more challenging legislation around anti-competitive practices. As well, we anticipate any tax hikes in this scenario would impact profitable Internet companies.

Tech regulation continues to be a focus for US policy makers after activity in the UK and Europe has focused on 1) increasing antitrust scrutiny, and 2) applying existing content standards for traditional media to social media. As outlined in our regulatory deep dive report (see here), regulation could challenge companies' ability to grow through acquisitions while creating a burden for newer entrants. In the US, we expect proposals skew more moderate, and both existing legislative templates and public statements from members of Congress suggest that plausible US policy outcomes will focus more on data transparency and content moderation than portability and antitrust issues.

Exhibit 47: We expect reforms that are on the more restrictive end of the spectrum will be more difficult for Congress to enact

How Could Regulation Change the Rules for Internet Platforms?

Least restrictive → *Most restrictive*

	1) Transparency	Plausible Path	2) Content Moderation and Removal	Plausible Path	3) Data Privacy and Portability	Plausible Path	4) Competitive Practices	Plausible Path
Goals	**Create requirements to clearly state policies and report performance**		**Broaden instances in which platforms must remove content, narrow protections from CDA 230**		**Increase users' and third-parties' control over their data**		**Prevent platforms from discriminating against competitors**	
Potential Measures	Require companies to publish acceptable use and moderation policies and describe how users can report violations or illegal content	*Likely*	Require companies to review and remove illegal or policy-violating content in a timely manner	*Possible (less than Likely)*	Require companies to actively solicit users' permission to collect sensitive data	*Possible/Likely*	Ban companies from enforcing anti-steering rules (e.g. GOOGL preventing apps on the Play Store from directing customers to subscribe to services on the app company's website)	*Undetermined*
	Require companies to publish periodic reports on content removed	*Likely*	Require companies to implement a formal appeals process for affected content	*Possible (less than Likely)*	Require companies to allow users to easily move their data to other services	*Undetermined/ Possible*	Ban companies from tying products together (i.e. conditioning the use of one product on the use of another)	*Unlikely*
	Require companies to provide real-time access to advertisers, publishers, and users of relevant data	*Unlikely*	Prevent companies from using Section 230 as a defense for a period of time following infractions by the companies	*Undetermined/ Unlikely*	Enact legislation requiring platforms provide portability and tools to fascilitate	*Undetermined/ Possible*	Restrict companies from giving preferential placement to their products that compete with third-party products on the platform	*Unlikely*
			Establish legal/financial liability for harmful or illegal content	*Unlikely*			Ban companies from using data from third-party businesses on a platform to improve the platform's own products	*Unlikely*

Source: Company data, Morgan Stanley Research

A divided government (DR or RD) or a Republican sweep (RR) would be viewed as neutral. There is bipartisan support for some baseline consumer protections and increased regulation. That being said, under these government scenarios, lawmakers are likely to have reduced ambitions and would focus on less restrictive legislation including transparency and data privacy.

A Democratic sweep (DD) would be viewed as a negative for the industry. We would anticipate a heavier focus on more challenging areas such as anti-competitive practices in addition to legislation covering transparency, content moderation, and data privacy. The extent to which increased regulation affects social media companies' ability to capture, retain, and analyze data could lead to lower ad targeting and/or ad efficacy (leading to lower effective ad pricing growth). Keep in mind that regulatory risk is not new, and we have seen companies such as FB take steps to self-regulate, including growing the safety and content review team, providing users with more control and portability, and reducing the number of political ads. A tax hike is also probable under a DD scenario; see here for a framework on possible outcomes of tax changes and the potential impact to AMZN, ATVI, BKNG, EA, ETSY, EXPE, FB, GOOGL, PLTK, and TTWO.

Exhibit 48: Summary Impact Table

	(+)	(-)
D Senate D House		FB, GOOGL, SNAP, PINS, KIND, YELP, AMZN, Z, COMP, IS, APP, TTWO, PLTK, EA, ZNGA, SCPL, MYPS, ETSY, BKNG, EXPE, RBLX
D Senate R House R Senate D House	FB, GOOGL, SNAP, PINS, KIND, YELP, AMZN, Z, COMP, IS, APP, TTWO, PLTK, EA, ZNGA, SCPL, MYPS, ETSY, BKNG, EXPE, RBLX	
R Senate R House	FB, GOOGL, SNAP, PINS, KIND, YELP, AMZN, Z, COMP, IS, APP, TTWO, PLTK, EA, ZNGA, SCPL, MYPS, ETSY, BKNG, EXPE, RBLX	

Source: Company data, Morgan Stanley Research

IT Hardware

Erik W. Woodring

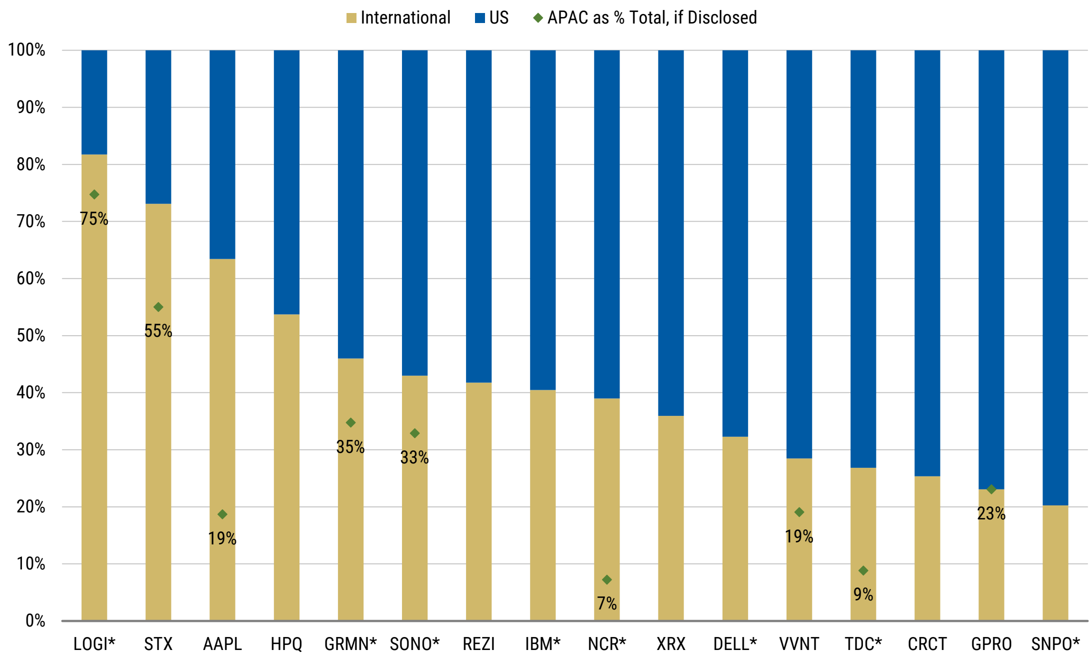
Key Takeaways

1. Any major changes to big tech regulation continue to be an area of concern for investors, particularly around the area of anti-trust and data privacy legislation. An increase in corporate taxation could also negatively impact the bottom line for our coverage. While the Make It in America Act could help reinvigorate American innovation in certain industries, the US IT Hardware industry continues to rely heavily on Chinese manufacturing, assembly, and tooling expertise, and any regulation that makes it more challenging for US companies to manufacture in China would present a challenge to our group.
2. A Republican sweep would be viewed as the most positive outcome for the tech hardware industry and would likely result in the least restrictive legislation. A divided government would also be viewed as neutral and less aggressive legislation than a full Democratic sweep.
3. A Democratic sweep would be viewed as having the most negative impact on IT hardware companies. A DD scenario would likely result in stronger legislation on anti-competitive practices and an increased statutory tax rate of 25%, resulting in larger tax obligations for tech hardware companies. Policies focused on China remain a wildcard given China is an "independent policy vector" in DC.

Companies within the Tech Hardware industry are likely to be impacted by anti-competitive legislation aimed at big tech and corporate tax-related regulation. The US Innovation and Competition Act supports investments for domestic tech innovation and re-shoring supply chains, which could positively benefit the Tech HW industry as a shortage of components (particularly semiconductors) has wreaked havoc on supply chains over the past two years. This type of regulation would likely aim to decrease dependence on China for imports; however, the US IT Hardware sector has significant exposure to the Asia-based supply chain (from the perspective of component supply, testing, packaging, tooling, assembly, etc.; Exhibit 49) and therefore any tightening of regulation regarding imports could have an adverse impact on large tech hardware companies that have significant manufacturing presence in China, such as AAPL, DELL, HPQ, LOGI, and STX . Depending on the outcome, we see a Democratic sweep as having the largest potential impact to our group, while a divided government or Republican sweep would be the most neutral. Regardless of the outcome, we believe our IT Hardware companies will work to mitigate headwinds and defend against big tech regulation. Therefore, we expect risks to be more around headlines and sentiment, rather than any impact to fundamentals, with China regulation being an important swing factor.

Exhibit 49: LOGI, STX, AAPL, and HPQ all have >50% of their long-lived assets held internationally, with >50% in the APAC region for LOGI (primarily in China) and STX (primarily in Thailand & Singapore)

Long-Lived Assets International Exposure



Source: Company Data, Morgan Stanley Research; *Note: PP&E mix is used as a proxy in the case that long-lived assets by region is not disclosed.

(-) A Democratic sweep would be viewed as the most negative outcome for our Tech Hardware coverage. Criticism of big tech companies has grown over the past few years, with increased scrutiny on areas such as data privacy and anti-competitiveness. A corporate tax hike is more likely under a Democratic sweep scenario, and would have an adverse impact to our Tech HW coverage. On the anti-trust side, Apple is one of our most exposed names with allegations of monopolization regarding the App store (see more here and here); however, our survey work and App Store analysis (see here and here) suggests that <20% of US consumers are willing to purchase a mobile app directly from a developer, limiting the impact to 4-5% of EPS in a worst-case scenario in which the top 10-20 apps completely circumvent the App Store. On the data privacy side, a DD scenario would have the most stringent legislation, which could negatively affect big tech more broader. However, we'd like to note that Apple CEO Tim Cook's focus on consumer privacy and App Tracking Transparency puts Apple at less risk than others on the data privacy regulation side.

(=/+) A divided government or Republican sweep would be viewed as the most neutral or positive outcome. In the case of a divided government (DR), we view some combination of the Democratic sweep scenario outlined above, but more dilutive and less aggressive. In both cases of a DR or RR scenario, we see legislation focusing more on areas such as data privacy versus anti-competitive practices, which would have a lesser impact to our coverage. It is also less likely, especially in a RR scenario, that there would be an increase of the statutory tax rate, or the introduction of a corporate tax minimum.

Exhibit 50: Summary Impact Table

	(+)	(-)
D Senate D House		AAPL, LOGI, HPQ, DELL, STX, SONO, GRPO
D Senate R House R Senate D House	AAPL, LOGI, HPQ, DELL, STX, SONO, GRPO	
R Senate R House	AAPL, LOGI, HPQ, DELL, STX, SONO, GRPO	

Source: Company Data, Morgan Stanley Research

Metals & Mining

Carlos de Alba

Key Takeaways

1. Any additional fiscal stimulus or government support (monetary or legislative) to reshore US supply chains remains an investor focus as it directly impacts demand for commodities and raw materials (i.e., steel, copper, aluminum).
2. The most positive outcome would be a Democrat sweep as fiscal policy is likely to be more proactive, which will further increase demand for commodities and raw materials. The uncertainty under this scenario is approval of domestic mining projects, as this has been a complex issue under recent Democratic administrations.
3. A divided government or a Republican sweep would be viewed as neutral as fiscal spending is likely to be reactive only, lowering the potential for additional demand for commodities and raw materials in an already healthy market.

Companies under our coverage in the US steel sector (X, CLF, STLD, and NUE) posted a solid 1Q22 print and have guided to strong sequential (in some cases, record) results for 2Q22. Although these strong results were aided by a rebound in steel prices due to the Russia's evasion of Ukraine, as well as tightening global steel and scrap/metallics markets, all companies noted that they continue to see strong demand across their end markets, in particular construction, with order back logs in some cases reaching early 2023. A large driver of this strong outlook has been on the back of the infrastructure bill, and any further fiscal stimulus will only increase demand in what is already a healthy market and directly benefit the steel sector.

The current administration has continued to show interest and support through public funding in developing US supply chains for critical materials and the green economy. MP Materials, which mines rare earths essential for power EVs and wind turbine motors, is a direct beneficiary of this support (see here) through government grants to help develop domestic permanent magnetic supply chains to decrease the US's dependance on China for imports. We think additional legislative support and spending on the reshoring of US supply chains will continue to benefit MP.

A Democratic sweep (DD) would be viewed as a positive for the industry. Continued focus on Building Back Better and an expected proactive fiscal regime associated with in a DD scenario will, in our view, increase demand for raw materials and commodities in what is already a strong market. We see this directly benefiting steel equities under our coverage (X, CLF, STLD, and NUE), and to lesser degree miners (FCX, TECK, and AA) as base metals commodity markets are more dependent on global S/D dynamics. Continued focus and support for developing a green economy and reshoring supply chains will also benefit MP Materials, and possibly Largo.

A Republican control of the house and senate (RR) or a divided government (RD or DR) would be viewed as neutral. Less impactful legislation and a reactive fiscal policy associated with these outcomes would be neutral for the sector as end-market demand for commodities will continue to be healthy, but is likely to remain status quo. In the steel sector, demand is strong and order backs logs are extending into early next year in some cases. We believe incremental demand is unlikely without help from additional proactive fiscal stimulus. Similar rationale applies to the miners under our coverage. However, for miners local demand is less relevant as the base metals commodity markets depend on global S/D dynamics.

Exhibit 51: Summary Impact Table

	(+)	(-)
D Senate D House	STLD, NUE, X, CLF, MP, AA, TECK, FCX	
D Senate R House R Senate D House		
R Senate R House		

Source: Morgan Stanley Research

Pharmaceuticals

Terence Flynn, Ph.D.

Key Takeaways

1. **Any changes to US prescription drug pricing dynamics remain an investor focus given the potential impact to growth and margins.**
2. **A divided government would be viewed as a positive outcome for the industry as we would expect any drug pricing legislation passed in a bipartisan fashion to be scoped down substantially from other unilateral proposals.**
3. **A sweep by the Democrats would be viewed as a negative for the industry as we would expect Democrats to likely work off the legislation proposed as part of the Build Back Better plan, which as of December 2021 included allowing the government to negotiate the prices for certain high-cost drugs covered under Medicare Part D and Part B after the drugs have been on the market for a fixed number of years (not allowed under current law).**

US healthcare spending continues to rise (representing 18% of GDP in 2019 vs. 4% in 1950) and at a faster rate than 15 other high-income countries (Skinner, NEJM 2022). As a result, US policymakers have been looking for ways to control healthcare costs, including via changes to drug pricing. However, we'd note that spending on drugs is only ~13% of total healthcare expenditures.

Divided government (DR or RD) would be viewed as a positive outcome for the industry as we would expect any drug pricing legislation passed in a bipartisan fashion to be scoped down substantially from other unilateral proposals. If Republicans gain control of Congress (RR) and advance something similar to Grassley-Widen (which caps seniors' out-of-pocket drug costs in Medicare and limits Medicare drug price increases to the rate of inflation), and President Biden gets on board as well, this would be an incremental negative (change from current status quo), but much better than Build Back Better/direct price negotiations (below), so we view this as a neutral outcome for the industry.

A sweep by the Democrats (DD) would be viewed as a negative for the industry as we would expect Democrats to likely work off the legislation proposed as part of the Build Back Better plan, which as of December 2021 included allowing the government to negotiate the prices for certain high-cost prescription drugs covered under Medicare Part D and Part B after the drugs have been on the market for a fixed number of years (10-20 drugs depending on the year); imposing an excise tax on drug manufacturers that refuse to negotiate pricing with Medicare; requiring inflation rebates to limit annual drug price increases in Medicare and private insurance; and limiting cost-sharing for insulin products, among other provisions.

Within our coverage, BMY, LLY, MRK, and PFE have the highest exposure to Medicare, and JNJ has the lowest (given its Medtech and Consumer segments).

Exhibit 52: Summary Impact Table

	(+)	(-)
D Senate D House		ABBV, BMY, JNJ, LLY, MRK, PFE, RPRX
D Senate R House R Senate D House	ABBV, BMY, JNJ, LLY, MRK, PFE, RPRX	
R Senate R House		

Source: Morgan Stanley Research

Semiconductors

Joseph Moore

Key Takeaways

1. There are two areas in which legislation could affect semiconductors: 1) subsidization, and 2) potential export controls on goods from China (although the latter is an executive branch implementation, legislators still play an important role).
2. Support for semiconductor-related initiatives is relatively bipartisan, especially given the recent semiconductor shortage, though the focus may shift, and the details matter.
3. Subsidization could be an important offset for manufacturers dealing with large increases in capital intensity, and is an important positive for capital equipment stocks as well. Export controls could extend current shortage conditions and have mixed impact. Neither is likely to be the defining factor in semiconductor stock performance, but both are important at the margin.

Subsidy measures seem likely to pass Congress regardless of midterms outcome, but details matter

There have been various versions of the so-called "CHIPS" Act since last year. It is a $52bn federal provision to subsidize/invest in the research, design, and manufacturing of semiconductors domestically. It was originally part of the Build Back Better program, but the bill resurfaced as the US Innovation and Competition Act, which passed the Senate originally in June 2021. The House passed its version of that bill, the COMPETES Act, in early February, setting up the path for lawmakers to begin conference committee. That process involves representatives from the House and Senate reconciling the differences between the two chambers' pieces of legislation and ultimately producing a bill that will garner sufficient votes in the House and Senate.

The primary focus of this legislation (the broader CHIPS Act) is to subsidize domestic semiconductor fabrication spending, some of which may come from international companies (notably TSMC's Arizona operations and Samsung's Texas operations), as the government estimates that only 12% of domestic production comes from the US vs. 40% of consumption. Several semiconductor companies in our coverage would stand to benefit from such subsidization, with the largest US capital spending footprints coming from Intel, Texas Instruments, GlobalFoundries, Wolfspeed, and Micron. We also see significant benefit accruing to capital equipment providers, including Applied Materials, Lam Research, KLA, and Teradyne.

Another intriguing element of this pending legislation is potential investment in "public private partnerships" whereby public sector investment intersects private sector initiatives – which could create incremental demand for device manufacturers; the original CHIPS Act estimated those partnerships could total up to $10 bn in costs.

In the context of the current semiconductor shortage, as well as ongoing tensions regarding Taiwan, we see bipartisan support for this legislation, so some version of it seems likely to pass regardless of midterms outcome. We note that the Senate vote in March for the US Innovation and Competition Act passed 68-28, but the priorities embedded in the bill – domestic job creation, access to funding for non-US companies, the nature of public private partnerships – still could be altered by the ongoing reconciliation process.

While basic legislation on export controls has already been passed by Congress, the urgency to move forward on defining potential controls (or lack thereof) on semiconductor capital equipment could be impacted by the midterms outcome. The Export Control Reform Act of 2018 enacts the potential for export controls that could impact the semiconductor industry. While this isn't an issue Congress is addressing directly at this point, there is indirect influence – we note that bipartisan legislative pressure from Senators Chuck Schumer (D-NY) and Tom Cotton (R-Ark) acted as an accelerant in 2020, when the Bureau of Industry and Security held a request for comments from the public to review potential controls on what they called "foundational technologies", one of which was semiconductor capital equipment.

We reviewed the comments, and there are clearly those who favor restrictions on shipments of semiconductor capital equipment to China, either in totality or for advanced nodes. However, that is not a universal sentiment, as China is of growing importance as a source of supply for American hardware manufacturers.

We would note that various export controls have already had a significant role in the current semiconductor shortage, as US Commerce Department restrictions on shipments to certain Chinese customers triggered an inventory build without China, and then further actions restricting US semiconductor companies sourcing from China foundries have created tight supply within non-China foundries. That could be an incentive to move slowly on export controls now.

Who could benefit from export controls for semiconductor equipment in China? We think the most significant beneficiaries would be companies facing direct competition from China, most prominently Western Digital and Micron in the memory space, and Global Foundries in foundry. We also think that export controls would be positive for most device manufacturers, as it could lead to a more sustained shortage environment vs. our current expectation that supply constraints will ease over the course of the year.

Longer term, we note that the US strength in semiconductor capital equipment would make any export controls implemented by the US very significant restriction to China's development efforts – and could increase tensions over the role of Taiwan in semiconductor production.

Who could be hurt by such restrictions? Semiconductor capital equipment vendors such as Applied Materials, Lam Research, and KLA could be impacted, with around 15% of global capital spending coming from domestic China. Some of that lost spending would likely be recaptured in other geographies, but the magnitude is debateable; there are some areas in which spending reflects caution about China entry, but there are also cases of companies spending money on capital investments to be competitive with China entry; overall, we would estimate that a 10-12% reduction in revenues is possible – this could be more significant in the short term.

Important note regarding export controls. This note references export controls maintained by the U.S. Department of Commerce Bureau of Industry and Security (BIS). This disclaimer does not represent Morgan Stanley's view as to whether any activity is subject to export controls laws. Investors are solely responsible for ensuring that their investment activities in relation to any entities are carried out in compliance with applicable export controls laws.

Telecom Services

Simon Flannery

Key Takeaways

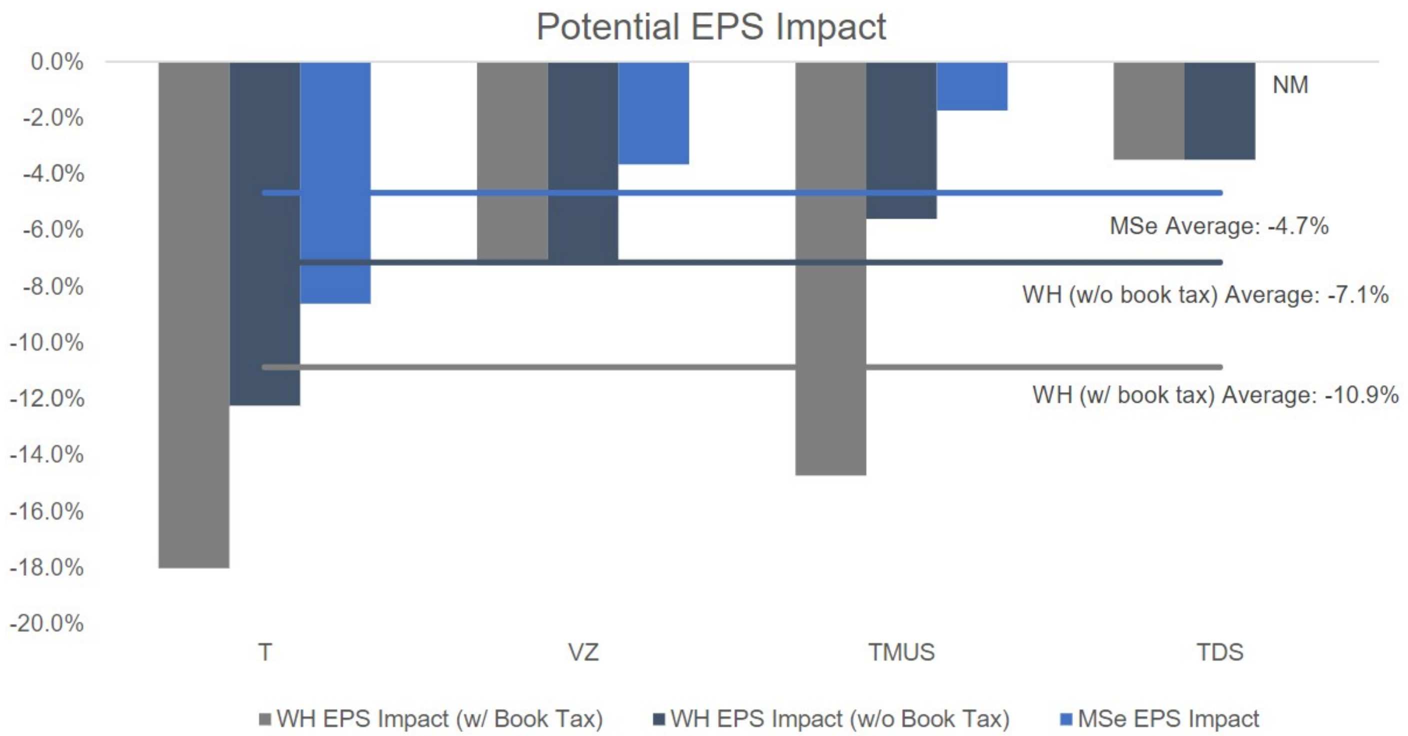
1. We are most focused on potential increases in corporate taxation; the large US Telcos currently benefit from accelerated depreciation on their heavy capex programs, limiting their federal cash tax obligations.
2. A Republican House and/or Senate would likely largely eliminate the risk of an increase in the corporate tax rate or introduction of a minimum/book tax. We could also see a bipartisan agreement to extend bonus depreciation, which is currently set to taper and then expire by 2026 under the TCJA.
3. A Democrat sweep with a larger Senate majority could see passage of an increase in the corporate tax rate to about 25%, as well as a potential minimum tax. This could increase annual cash tax obligations by several billion dollars for the US Telco sector. An increase in the dividend tax rate could also reduce the attractiveness of dividend-paying stocks to investors.

The recent passage of the Infrastructure and Jobs Act sets aside $65bn for broadband deployment over the coming years to be administered by the NTIA via the states. This represented the main telecom industry policy priority from a legislative point of view. We also expect the FCC to look to re-regulate broadband via a Net Neutrality proceeding once a fifth Commissioner (Gigi Sohn's nomination is pending) is confirmed by the Senate. It is possible that a fifth Commissioner will not be confirmed before Election Day, setting up a potential recess appointment after the election, which would last for one year. The makeup of the Senate post-election could well impact this choice.

With no major regulatory legislation expected, corporate taxes would be the biggest focus. Assuming there is no passage of corporate tax hikes in the remainder of 2022, we think it would be even more difficult to pass a corporate tax hike in the next session of Congress, unless the Democrats retain the House and gain seats in the Senate. In the event that we did see an increase in the corporate tax rates before the end of 2022 and a potential minimum book tax, there could be a meaningful impact to EPS and cash flows for the sector; see US Telecom & GVAT: Telecom & Taxes: What's the Potential Impact? (3 Jun 2021).

We see little sector impact in the event that Republicans gain control of one or both chambers of Congress in November. In the event of a Democrat sweep in November, we see AT&T, Verizon, and T-Mobile as being the most exposed to tax increases. We project an EPS impact of between 5% (MSe) and 11% depending on what combination of tax proposals are ultimately implemented. Tower and Data Center stocks would not be materially impacted due to their REIT status.

Exhibit 53: We estimate an average ~4.7% decrease in EPS under our Morgan Stanley scenario and a ~7.1% decrease in EPS under the Biden administration's proposal



Source: Calcbench, FactSet, Refinitiv, Company Data, Morgan Stanley ResearchNote: T is based on FY2019 data

Exhibit 54: Summary Impact Table

	(+)	(-)
D Senate D House		T, VZ, TMUS
D Senate R House R Senate D House	T, VZ, TMUS	
R Senate R House	T, VZ, TMUS	

Source: Company data, Morgan Stanley Research

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(as of May 31, 2022)

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	Coverage Universe		Investment Banking Clients (IBC)			Other Material Investment Services Clients (MISC)	
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category	Count	% of Total Other MISC
Overweight/Buy	1398	39%	344	44%	25%	599	39%
Equal-weight/Hold	1576	45%	354	45%	22%	721	47%
Not-Rated/Hold	1	0%	1	0%	100%	0	0%
Underweight/Sell	565	16%	86	11%	15%	211	14%
Total	3,540		785			1531	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

Analyst Stock Ratings

Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Equal-weight (E). The stock's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Not-Rated (NR). Currently the analyst does not have adequate conviction about the stock's total return relative to the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index or MSCI sub-regional index or MSCI AC Asia Pacific ex Japan Index.

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