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WEALTH MANAGEMENT

INVESTMENT STRATEGY

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US Policy Pulse

Deregulation Risks and Opportunities

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In this report, we discuss the potential economic and market outcomes of increased federal deregulation.

Key Insights:

- Deregulation is a central component of President Trump's agenda, but significant related economic and market impacts may be delayed, as trade policy and fiscal austerity take center stage for now and defensives outperform cyclicals.
- From 2002 to 2014, US firms spent between 1.3% and 3.3% of their total wage bill on labor-compliance regulations, growing at a 1% rate each year.
- Deregulation is likely to benefit industries that are most highly regulated, such as financials, energy, information technology and health care. Market performance in the days after the 2016 and 2024 elections reflected these reduced-regulation expectations.
- The financials sector could benefit from deregulation associated with decreased supervisory oversight, lower capital requirements through the "Basel III Endgame" process and reduced M&A scrutiny. Favorable crypto legislation and regulation could continue to boost retail and institutional adoption.
- AI regulation is likely to remain in the back seat as the Trump administration adopts a "develop first, regulate later" approach, while tech performance will likely be driven by AI adopters in cybersecurity and software.
- Trump is focused on boosting energy production, but oil production already sits at a record high and is unlikely to meaningfully increase without strong market incentives. Meanwhile, demand for natural gas remains robust, supported by regulatory tailwinds.
- Potential cuts to Medicaid and rollbacks of vaccine mandates could pressure pharma and managed care companies, though biotechnology companies could benefit from rate cuts.

The interplay of pro-regulatory and anti-regulatory policies has become synonymous with the Democratic and Republican parties. The often-contrary approaches to policymaking have been especially pronounced in recent years, as control of the White House has changed party hands the past three general elections. Prior to this era, former Presidents Bill Clinton, George W. Bush and Barack Obama enjoyed two consecutive terms, fostering less policy-related uncertainty as executive branch priorities were extended over an eight-year period.

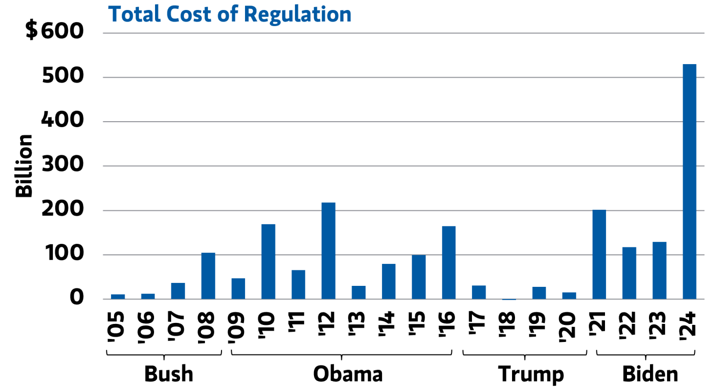
The Trump administration has ushered in a bold deregulatory agenda, building from Trump's first term when he asked federal agencies to eliminate two regulations for every new one issued. Currently, the incoming administration is seeking to eliminate 10 regulations for every new one. The reduction in government regulation could have notable consequences for the oversight of private sector activity, which could introduce economic and market risks. That said, reduced regulatory burdens have also been found to provide meaningful tailwinds for market performance and could bolster investment outcomes.

The balance between risks and benefits is critical as the new administration continues to unveil its regulatory and policy agendas. For example, Trump began his first term focused on growth- and productivity-related policies through a combination of deregulation and tax cuts. This was followed by tariff policy, which negatively impacted select sector and industry performance. In contrast, Trump's second term is prioritizing restrictive economic and trade policy while implementing fiscal austerity measures through government spending cuts. This will likely be followed by pro-growth policies through the deregulation of targeted industries and passage of tax cuts, the impact of which might be delayed until 2026 when tax policy goes into effect. The important difference between the policy paths of the current and prior Trump administrations pertains to the sequencing, pace and magnitude of implementation. These critical variables play a notable role in influencing final policy outcomes and could alter economic and market performance. Given these dynamics, we discuss the potential effects of deregulation on private sector activity and investment, while highlighting sectors where we expect to see significant regulatory change—namely, financials, tech, energy, industrials and health care.

Economic and Market Impact

When assessing the impact of deregulation on the economy, it is important first to acknowledge that the full set of risks and benefits of regulation/deregulation are challenging to value. For example, research outlining the negative and positive ramifications often features imperfect inputs that may not capture the full scope of policy consequences. We think it is critical to understand the recent historical context of regulatory trends. For example, the estimated total cost of regulation to the economy under President Trump's first term was $65 billion, 2.5 times less than under George W. Bush ($163 billion) and 15 times less than the total in Obama's two terms ($872 billion) and Biden's single term ($978 billion), as illustrated in Exhibit 1. While the total cost of regulation under Biden was the most significant, a congressional research report notes that he implemented fewer regulations per year than Obama and Trump, and the robust cost estimates are attributed to the scope of the regulations enacted (e.g., in the case of student loan provisions and vaccine mandates). In addition, the budgetary costs associated with growing government oversight have added to deficit spending and spurred the recent GOP movement to reduce the size of the federal government through major agency-level expenditure cuts and deregulation.

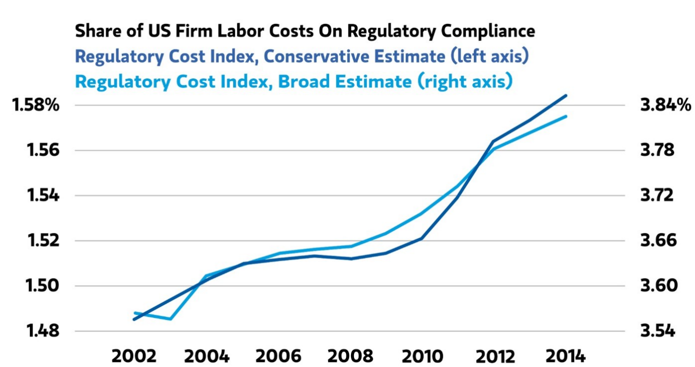
Exhibit 1: Annual Regulatory Costs Vary by Number of Policies and Their Price Tags



Source: American Action Forum, Piper Sandler, Morgan Stanley Wealth Management Global Investment Office as of April 24, 2024

Not only are increased costs due to regulation found at the government level, they also have implications for the business community. According to a University of California, Berkley, study, which analyzed jobs across industries where regulation-related tasks must be performed, the average firm spent between 1.3% and 3.3% of its total wage bill on jobs associated with regulatory actions from 2002 to 2014, with the aggregate wage bill growing at a 1% annual rate after adjusting for inflation (see Exhibit 2). The research only focused on the wage cost of regulatory compliance and did not account for capital expenditure costs or outsourced compliance costs, so the actual impacts could be greater.

Exhibit 2: Federal Regulations Pressure Labor Costs

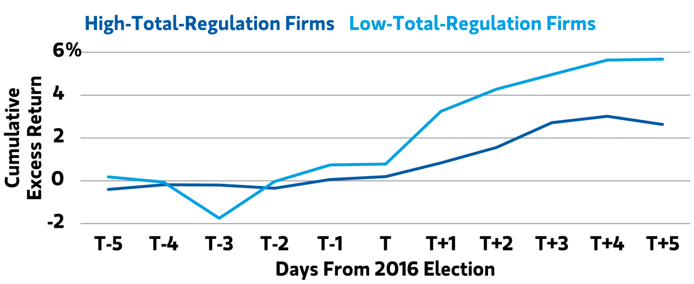


Note: The Regulatory Cost Index measures the percent of an establishment's annual labor spending on regulation-related tasks.
Source: National Bureau of Economic Research (NBER), Morgan Stanley Wealth Management Global Investment Office as of Jan. 31, 2023

Reduced regulation could decrease regulation-related wage expenses and allow business owners to redirect revenue to growth initiatives, potentially spurring innovation. Furthermore, a National Bureau of Economic Research (NBER) study found that in Organization for Economic Cooperation and Development (OECD)-member countries, which include the US, a single-point reduction in the OECD regulatory index results in a 1.1% increase in private and public investment. The study also found that a percentage-point decline in regulation reducing barriers to entry caused private and public investment to grow by 1.7%, increasing market competition.

From a financial markets perspective, deregulation may be beneficial to investment performance and provide the greatest upside to companies in industries that are highly regulated. Using the 2016 general election result as an example, when Trump defeated his opponent in what could be called a surprise win, firms that were subject to high regulatory burdens outperformed those with low burdens by over 3% in the five days following the election. This argument assumes that prior to the election, stocks had rationally priced in the expectation for continued or greater regulatory effects and that the promise of lower regulation created a bull market response (see Exhibit 3).

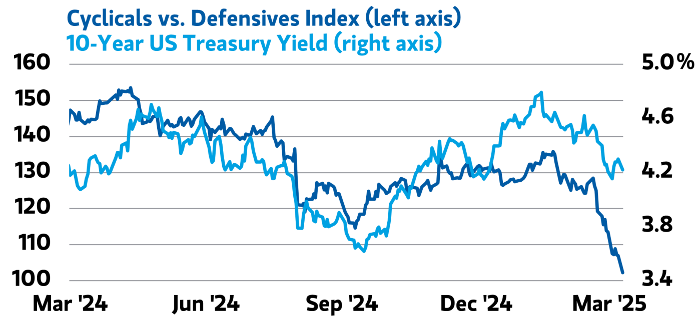
Exhibit 3: Stocks With High Regulatory Burden Outperformed in 2016 on Deregulation Expectations



Note: Excess return refers to total returns in excess of the equal-weighted market return.
Source: NBER, Morgan Stanley Wealth Management Global Investment Office as of Jan. 31, 2023

Market performance after Trump's second win has echoed this dynamic, with the S&P 500 Index rallying as much as 6% in the following weeks due to investor anticipation of pro-growth policies like lower taxes and robust deregulation. Since then, swift tariff action with heightened policy uncertainty has fostered investor growth concerns. The restrictive nature of tariffs, along with reduced immigration and economic fears, has supported a flight to quality, causing US Treasury yields to fall and defensive sectors to outperform cyclicals amid expectations for slower growth (see Exhibit 4).

Exhibit 4: Defensives Have Outperformed Cyclicals as the 10-Year US Treasury Yield Has Fallen



Note: Cyclicals vs. Defensives Index compiled by Morgan Stanley Institutional Equity Division.
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of March 10, 2025

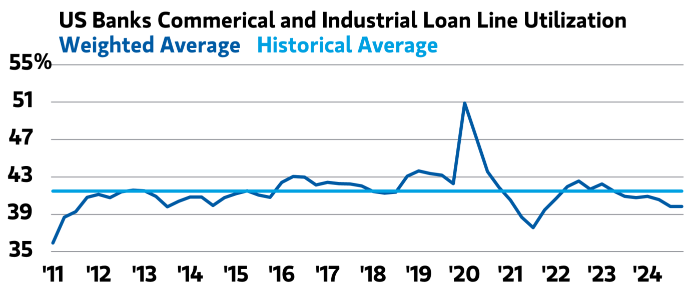
The economic and market consequences of deregulation are complex, with myriad potential outcomes, and recent deregulatory efforts, like the reduction in funding for the Consumer Finance Protection Bureau (CFPB), have not offset exogenous factors that have suppressed market enthusiasm. Furthermore, it is important to highlight that reduced regulation and government oversight from entities like the CFPB may also result in greater risk to the consumer, increased market instability and a decline in business certainty. That said, we expect that broad deregulation could have positive impacts for several US sectors and industries over the long run, primarily benefiting financials, tech, energy, industrials and health care.

Financials and Deregulation

Financials is one of the sectors we consider to be well positioned to benefit quickly from deregulatory tailwinds. The Trump administration has outlined several priorities, including loosening regulatory and compliance burdens for community banks and reconsidering regulations impacting big banks—such as those pertaining to mergers and final Basel III capital requirement rules, known as the Basel III Endgame. Other priorities include reviewing supervisory roles of the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Securities and Exchange Commission, as well as providing support for cryptocurrencies and other digital currencies.

Importantly, changes to community banks may drive looser lending standards for small businesses, thereby improving access to capital. Morgan Stanley and Co. Research analysts expect commercial and industrial (C&I) loan growth to improve as the yield curve become less inverted versus recent years, thereby increasing the relative attractiveness of shorter-term interest rates. C&I line utilization, a proxy for loan demand, sat at 39.8% at the end of 2024 versus a historical average of 41.5% (see Exhibit 5). A reversion to the average would add 4% to C&I loan growth. Potentially lower interest rates, in addition to looser lending regulatory oversight, could stimulate community banking activity in the second half of 2025. That said, material weakening of the CFPB, which mitigates predatory lending practices, could create greater consumer lending and credit risk. Other changes to the banking system may include less-stringent mergers and acquisitions (M&A) criteria, allowing for more financial services mergers. In addition, the Basel III Endgame may be revised with looser capital requirements, resulting in a capital-neutral rule which could benefit large-cap banks.

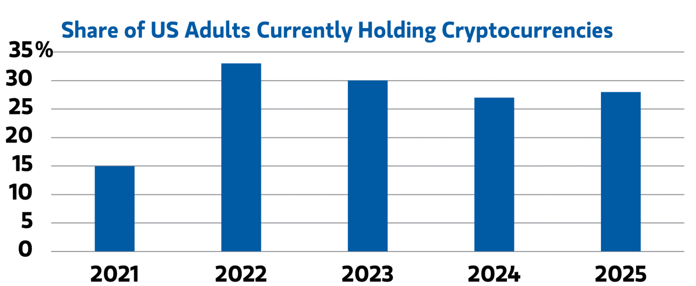
Exhibit 5: Looser Regulation and a More Favorable Rate Environment May Increase C&I Line Utilization



Source: Federal Reserve, Morgan Stanley & Co. Research, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2024

Additionally, reduced federal scrutiny is likely to create a more favorable environment for blockchain technology and cryptocurrencies, which rallied post-election. The crypto industry was one of the largest donors during the 2024 general election cycle, with $133 million donated to help elect pro-crypto lawmakers. Importantly, 85% of the congressional candidates the industry supported won their races, and 59% of Senate and 66% of House seats are considered "pro-crypto," across both sides of the aisle. More favorable regulation and sentiment from lawmakers could help adoption of cryptocurrencies (currently at roughly 28% of adults) among retail investors continue to increase, while also raising popularity among institutional investors (see Exhibit 6). For this reason, we are likely to see more favorable crypto news despite rising macro headwinds.

Exhibit 6: Favorable Crypto Legislation and Regulation Could Continue to Boost Ownership



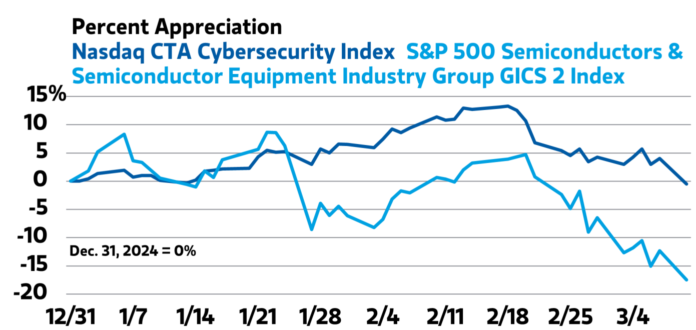
Source: Security.org, Morgan Stanley Wealth Management Global Investment Office as of Jan. 31, 2025

Deregulating the Tech Sector

As we have noted in prior reports, leaders and laggards may also emerge in the tech sector during the Trump administration, as idiosyncratic risks develop. The wave of ambitious and exciting artificial intelligence (AI) initiatives since 2022 has been met with federal support and continued investment, as the administration adopts a "develop first, regulate later approach" toward innovation. Any regulation of AI is likely to come from individual states, rather than from the federal government, insulating these companies for now. Generational investments in AI and reshoring of semiconductors signal that AI policy has become a national security priority on both sides of the aisle.

We believe there is also a risk of increased scrutiny of social media and information-related companies, particularly those at ideological odds with the administration. While these industries could face pressure from a more selective regulatory approach, we view the risk as more idiosyncratic. Equity performance of this sector will likely be driven by the extent to which AI adoption and diffusion boost margins for cybersecurity and software companies, and the extent to which tariffs impact hardware tech companies. For these reasons, we prefer cybersecurity and software tech companies, which have outperformed semis and hardware tech this year by 17% (see Exhibit 7).

Exhibit 7: Cybersecurity Software Has Outperformed Tech Hardware by 17% This Year



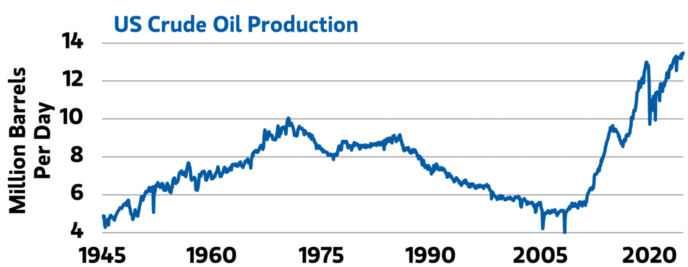
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of March 10, 2025

Energy Deregulation

Many of Trump's 70-plus executive orders signed so far focus on energy, and reducing energy prices has been a top priority of the administration. For example, Trump declared a national energy emergency in an effort to boost domestic energy production by expediting permitting and slashing regulations for oil, natural gas and mining of coal and critical minerals. Several climate-focused actions establishing electric vehicle (EV) mandates or strengthening tailpipe-emissions standards have been paused, supporting traditional car manufacturers.

While President Trump aims to increase oil production, we underscore that US production already sits at a record level and close to capacity, and production is unlikely to increase despite looser permitting restrictions or the introduction of other incentives like tax credits (see Exhibit 8). Trump could commit to replenishing the Strategic Petroleum Reserve at prices equal to or greater than the break-even price, in exchange for greater domestic production, but this would increase supply and lower prices in the short term. Global oil market fundamentals play a larger part when it comes to pricing, as exhibited by the 7% price decline in West Texas Intermediate crude oil in 2025. The current $66-per-barrel level, which is the second lowest since late-2021, has come on the back of investor concerns over an economic slowdown as well as OPEC+'s recent announcement to boost oil production starting in April. Furthermore, if the increased global supply coincides with sluggish global demand, producers may be disincentivized from accelerating production at prices close to break-even levels, which recent surveys from the Federal Reserve Bank of Dallas and the Federal Reserve Bank of Kansas City put at around $65.

Exhibit 8: US Crude Oil Production Has Reached a Record Level



Source: Bloomberg, DOE, EIA, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2024

In contrast to the dynamics around crude oil, deregulation of natural gas, such as lifting the Biden-era pause on new natural gas export permits, could be met with increased foreign demand. The European Union maintains a 56 billion euro energy trade deficit with the US and has recently signaled a willingness to buy more US-made goods.

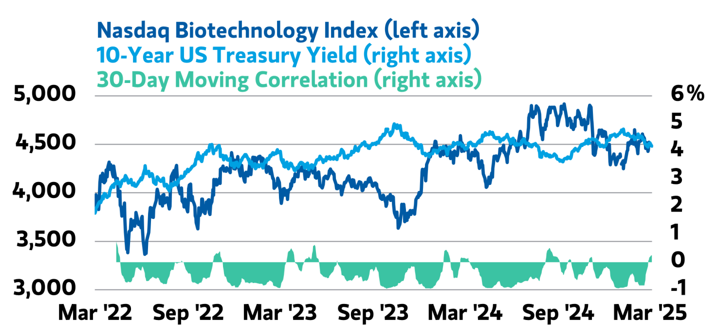
While policies supporting fossil fuel production may create headwinds for clean energy-related stocks, certain aspects of clean tech could have long-term staying power. If rates continue to fall this year, clean energy stocks could benefit from lower borrowing costs. Furthermore, a potential repeal of the Inflation Reduction Act is likely to be limited, as over 80% of its fiscal outlays were directed toward GOP-controlled states. Lastly, the Trump administration has embraced and continued the Biden-era policy of supporting nuclear energy, which is likely to benefit from a reduced regulatory burden as large tech companies turn to nuclear as an alternate energy source to meet the growing demand from AI and data centers, which require significantly greater energy in addition to natural gas.

Health Care Deregulation

The health care sector has also been front and center during the new administration's transition as regulatory changes could have mixed consequences for numerous industry participants. Policies ranging from the rollback of vaccine mandates to the reconsideration of Medicaid entitlements may experience notable changes. Importantly, both those policies are likely to result in negative public health outcomes. Select changes to vaccine mandates could have a more muted impact on market performance if the pharmaceuticals companies impacted have a well-diversified drug portfolio that can help them mitigate deregulation-related risks. The potential downsizing of Medicaid may have notable public health impacts for individuals who are unable to receive the care they need and could pressure lower-end consumers as their out-of-pocket health care expenses rise, creating downside risk for managed care-related companies and consumer discretionary stocks. Furthermore, nonprofit hospitals may experience credit ratings pressure, as Medicaid cuts could materially weaken revenues.

Not all health care sector deregulation is created equal, however, and we believe upside can be found in biotech. Although the appointment of Robert F. Kennedy Jr. as secretary of Health and Human Services may delay swift FDA approvals and cuts to the National Institute of Health and health care innovation grants may hinder development, we underscore biotech's sensitivity to the interest rate environment (see Exhibit 9). Biotech performance is inversely correlated with interest rates; a decline in rates in line with market expectations for three 25-basis-point cuts by year-end could support greater access to capital, boost research and development and foster a constructive environment for market performance. While M&A activity has been modest this year, reduced regulatory scrutiny and low rates may generate tailwinds for a pickup in activity later this year. These factors may encourage biotech consolidation, which may in turn fuel higher market valuations.

Exhibit 9: Biotech is Negatively Correlated With the Interest Rate Environment



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of March 10, 2025

Investment Conclusion

While deregulation is a central component of President Trump's agenda, meaningful impacts may be delayed, as other items take center stage. However, despite recent weakness in cyclical stocks relative to defensives, investors may see opportunity in high-quality cyclicals such as in financials and industrial and among select tech names, which could also benefit from deregulation tailwinds. For example, financials could benefit from deregulation of supervisory oversight and capital requirements, while favorable crypto legislation and regulation could continue to boost retail and institutional adoption. Tech performance will likely be driven by AI adopters in cybersecurity and software, as the administration takes a "develop first, regulate later" approach. Oil production is unlikely to notably accelerate, though natural gas demand, supported by regulatory tailwinds, remains robust. Pharma and managed care could face pressure from potential Medicaid cuts and vaccine mandate rollbacks, while biotech could benefit from rate cuts.

Disclosure Section

Index Definitions

For index, indicator and survey definitions referenced in this report please visit the following:

https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Glossary

Artificial Intelligence (AI) A field of study that seeks to train computers to process large amounts of unstructured information in a manner similar to human intelligence, capable of performing tasks such as learning and problem solving.

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Growth investing does not guarantee a profit or eliminate risk. The stocks of these companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be more risky than an investment in a company with more modest growth expectations.

Value investing does not guarantee a profit or eliminate risk. Not all companies whose stocks are considered to be value stocks are able to turn their business around or successfully employ corrective strategies which would result in stock prices that do not rise as initially expected.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

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Treasury Inflation Protection Securities' (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies. **Technology stocks** may be especially volatile. Risks applicable to companies in the **energy and natural resources** sectors include commodity pricing risk, supply and demand risk, depletion risk and exploration risk. **Health care sector stocks** are subject to government regulation, as well as government approval of products and services, which can significantly impact price and availability, and which can also be significantly affected by rapid obsolescence and patent expirations.

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