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US Policy Pulse

10 Policy Actions to Watch in 2024

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In this report we discuss our top 10 policy actions to watch and how they might affect both the markets and the economy.

Key Insights:

1. 2024 Budget Fight Continues as Temporary Market and Economic Risks Loom
2. General Election Certainties May Drive Sector-Specific Market Volatility
3. Basel III: Endgame Could Provide Upside Surprise for Financials
4. Geopolitical Risks Positioned to Benefit Defense
5. Retirement Policy Remains in the Spotlight
6. Clean Energy Tax Credits Constructive in Near Term
7. States Likely to Accelerate AI Regulation
8. Increased Tariffs on Chinese Goods and Decreased US Investment in China Could Benefit Mexico
9. Democrats Likely to Support Record Oil Production to Lower Gas Prices
10. Health Care Risks Are Likely Priced-in; Managed Care May Benefit From Robust ACA Enrollment

As we embark on the new year, we continue to navigate the long-term effects of robust fiscal spending and the hawkish monetary policy response to rising inflation. While inflation has recently moderated and market strategists and economists have increased the odds of a soft economic landing, the policy narrative of the past is positioned to inform our expectations for market and economic performance. For example, the fiscal year 2024 budget remains unresolved and geopolitical risks place notable pressure on additional spending priorities. That said, though the 2024 election cycle is likely to stymie the development of legislation that is not budget-related, Washington will still be active as foreign policy and domestic regulators take center stage. In this report, we discuss the top public policy and regulatory actions we anticipate may impact the markets and the economy in 2024.

1. 2024 Budget Fight Continues as Temporary Market and Economic Risks Loom

The House and Senate are quickly approaching a partial-government shutdown on Jan. 19, but it appears both Democratic and Republican leadership are negotiating in earnest in a bid to avert the partial closure. The most recent proposal to emerge from leadership conversations includes a less than 1% cut to nondefense budgets and a 3% increase to military spending, consistent with the already-passed National Defense Authorization Act. Importantly, this deal is unlikely to be final, as the spending decreases are less than those included in the previously negotiated debt limit deal (the Fiscal Responsibility Act), which reduced expenditures not related to defense by 1% across the board.

Legislators are likely to seek to avoid a shutdown during an election year, which would damage reelection prospects for both parties. If legislators are unable to move beyond budget trench warfare, the FRA's 1% budget cut will be triggered and go into effect on April 30. An inability to resolve the budget crisis between February and late April could cause interim market volatility and economic weakness before the FRA goes into effect. Turmoil is likely to be limited, as government shutdowns tend to result in only modest GDP losses, though a lengthy shutdown may have a greater impact on growth. During the last shutdown, which lasted 30 days and occurred in 2018-2019, the Congressional Budget Office (CBO) estimated that GDP declined $3 billion in the following quarter, which is a notably minor sum in what was then a $21.4 trillion economy. Economic activity rebounded, highlighting the temporary nature of potential risks.

We expect that legislators will resolve budget concerns in the first quarter, either through the approval of a bipartisan 2024 budget bill or by passing a year-long continuing resolution, which would extend the prior year's funding at least through the election.

2. General Election Certainties May Drive Sector-Specific Market Volatility

While the 2024 general election play-by-play is likely to dominate the headlines, investors should focus on the relationship between electoral cycles and the markets. In an analysis of market performance during presidential election years, we find that the S&P 500, on average, shows positive returns of about 3% regardless of which party wins. Furthermore, returns during post-primary months report average excess returns of 0.7% versus nonelection years, due to the confirmation of party nominees and policy initiatives that emerge during the final months of the campaign.

While markets tend to rally in response to election certainty, we highlight that sector and industry specific volatility is likely. For example, utilities and energy significantly outperformed in election years when a Republican president won office (27.8% and 21.9%, respectively), while information technology and consumer discretionary performed best when a Democrat won that year (11.1% and 9.4%, respectively) (see Exhibit 1).

Exhibit 1: Sector Returns By Democrat and Republican Election Year Wins

Democratic Win Average Performance in Election Year

	Full Year	Q1	Q2	Q3	Q4
S&P 500	3.2%	-3.3%	3.7%	2.0%	0.0%
Information Technology	11.1%	0.7%	6.5%	2.4%	-1.0%
Health Care	0.6%	-5.3%	2.2%	2.8%	0.3%
Energy	-10.3%	-12.1%	10.6%	-5.8%	1.0%
Consumer Discretionary	9.4%	0.5%	5.0%	4.2%	-0.7%
Consumer Staples	4.7%	-2.6%	2.4%	5.3%	-0.4%
Communication Services	2.0%	-8.7%	7.2%	-0.8%	4.4%
Utilities	-7.4%	-7.9%	4.5%	-3.0%	-0.9%
Real Estate	-11.3%	-2.9%	3.1%	0.8%	-12.0%
Materials	0.8%	-0.4%	4.1%	-1.1%	-1.7%
Financials	6.1%	-3.6%	-1.9%	3.8%	3.3%
Industrials	1.9%	-2.8%	0.7%	2.3%	1.3%

Republican Win Average Performance in Election Year

	Full Year	Q1	Q2	Q3	Q4
S&P 500	2.8%	1.4%	0.1%	-0.1%	1.3%
Information Technology	-8.9%	4.4%	-3.3%	-3.8%	-6.4%
Health Care	10.5%	-2.3%	10.4%	-1.9%	3.7%
Energy	21.9%	3.2%	6.7%	6.7%	3.8%
Consumer Discretionary	-1.4%	-0.6%	-3.5%	-1.4%	3.5%
Consumer Staples	7.7%	-2.5%	5.7%	-2.5%	8.5%
Communication Services	-2.0%	5.8%	-3.4%	-4.1%	-2.8%
Utilities	27.8%	8.3%	2.8%	10.3%	4.5%
Real Estate	10.9%	5.6%	-0.4%	0.9%	4.8%
Materials	2.4%	-4.0%	-3.4%	-0.7%	11.2%
Financials	17.3%	0.2%	-1.6%	9.0%	9.8%
Industrials	12.2%	0.5%	2.5%	3.9%	5.1%

Note: Indicates sector performance for each election year quarter, ending on Dec. 31 of that election year.
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Jan. 9, 2023

3. Basel III: Endgame Could Provide Upside Surprise for Financials

The government's initial Basel III Endgame (Basel III) proposal was released in July 2023 to significant financial industry resistance. While the proposal is comprehensive, we focus on potential changes to capital requirements within the banking system as limitations to liquidity could affect financial sector performance. Basel III is estimated to increase capital requirements for banks with at least $100 billion in assets by 16% on average, due to the inclusion of more risk-weighted assets on bank balance sheets. When considering the impact to Global Systemically Important Banks, capital reserves are estimated to increase by approximately 2%. The current proposal also includes a three-year phase-in period starting July 1, 2025.

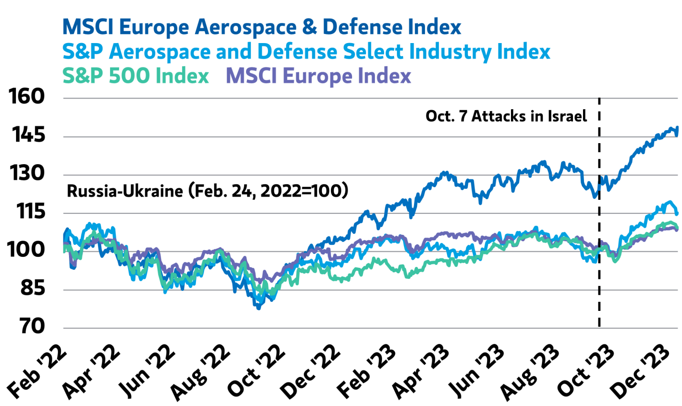
We expect that regulators will release a final Basel rule later this year, but that the provisions are likely to be less onerous than originally anticipated, in part due to the robust industry backlash. That said, if changes are not satisfactory to the industry, it is likely that lawsuits will follow, with the final parameters for the regulation decided in court. Should the final rule purport less stringent requirements for risk-weighted assets, the sector is well positioned for upside surprise.

4. Geopolitical Risks Positioned to Benefit Defense

Geopolitical tensions remain high across the globe, as the Russia-Ukraine conflict drags on and the risks of a wider Middle East conflict increase. Since Russia's invasion of Ukraine in February 2022, both US and European defense contractors have outperformed the S&P 500 and MSCI Europe indexes. However, differences in regional defense performance are difficult to ignore: European defense stocks have outperformed US defense stocks by more than 30%, and the MSCI Europe Index by more than 40%, since the start of the conflict (see Exhibit 2). Performance is likely driven by higher NATO defense spending and the Russian threat on Europe's doorstep.

Nevertheless, greater global defense expenditures and a renewed focus on military competitiveness serve as strong tailwinds for US contractors. Congress recently approved a 3.2% increase to the defense budget and remains committed to considering over $100 billion in supplemental spending. We see opportunities particularly in categories that are expected to benefit from spending increases such as missiles, munitions and shipbuilding manufacturers, as well as cybersecurity, semiconductor and satellite developers.

Exhibit 2: European Defense Has Outperformed On the Back of the Russia-Ukraine War



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2023

5. Retirement Policy Remains in the Spotlight

Changes to retirement policy are likely to remain a priority in 2024, with the Department of Labor, IRS and Congress pursuing various efforts. These include fixing technical errors in prior retirement legislation, weighing comments on pending regulatory actions and the consideration of new policy proposals. We believe individual investors are likely to receive more clarity regarding product and industry investing options, as well as more guidance on the legality of certain retirement investing strategies.

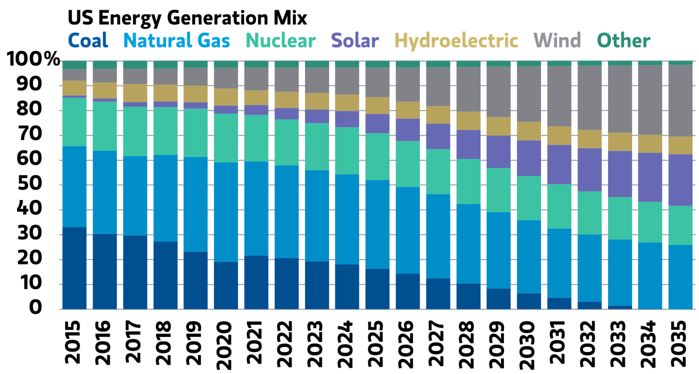
For example, we expect clarification of certain Secure 2.0 provisions including, but not limited to, changes to allow increased catch-up contributions to retirement accounts and updates reflecting the bill's original intention to increase the required minimum distribution (RMD) age to 73 starting on Jan. 1, 2023 and age 75 starting on Jan.1, 2033. In addition, the DOL will continue to weigh a proposed change to the definition of fiduciaries which could have numerous implications for certain investors and may limit the use of non-securities investment products like fixed income annuities in retirement accounts. A final rule is expected mid-2024. Furthermore, legislators may seek to reintroduce legislation in the next session that would allow retirement savers to roll over their Roth IRA savings into a Roth workplace retirement plan such as a Roth 401(k), Roth 403(b) or Roth 457(b) plan. It is unclear if the legislation has a path toward enactment.

6. Clean Energy Tax Credits Constructive in Near Term

Clean energy received a $369 billion allocation in 2023 as part of the Inflation Reduction Act (IRA). This is the largest one-time clean energy appropriation in US history, which supports our long-term market expectations favoring clean energy stocks and also bolsters capital spending. While a GOP win in 2024 could result in the repeal of certain clean energy tax credits in 2025, policy action this year is likely to remain constructive for the industry as the IRS clarifies qualification requirements and awards tax credits.

This fiscal policy support provides tailwinds for our expectation for a decades-long shift in the US energy mix. For example, Morgan Stanley and Co. analysts project solar and wind to comprise approximately 50% of US energy generation mix by 2035, absent the introduction of future policy roadblocks (see Exhibit 3).

Exhibit 3: Solar and Wind Are Projected to Comprise 50% of US Energy Mix by 2035



Source: Morgan Stanley & Co. Research, S&P Capital IQ, Morgan Stanley Wealth Management Global Investment Office as of Dec. 8, 2023

7. States Likely to Accelerate AI Regulation

Last year's wave of ambitious and exciting AI initiatives caught the attention of policymakers. The White House recently issued a first-of-its-kind AI executive order that sets new standards for AI safety and security, while Congress has signaled bipartisan interest in creating legislative frameworks for future regulation. For example, the SAFE Innovation Framework for AI Policy was released in the Senate to help guide Congress when considering the future of AI legislation and, in the House, the bipartisan National AI Commission Act was introduced, which would create a panel of experts to review the current US approach to AI regulation.

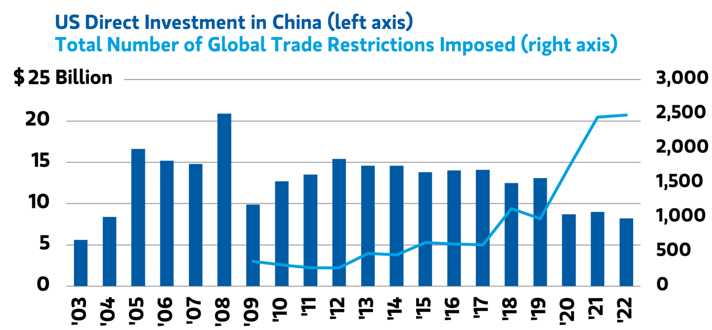
While we expect Congress to remain relatively quiet on AI this year, states are increasingly taking action. To date, 12 states have enacted various policies concerning AI reform, which range from increased government review and understanding of the industry, to monitoring the use of AI in government and data privacy programming. The continued adoption of AI throughout industry and government is likely to continue to highlight risks and opportunities of the developing technology and places the industry squarely in the sights of regulators.

8. Increased Tariffs on Chinese Goods and Decreased US Investment in China Could Benefit Mexico

Recent deglobalization, derisking and trade policy trends are likely to remain in focus in this year. US-China relations have been strained in recent years, and though relatively calm of late, they broadly remain a risk in 2024 with upcoming elections in the US and Taiwan. The Biden administration has tightened export restrictions on advanced AI chips and manufacturing equipment to China as recently as October 2023, in an effort to limit China's access to critical US technology and protect national security interests. Additionally, the administration has retained Trump-era tariffs on about $300 billion of Chinese goods and recently signaled the potential for greater tariffs in 2024 on Chinese electric vehicles to promote US electric vehicle production.

As trade restrictions have increased, US direct investment in China has decreased, falling to $8 billion in 2022 from $13 billion in 2019, a 38% reduction (see Exhibit 4). Furthermore, global direct investment in China turned negative in 2023's third quarter for the first time in 25 years, highlighting the broader implications of comprehensive global de-risking. As the reshoring and friendshoring of key supply chains and goods continues, Mexico is positioned to overtake China as the US' largest source of imports.

Exhibit 4: US Investment in China Has Waned as Global Trade Becomes More Restrictive



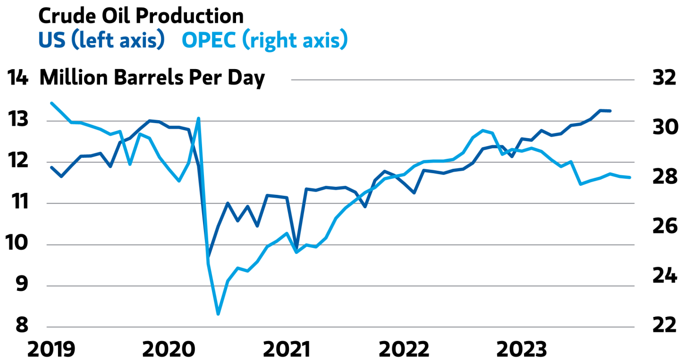
Source: Rhodium Group, Strategas, Morgan Stanley & Co. Research, Morgan Stanley Wealth Management Global Investment Office as of Sep. 12, 2023

9. Democrats Likely to Support Record Oil Production in an Effort to Lower Gas Prices

While clean energy policy has dominated the priority list for Democratic legislators, the Biden White House has been one of the more pro-fossil fuel administrations in recent history. For example, the administration has failed to curb offshore drilling and, according to the US Bureau of Land Management, has also auctioned off approximately 593 drilling leases during the past three years. While this pales in comparison to the Trump administration's auction of 2,740 leases in 2019-2020, Biden has done little to meaningfully offset production.

In fact, US crude oil production has reached all time highs, at 13.2 million barrels per day, a 19% increase from January 2021. Importantly, robust US production has likely offset upward pricing pressure from recent OPEC production cuts. This has, in part, led to a fall in the average US price of a gallon of gasoline to $3.62 today from a peak of $5.47 in June 2022—a 33% decrease (see Exhibit 5). We expect the Biden administration to continue to rely on crude oil production and support pro-fossil fuel policies in 2024 in an effort to increase voter support and bolster election prospects.

Exhibit 5: The US Has Produced More Oil Than Ever in the Wake of OPEC Cuts



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2023

10. Health Care Risks Are Likely Priced-in; Managed Care May Benefit From Robust ACA Enrollment

Health care has already become a talking point in the 2024 election cycle with some candidates suggesting future efforts to dismantle the Affordable Care Act (ACA). However, it is unlikely that politicians will ultimately pursue this as the ACA remains well-fortified legally and has become entrenched in the health care system. That said, the S&P 500 outperformed the health care sector in 2023 by 24% and managed care by more than 27%. Broad weakness was attributable to several factors including the expirations of COVID-era Medicaid expansion, the introduction of pharmaceutical price restrictions and macro trends favoring cyclicals over defensives. We expect recent health insurance enrollment trends to support the sector.

While the end of Medicaid auto-enrollments in March 2023 caused a 6% net reduction in total Medicaid participants by September 2023, we believe the Medicaid fall-off has been priced into the market. A potential offset to these pressures include recent ACA enrollment, reporting a 13% rise in 2023, which will likely continue to support certain managed care companies and their related industries.

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

Volatility This is a statistical measure of the dispersion of returns for a given security or market index. Volatility can either be measured by using the standard deviation or variance between returns from that same security or market index. Commonly, the higher the volatility, the riskier the security.

Risk Considerations

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