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WEALTH MANAGEMENT

INVESTMENT STRATEGY

Market Research & Strategy | July 13, 2022

US Policy Pulse

Taxes, Retirement and Semis—Oh My!

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Special thanks to Georgia Fox for her contributions to this report.

In this report we discuss the remainder of the 2022 legislative calendar, what policies could pass before and after the midterm elections and how they may affect the economy and the markets.

Key Insights:

- There are 40 legislative days before the end of the year, and Congress has a full policy agenda that could have numerous implications for investors.
- The $1 trillion “Build Back Smaller” (BBS) proposal is likely to be focused on clean energy and health care-related initiatives.
- Clean energy policies in BBS may support valuations of the S&P Global Clean Energy Index, which currently trades five times higher than the S&P 500 Index on a forward price/earnings (P/E) multiple basis.
- Drug pricing regulation may cause pharmaceutical sector forward P/Es to contract relative to the S&P 500.
- Tax provisions in BBS are likely to target corporations and could pressure earnings while making dividends relatively more attractive.
- The Bipartisan Innovation Act (BIA) includes $52 billion for the semiconductor industry. If passed, it could support capital expenditure in 2023.
- The 2023 federal budget is likely to provide tailwinds for the defense industry, as Congress is expected to increase appropriations beyond President Biden’s $813 billion budget request.
- Current estimated 2023 budget initiatives, which decrease federal deficit growth by $1 trillion over a 10-year period, are technically considered deficit-neutral.
- Deficit reduction measures may not offset other fiscal spending, as the federal deficit is still projected to increase nearly 55% over the 10 years to $1.7 trillion.
- Pending retirement legislation could increase the required minimum distribution (RMD) age over time to 75 from 72, while raising the catch-up contribution limit to $10,000.
- Other retirement-related provisions could expand tax-efficient investing options and introduce benefits permitting employer-matching contributions contingent on student loan payments.

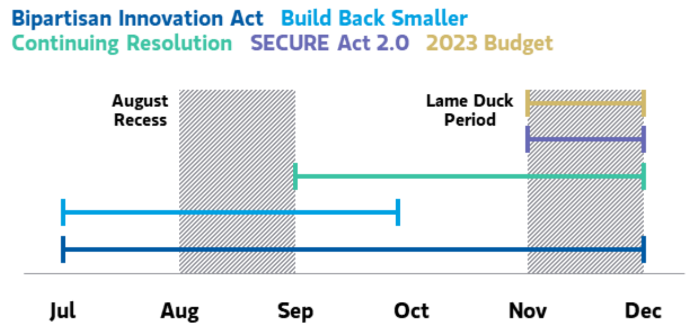
While there are still more than five months left in 2022, Congress is quickly running out of time to enact legislation. More specifically, there are only 23 legislative days before the midterm elections and 40 before the end of the year. The limited runway to enact many of President Biden's core policies—including aspects of his clean energy and health care proposals—has prompted the Democratic Party to narrow its focus to a select number of legislative pursuits. While evolving political dynamics will ultimately shape these efforts, we expect a slimmed down version of the Build Back Better Act (Build Back Smaller), the Bipartisan Innovation Act (BIA), the 2023 federal budget and the Securing a Strong Retirement Act of 2022 (SECURE Act 2.0) to monopolize the remainder of this congressional session. These priorities have helped draw a likely roadmap for the rest of the year that may also serve as a guide for investor decision making.

What Lies Ahead

The limited legislative calendar, along with political party gamesmanship and negotiations, has pushed Democratic leadership to prioritize bills with a higher likelihood of passage by year-end. This becomes increasingly important against the backdrop of the midterm elections and the growing likelihood that the Democrats will lose control of one or both chambers of Congress, resulting in a diminished timeline for enactment of their agenda.

BBS, BIA, the 2023 budget resolution and the SECURE Act 2.0 have myriad implications for saving and investing strategies, and their impact is likely to be multifaceted. These include, but are not limited to, changes to tax incidence, alterations to the treatment of retirement plans and fiscal policy tailwinds for certain sector and industry winners. Before we analyze each of these major legislative initiatives—highlighting principal taxation and investment implications—we believe it is helpful to consider the order in which legislative action may unfold. First, it is important to acknowledge that legislation is not conducted in a straight line and behind-the-scenes negotiations are likely to transpire on a concurrent basis. In addition, Congress may reconvene for additional voting sessions to consider legislative business, especially as it relates to continuing resolution provisions and the 2023 budget. Continuing resolutions are typically reserved for the extension of the current budget to fund government operations until the next year's budget has been passed. That said, many of the legislative priorities we listed are likely to be the subject of some negotiating overlap, with the August recess, midterm elections and subsequent lame duck session serving as strategic catalysts for policymaking (see Exhibit 1).

Exhibit 1: Consideration of Viable Policy Action Is Impacted by the Legislative Calendar



Note: Ranges indicate potential windows of consideration.
Source: Morgan Stanley Wealth Management Global Investment Office as of July 13, 2022

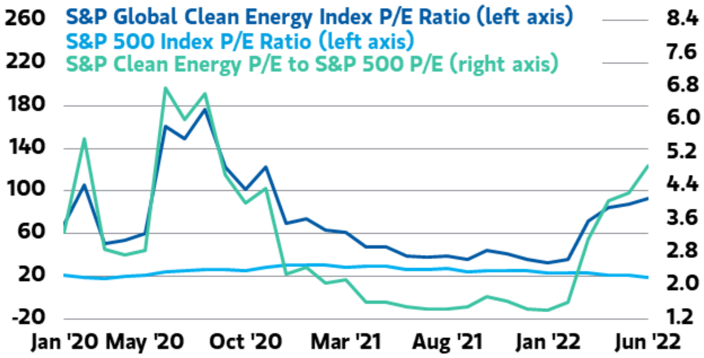
Build Back Smaller

The Biden administration's $3 trillion Build Back Better plan was announced in early 2021 but quickly met resistance in Congress. Legislators voiced concerns about total spending as well as the proposed methods for revenue-raising to support the initiative. Protracted negotiations have resulted in a more modest proposal, currently slated to focus on clean energy and health care, at an estimated cost of approximately $1 trillion—a departure from the previously broader economic and social policy agenda. While the revised spending package is still being debated, the legislation could be considered by the Senate as early as its return from the July 4 recess and as late as Sept. 30, at which time the budget reconciliation vehicle attached to this effort expires.

Clean Energy

We believe the narrowed scope of BBS supports our long-term market expectations favoring clean energy stocks. The S&P Global Clean Energy Index, components of which are expected to benefit from Biden's climate change agenda, traded at a "green premium" prior to the 2020 general election. While stalled negotiations related to clean energy caused P/E multiples to fall in the first quarter of 2022, the index rebounded as traditional energy sources were impacted by geopolitical conflict and Congress renewed its legislative focus; it recently traded at an elevated price of approximately 90 times one-year forward earnings—five times that of the S&P 500 (see Exhibit 2). This indicates that the market expects clean energy to remain a winner despite the White House's pro-fossil fuel policies employed in response to rising gas prices. Fiscal support for clean energy will likely be directed toward electrification, solar, wind and hydrogen-cell.

Exhibit 2: Higher Energy Prices and Renewed Legislative Support Have Caused Clean Energy P/E Ratios to Rebound



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 30, 2022

Health Care

We continue to expect drug pricing and the expansion of the Affordable Care Act (ACA) to drive the health care policy conversation this year. The Senate's recently revised prescription drug reform platform, included in the BBS, underscores this view. Provisions supporting ACA expansion provide the biggest lift to managed care-related companies, hospitals, continuing care retirement communities and state governments burdened by Medicaid expenses. In contrast, drug pricing policies are likely to create a drag on pharmaceutical stocks, as the latest proposal permits Medicare to negotiate pricing for the 10 most expensive prescription drugs on the market. Importantly, the policy would expand to the 20 most expensive drugs by 2029. While the provision is currently limited in scope, it could be an important step toward enacting additional price controls.

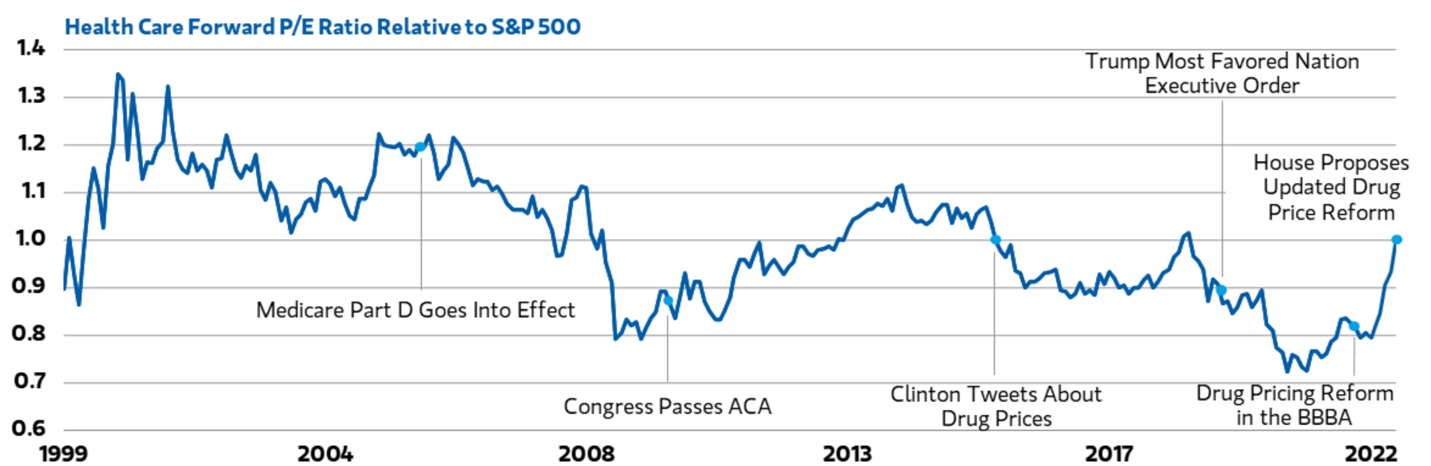
When assessing health care sector expectations reflected in forward P/E multiples relative to the S&P 500 over the past 20 years, we found that investor sentiment declines on drug pricing policy news. On average, relative P/E multiples have contracted following pharmaceutical pricing policy-related events (see Exhibit 3). That said, markets have yet to respond to the recently released drug pricing provisions, which indicates they may not be fully pricing in pharmaceutical regulation. Should notable drug pricing reforms take shape before the midterms, investor behavior is likely to remain consistent with history and weigh on forward P/E ratios, signaling bearish expectations.

Taxation

The more limited scope of BBS means less spending, and with less spending comes less need to raise taxes. That said, taxes are likely to increase. As detailed in our previous *US Policy Pulse* reports, taxation for individuals is likely to remain relatively modest, with the onus of revenue-raising provisions on corporations. While the tax provisions are still being negotiated, many of the taxing mechanisms included in prior versions are expected to appear. However, we caution investors that new or modified tax policies could also arise. For example, an income surcharge on ultra high net worth individuals may be replaced by a 3.8% investment income surcharge for individuals making more than $400,000 and couples, estates and trusts earning more than $500,000. Importantly, we do not expect individual income taxes or capital gains tax rates to increase.

On the corporate front, we still expect the enactment of a 15% global intangible low-taxed income rate (GILTI)—an increase from the current 10.5% rate. This change, which would apply to corporations paying less than 15% on foreign intangible income, remains consistent with our expectations for moderate Democrats to continue to temper the proposed tax agenda.

Exhibit 3: The Health Care Sector May Experience Pricing Pressures as Pharma Regulation Unfolds



Source: FactSet, Morgan Stanley & Co. Research, Morgan Stanley Wealth Management Global Investment Office as of June 30, 2022

Other measures include the introduction of a new corporate alternative minimum tax (AMT), at a rate of 15% on the adjusted financial statement for corporations that report income over $1 billion. In addition, the bill could seek to curb corporate stock buybacks by levying a 1% tax on stock repurchased by corporations during the tax year (see Exhibit 4). These two policies would mitigate the need to raise the top marginal corporate tax rate. According to Morgan Stanley and Co. Research analysts, however, an increase in the corporate income tax rate to 25% from 20% could emerge as a possibility if the GILTI or AMT initiatives are not adopted. That said, we remind investors that when we examined changes to marginal corporate income tax rates going back to 1928, we found them to have little to no correlation with economic and/or market performance. Taxes that make stock buybacks more expensive will likely make dividends relatively more attractive. Furthermore, corporations that shift from buyback policies to dividends could experience lower total-return volatility.

Exhibit 4: The Corporate Tax Agenda Has Taken Precedence Over Taxes on Individuals

Potential Build Back Smaller Tax Policies	
Corporate	
Corporate Rate	x
Corporate AMT	15%
Stock Buybacks	1%
GILTI	15%
Individual	
Capital Gains	x
Top Individual Rate	x
Investment Income Surcharge	3.8%
Billionaire Tax	x
SALT Relief	$80,000 or Less
Eliminate Stepped-Up Basis	x

Note: X indicates policy change not currently under consideration.
Source: House of Representatives, Morgan Stanley Wealth Management Global Investment Office as of July 13, 2022

Bipartisan Innovation Act

The BIA, a bill intended to address US competitiveness with China, could receive consideration during the second half of 2022. Versions of the legislation have moved through both chambers of Congress but are now entrenched in partisan negotiations as legislators seek to reconcile the House's America Creating Opportunities for Manufacturing, Pre-Eminence in Technology and Economic Strength Act of 2022 (COMPETES Act) with the Senate's US Innovation and Competition Act (USICA) in conference committee. The consolidated package, now referred to as the Bipartisan Innovation Act, or BIA, faces significant hurdles as congressional leadership debates key provisions. However, vulnerabilities derived from globalization have catalyzed support for the BIA and underscore our belief that geopolitics will generate tailwinds for eventual passage.

While details of a final bill have yet to be settled, the policy aims to bolster international antitrust laws, address treatment of Chinese companies on US stock exchanges and support corporate reshoring and supply chain restructuring. Importantly, the bill directs over $52 billion toward reshoring semiconductor and clean energy supply chains. We expect these initial efforts to set a precedent for ongoing government investment focused on strengthening US domestic supply chains and fortifying the US position against overreliance on foreign competitors for mission-critical parts and infrastructure. We believe the reshoring of critical supply chains addresses a growing deglobalization trend and provides upside for industrial sector stock performance and a notable tailwind for a new capex cycle in the US in the second half of 2023.

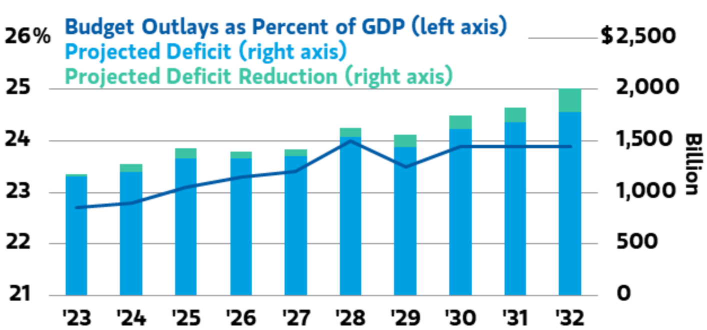
2023 Budget

The Biden administration released its $5.8 trillion 2023 budget proposal earlier this year. Since then, the House of Representatives has been developing a formal 2023 budget resolution. While House appropriators are working through various spending bills, Congress will likely table final votes until the lame duck session, beginning Nov. 14, 2022. Two major factors are influencing this timing. First, legislators are currently focused on passing key aspects of the Democratic agenda, which takes strategic precedence over the budget ahead of the electoral cycle. Second, while the federal budget expires in October, Congress can pass continuing resolutions to extend the funding of government operations, which lessens the urgency to act before voters head to the polls. That said, we believe it is still critical to understand some of the spending and revenue-raising measures that may emerge from the 2023 budget.

Importantly, national defense, at $813 billion, is the largest expenditure in the president's budget, with the Department of Defense receiving $773 billion. While this is a sizeable ask, Congress recently approved a 5.6% increase for defense, to $782 billion, in the 2022 budget, which supports our expectations for the final 2023 budget to generously outpace Biden's current defense requests. Increases to defense spending are likely to escalate, as the conflict abroad has spurred additional urgency to address military competitiveness and mission-critical capex needs. Positive tailwinds are likely to develop for defense contractors and cybersecurity, as well as for satellite and rocket development. Other major spending categories include labor, health and human services and education, as well as Veterans Affairs (VA) medical support. No budget would be complete without revenue-raising provisions, however, and investors should be mindful that tax policies not being considered for BBS could emerge as part of the 2023 budget. These include, but are not limited to, increases in capital gains taxes and the top marginal individual income tax rate, as well as the potential for a billionaire's tax.

Biden's budget plan is viewed as deficit-neutral, as it is structured to reduce the federal deficit by $1 trillion over 10 years. That said, deficit-reducing measures are likely not enough to offset the trajectory of the growing federal deficit. Comparing 2023 budget outlays as a percent of US GDP to expectations for the federal budget deficit, we found that projected spending as a percent of GDP remained relatively range-bound from 2023 to 2032, at 22.8% to 23.9%. In contrast, projections for the federal deficit increased nearly 55% over the same period, to $1.7 trillion, despite deficit reduction measures, which highlights the long-term effects of previously enacted fiscal policies (see Exhibit 5).

Exhibit 5: Increases to the Federal Deficit May Be Attributed to Prior Fiscal Spending Measures



Source: White House, Morgan Stanley Wealth Management Global Investment Office as of March 28, 2022

SECURE Act 2.0

We believe SECURE Act 2.0 is likely to pass during the lame duck session, due to bipartisan support in both the House and Senate. If enacted, the legislation could have implications for saving and investing strategies. For example, the proposal increases the required minimum distribution (RMD) age by 2033 to 75 from 72, while raising the catch-up contribution limit to $10,000. The bill also contains a safe harbor provision that permits defined contribution (DC) plans to offer annuity products with certain increasing or accelerated payment features—such as guaranteed increases of up to 5%, full or partial lump sum commutations and return of premium death payments. In addition, the legislation eliminates partial annuitization penalties, which fail to account for the fact that amounts received from annuitized sources often exceed RMD amounts from non-annuitized assets. The law would also ensure such solutions do not run afoul of RMD rules.

The bill also allows investors to roll over Roth IRA savings into qualified DC plans, as well as into 403(b) and governmental 457(b) plans. Other features that could impact certain types of DC plans include the expansion of collective investment trust (CIT) options. Currently allowed in 401(k) plans, CITs would be permitted in 403(b) plans as well. Furthermore, the legislation allows employers to provide a match for student loan payments. The provision has two purposes: first, to constitute an attractive benefit and, second, to incentivize investments in retirement savings that may otherwise have been applied to student loan obligations.

Passage of notable retirement reforms is intended to boost enrollment in qualified retirement plans and increase support for participants as they approach the retirement-income phase of their investment lives. Furthermore, the policies are intended to foster more flexibility for investors as they prepare for retirement, including increased access to tax-efficient options and additional benefits intended to support savings and wealth accrual.

Investment Implications

While time left on the legislative calendar is short, the agenda is full. Accounting for the August recess, midterm elections and the following lame duck session, there are several opportunities to catalyze swift legislative action. Democratic leadership is carefully balancing the political realities of this election cycle with viable policy avenues and is pursuing agenda items that may not only benefit them at the polls, but support the president's platform. These include BBS, BIA, the 2023 budget resolution and SECURE Act 2.0. Should the policies become law, each of these bills carries its own unique set of economic and investment-related consequences.

For example, a final version of BBS could create additional upside for clean energy, while drug pricing provisions could foster headwinds for the pharmaceutical industry. The bill's tax elements may also pressure corporate earnings while simultaneously encouraging a shift from stock buybacks toward dividends. In addition, the BIA could support American competitiveness abroad and provide tailwinds for capex in coming years. The 2023 budget resolution is likely to continue the trend of robust defense spending and support defense-related stocks, while associated revenue-raising measures could impact individual tax planning. Finally, SECURE Act 2.0 creates new incentives for individuals to increase their retirement savings—not only through expansion of tax-efficient products, but through enhanced benefit options as well.

We expect that many of these policies will change before final passage, as legislative debate is ongoing. That said, we remind investors that markets are more strongly influenced by the business cycle than policy or political outcomes. Details of this report may serve as a guide for investors to consider potential opportunities and navigate ongoing market and economic uncertainties. We encourage investors to remain focused on their long-term priorities as legislative and political events unfold.

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

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

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RSI1657719600197 07/2022