Morgan Stanley

WEALTH MANAGEMENT

INVESTMENT STRATEGY

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US Policy Pulse

2024 General Election Series

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The 2024 general election series consists of monthly reports examining the relationship between financial markets, the economy and electoral outcomes. Please note that this series will be published in addition to our flagship *US Policy Pulse* reports.

New in This Edition

- We have long held that a criminal conviction likely hurts former President Trump on a net basis, though polls only marginally reflect this so far. However, President Biden faces the twin risks of economic uncertainty and domestic social unrest related to US Middle East policy.
- Biden's historically high disapproval rating remains above Trump's at this point in his term, while Trump leads in all swing-state polling despite the conviction. The June 27 debate is an opportunity for Biden to appeal to voters ahead of the fall.
- Biden maintains a strong funding and cash advantage over Trump, but Trump has reportedly raised an extraordinary $141 million in May.
- The 2024 election will determine the future of tax policy and the Tax Cuts and Jobs Act (TCJA), though record-high debts and deficits may force lawmakers to skew toward higher taxes. Biden's executive order aims to tighten border control, another move to neutralize Trump's campaign strengths.
- Consumer sentiment declined for a third straight month in June and remains below the election-year average, which by historical standards now indicates a Republican presidential victory. Sentiment among independents continued falling and remains anchored to Republican sentiment.
- Our analysis of industries that may benefit from a Democratic or Republican outcome indicates that the stock market may be positioning for a GOP victory.

The 2024 General Election

The 2024 election is less than five months away and will have significant investor implications. The next president will play an important role in developing tax and trade policy, addressing debts and deficits, and navigating geopolitical unrest. We leverage financial market and economic data to guide investors and identify risks and opportunities as they develop. This report focuses on current performance and we encourage investors to view our Feb. 8 *US Policy Pulse* reports, "History of General Election Performance, Part 1" and "History of General Election Performance, Part 2" for our historical election analysis.

What's New in Policy

The extent to which President Biden and former President Trump can frame this election to their advantage is critical. Trump aims to cast it as a referendum on Biden's term in office, while Biden seeks to frame it as a choice between himself and Trump. We have long held that a Trump conviction likely hurts Trump on a net basis, though polls only marginally reflect this. In fact, Trump reportedly raised $141 million in May, indicating that voters beyond his base, such as independents, may be galvanized by his conviction.

However, Biden faces two risks: the economy and foreign policy. First, stickier inflation and slowing growth complicate Federal Reserve policy this year and hint at a weaker economy, weighing on households. The economy is a top indicator of reelection prospects. Second, domestic social unrest from the Middle East conflict has impacted Biden's favorability. We believe this could persist, especially if enthusiasm among younger and more left-leaning voters, who make up much of his base, continues to fade. The debate scheduled for June 27 is an opportunity for Biden to raise his approval rating and push for votes well ahead of the election.

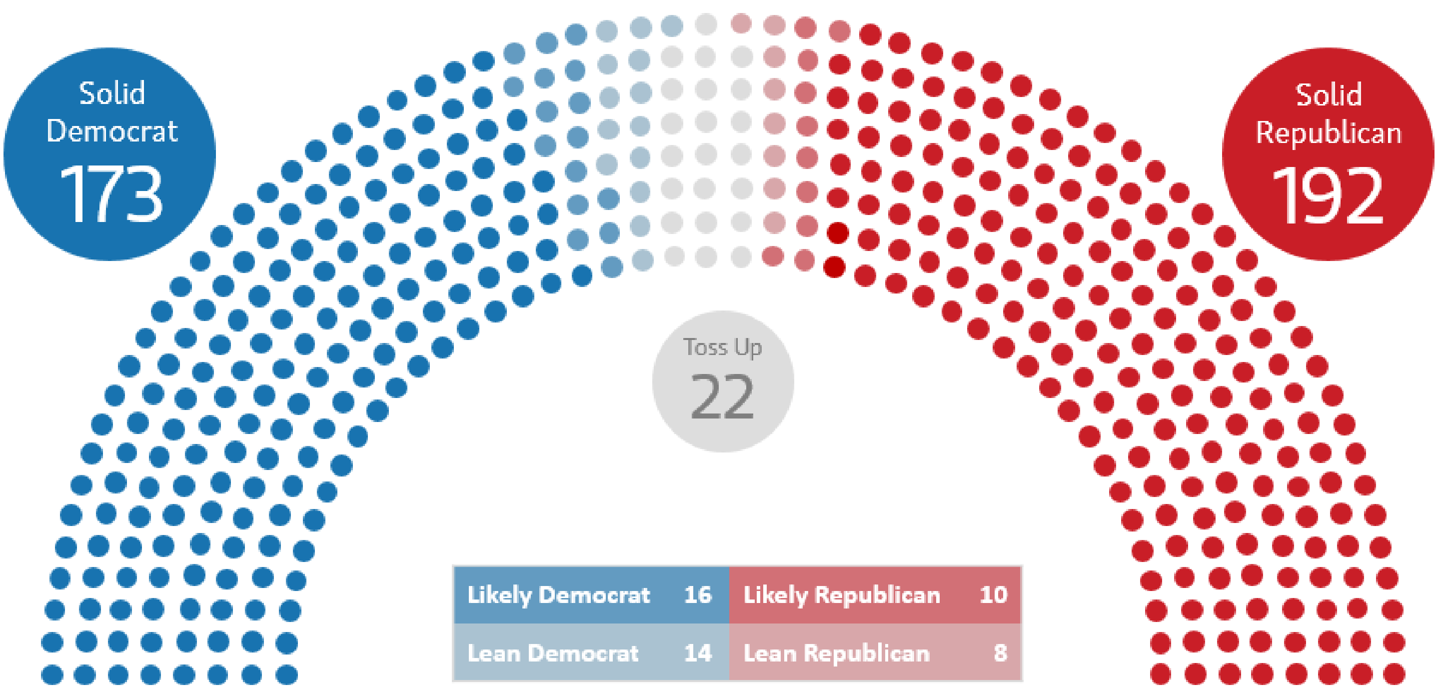
The TCJA's future depends on both the presidential and congressional elections, given its scheduled expiration at the end of 2025 and record debt and deficits. We believe it is skewed toward tax increases. A GOP sweep would not guarantee a full extension of the TCJA, given the fiscal situation and projections that it would add $5 trillion to deficits. Conversely, a Democratic sweep would almost certainly result in higher taxes. Finally, Biden issued an executive order tightening immigration and border control this month, echoing similar efforts to neutralize Trump's campaign strengths.

The House of Representatives

Republicans currently maintain a narrow 218-213 majority over Democrats in the House of Representatives, with three GOP and one Democratic seat vacant, allowing for just a few Republicans to defect before control would tip to the Democrats. The balance of power is subject to further change, as every two years all 435 House seats are up for election. The ultimate composition depends on several factors, including candidate electability, voting trend shifts due to redistricting and the combination of retirements and legislators seeking other public offices. As of today, 44 House members (20 Republicans and 24 Democrats) are planning to leave their seats either to pursue other offices or to retire.

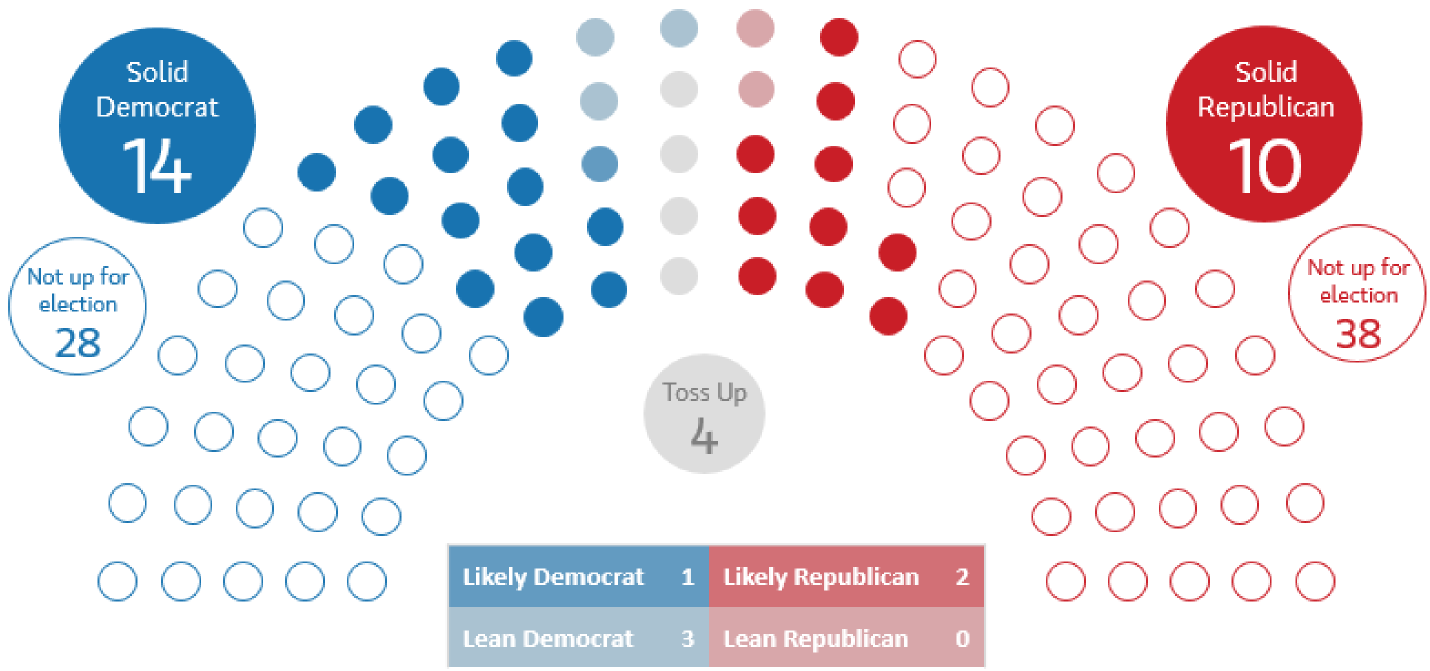
While both parties see opportunity in certain races, we think that the House will likely fall under Democratic control, primarily due to advantages from recent congressional redistricting, although the margin may be tight. The Cook Political Report (CPR) rates 173 seats as Solid Democrat (not considered competitive) and 30 as Likely Democrat or Lean Democrat. It rates 192 seats as Solid Republican and 18 as Likely Republican or Lean Republican (see Exhibit 1). CPR has also assigned its Toss Up rating (most competitive) to 22 races, indicating the potential for especially strong competition in the fight for House control.

Exhibit 1: House Race Competitiveness



Source: Cook Political Report, Morgan Stanley Wealth Management Global Investment Office as of June 14, 2024

Exhibit 2: Senate Race Competitiveness



Source: Cook Political Report, Morgan Stanley Wealth Management Global Investment Office as of June 14, 2024

The Senate

In the Senate, Republicans hold 49 seats, as Democrats and independents who caucus with them maintain a slim 51-49 majority. Unlike the House, where all seats are up for election every two years, Senate terms are six years, so only one-third of seats are up for election every two years. Of the seats up this year, CPR currently rates 14 Solid Democrat, 10 Solid Republican, four Likely Democrat or Lean Democrat and two Likely Republican or Lean Republican. Four seats are rated Toss Up (see Exhibit 2). We believe this breakdown puts the Democratic majority in the Senate at risk. As of now, the retirement of Sen. Joe Manchin (D-WV) opens a seat in a state where Trump won 69% of the vote in 2020. However, he recently filed as an independent—raising questions over whether he will run for senator or governor before the Aug. 1 filing deadline. The retirement of Sen. Kyrsten Sinema (I-AZ) opens another seat in a state that Biden won by a narrow 10,000 votes in 2020. Lastly, the retirement of Michigan Democratic Senator Debbie Stabenow sets up a potential flip in another swing state.

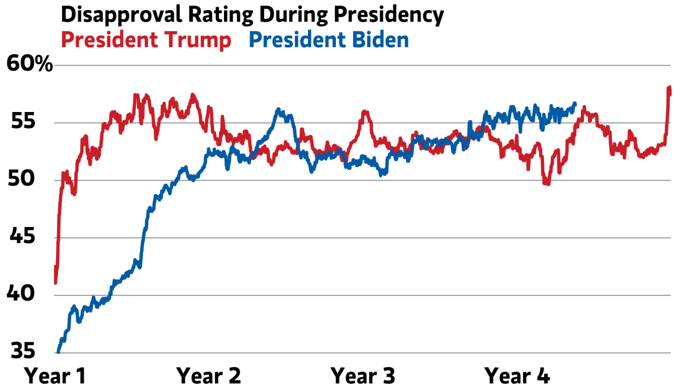
The Presidency

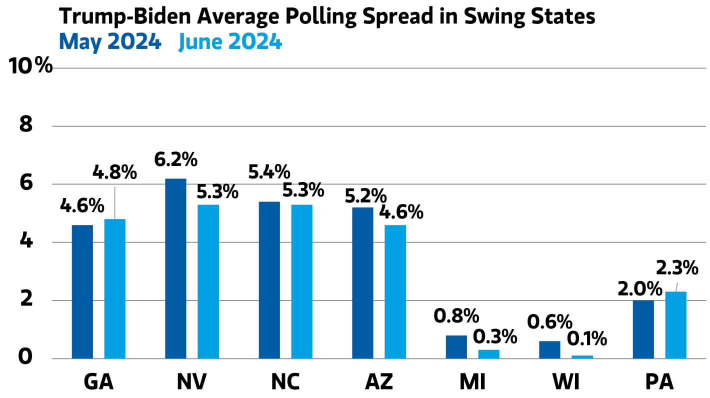
Biden's historically high 57% disapproval rating exceeds Trump's 54% at this point in his term (see Exhibit 3, left). Voters remain concerned about the president's age and health, as well as his handling of other issues such as the economy and foreign policy. Many voters still view the high cost of living as their top concern, despite moderating inflation. Simmering global conflict, as well as immigration problems and social unrest, further pressure Biden's favorability. The early-summer debate should be another near-term catalyst for the election.

According to RealClearPolitics polling averages, Trump still leads Biden in all seven swing states, each of which were decided by less than three percentage points in 2020, though his lead has shrunk slightly since last month (see Exhibit 3, right). At this early time, polling only marginally reflects the conviction, and polling error remains elevated before Labor Day, though we believe that the conviction is more likely a net negative than a net positive for him.

However, Biden has a $70 million cumulative fundraising lead, and $34 million cash-on-hand lead, according to Federal Election Commission filings, though Trump reportedly raised $141 million in May, which is not yet reflected in the filings. Though fundraising does not ensure victory, it positions each to expand campaigning and advertising operations in swing states. Meanwhile, we expect both candidates to focus on painting starkly different pictures of America to voters.

Exhibit 3: President Biden Remains Unpopular Among Voters, While Trump Continues to Lead in Swing States



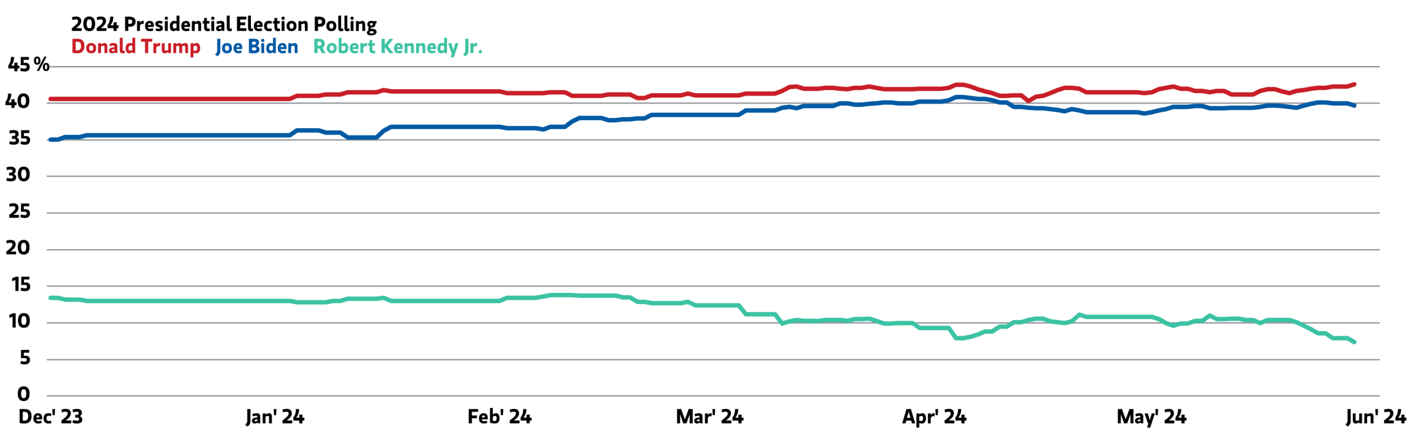


Source: 538, RealClearPolitics, Morgan Stanley Wealth Management Global Investment Office as of June 17, 2024

Polling for Trump, Biden and Robert F. Kennedy Jr., the leading independent candidate, shows notable disparities as well. In average polling, Trump still leads Biden by three points, while Kennedy's polling has fallen to 7.4% from 10.8% in mid-May (see Exhibit 4). Though Kennedy is not on the ballot in every state (nor is he currently eligible for the June 27 debate), the historically high disapproval of the two major-party candidates provides an opening for a challenger (see Exhibit 4).

Kennedy's polling is crucial to watch because he can divert votes from major-party candidates in the states where he is on the ballot, such as Michigan, where just a football stadium's worth of votes decided the outcome in 2016 and 2020. Not only will both Trump and Biden seek to retain their votes in the face of competition from Kennedy, they will also need to pull voters away from him as long as his polling numbers remain high. As a result, we expect sustained rhetoric from both major-party candidates against Kennedy for the remainder of his campaign.

Exhibit 4: Third-Party Candidates Could Impact Major-Party Candidate Polling in the Near Term



Source: RealClearPolitics, Morgan Stanley Wealth Management Global Investment Office as of June 14, 2024

Macroeconomics, Markets and the Election

Macroeconomic Indicators

While not the only determinant, voter sentiment on the economy, namely in regard to GDP in the months before the election, is correlated with presidential outcomes. According to the Center for the Study of Democratic Institutions, a 5% increase in GDP results in a corresponding 6% gain in incumbent vote share. Slower annualized first quarter GDP of 1.3% has corresponded to a 2% drop in Biden's approval rating this year.

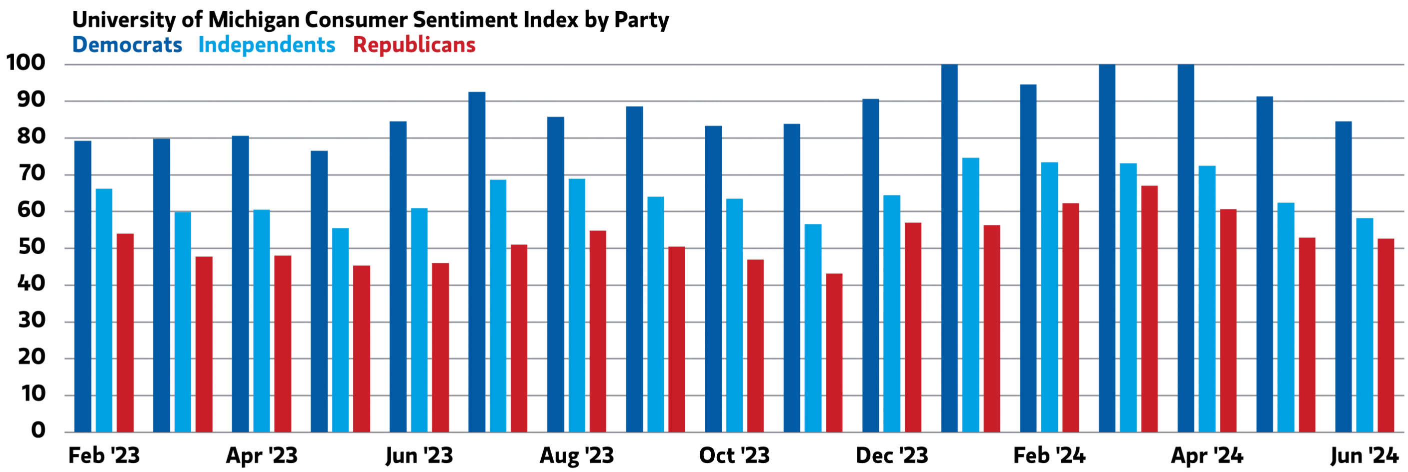
Beyond GDP, voters' perceived wealth is often connected to inflation and the "economic pinch." For example, Morgan Stanley & Co. Research's latest AlphaWise survey shows inflation and the economy to be the top concern for 63% of consumers, a higher rate than last month. While US gasoline prices have moderated from their year-to-date peak in mid-April, perhaps more importantly to voters, average gas prices are up almost 50% since Biden took office. Wage growth is slowing and unemployment is on an uptrend, while stickier-than-expected inflation has pushed out Fed rate-cut expectations and is weighing on many parts of the economy. All told, Biden's reelection prospects hinge in large part on a patchwork of geopolitical, inflationary and economic outcomes, and the extent of any related drag on consumer confidence.

The University of Michigan Consumer Sentiment Index (MCSI), a proxy for consumer confidence, fell for a third straight month and to a seven-month low of 65.6 on a preliminary basis in June, from 69.1 in May. The index remains below its pre-pandemic level and its historical election year average of 85.0, indicating hesitancy about the economic outlook amid election uncertainty. In fact, going back to 1978, consumer sentiment has only been this low in June of an election year two other times, one of which resulted in the unseating of the incumbent and the other in a party change, given that it was an open election.

Analyzing sentiment by political party, we unsurprisingly see high readings among Democrats and low readings among Republicans today, which is historically consistent with the party in office. Sentiment for Republicans hardly changed from May to June, but fell by seven and four points for Democrats and independents, respectively. Notably, consumer sentiment among independents has deteriorated for the fifth straight month and has moved even closer to that of Republicans than Democrats, perhaps signifying the direction independents may lean on Election Day (see Exhibit 5).

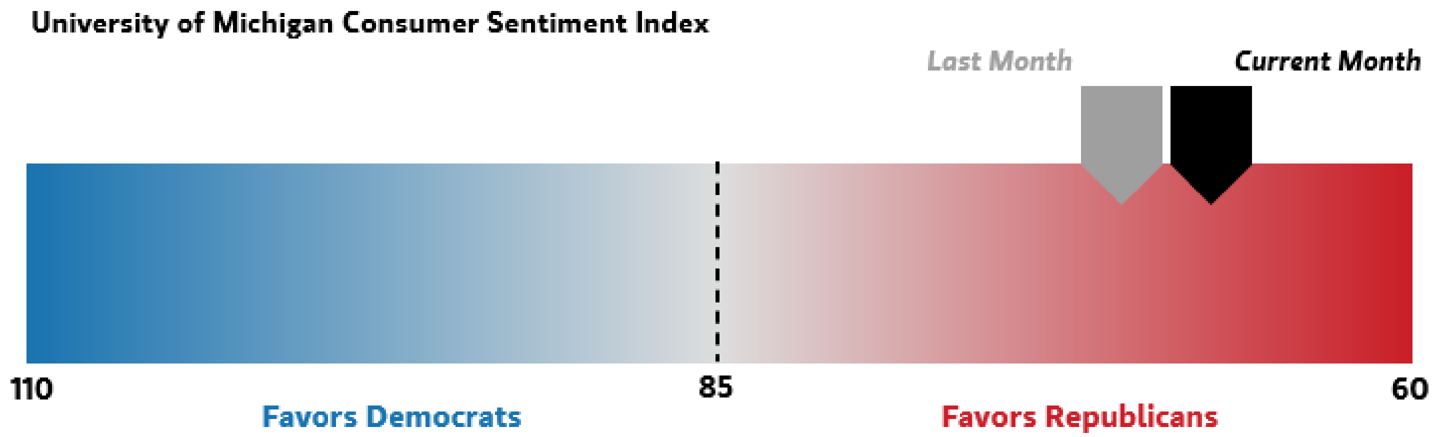
The index has a positive correlation with incumbent presidential results of 0.5. The index has averaged 92 when the incumbent party has won and 80 when the incumbent party has lost. While the MCSI continues to point to favor Republicans, we emphasize that it is just one of many possible leading indicators of election results, and we encourage investors to consider economic conditions holistically (see Exhibit 6).

Exhibit 5: Consumer Sentiment Among Independents Remains Closer to Republicans Than Democrats



Note: Latest index reading is preliminary
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 17, 2024

Exhibit 6: Consumer Sentiment Fell Modestly and Still Favors Republicans



Note: Latest index reading is preliminary
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 17, 2024

Market Indicators

On average, the S&P 500 Index has risen in election years. As investors position their portfolios ahead of the election, our analysis indicates that equity markets tend to be strongest amid gridlocked outcomes (split Congress and White House), given the restraint gridlock places on drastic policymaking. Morgan Stanley & Co. Research's US public policy team also notes in their June 14 report, "Navigating a Noisy Election," that there is a skew toward US dollar and US Treasury strength around elections. Market volatility also tends to rise, though 2024 may be even more volatile, given macroeconomic and geopolitical uncertainty, polarization and social media and artificial intelligence (AI) influences.

Analyzing equity performance by sector, patterns emerge that may serve as opportunities, as political outcomes and policy platforms can impact an industry's regulation and profitability. For example, if investors anticipate a Republican win, Utilities, Energy, Financials and Industrials may track the strong performance of those sectors in election years when Republicans have won. Conversely, Information Technology and Consumer Discretionary performed favorably when a Democrat was the eventual winner (see Exhibit 7). We believe that investment opportunities in certain sectors and industries may arise as Election Day approaches.

For example, despite recent fiscal support, the election still hangs over the defense industry. The S&P 500 relative to defense has closely tracked Biden's reelection chances. When his chances have improved, defense has underperformed the broader market and vice versa (see Exhibit 8). Although this follows the traditional assumption that Republican administrations benefit defense sentiment more, we believe that sectors in our "Security" theme, including defense, cybersecurity, semiconductors and more, will benefit regardless of outcome, as both parties are incentivized to spend more on national security, with potentially greater global defense spending if Republicans win the presidency.

Exhibit 7: Sector Returns by Democrat and Republican Election-Year Results

Average Performance in Republican-Win Election Year

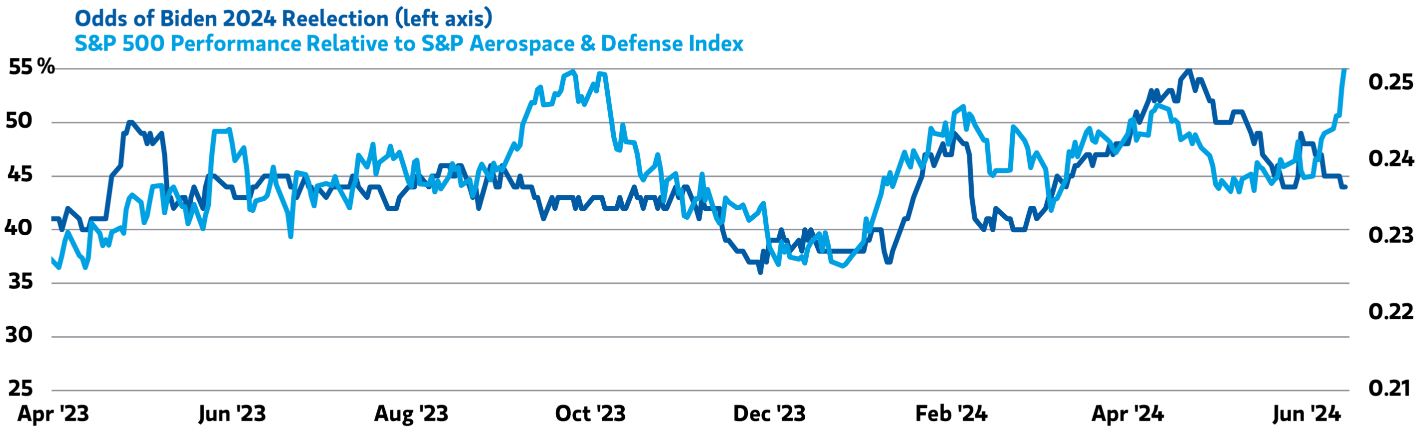
	Full Year	Q1	Q2	Q3	Q4	YTD
S&P 500	2.8%	1.4%	0.1%	-0.1%	1.3%	13.9%
Information Technology	-8.9%	4.4%	-3.3%	-3.8%	-6.4%	29.2%
Health Care	10.5%	-2.3%	10.4%	-1.9%	3.7%	6.7%
Energy	21.9%	3.2%	6.7%	6.7%	3.8%	4.3%
Consumer Discretionary	-1.4%	-0.6%	-3.5%	-1.4%	3.5%	2.2%
Consumer Staples	7.7%	-2.5%	5.7%	-2.5%	8.5%	7.3%
Communication Services	-2.0%	5.8%	-3.4%	-4.1%	-2.8%	23.6%
Utilities	27.8%	8.3%	2.8%	10.3%	4.5%	9.6%
Real Estate	10.9%	5.6%	-0.4%	0.9%	4.8%	-4.5%
Materials	2.4%	-4.0%	-3.4%	-0.7%	11.2%	3.5%
Financials	17.3%	0.2%	-1.6%	9.0%	9.8%	7.7%
Industrials	12.2%	0.5%	2.5%	3.9%	5.1%	6.0%

Average Performance in Democratic-Win Election Year

	Full Year	Q1	Q2	Q3	Q4	YTD
S&P 500	3.2%	-3.3%	3.7%	2.0%	0.0%	13.9%
Information Technology	11.1%	0.7%	6.5%	2.4%	-1.0%	29.2%
Health Care	0.6%	-5.3%	2.2%	2.8%	0.3%	6.7%
Energy	-10.3%	-12.1%	10.6%	-5.8%	1.0%	4.3%
Consumer Discretionary	9.4%	0.5%	5.0%	4.2%	-0.7%	2.2%
Consumer Staples	4.7%	-2.6%	2.4%	5.3%	-0.4%	7.3%
Communication Services	2.0%	-8.7%	7.2%	-0.8%	4.4%	23.6%
Utilities	-7.4%	-7.9%	4.5%	-3.0%	-0.9%	9.6%
Real Estate	-11.3%	-2.9%	3.1%	0.8%	-12.0%	-4.5%
Materials	0.8%	-0.4%	4.1%	-1.1%	-1.7%	3.5%
Financials	6.1%	-3.6%	-1.9%	3.8%	3.3%	7.7%
Industrials	1.9%	-2.8%	0.7%	2.3%	1.3%	6.0%

Note: Percents indicate sector performance for each election-year quarter or other period, ending on Dec. 31 of that election year.
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 14, 2024

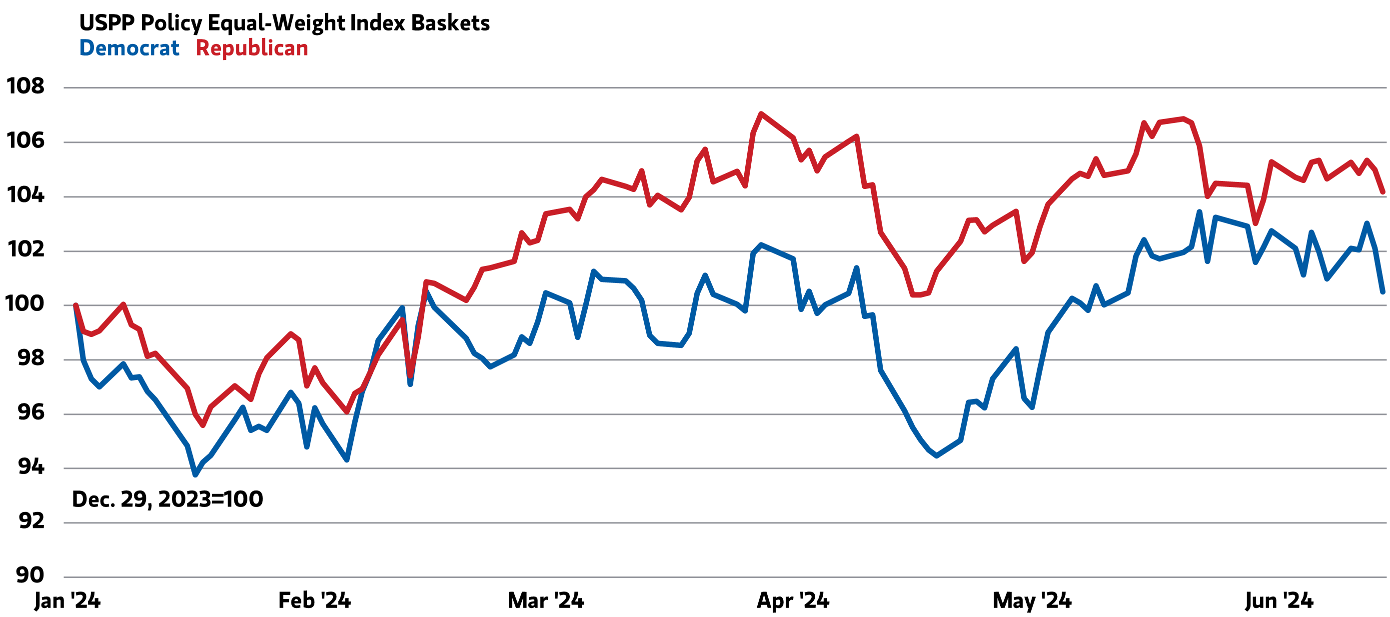
Exhibit 8: Defense Has Closely Tracked Biden's Reelection Odds



Source: Bloomberg, PredictIt.org, Morgan Stanley Wealth Management Global Investment Office as of June 14, 2024

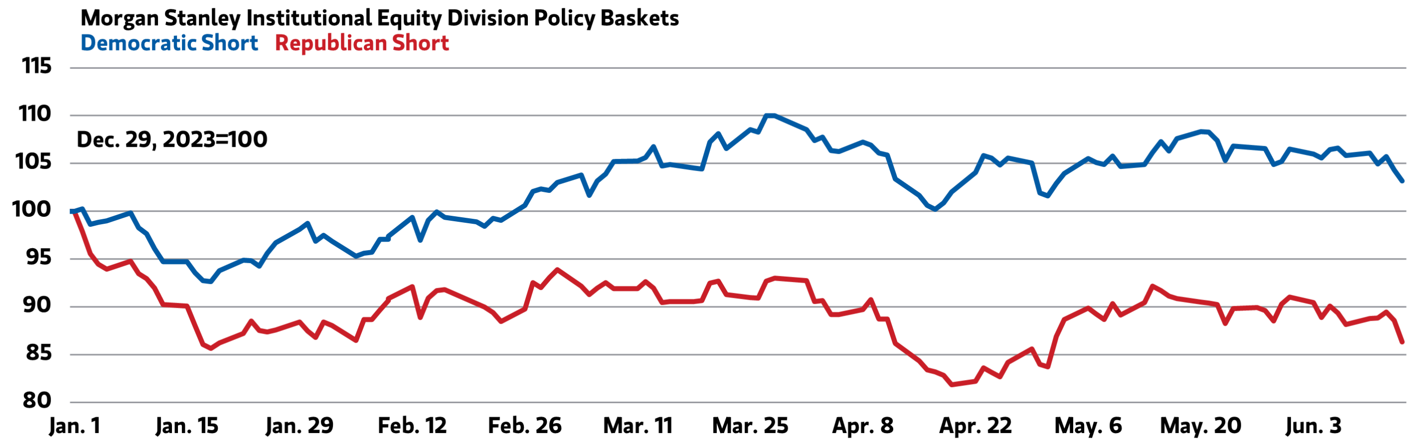
We developed two political party equal-weight baskets, each tracking 12 sector and industry exchange-traded funds (ETFs) positioned to benefit from either a Democratic or Republican victory. For example, sectors and industries that we expect to benefit from Democratic policymaking are clean energy, including electric vehicles (EVs) and solar; managed care; infrastructure; defense; and technology, including cybersecurity and semiconductors. Areas that we consider likely to benefit most from a Republican win are traditional energy, master limited partnerships, utilities, materials, real estate, block-chain technology, banks, pharma and biotechnology. The Republican basket has outperformed the Democratic basket by about 3.5% this year, slightly less than last month's 4.5%, but still indicating market positioning for a Republican win (see Exhibit 9).

Exhibit 9: Republican Equal-Weight Basket Has Outperformed the Democratic Basket



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 14, 2024

Exhibit 10: Investors May Be Avoiding Stocks Vulnerable to a Trump Presidency



Source: Bloomberg, Morgan Stanley Institutional Equity Division, Morgan Stanley Wealth Management Global Investment Office as of June 14, 2024

Analyzing election-related market performance from a different angle, we considered two baskets of stocks from Morgan Stanley's Institutional Equity Division: a Democratic short basket, which contains stocks that may be disadvantaged if a Democrat wins the White House, and a Republican short basket, which contains stocks that may perform poorly if a Republican wins (see Exhibit 10). The Republican short basket, down more than 15% for the year to date, has continued to underperform, indicating that investors could already be hedging against a Trump victory by selling stocks they anticipate would be negatively affected. In other words, the market may be bracing for changes to the status quo, mostly impacting companies with exposure to potential for higher tariffs, weaker support for EVs and repeal of parts of the Inflation Reduction Act.

Investment Conclusion

A unique and highly consequential election is just months away. The future of tax policy and the expiration of the TCJA depend heavily on who wins the White House and the makeup of the Senate and House of Representatives, with debt and deficits the primary focus. Meanwhile, the June 27 presidential debate is an opportunity for Biden to make an early impression on voters, raise his approval rating, defend his record and dispel concerns about his age and health well ahead of the fall. However, the trajectory of the economy and inflation, as well as social unrest due to foreign policy, pose a risk to the Biden campaign. Meanwhile, Trump's conviction is likely a net negative for him, though it has only been marginally reflected in his polling. In Washington, the Biden administration has pursued initiatives on trade, sanctions, student loans and, more recently, immigration and border control, attempting to neutralize Trump's election strengths.

Consumer sentiment data has deteriorated for the third straight month and remains below election-year averages, while sentiment among independents has fallen again for the fifth straight month, anchoring even closer to Republican sentiment than Democratic. This continues to suggest a Republican win. Analyzing market returns in election years, we find that opportunities may emerge in energy, utilities, financials and industrials if investors anticipate a Republican win, and in information technology and consumer discretionary if investors expect a Democratic win. Finally, when assessing performance of the USPP Policy Equal-Weight Index Baskets and the Morgan Stanley Institutional Equity Division Policy Baskets, we see the stock market positioning for a GOP win.

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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

Glossary

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Investing in foreign markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. **Investing in currency i**nvolves additional special risks such as credit, interest rate fluctuations, derivative investment risk, and domestic and foreign inflation rates, which can be volatile and may be less liquid than other securities and more sensitive to the effect of varied economic conditions. In addition, international investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with **emerging markets and frontier markets**, since these countries may have relatively unstable governments and less established markets and economies.

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.

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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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