Morgan Stanley

WEALTH MANAGEMENT

INVESTMENT STRATEGY

Global Investment Office | June 25, 2025

US Policy Pulse

The Power Playbook

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In this report, we explore the various drivers of the energy sector including global and domestic supply-and-demand dynamics, as well as geopolitical risk considerations and the growth of alternative energy sources.

Key Insights:

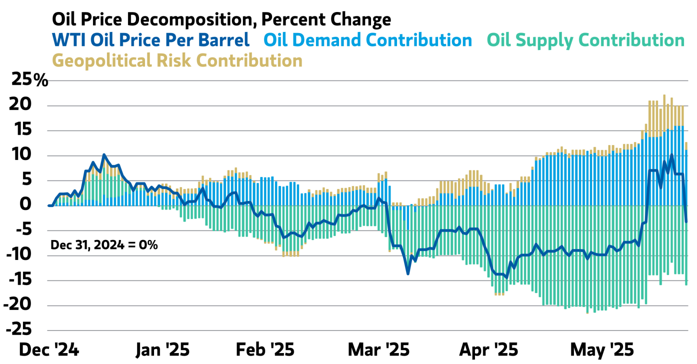
- Crude oil prices have been volatile, dropping early in the year due to oversupply and tariff-driven demand fears but rebounding on geopolitical tensions.
- Falling oil prices earlier this year contributed to slower production, falling rig counts and softer inflation, but these dynamics could reverse if oil prices remain high or if geopolitical risks accelerate and disrupt supply.
- Meanwhile, demand for US natural gas is rising due to artificial intelligence (AI) and data center power needs, prospective industrial onshoring and export demand, particularly from Europe.
- Midstream energy infrastructure stocks like MLPs are outperforming broader energy stocks due to increased gas export volumes; MLPs can also serve as a potential inflation hedge.
- In an echo of President Trump's first term, clean energy has outperformed traditional energy this year by 10% despite policy pressure, as Inflation Reduction Act (IRA) clean energy phaseouts could be softened, with carveouts for nuclear, hydrogen or carbon capture.
- Nuclear energy stocks have surged 50% since April and could continue to gain momentum with strong policy and AI data center tailwinds.

Energy has been a critical focal point of the Trump administration's agenda, which has sought to boost oil and natural gas production to drive US energy independence, while also targeting lower energy prices. As noted in our March *US Policy Pulse*, deregulation of the energy sector has been a crucial ingredient for achieving these goals. We highlighted energy as a key beneficiary of deregulation, as Trump declared a national energy emergency to expedite permitting and slash regulations for oil, natural gas and mining of coal and critical minerals. However, not all regulation is created equal, and while some policies could lower costs for the consumer, others may create tailwinds for sector performance and place upward pressure on consumer pricing. Furthermore, the recent bipartisan support of alternative energy, along with the ongoing debate regarding the IRA's clean energy tax credits, has introduced meaningful nuance when considering potential winners and losers. The dynamic nature of the energy sector at both the global and domestic levels, as well as the rapidly changing geopolitical landscape, has prompted us to discuss the primary macro and micro drivers and policy factors that could impact market performance of traditional, alternative and clean energy stocks.

Understanding the Oil and Natural Gas Market

Oil prices are typically driven by global and domestic supply-and-demand dynamics, as well as geopolitical risk considerations. This year, oil prices were trending lower due to increased supply and reduced demand, but that dynamic has shifted as demand recovered and geopolitical risk increased. On the supply side, OPEC countries have announced multiple production increases this year, a shift in strategy from defending prices to defending market share and accepting greater oil production sold at lower prices. Demand, according to Bloomberg Economics, had initially stayed strong this year, but fell in the period after the April 2 "Liberation Day" tariff announcement that threatened to weaken the global economy and negatively impact oil consumption. The two forces of greater supply and expectations for subdued demand, exerted downward pressure on oil prices in the aftermath of Liberation Day, falling more than 20% to a low of $58 per barrel by early May (see Exhibit 1).

Exhibit 1: Oil Prices Remain Volatile, Driven by Supply, Demand and Geopolitical Factors

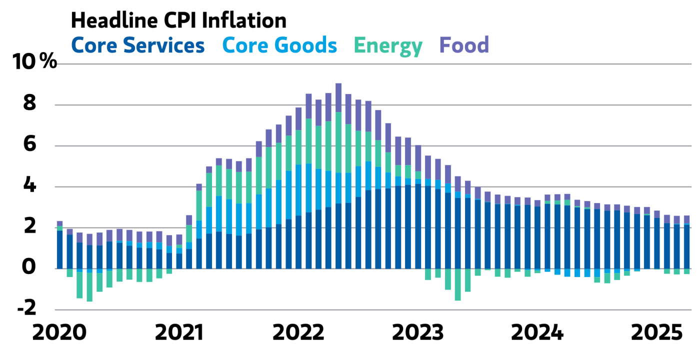


Source: Bloomberg Economics, Morgan Stanley Wealth Management Global Investment Office as of June 20, 2025

However, the macro environment has changed in recent weeks with West Texas Intermediate (WTI) oil prices retracing much of this year's losses, yet still down 8% year to date. First, demand has notably recovered as investors believe we may be past peak tariff and policy uncertainty, despite mixed economic data and an expectation for tariff-related growth and inflation pressures to materialize later this summer. Second, geopolitical risks have increased this year, and with it, risks to supply: the Russia-Ukraine war shows signs of escalation, not de-escalation, and the Israel-Iran conflict pushes investors to once again factor in geopolitical risk premium to oil prices. Although diminished, the risk that Iran moves to close the Strait of Hormuz, through which one-fifth of the world's oil traverses, means that oil prices remain vulnerable to upside risks through potential supply disruption. Should this not materialize and geopolitical factors subside, supply could remain plentiful, and downside risks could emerge through demand impacts from tariffs. Overall, we believe any significant oil price rallies are structurally capped due to the buildup of spare capacity from OPEC, limiting prolonged upside.

Energy had been a strong driver of inflation coming out of the Covid pandemic in 2021 and following the outbreak of the Russia-Ukraine war in 2022 as oil and liquefied natural gas (LNG) prices increased. Today, geopolitical factors are also driving energy prices. The 20% decline in WTI oil prices from the start of the year through early May has had a disinflationary impact on the headline consumer price index (CPI), which fell from 3% to 2.35% in May (see Exhibit 2). However, the Israel-Iran conflict risks threatening regional oil supply, and combined with the potential flow-through of tariff impacts this summer, could add inflationary pressure to CPI in the summer and fall. Prior to the announced ceasefire deal earlier this week, oil volatility had spiked to the highest levels since the outbreak of the Russia-Ukraine war, emphasizing the sensitivity of the market to macro factors. However, we note that impacts to energy prices are likely to be less severe than in the 1970s and early 2000s, given that the US has become more energy independent and less price sensitive.

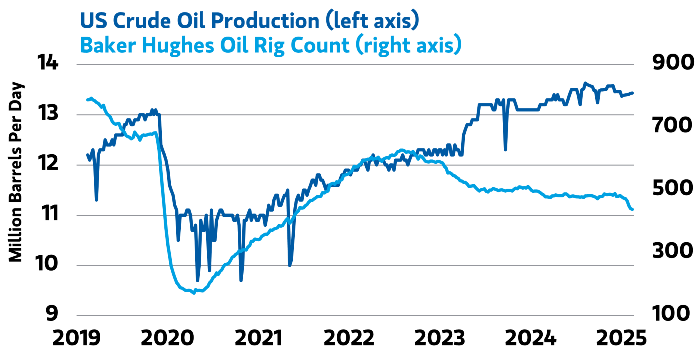
Exhibit 2: Falling Energy Prices This Year Have Driven Softer Inflation Prints, But Could Reverse



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 25, 2025

While global conflict may cause WTI oil prices to remain elevated in the near term and higher prices could incentivize a marginal increase in domestic production, we have long been skeptical that the administration's preference for increased domestic supply would meaningfully lower prices. Notably, executive branch action alone has a limited menu of policy options that could spur greater production. Some of these include increasing the sale of oil leases, providing significant tax credits and other tax benefits for drillers, and refilling the Strategic Petroleum Reserve at above market or breakeven prices. Oil production is already at or close to record-highs, as producers operate near capacity. Since early 2024, US oil production has stagnated around 13.4 million barrels per day, while crude oil rig counts have fallen from a peak of 510 to 438, the lowest since October 2021, and down from 482 at the start of the year (see Exhibit 3). In other words, lower oil prices at the outset of the year have led to reduced production, though this could reverse if prices stay high.

Exhibit 3: Oil Production Has Stagnated Near Record Levels, While Rig Counts Have Fallen

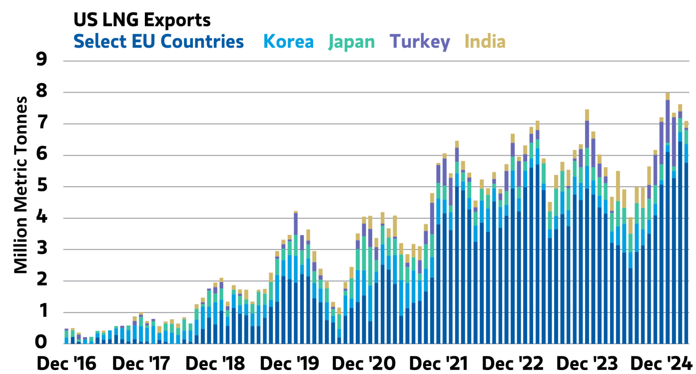


Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 20, 2025

The relationship between oil production and prices is further explained when analyzing production fundamentals. Survey results last month from the Federal Reserve Bank of Dallas and the Kansas City Fed reported that oil exploration and production firms, on average, need WTI oil prices at $41 to cover operating expenses for existing wells. Given it is cheaper to keep existing wells operating than it is to drill new ones, that same survey indicated a WTI oil breakeven at $65 to profitably drill new wells, up from $64 a year prior. With oil now trading close to breakeven, at $65 per barrel, the incentive for firms to drill new wells is only marginally improved, as increased production would likely come from the reactivation of ready stacked rigs. Morgan Stanley & Co. Research forecasts WTI oil prices to hover in the $53-$56 range until the end of 2026, driven by rising supply and demand headwinds, but the various geopolitical scenarios could alter this path.

In contrast with crude oil, we have more conviction in the outlook for US natural gas pricing and production, driven by expectations for higher-for-longer demand and more constrained global supply. For example, additional load growth—that is, the increase to the power load required to do business—drives tailwinds for natural gas via the growing demands to power data centers and generative AI, as well as prospective industrial onshoring. From a policy perspective, the One Big Beautiful Bill Act (OBBBA) that is currently under debate in the Senate, repeals or phases out some of the Inflation Reduction Act (IRA) clean energy tax credits, potentially increasing natural gas demand. Additionally, robust foreign demand for US natural gas has emerged as the European Union has diversified its energy sources away from Russia, as shown by a quadrupling in US natural gas exports to major European countries since late-2021 (see Exhibit 4). Natural gas exports are likely to continue to be an integral part of ongoing trade negotiations, with countries potentially subject to reciprocal tariff policies.

Exhibit 4: Trade Negotiations May Include LNG Exports



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of April 30, 2025

Traditional Energy Stock Performance

Energy stock performance has been bifurcated among those more exposed to market prices versus those mostly dependent on volume of production and exports. Energy infrastructure, such as MLPs, derive most of their revenues from midstream activities, including transporting, distributing and exporting commodities like oil and natural gas through pipelines and other networks. As such, the significant increase in US natural gas production and exports driven by the above tailwinds has pushed greater volumes through MLPs, contributing to a 9% outperformance against the broader energy sector since the election (see exhibits 5a and 5b). We maintain a constructive view on the long-term outlook of energy production and volume, particularly natural gas, which may continue to support MLP performance. According to Morgan Stanley & Co. Research analysts, domestic demand for LNG is expected to increase by 5% in the next year, providing continued tailwinds for MLPs. In addition, we highlight that MLPs could serve as an inflation hedge, given expectations for a higher inflationary environment.

Exhibit 5a: MLPs Have Outperformed Broader Energy…

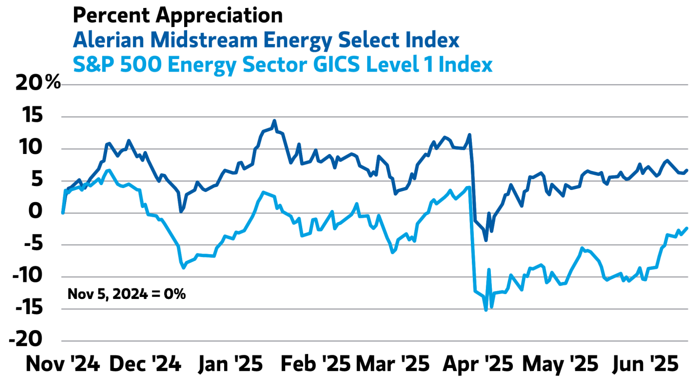
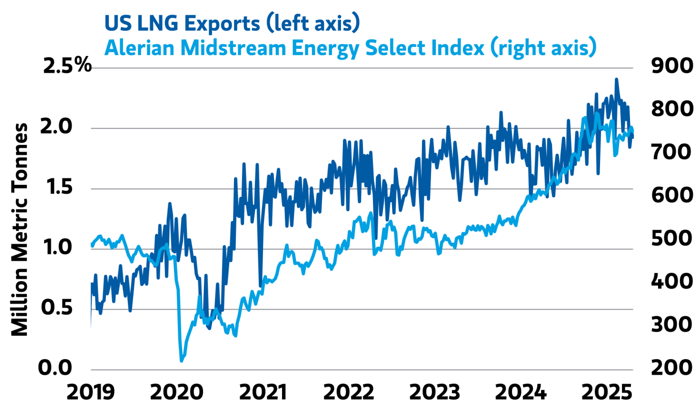


Exhibit 5b: …Driven by Greater US LNG Exports and Demand

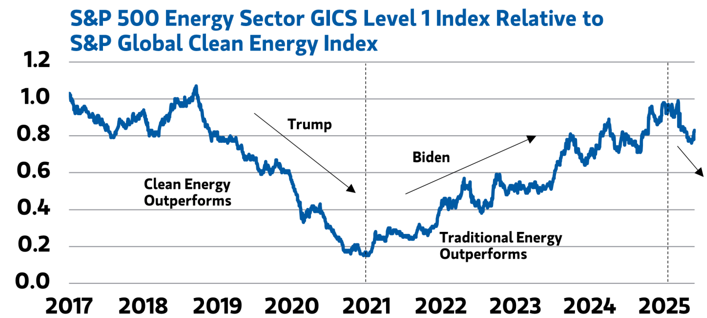


Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 23, 2025

The Future of Clean Energy

Shortly after the 2024 election, we noted that, while the administration's priorities are likely to present headwinds for the industry, clean energy could outperform traditional energy. Our thesis was driven by a number of observations: Over a long-term horizon, clean energy outperformed during Trump's first presidency, when interest rates were lower, while traditional energy outperformed during Biden's term, when rates were higher and oil prices were elevated, indicating that macroeconomics and geopolitics are key drivers of performance. In other words, over the long term, clean energy stocks remain sensitive to interest rates, with many companies benefiting from lower borrowing costs. These dynamics challenge the assumption that Trump is a positive for traditional energy over clean energy, as shown by clean energy's continued outperformance under Trump 2.0 (see Exhibit 6).

Exhibit 6: Clean Energy Has Been Outperforming Under Trump Again



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 23, 2025

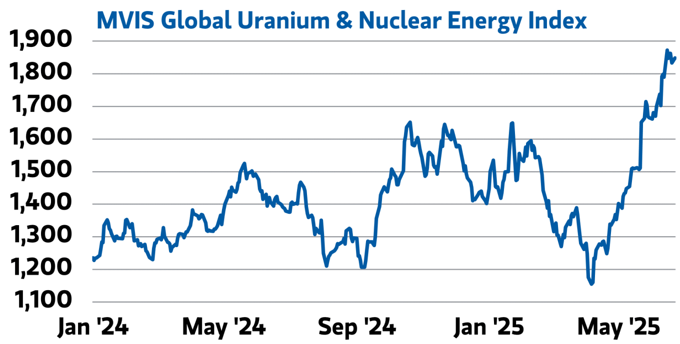
Beyond market and macro drivers, we highlighted that despite expectations of policies to dismantle the IRA, rolling back the IRA's clean-energy funding may not be as simple as it sounds. Many Republican legislators have begun viewing the IRA no longer as a climate policy alone, but rather as an industrial infrastructure policy that supports economic activity and job creation in their states. In fact, approximately 84% of its investments has gone toward benefiting Republican-controlled states and districts, and in the 35 instances where the government has obligated over $1 billion in investment, 83% of those projects are in Republican-controlled states and districts. The Senate's current version of the OBBBA, released last week, softens the House-approved rollback to clean energy tax credits. In the final bill, there could be further carveouts for nuclear, hydrogen and carbon capture, and timeline changes from immediate repeal and accelerated phaseouts to delayed phaseouts, as the two chambers go to negotiate a final bill over the coming weeks. The relationship between the IRA and red states is central to our thesis, as well as to the eventual outcome of tax policy provisions and market performance of the industry.

Renewed Interest in Nuclear Energy

Our expectations for increased power demand due to generative AI (GenAI) advancements and data center needs are likely to require nuclear energy in addition to traditional energy to meet the load growth required. This has been supported by policymaking from both sides of the political aisle.

Under President Biden, a nuclear energy deployment strategy sought to quadruple US nuclear energy capacity by 2050. In May 2025, President Trump issued four executive orders aimed to promote deployment of nuclear technology, build out supply chains of nuclear fuel, expedite licensing and increase US nuclear exports. These actions are consistent with Trump's deregulatory agenda, as well as his commitment to energy independence and prioritization of AI development as a national security issue. For example, one of the executive orders grants more responsibility to the Department of Energy (DOE) and Department of Defense (DoD) for development of nuclear energy, while another seeks to fast-track construction by reforming the Nuclear Regulatory Commission (NRC) and establishing maximum deadlines of 18 months for final decisions. Performance of the MVIS Global Uranium and Nuclear Energy Index, which rebounded nearly 50% since early April, reflects these recent policy actions and the embrace by Washington of nuclear energy (see Exhibit 7).

Exhibit 7: Nuclear Has Benefited From Supportive Policy Action and Increased Power Demand



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 23, 2025

Investment Conclusion

Oil prices initially fell this year due to oversupply and tariff-driven demand fears but rebounded as geopolitical risks rose. Earlier price declines led to slowed production, reduced rig counts, and softened inflation. However, renewed supply risks, although diminished, could drive prices higher and reverse these dynamics. In contrast, US natural gas demand is rising, fueled by AI-driven power needs, prospective industrial onshoring and strong European export demand. Energy stock performance have diverged, with midstream infrastructure companies such as MLPs outperforming due to higher export volumes, while serving as a potential inflation hedge. Despite policy headwinds, clean energy could benefit from softened IRA rollbacks, especially with carveouts for nuclear, hydrogen and carbon capture. Meanwhile, nuclear energy stocks have surged 50% since April, supported by strong policy momentum and rising AI-related power demand.

Disclosure Section

For index, indicator and survey definitions referenced in this report please visit the following:
https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Glossary

Risk premium is the return in excess of the risk-free rate of return an investment is expected to yield.

Risk Considerations

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** involves 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.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Companies paying **dividends** can reduce or cut payouts at any time.

Artificial intelligence (AI) is subject to limitations, and you should be aware that any output from an AI-supported tool or service made available by the Firm for your use is subject to such limitations, including but not limited to inaccuracy, incompleteness, or embedded bias. You should always verify the results of any AI-generated output.

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies. Risks applicable to companies in the **energy and natural resources sectors** include commodity pricing risk, supply and demand risk, depletion risk and exploration risk.

Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

Master Limited Partnerships (MLPs) are limited partnerships or limited liability companies that are taxed as partnerships and whose interests (limited partnership units or limited liability company units) are traded on securities exchanges like shares of common stock. Currently, most MLPs operate in the energy, natural resources or real estate sectors. Investments in MLP interests are subject to the risks generally applicable to companies in the energy and natural resources sectors, including commodity pricing risk, supply and demand risk, depletion risk and exploration risk. MLPs carry interest rate risk and may underperform in a rising interest rate environment.

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