Investment Insights

APRIL 2017

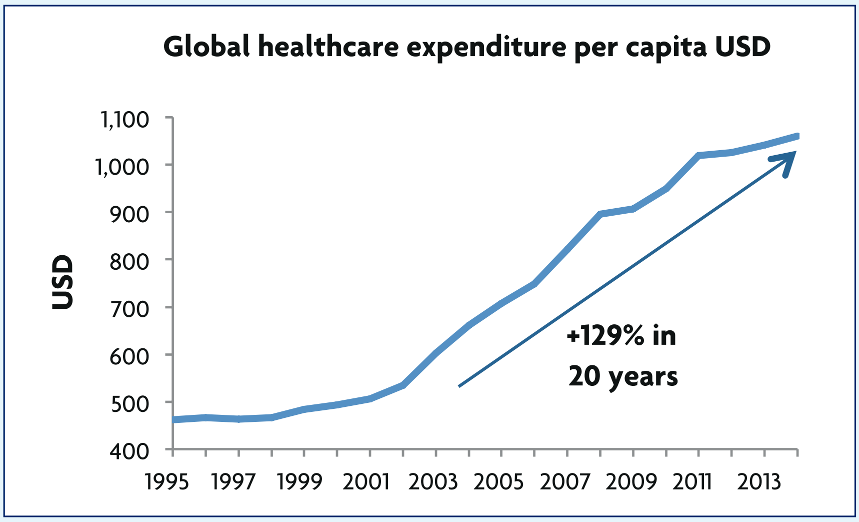
Healthcare Sector - Time to revisit?

Healthcare – A combination of resilience and growth

The healthcare sector is relatively independent from the economy, unlike most other industries. As birth, aging, sickness and death are the inescapable realities of life, healthcare deals with all phases of the human life.

With an aging global population and increasing prosperity in the emerging economies, healthcare expenditure has increased steadily over the last two decades. On per capita basis, healthcare expenditure climbed from USD462 in 1995 to USD1,061 in 2014, equivalent to 4.2% increase per year. The aggregated global spending is much bigger, given that the world has increased another 1.6 billion people in the same time period (from 5.7 billion to 7.3 billion).

Figure 1: Global healthcare spending is on the rise



Source: World Bank, Data from 1995 to 2014

Inside

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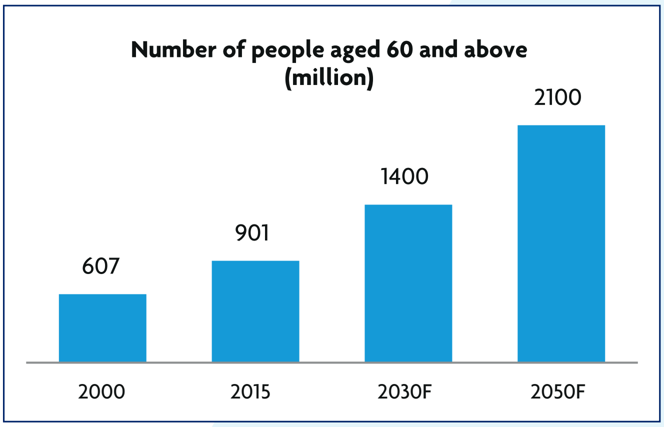
Opportunity in healthcare is huge

The secular trend for spending more on healthcare is likely to continue, underpinned by rapidly changing demographics. The growth in the number of people reaching and living past 60 years old is accelerating.

Worldwide, there were 901 million people aged 60 years or above in 2015. By 2030, the number is projected to grow 56% to 1.4 billion. By 2050 the number is projected to more than double its current size, reaching 2.1 billion. The median healthcare expenditure for this age group in the US is about **USD4,430 per year** in 2014. As people age, the spending on healthcare is many folds higher. (Data extracted from Agency for Healthcare Research and Quality.)

Other than aging proportion, the leap in demand from a low base within emerging markets (EM) is likely to provide additional boost in demand. For instance, there are only 3.4 hospital beds per 1,000 people in EM, compared to 9.5 in the developed countries. Also, the large EM population can significantly boost short and longer term demands as they seek a higher quality of life. This can further boost the earnings of pharmaceutical companies, medical devices and services providers.

Figure 2: The world is aging rapidly



Source: United Nations. World population aging, 2015

Strong innovation to propel new frontiers

The healthcare industry is always evolving and staying ahead with exciting research and development (R&D) projects. These efforts are rewarded handsomely when the product/technique is successful at addressing the current pain points in the treatment methods. There are many smaller biotechnology companies that are attractive takeover candidates for the cash-rich mega-pharmaceutical companies.

One such example is immuno-oncology, the study of interaction between the immune system and cancer cells. It is already making progress towards major breakthroughs in cancer therapy. The use of the body's own human T-cells to recognise and kill cancer cells can avoid the long-term side effects of current treatments like chemotherapy and radiotherapy and potentially improve success rates.

Billions of R&D capital is deployed in global healthcare to help improve the lives of patients. New advanced drugs and products can then help companies generate the competitive advantage and pricing power to help fund on-going projects.

Table 1: Interesting medical developments

Amazing Healthcare Advances of 2017 – Selected Examples
1. Human head transplants – using a special blade and a polymer to help start growth in spinal cord nerves.
2. Heart in a box – a new process called warm perfusion can keep hearts beating outside the body.
3. 3D printed drugs – able to produce optimal medication dose based on factors like age, race and gender to be printed and treat multiple ailments at once.
4. Bio-absorbable stents – the current use of metal coronary stents are used. However, the stent stays there, long after its mission is complete and may, in the future, inhibit blood flow. The use of naturally dissolving polymer helps address this limitation.

Source: referralmd.com, 17 January 2017

What it means for investors? ▶▶

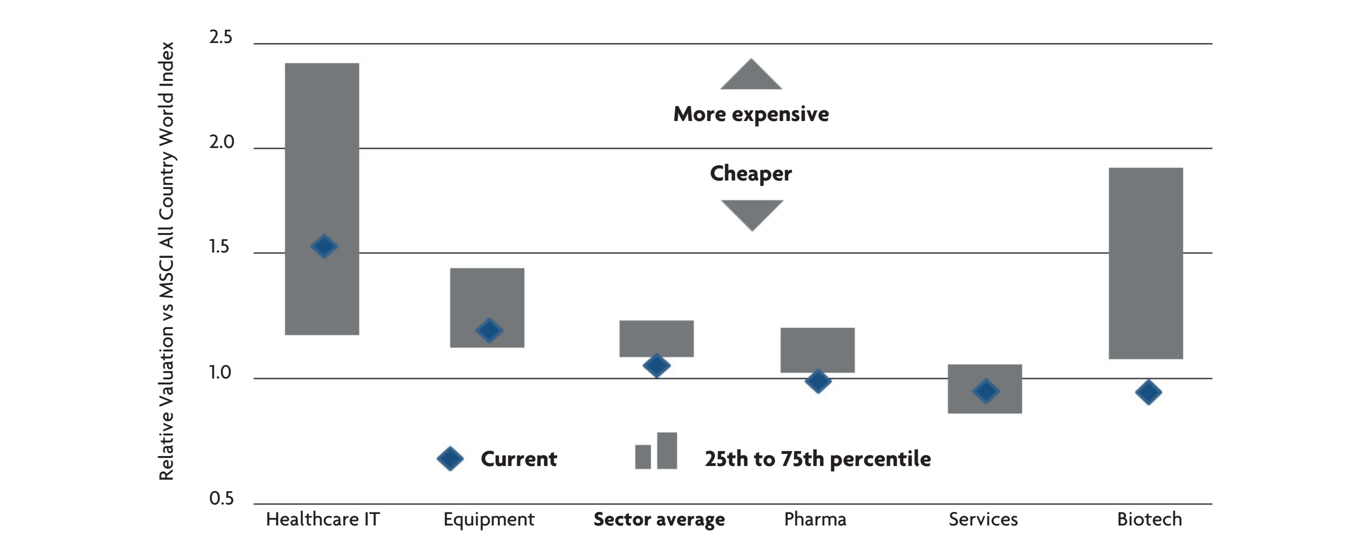
Healthcare valuations are attractive

Healthcare stocks have recently rebounded after almost two years of underperformance. Historically, this sector has traded at a premium to the broader market, reflecting both the growth characteristics and the high dividend yield.

Biotech stocks declined over 30% from the peak to trough during the US presidential campaign period from July 2015 to November 2016. Despite the recent bounce, biotech and pharmaceutical stocks are still trading at the lower end of historical valuations. See Figure 3.

We believe that the current valuation bargain in these stocks is temporary. Investors that invest in good quality healthcare stocks can potentially benefit from the valuation discount for higher capital appreciation potential. Furthermore, many of the dividend-paying stocks are offering attractive dividend yield. This income component "pays" investors to hold, if the capital appreciation story takes longer to pan out.

Figure 3: Healthcare stocks are trading at attractive valuations vs historical (1996 to 2017)



Source: Blackrock Investment Institute – Healthcare convalescence, 23 March 2017

Catalyst for healthcare is found in the M&A space

This industry is also interesting in its mix of companies. On one hand, there are the large pharmaceutical companies, which are very profitable and cash-rich but many of them do not have enough in the product pipeline to replace yesterday's blockbuster drugs. On the other hand, smaller biotech firms eagerly push the boundaries of innovation and look ready to be acquisition targets for their intellectual rights and patents.

We believe the summation of factors above like the lack of product pipeline, years of cash accumulation and the cheaper valuation of biotech companies forms a compelling proposition for an increase in M&A activities, thereby pushing equity valuations higher.

US tax reforms, though sketchy till date, look likely to include a one-off special tax rate on overseas cash. This could lead companies to repatriate the cash back, providing a catalyst for another wave of industry consolidation through M&A.

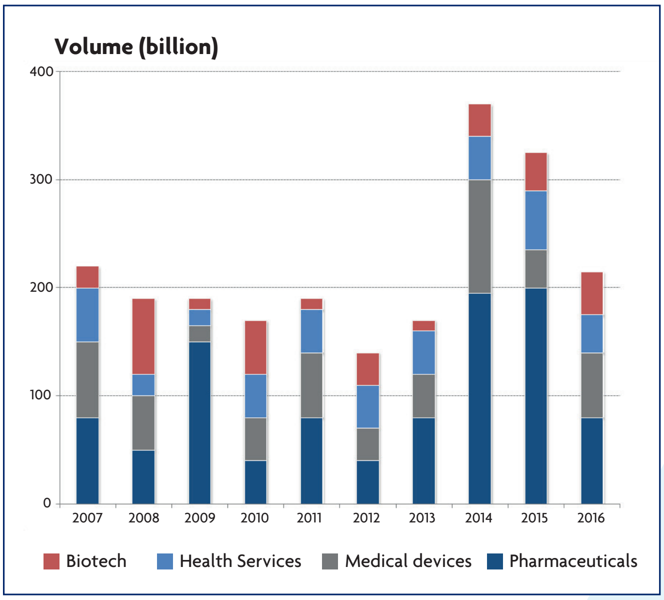
These prospects could boost investors' sentiments for biotechnology companies, especially the small and mid-size biotech firms. However, we emphasize the need to be selective in this sector. There will be winners and losers in this highly competitive industry. The stakes can be quite high. A good stock picking fund manager can potentially enhance the investment returns.

Table 2: Some pharmaceutical companies' recent views towards M&A

Company	Market Cap (billion USD)	Extract from 4Q16 Earning Call
AbbVie	103.8	Tax Reform could spur acquisitions
Johnson & Johnson	338.0	Actelion takeover
Merck & Co	174.8	Continue to target bold-on acquisition and partnerships
Pfizer	204.5	Tax reform would make some previously unviable deals more affordable Bias towards deals that provide immediate or near term revenue growth

Source: Bloomberg Intelligence, 05 April 2017

Figure 4: Global healthcare M&A volumes have increased in recent years, 2007 to 2016



Sources: Blackrock Investment Institute and Bloomberg, March 2017

Bottom line

On the backdrop, we continue to see increasing demand for healthcare products and services in both developed and emerging markets. This stems from the structural story of aging population and more affluent demographics.

There are opportunities in the biotech and selected big pharmaceuticals with promising drug pipelines. We feel that the catalyst for this year could be the potential surge of M&A activities, from the proposed repatriation of overseas profits.

At current cheap valuations and dividend yield, investors are paid to wait until the market reprices the true value of such medical innovations.

As the divergence of stocks within the healthcare sector is large, a good stock picking fund manager can potentially enhance the investment returns.

Market Outlook ▶▶

Investment Perspective – March 2017

Equity	Focus on Asia ex-Japan equities, but with a low volatility approach. Selective on US equities. Focus on Financials. We think the run-up in Industrials have largely run its course and have taken the opportunity to take profit this month.
Fixed Income	US short duration high yield. Subordinated bonds of high quality issuers. Hybrid credits that allow for reset at call date, with a preference for bonds with a high reset spread.
Alternative	Structured notes that allow participation to the equity markets through a customised payoff structure. Investors should provision for more buffers or consider principal protected structures.
Currency	USD strength should return in the coming months as the Fed still sees a base case for three rate hikes in 2017. Expect AUDSGD and AUDUSD to consolidate. GBPUSD to remain under pressure as Article 50 draws closer.

Source: UOB Investment Insights – March 2017

Investment Perspective – April 2017

Equity	Focus on **Asia ex-Japan** equities. Recent trade and manufacturing data suggests strong underlying growth drivers. Selective on US equities. Focus on **Financials and Healthcare. New!** European economic fundamentals continue to post strong numbers, suggesting a positive backdrop. However, investors still need to observe the political scene in France and Germany. Participate in **European equities** with dividends. **New!**
Fixed Income	US short duration high yield. Subordinated bonds of high quality financial issuers.
Alternative	Structured notes that allow participation to the equity markets through a customised payoff structure. Investors should provision for more buffers or consider principal protected structures.
Currency	USD grinds down slowly in the short term but the overall outlook remains positive. Expect gradual appreciation for AUD. GBP is prone to weakness on tough Brexit negotiations.

Strategies ▶▶

Strategy for the month of April

- We have maintained our Asia-ex-Japan equities and upgraded European equities this month. Also, we feel that Healthcare sector is attractively priced and recent price action suggests upside momentum (after almost two years of underperformance).
- The US Fed proceeded to raise interest rates by 25 bps to 0.75% to 1.00% on the March meeting, in line with market's expectation. The Fed is still projecting three rate hikes for 2017.

  Furthermore, the policy makers are also expecting to reduce the size of the central bank's balance sheet ($4.5 trillion) later this year. The intent should be communicated effectively to prevent disruption to the market. Starting this process would be a major milestone as the Fed unwinds its ultra-loose monetary policy. Fixed income investors therefore should reduce duration (interest rate sensitivity) to prevent excessive price swings.
- We see some short term pressure on the USD as the typical "buy the rumour, sell the fact" trades dominate around Fed meetings. Traders usually buy USD in anticipation of the rate hike and subsequently take profit after the event. We expect Chinese economy to be stable for the year, supporting commodity prices. This should help AUD to gradually appreciate.

Strategies ▶▶

Strategy		Analysis
	Short Duration High Yield Bonds	
1 Position for higher rates through short duration high yield bonds and subordinated bonds. **Heightened Interest Rate Risks**	Value	Albeit spreads have narrowed due to recent outperformance, **the yields are attractive** compared to US Treasuries.
	Trend	Investor fund inflows have been **supportive**, but the asset class may be overbought in the near term.
	Activity	Economic outlook should remain **positive** in the medium term.
	Risk	Strong economic momentum and governments' efforts to boost growth will **keep default rates at low levels**.
	Subordinated Bonds	
	Value	**Yields are attractive** compared to senior bonds of similar rated investment grade companies.
	Trend	Technical indicators point to **sideways movements**.
	Activity	Inflation may pick up. **Higher yields could cushion negative impacts on prices**.
	Risk	**Default risk is likely to stay low** for companies with strong balance sheets.
	Asia Ex-Japan Equities	
2 Asian equities are attractive, given low relative valuations and supportive economic backdrop. **Tap on Asia Value**	Value	Price to earnings ratio (P/E) for Asia ex-Japan equities at 15.1x is **attractive relative to DM equities** at 22.1x. Earnings forecasts for the region have turned positive after 2 years of underperformance.
	Trend	**Trend turned positive towards earlier this year and looks to continue**. Strong gains of 12.9% since start of year.
	Activity	**Economic data are supportive**. PMI for key countries have been resilient and export growth also looks buoyant.
	Risk	**G20 finance ministers meeting was inconclusive on free trade, while US has yet to enact barriers**. Constricted trade flows could dampen sentiments.
	US Financials	
3 Invest in US through sectorial plays on Financials and Healthcare. **Selective on US sectors. Rotation play to be nimble.**	Value	**Earnings per share growth is poised to pick up** with improved net interest margins due to steeper yield curve.
	Trend	**Momentum is not strong**, some consolidation is expected after the strong run-up.
	Activity	**Business and consumer sentiments are positive**. Relaxation of financial regulation could boost earnings.
	Risk	Due to current high earnings growth expectations, **investors may take some profits off the table**.
	US Healthcare NEW!	
	Value	**Earnings per share looks resilient and supported**. Relative price-to-earnings valuation is in the cheap region.
	Trend	**Momentum gained strength**, with short and long term trends in place.
	Activity	**Business and consumer sentiments are positive**. Stronger economy, more innovative medical practices and an aging population are positive.
	Risk	**Bill to replace the Affordable Care Act (ACA) has been withdrawn**, but uncertain as to whether there could be future replacements.

Strategies ▶▶

Strategy	Analysis	
	European Equities NEW!	
4 European equities are well supported by relatively attractive valuation and solid economic fundamentals. **Approach European equities with dividend focus.**	Value	**European equities are trading at wide valuation gap to US equities**. Earnings forecasts are revised upwards in 2017.
	Trend	**Trend turned positive and is at early stage of recovery**. As risk of French election moderates, the outflows since 2016 may potentially reverse in 2017. We are already witnessing investor flows into European equities since the start of March 2017.
	Activity	**Economic data are supportive**. Better PMI figures and corporate borrowings indicate that the Eurozone economy is recovering.
	Risk	**Unexpected outcome from the French election could upset the market**. Le Pen's victory could lead to risk-off sentiments.
	Global Quality Equities NEW!	
5 Gain managed equity exposure through global quality stocks. **Focus on global companies that emphasize on generating free cash flow.**	Value	**Earnings per share growth remains robust** as good quality companies often operate in sectors and industries with improving fundamentals.
	Trend	**Both long-term and short-term trend are positive**. Technical indicators are trending up.
	Activity	**Stable global growth** provides a benign environment to invest in global equities.
	Risk	Global recession risk stays low. However, relatively hefty valuations **increase the probability of short-term correction**. Uncertainties still exist in the world which may suggest more volatile times ahead.
FX Expected sideway movement before gradual upward trajectory on USD.	• USD grinds down slowly but the overall outlook remains positive. • Gradual appreciation expected for AUD. • GBP prone to weakness on tough Brexit negotiations.	
Rates Rising US rates expectations on the back of Fed tightening.	• Continue to **expect 2 more rate hikes** from the Fed in 2017, following recent increase in March. • **USD 3M Libor has increased significantly** from 0.62% in January 2016 to 1.15% in March 2017. USD 3M Libor is forecasted to reach 1.88% in 2018Q2.	

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