UOB Investment Insights

Monthly Market Views

May 2019

The global healthcare sector: preparing portfolios for politics

1-minute digest

- Although we see global healthcare as a megatrend, stocks in this sector witnessed a sell-off in March and April as investor concerns about policy uncertainties in the US impacted the various industry players.
- The negative sentiment has focused on potentially downward pressure on prices for drugs and other medical services as a result of the new, election-inspired “Medicare for All” plan, a government-led national health programme to cover every legal resident. Yet investors may have overreacted as political and fiscal hurdles suggest the chance of full implementation is relatively slim.
- While further near-term volatility in healthcare is possible, the sector represents a structural growth story in the longer term, with valuations at a relative discount to its recent history.
- Buying on dips looks like the best approach for investors who seek attractive returns from healthcare – both before and after the 2020 election.

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An abrupt about-turn for healthcare stocks

The healthcare sector has underperformed the broad market year-to-date after so much growth. Two main, interconnected factors have driven the downward trend:

1. Profit-taking by investors

- From the start of 2018 to February 2019, the global healthcare sector delivered a total return of +11% in line with the dual drivers of demographics and industry resilience. By contrast, global equities returned only 1% during this time as concerns over a global slowdown grew.

- But the political rhetoric in the early days of the 2020 presidential race, notably in March and April, led to some investors taking profit.

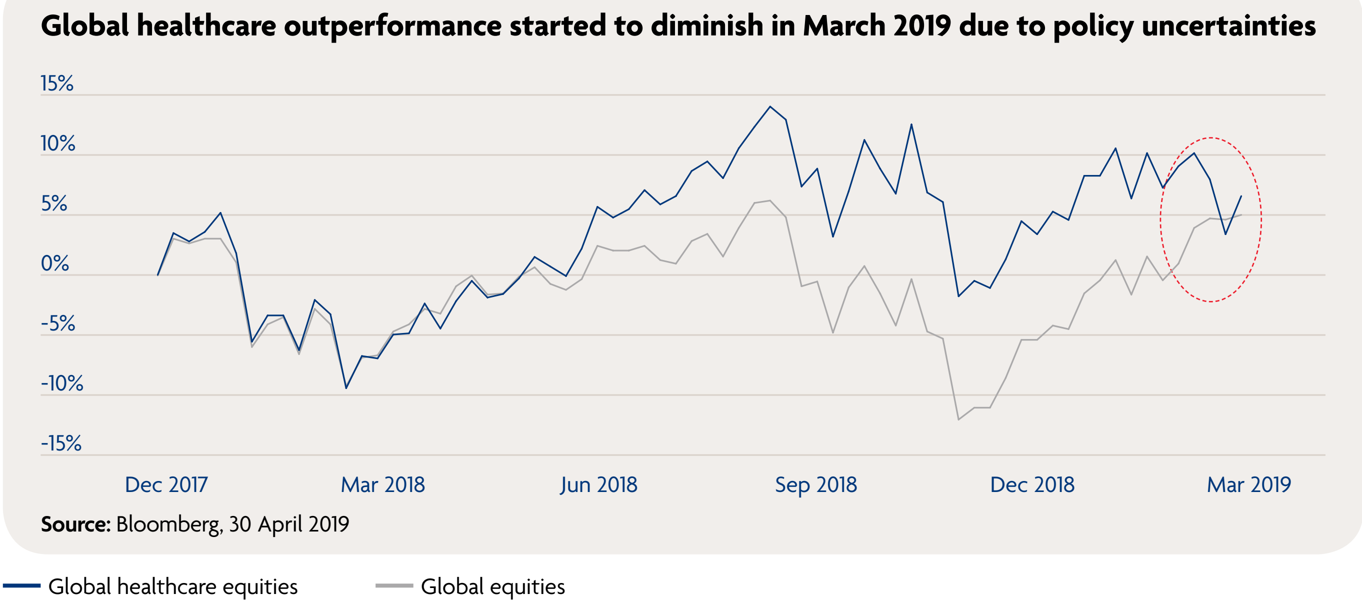
2. Policy-related concerns in the US

- As candidates from various political parties have started to jostle with each other in preparation for the election in November 2020, Democrat and presidential candidate Bernie Sanders has dominated headlines with the "Medicare for All" proposal – considered by some observers to be a burden for the healthcare industry.

- These plans, if enacted, would greatly limit (possibly eliminate) the role of private health insurance, plus hamper the earnings of all companies associated with the sector since the federal and state governments will likely acquire excessive bargaining power to drive down costs of pharmaceutical drugs, managed care services, medical equipment and other related businesses.

- There is also limited clarity about how "Medicare for All" will work in practise, so investors have become increasingly focused on the potential negative implications, including the expected cost (several trillion US dollars).

Figure 1



Source: Bloomberg, 30 April 2019

A doubtful future for "Medicare for All"?

Discussion over the prospect of "Medicare for All" looks set to dominate US media headlines for the foreseeable future and, in turn, impact the various related healthcare stocks. Yet, odds are the US won't implement this type of single-payer health care system any time soon:

• Unlikely to pass in Congress

Sanders is so far the only major presidential candidate to explicitly commit to a plan that eliminates private insurers; moderate Democrats are wary. There is also a lack of detail about how to pay for the programme, and how it would actually keep costs down. As a result, garnering enough support from fellow Senators could be a blockage.

• Voters likely to be cautious

Potential tax increases or delays in medical tests and treatment will likely derail some policy advocates – many of which also (wrongly) assume they could keep their current health insurance under a single-payer plan.

Against this backdrop, calls for a more moderate approach are expected to get louder.

Keeping portfolios healthy: 6 reasons to buy on dips

Despite current concerns and uncertainty within the healthcare space, the sector's fundamentals promise longer term growth. While stock prices seem to have overreacted to "Medicare for All" in the short run, fuelled by the likelihood of pre-election volatility, we believe the downside is limited for several fundamental reasons:

1. A structural growth trend

According to the World Health Organization, between 2015 and 2050 the proportion of the world's population aged 60-plus will nearly double, from 12% to 22%[1]. In line with this, global spending on healthcare is expected to increase from US$9.2 trillion in 2014 to US$24.5 trillion in 2040.

2. Hi-tech healthcare

Technological innovation continues to redefine the industry, transforming how companies manufacture drugs, conduct diagnoses and deliver patient care. Patents based on such evolution have the potential to provide venture capital-like returns.

What is "Medicare for All" about?

Medicare

- Since taking effect in 1966, Medicare has provided health insurance only for Americans aged 65 or older, younger people with disabilities and people with permanent kidney failure.
- It is funded entirely by the federal government and paid for in part through payroll taxes.
- Recipients can opt for extra health coverage from approved private insurers for services like dental, vision and prescription drugs.

"Medicare for All"

- This aims to create a single, national health insurance programme to cover everyone who is legally allowed to live in the US.
- In its current form, the government would pay for every required service, from routine doctor visits, surgery, and dental and vision care, to mental health and prescription drugs.
- Under this single-payer system, the US government is expected to have greater negotiating power over drugs and some other medical services, therefore driving down prices to create an effective pay cut for providers who today service patients with private cover.

[1] World Health Organization (February 5, 2018) https://www.who.int/news-room/fact-sheets/detail/ageing-and-health

3. Healthcare stocks typically bounce back

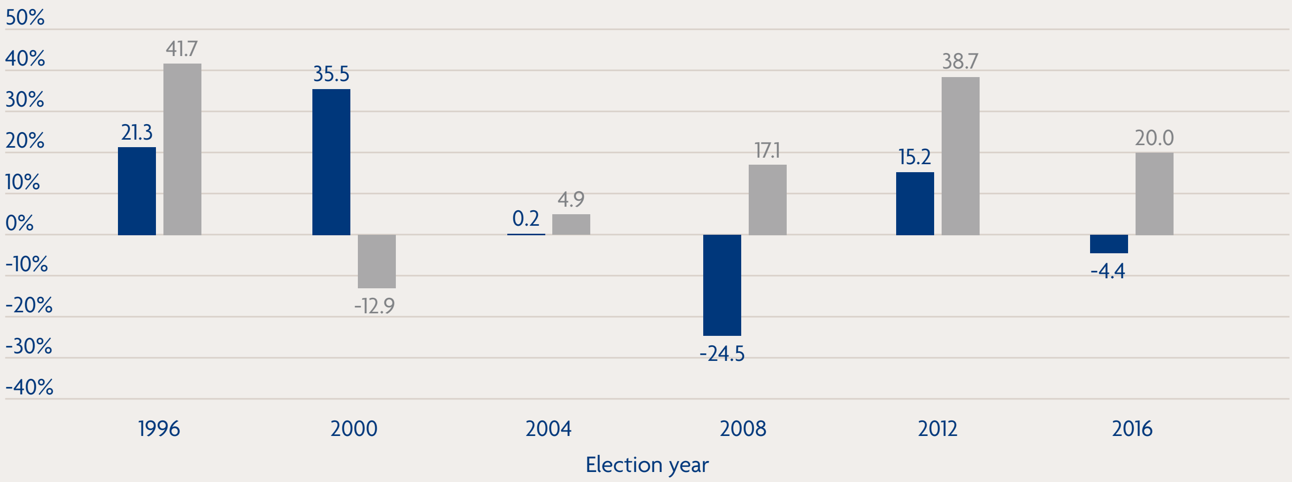
Although relatively volatile during election years, given public dissatisfaction with high medical expenses and candidates proposing reforms to win votes, healthcare stocks tend to return to an upward trajectory when political noises dissipate.

4. Data doesn't lie

According to historical data, in the six election years since 1996, the healthcare sector rose in four of them (1996, 2000, 2004 and 2012) and fell in the other two (2008 and 2016). Further, in the following year after the election, the healthcare sector increased in all cases except 2000.

Figure 2

Healthcare sector has held up well in the election year and the year after the election



Source: Bloomberg, 30 April 2019

● Performance in the election year*   ● Performance in the following year after the election year*

* Price return based the S&P 500 Health Care Index as example

5. Good for a defensive stance

The sector has proven to be a relatively defensive industry. Market data shows that when prices generally fall, the performance of healthcare stocks fares relatively well.

6. Attractive valuations

The current forward price-to-earnings (P/E) ratio of 15.8x for the healthcare sector compares with its 10-year average valuation. It is also well below the levels in the years 2000 (31x) and 2015 (20x).

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Market outlook and strategies

Economic drivers

Global growth

The IMF forecasts global GDP growth to slow to **3.3% in 2019**[1] **from its earlier 3.5% forecast**, citing ongoing trade tensions as an overhang. However, a recession is still not expected in 2019.

Inflation and central banks

Central banks have adopted a **dovish tone**. The Fed and ECB will not be hiking rates in 2019, while the BoJ will likely stay accommodative for the foreseeable future.

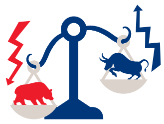
Corporate earnings

In 2019, strong personal consumption supported by a healthy jobs market should continue to drive the **positive trend** in corporate profits. Global earnings growth is expected to rise around **8% in both 2019 and 2020**.

Risks

Rising US protectionism

The trade tension between the US and China re-escalated as Trump administration hiked tariffs **from 10% to 25% on USD 200 billion** worth of Chinese products, starting from 10 May. The trade negotiation will be **long-drawn** and US and China are expected to **reach resolution in 2H 2019**. Meanwhile, the news flows will continue to drive market volatilities.



Central bank policy missteps

Inflation continues to rise mildly amidst a tight labour market. **Excessive dovishness** by central banks could lead to an inflation overshoot. Conversely, if central banks are **overly-aggressive in tightening** monetary policy without high inflation, the excessive reduction in liquidity could suffocate economic growth.

Political uncertainty in Europe

The original Brexit Day of 29 March came and went, but the UK Parliament has not accepted any Brexit proposal. Parliament has until 31 October 2019 to strike a deal or risk a no-deal Brexit again. As a result, financial markets could see **increasing volatility** as politicians continue to bicker.

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High-conviction strategies

Conviction	Key proposition	Risk
Global quality equities	Global quality equities tend to outperform broad equity markets over longer investment cycles.	Relatively expensive valuations could increase the probability of short-term corrections. However, the quality companies tend to better weather the economic slowdown, limiting the likelihood of large corrections in quality stocks.
Emerging market equities	Broad EM equities are supported by stronger fundamentals and attractive valuations.	An unexpected surge in USD strength could cause a retreat from EM equities, as seen in the Turkey situation last year. A worsening of US-China trade tensions could also lead to higher market volatility.
US financial equities	Attractive valuations and higher earnings due to resuming loan growth.	An escalation in the US-China trade war will hurt global growth. US banks will feel the impact directly. Increase in regulatory pressure on certain wayward banks that have been alleged of criminal wrongdoing (e.g. money laundering) will pose idiosyncratic risks.
Unconstrained bonds	A dovish stance from major central banks will keep key global interest rates low. An unconstrained bond strategy has the flexibility to allocate to a variety of fixed-income assets, and tends to outperform the broad fixed income market.	Rising rates and inflation are major risks to fixed income in general. However, unconstrained bond strategy can allocate to higher-yielding fixed income assets to mitigate such risks.

Megatrends

Conviction	Key proposition	Risk
Global healthcare equities	Healthcare is a structural growth story driven by long-term growth in an aging global population. In the medium-term, we expect drug approvals and an increase in M&A activity to be catalysts for a sector re-rating.	Policy uncertainty could weigh on sentiment for the sector. The Medicare-for-all proposed by Democrat Presidential candidate Bernie Sanders could lead to volatility, but the probability for the programme to pass is low at the present time. This risk will likely be mitigated in the long-term as a growing silver segment should contribute to stronger increase in demand.
Chinese equities	Chinese equities are underowned by global investors, and provide a good risk-reward and diversification benefits.	A US-China trade war remains a key risk in the near term. Negotiations are likely to be long-drawn, and news flows will continue to drive sentiments. Financial deleveraging could continue to put pressure on growth and lead to higher risks of policy missteps.
AI & innovation-driven companies	Artificial Intelligence (AI) has the ability to drive multi-fold increases in productivity by utilising big data and powerful computing hardware to accurately and reliably solve real-world problems with little human input.	Policy and regulatory uncertainty is a key risk to watch for. As AI permeates more and more into people's daily lives, questions about safeguarding individual privacy and appropriate use of such tools will surface. Regulators may step up efforts to curb the uses and applications, while differing standards from various countries can create barriers to universal adoption.

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