CIO Strategy Bulletin

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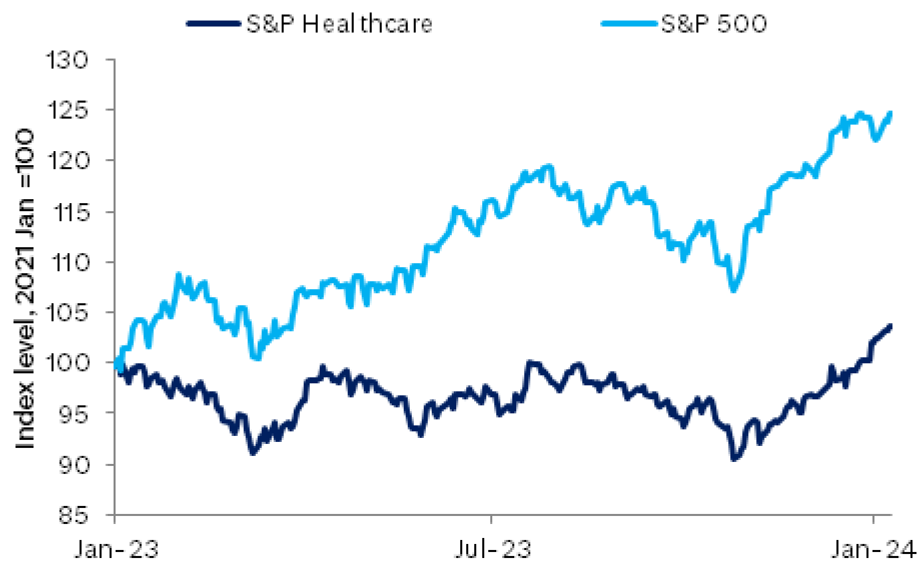
# Having Missed the '23 Rally, Healthcare Remains "On Sale"

- Just two weeks into 2024, the healthcare sector has shrugged off the title of being a notable laggard in 2023. In contrast to the previous year's sluggish 0.3% return (vs 24.2% S&P 500), healthcare now leads the performance chart among all the other sectors year-to-date, boasting a 3.0% return (vs -0.3% S&P 500).
- As we noted in our Wealth Outlook 2024, tighter financial conditions, regulatory uncertainties, the glut of inventories post-COVID and investor fear that GLP weight-loss and diabetes drugs will negatively alter demand for other health care modalities have been the culprits behind a rare healthcare earnings recession.
- Our view is that the new generation of GLP-1 drugs are not substitutes for other treatments and procedures but are likely to function as a complement that will help drive better health outcomes and market performance for selected shares.

# Healthcare is Still "On Sale"

In our Wealth Outlook 2024, we illustrated a “perfect storm” in healthcare that drove underperformance in related shares over the last two years. In our view, astute investors may find themselves with a trove of rebound opportunities. This Bulletin breaks down the current landscape - both the headwinds that have hampered health care and the opportunities that have arisen (FIGURE 1).

**FIGURE 1**: Healthcare sector significantly lagged in 2023




Source: Bloomberg as of January 11, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. **Past performance is no guarantee of future results.** Real results may vary.

## A Good Start to 2024

Just two weeks into 2024, the healthcare sector has shrugged off “laggard” title from 2023. In contrast to the anemic 0.3% ’23 return vs. 24.2% for the S&P 500, healthcare now leads the performance chart among all sectors year-to-date, boasting a 3.0% return vs -0.3% for the S&P 500.

Emerging from a poor capital raising environment in ’22-23, where early-stage biotech companies grappled to fund their Research and Development efforts amid rising interest rates, the battered sector finally is seeing a revival in Mergers and Acquisition deals as the new year begins. The drumbeat of deals saw about $9.6b[1] worth of transactions in January alone.

Early indicators of market activity are setting the stage for a broader sector recovery this year, especially in areas that were most beaten down in 2023. As we noted in our Wealth Outlook 2024, tighter financial conditions, regulatory uncertainties, the glut of inventories post-COVID and investor fear that GLP drugs (medications utilized in the treatment of type 2 diabetes and obesity) will permanently impair the need for other healthcare have been the key culprits behind a rare earnings recession in healthcare over the past decades (**FIGURE 1**).

At this point, we believe investors should reflect on the inherent resilience of healthcare over the long term: the sector recorded positive earnings growth during all three recent global earnings recessions (**FIGURE 2**). As macro tides shift, we see health care as an unstoppable trend beneficiary, with growth prospects well beyond the anti-obesity drugmakers. In fact, given demographic shifts and the benefits of AI, healthcare appears ready to return to leadership due to its consistent and secular earnings growth (**FIGURE 3**). We expect the healthcare earnings recovery in 2024 to be one of the main drivers of potential outperformance in the sector.

[1] Bloomberg as of January 11, 2024

**FIGURE 2:** Global Equity vs Healthcare earnings cycles

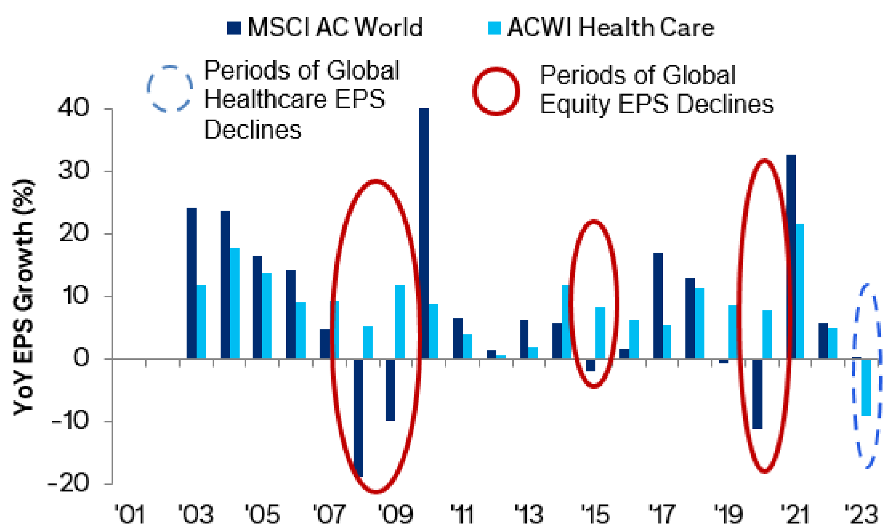



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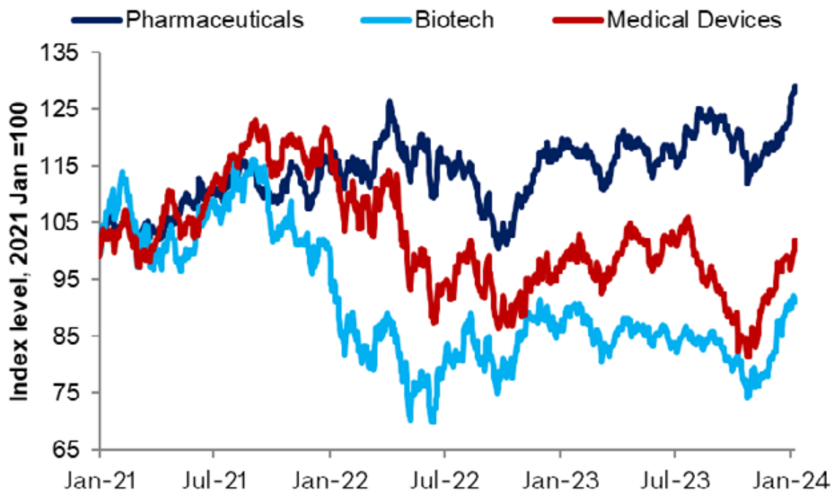
**FIGURE 3:** US Healthcare market cap and earnings as of % of S&P 500


Source: Bloomberg as of January 11, 2024. US Healthcare is represented by the S&P 500 Health Care sector index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. **Past performance is no guarantee of future results.** Real results may vary.

## Healthcare Still "On Sale"

We believe Healthcare innovation remains "on sale." We are particularly drawn to discounted valuations in the medical technology and tools segments, while biotech seems like a high-risk, high-reward bet as financial conditions ease (**FIGURE 4**). Some medical device makers are necessary "picks and shovels" for drug development. They work in conjunction with biopharma partners in the early stages of cell line production and later in the purification, formulation and packaging of an approved drug. Others are the producers of the new generation of devices either worn on or implanted in the body to address chronic conditions like heart disease and diabetes. Another potential investment opportunity is the makers of the equipment used in robotics-assisted surgery. Atypically, both large and small company valuations have suffered equally these past two years. In our view, cash-rich, cheaply-valued companies that facilitate drug research and development, save costs and improve patient outcomes look like a potentially safer way to play the Healthcare sector's convalescence.

**FIGURE 4:** Medical tech and devices, biotech are still "on sale"




Source: Bloomberg as of January 11, 2024. Pharmaceuticals is VANECK PHARMACEUTICAL ETF, Biotech is ISHARES BIOTECHNOLOGY ETF and Medical Devices is ISHARES U.S. MEDICAL DEVICES. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. **Past performance is no guarantee of future results.** Real results may vary.

## GLP-1 Weight Loss Drugs Won't Kill Health Care Demand

Even a revolution in weight loss won't threaten the unstoppable trends associated with longevity and healthcare.

Since 2018, we've been highlighting the favorable demographic tailwinds underpinning the global health care sector. Despite an ever-changing market, we all share the inevitable journey of aging. The world is aging, and in the developed market populations are aging even faster. An inevitable corollary of an aging population is the growing share of total consumption going to health care.

Historically this growth combined with the defensive properties of healthcare made it a secular growth component of portfolios. We believe it is the second most compelling industry investment sector along next to Information Technology. In 2023, the health care sector experienced a mirror of the broader market, with most of the gains concentrated in a few mega-winners and the rest struggled amidst an unusual profit recession.

We are firm believers in the transformative value of innovation (for lives and portfolios). Recent breakthroughs in treating obesity are being received by the market as being truly revolutionary.

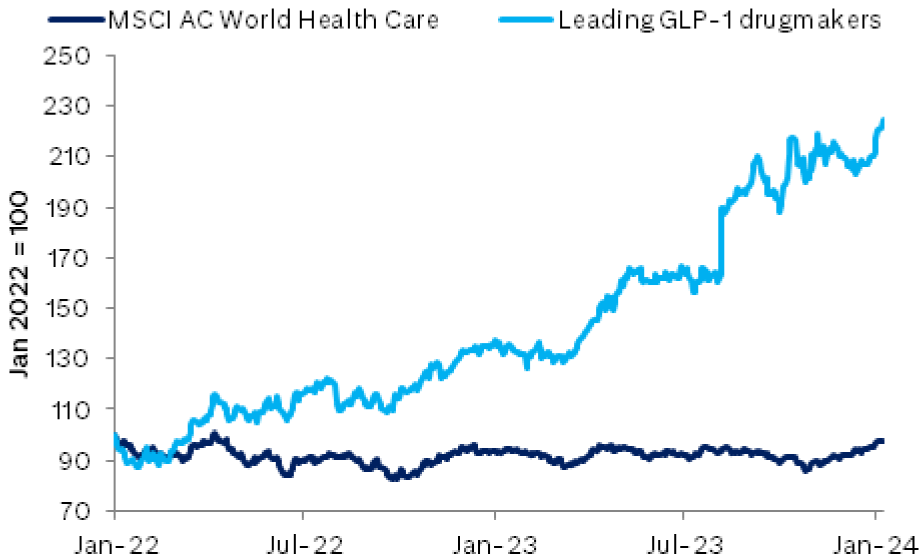
Treating obesity is an example of how healthcare can change rapidly. With a new generation of weight-loss medications (GLP-1 drugs), we are already seeing reports of lower rates of diabetes, heart disease and associated co-morbidities among their growing user base. Taken to an extreme, this could mean less health care spending on treating co-morbidities.

But these medicines do not make people younger. In fact, a decrease in the rate of obesity-related deaths will be exactly offset by increases in other causes of death, while allowing many people to live longer and increase overall health care consumption as they do so. This was on clear display through the middle of the 20th century when breakthroughs in vaccinations and anti-biotics prevented countless premature deaths but drove up the rate at which people died from age-related maladies. This illustrates the aging dynamic that has powered higher aggregate spending on health care for generations.

While GLP-1 makers have seen market caps explode amidst the broader health care profits recession, the magnitude of excitement in that segment should not be confused with a vote against the broader industry.

Ultimately, the new generation of GLP-1 drugs are not substitutes for other medical care but will complement other treatments to facilitate better health outcomes and associated stock market performance (**FIGURE 5**).

**FIGURE 5**: Share price returns for the pair of manufacturers responsible for the two leading GLP-1 weight loss drugs versus the rest of the developed market Healthcare sector

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|---|---|---|---|
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| Highest quality | Aaa | AAA | AAA |
| High quality (very strong) | Aa | AA | AA |
| Upper medium grade (Strong) | A | A | A |
| Medium grade | Baa | BBB | BBB |
| **Not Investment Grade** | | | |
| Lower medium grade (somewhat speculative) | Ba | BB | BB |
| Low grade (speculative) | B | B | B |
| Poor quality (may default) | Caa | CCC | CCC |
| Most speculative | Ca | CC | CC |
| No interest being paid or bankruptcy petition filed | C | D | C |
| In default | C | D | D |

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