

Healthcare outlook 2020

While the fundamentals of the healthcare industry are strong, across multiple subsectors, we recognise that the political environment in the US could create some volatility over the coming months. With apparent bipartisan support, it is drug pricing and affordability that we believe will be the most common healthcare topics as the Republicans and Democrats look to gain early traction with US voters.

The details, and timing, of any potential changes to the drug pricing environment in the US are impossible to predict but we believe the focus will likely be on US seniors (ie the over 65s). Unanswered questions might be: can Donald Trump, via Executive Order, introduce price controls for medicines that are administered in a physician's office (Medicare Part B) or can he extend those price controls to medicines taken at home (Medicare Part D)? Can an Executive Order be used to control inflation? Will any potential Bill garner support in the Senate? We also await with interest who will become the Democratic nominee, given the more progressive candidates (Bernie Sanders and Elizabeth Warren) could raise the spectre of greater government intervention, and therefore more disruption, to healthcare delivery in the US.

As mentioned above, the fundamentals for the sector remain robust with good sales and earnings strength relative to other areas of the market. Medical device companies continue to enjoy a cycle of innovative new products, while large-cap pharmaceutical companies are attractively valued, generate significant free cash flow and carry high dividend yields. Life science tools and services have robust end-markets, particularly those with exposure to biotechnology products as outsourcing trends continue. The biotechnology sector continues to innovate, with new technologies such as gene and cell therapy creating exciting new platforms for growth. These fundamentals should persist over the years ahead, generating attractive returns for investors. M&A could also continue in an industry that is searching for growth, is highly fragmented and could benefit from scale and cost synergies.

Despite the sound fundamentals, sentiment for the healthcare sector remains mixed with ETF flows negative through the latter half of 2019, and only reversing towards the back end of 2019. Further, valuations relative to the market are not far off the lows seen during previous episodes of political stress. This issue becomes significant every four years and is magnified when healthcare policy is an important part of the electoral debate. When this happens, negative sentiment can become extreme, as it did in the early '90s in 2008-09 and is at present.

Having experienced many of these sentiment cycles around politics, one needs to recall how fearful behaviour from investors can be a buying opportunity. The greatest fears have yet to come to pass, instead leading to changes to the healthcare system that have created an environment that separates the winners from the losers. This will likely happen again, with the market appearing to discount material risks ahead for 2020. Anything that goes the sector's way over the next year will likely justify a positive rerating for stocks currently sitting at relative discounts. Further, history would suggest that returns for investors in healthcare who are willing to invest when others are fearful, could be handsomely rewarded in the medium term.

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