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INVESTMENT MANAGEMENT

Global Multi-Asset Viewpoint

The Bull Case for the U.S. Health Care Sector

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The U.S. health care sector has underperformed the market by 21% since 2015 and is currently 14% undervalued based on our composite measure.[1] The sector has been weighed down by a cyclical upswing in global and U.S. growth, as well as concerns about health care reform—two factors that we believe have played out for now. From a cyclical standpoint, as global growth decelerates and the U.S. economy enters its late-cycle stage, health care's defensive characteristics should help it outperform. It has historically been profitable to discount worries about health care reform, especially when valuation provides an attractive starting point, and we believe this time is not different. We review our bull case for the U.S. health care sector below.

Over the past 45 years, the U.S. health care sector has outperformed the broader market. Its earnings and total returns have outpaced the market by 2.9% and 0.9% per year, respectively, since 1973 *(Display 2)*. It has also outperformed during five of the last six recessions, by 9% on average.[2] While most other sectors have occasionally underperformed for prolonged periods of time (e.g. energy in the 1990s and 2010s, tech in 1970s and 1980s), health care's underperformance has tended to be short-lived and has often occurred early in the expansion after sharp outperformance during recessions. Unlike the broader market, the sector's fundamental outperformance has not been based on margin expansion. In fact, margins have shrunk since the 1970s, from around a 10% net margin to 7.5% today.[3] In contrast, the broader market's net margins expanded from about 5.5% to 10% over that time period, disproportionately benefiting from capital and labor outsourcing as well as lower interest costs. Despite this, health care's return on equity (RoE) never dipped below that of the market.

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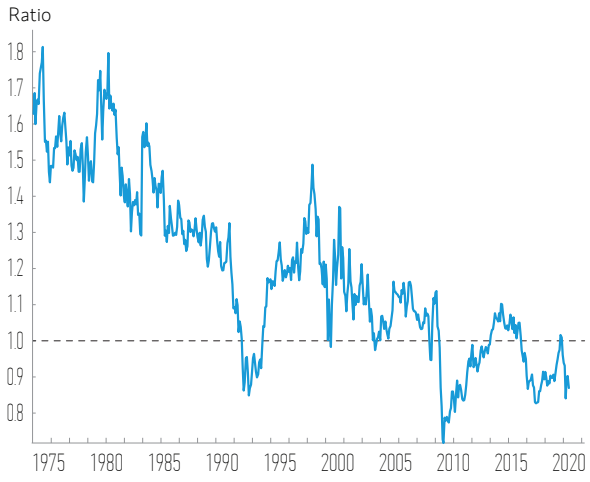
Display 1: **U.S. Health Care Cheap**

U.S. Healthcare vs. U.S. Relative Forward Price-to-Earnings



Source: MSIM Global Multi-Asset Team Analysis, FactSet, MSCI. Data as of June 30, 2019.
Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

Display 2: **Over the Past 45 years, the U.S. Health Care Sector has Outperformed the Broader Market**

U.S. Sectors Annualized Returns and Max Drawdowns

	ANNUALIZED RETURN		MAX DRAWDOWN	
Sector	Trailing EPS	Total Return	Trailing EPS	Total Return
Health Care	10.0%	11.1%	-20%	-45%
Technology	9.2%	9.6%	-147%	-80%
Staples	9.0%	12.0%	-18%	-47%
Industrials	7.5%	10.7%	-46%	-59%
Discretionary	7.0%	10.2%	-91%	-57%
Energy	6.6%	10.7%	-114%	-50%
Financials	4.2%	8.0%	-146%	-77%
Communications	2.5%	9.0%	-150%	-77%
Utilities	1.9%	9.7%	-53%	-55%

Source: MSIM Global Multi-Asset Team Analysis, FactSet, MSCI. Data January 31, 1973 to June 30, 2019.
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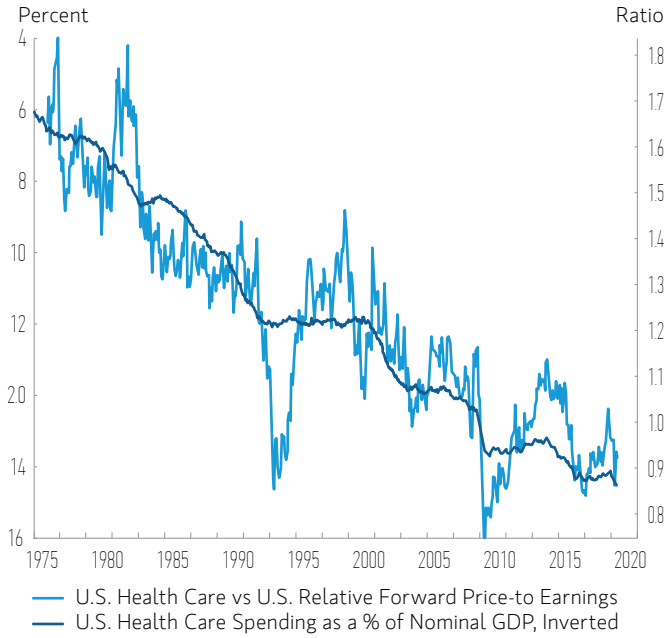
Despite these outstanding fundamental performance characteristics, investor skepticism has grown about the sustainability of the health care sector's superior qualities. The sector's relative forward price-to-earnings ratio (P/E) steadily de-rated from a 60% premium to the rest of the market in the late 1970s to an 8% discount at present. And the sector's free cash flow yield is 5%, 46 basis points higher than that of the market. The health care sector also seems anomalously undervalued relative to other defensive sectors—trading at a 17% discount to the average of staples and utilities forward P/E ratios—despite its historically superior performance and fundamentals, such as RoE and earnings growth, as well as shallower and shorter maximum relative drawdowns. What may explain this distrust? Perhaps the sector's past success is itself the reason not to extrapolate it. U.S. health care spending has already more than doubled as a share of household consumption: since the mid-1970s, health care spending has risen from 10% of consumption to nearly 22% today. More recently, health care spending relative to GDP growth has slowed: between 1970 and 2009, health care spending grew 2.7% faster than GDP, in nominal terms *(Display 3)*. Then in the 2010s, health care spending grew only 0.5% faster than GDP. But we note that even with slowing nominal spending growth, the sector's earnings have continued to outperform the market since the end of the 2000s expansion. The sector's discounted valuation clearly suggests that a much worse outlook is reflected in prices.

Concerns about affordability in the private segment of the market and the prospect of rising government spending on the publicly funded segment of health care have been widely discussed. A range of potential negative scenarios has recently weighed on the stocks, from proposed regulatory changes (mostly focused on drug pricing) to discussion of wide government-led coverage expansion, including replacement of the private health care market. The endpoint of the current momentum around health care reform is difficult to precisely pinpoint, but realistic scenarios for the sector are benign relative to what appears to be priced into the stocks.

In the near term, a bi-partisan deal in Congress seems unlikely in the currently polarized climate, and we would expect any reform to come via regulatory change and to be focused on lowering drug prices. The American Patients First blueprint to lower drug prices published by the White House and Department of Health and Human Services in May 2018 catalogues many of the excesses in drug industry pricing. If one of the key proposals—the international pricing index, which seeks to lower drug prices within Medicare programs—were to be adopted, we estimate the industry could lose approximately 1% of revenue and 3% of earnings over a five-year period (the proposed timeline to phase this measure in). If this hit to earnings were to be reflected immediately, the sector's forward P/E would rise from 15.8x to 16.3x; still an attractive valuation at a 5% discount to the market and a 14% discount to other defensive sectors. But we doubt the administration's proposal will be fully implemented, as the costs of aggressively disrupting the status quo outweigh the benefits. Successful drug price reform will be incremental and contingent on not excessively harming the industry and consumers.

Display 3: **More Recently, Health Care Spending Relative to GDP Growth Has Slowed**

U.S. Healthcare Spending as a % of Nominal GDP and Relative Forward Price-to-Earnings



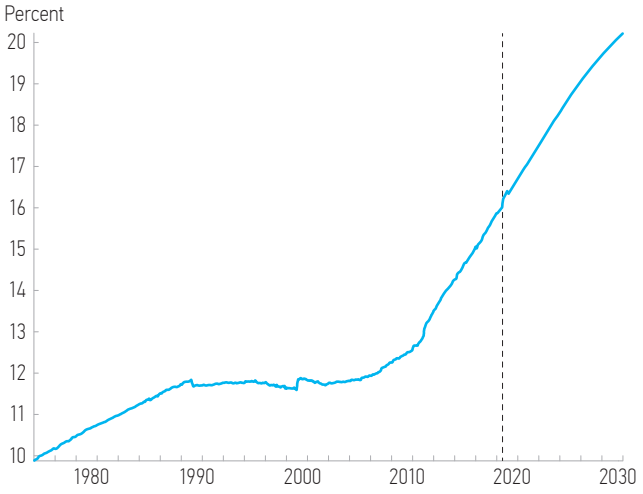
Source: MSIM Global Multi-Asset Team Analysis, Haver Analytics, FactSet, MSCI. Data as of June 30, 2019.
Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

Beyond this administration's efforts to rein in drug prices, the risk of reform rises after the 2020 presidential election. Ostensible commitments to some form of "Medicare for All" by leading Democratic potential presidential candidates notwithstanding, we do not expect a government-run replacement of private sector health care. First, surveys indicate that the vast majority of people using private insurance are satisfied with it.[4] Second, it would require an unpalatable spending increase, even in the current fiscally lax climate. The Committee for a Responsible Federal Budget (CRFB) estimates that replacing private health insurance with a government-run system would add $19 trillion to government spending over 10 years (assuming new tax revenues and cost savings under Senator Sanders's proposal; without that the cost would be $31 trillion).[5] A transformational "Medicare for All" policy requiring a major spending increase would require full control of Congress, which is unlikely. According to most polls and forecasts, the Senate is unlikely to change hands. Third, Democratic potential candidates appear more interested in expanding coverage (which would be a net positive for the health care sector) than in reducing spending due to fiscal concerns. In summary, we would expect the ultimate shape of health care reform (if any) to be less ambitious in scope than the proposals currently discussed and to be biased to expand coverage rather than curtail spending. As a result, such a potential reform would be a parallel to the Affordable Care Act, which expanded coverage, achieved limited cost control, and ultimately resulted in health care spending growth increasing by 200 basis points for two years (compared to the two years prior to implementation).

Near-term impact of reforms aside, we expect U.S. health care spending growth to continue to outpace the broader U.S. economy. Without meaningful cost containment measures, population aging will lead to material acceleration in spending growth because an older population is a more intensive user of health care. People older than 65 spend over $11,000 per year on health care, almost twice the amount of the middle-age cohort, and their share of population will increase from 16% today to 20% in 10 years *(Display 4)*.[6] According to the Congressional Budget Office (CBO), Medicare spending is likely to rise by 5.5% per year during the next 10 years, nearly 2% above nominal potential GDP growth.[7] At some point, some measure of cost containment could succeed, though, as discussed above, this does not appear imminent. In any scenario, we believe health care spending is likely to grow at least in line with GDP. Meanwhile, health care stocks are trading at a discount to the market, despite their defensive properties, implying that the market expects substantial moderation in health care spending and earnings underperformance. In the context of what we see as only a mild risk of reform in the near term and a structurally attractive market growth outlook, we believe that this undervaluation is unwarranted. Moreover, the current subdued late-cycle economic growth outlook makes U.S. health care stocks particularly attractive today.

Display 4: **Share of Population of People Aged 65+ to Increase to 20% in 10 years**

U.S. Population: 65 & Older as a % of Total



Source: MSIM Global Multi-Asset Team Analysis, Haver Analytics, U.S. Census. Data as of June 30, 2019.

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FOOTNOTES

[1] Source: MSCI since 1995; MSIM Global Multi-Asset Team Analysis pre-1995; average of forward price-to-earnings, price-to-book value, and dividend yield vs. historical average since 1985 relative to broader U.S. equity market.

[2] Source: MSIM Global Multi-Asset Team analysis; cumulative average performance of health care stocks' relative performance. When including all six recessions, the average performance has been 7%.

[3] MSCI; MSIM Global Multi-Asset Team Analysis.

[4] Source: McCarthy, Justin. "Most Americans Still Rate Their Healthcare Quite Positively." 7 December 2018, www.Gallup.com.

[5] Source: Committee for a Responsible Federal Budget. "Adding Up Senator Sanders's Campaign Proposals So Far." 19 May 2016, www.crfb.org.

[6] Source: U.S. Census Bureau

[7] Source: Congressional Budget Office. "CBO's Projections of Spending for the 2018-2028 Period." 17 April 2018, www.cbo.com.

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