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Healthcare: 2023’s Pain is 2024’s Gain

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Key Takeaways

MedTech Growth on Sale: In the US alone, 10,000 people turn 65 daily. Managing disease and chronic illness has become more expensive, and innovation within the healthcare industry is currently facilitating a shift from treatment to prevention. At our latest Global Investment Committee, we recommended that clients consider adding exposure to innovative healthcare companies, with a particular focus on high quality MedTech along with a selective or actively managed approach to biotech investments.

2023 was Tough for Healthcare Equity Performance, but 2024 Looks Promising: The 2023 downturn has created potential opportunities for the unstoppable trends of longevity and innovation. Healthcare stocks are transitory, in our opinion, thus creating a favorable setup for the sector’s potential outperformance in 2024. It already has had a solid start this year.

Don’t Fear an Election Year: Drugmakers are an easy punching bag for politicians on both the left and right, and in previous cycles socialized medicine and drug pricing reform were key topics of debate. However, on average, healthcare has returned 3.5% during election years, slightly outperforming the S&P 500. Among subsectors, medical devices and biotech have outperformed S&P 500 the most, by 5% and 2% respectively.

When Mr. Powell Speaks

Last week, Fed Chairman Powell gave testimony suggesting that rates cuts would be forthcoming in 2024, pending review of “a little more data”. Powell said, “What we want is just more evidence that will give us more confidence that inflation is on a path down to 2% sustainably[1].”

Potential Portfolio Implications

Medical devices and life sciences tools (MedTech) have historically traded at a premium to the S&P 500. Leading MedTech companies are looking to launch a wave of new products in areas such as cardiology and robotic surgery, and there are seven key product launches this year. We believe this should help this sector outperform in 2024. Our preference is on companies with strong balance sheets and innovative capacity and for quality MedTech companies and a selective or actively managed approach to biotech investments. The subsector that includes healthcare equipment and supply has grown dividends at a 9% annual rate the past three decades.

[1] Wall Street Journal (March 6, 2024) Jerome Powell says fed on track to cut rates this year. Available at: https://www.wsj.com/economy/central-banking/powell-says-fed-on-track-to-cut-rates-this-year-52e5feb3

When the Chairman Speaks, Markets Listen

Last week, Fed Chairman Powell gave testimony suggesting that rates cuts would be forthcoming in 2024, pending review of "a little more data". Interestingly, January's hot Consumer Price Index (CPI) report was not mentioned (see **FIGURE 1**). At his testimony, Powell said "we are not looking for inflation to go all the way down to 2%. What we want is just more evidence that will give us more confidence that inflation is on a path down to 2% sustainably."

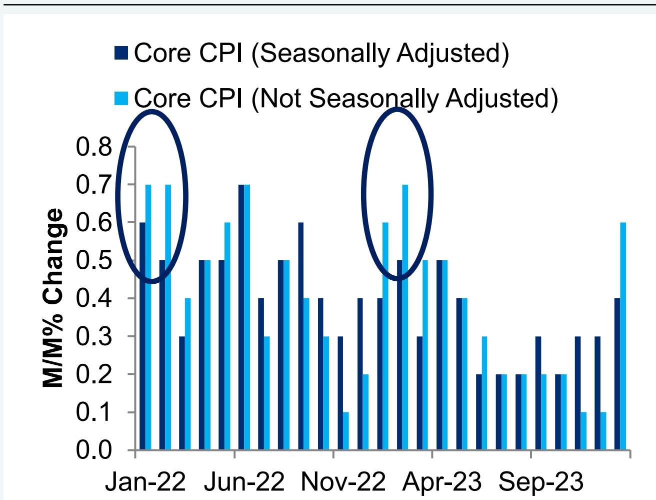
At Citi Wealth, we are even more optimistic than the Fed that it will meet its inflation targets by the end of 2024. The Fed's interpretation of its Congressional mandate is that it must not restrain employment when it is achieving its inflation target. We believe that its current policies are too restrictive for the path of employment and inflation that lies ahead.

We do expect a higher than consensus rate of inflation for February. This may spook markets for a bit. In our view, this is consistent with recent trends that see most price adjustments for firms taking place at the start of the year, measured over a couple of monthly reports.

Employment data for February showed why investors should not make important decisions based solely on the "impressions" that statistical agencies capture in their monthly snapshots of the economy. In an initial report for January, the US Bureau of Labor Statistics reported a powerful *acceleration* in hiring. After revisions, it now reports a *deceleration*. Job gains have decelerated since 2021, as have wages. As we discussed in our 2024 Wealth Outlook entitled "Slow than Grow", we see corporate profits accelerating and employment growth slowing this year.

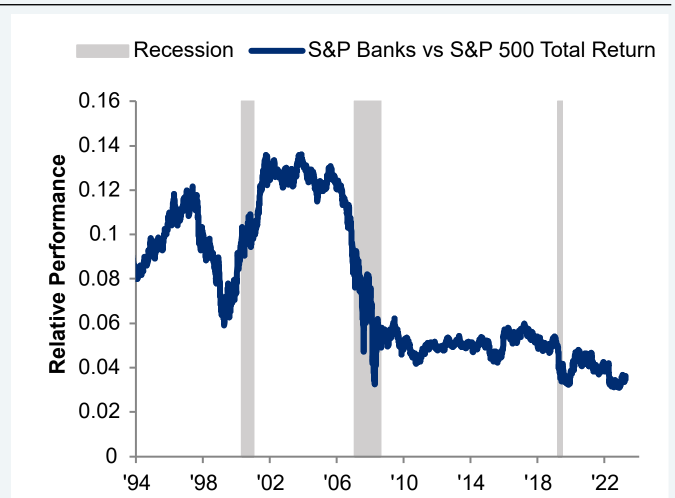
Of additional interest from his testimony, Powell said the Central Bank would not rule out a re-working of proposed capital rules that would force banks to shift funding to expensive long-term debt. While there are many issues for bank investors to consider - such as the commercial real estate exposure of regional lenders - capital uncertainty has been cited by investors as a drag on large bank share prices (see **FIGURE 2**).

FIGURE 1: US CPI: Strongest gains January and February



Source: Haver as of March 7, 2024. Seasonal adjustment is a statistical technique that measures and removes the influences of seasonal patterns and flows to reveal how economic data change from month to month.

FIGURE 2: Regulatory uncertainty relief in sight?



Source: Bloomberg as of March 7, 2024.

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MedTech: Growth on Sale

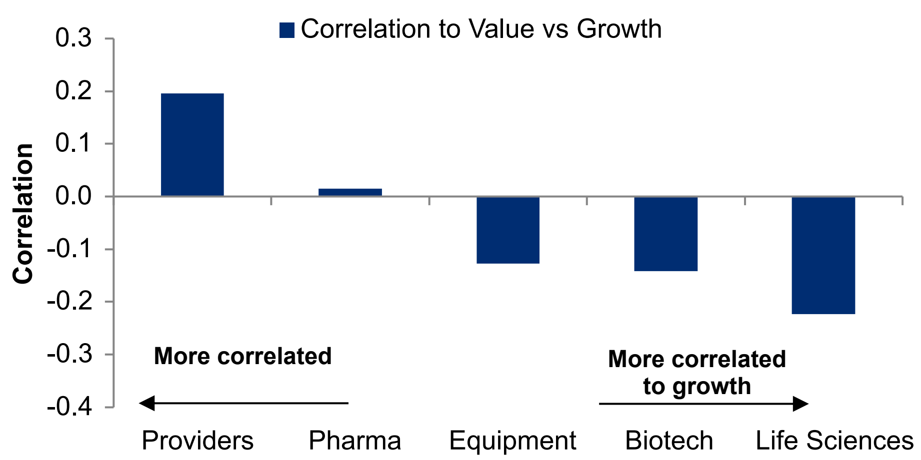
We are all getting older, but there are more people turning 65 now than ever before. According to American Association of Retired Persons (AARP), in the US alone, 10,000 people turn 65 each day[2].

With age comes wisdom, but also more illness. According to the National Council on Aging, nearly 80% of adults 60 and older have two or more chronic conditions[3]. As societies age, healthcare services consume an ever-growing share of government and household expenditures. And escalating costs for healthcare are impacting both.

Reversing that tide requires better health outcomes at a lower cost of care. And that will necessitate a shift from the traditional approach of managing symptoms to addressing underlying causes, and from treating disease to preventing it.

At our latest Global Investment Committee, we suggest that clients consider adding exposure to innovative healthcare companies, with a particular focus on high quality MedTech along with a selective or actively managed approach to biotech investments. The healthcare sector is highly diverse, and ranges from defensive value large cap pharma to speculative growth in small cap biotech. Medical devices and life science tools (MedTech) straddle in between (see **FIGURE 3**).

FIGURE 3: The healthcare sector is highly diverse under the hood



Source: Bloomberg as of March 7, 2024. S&P 500 Health Care Providers Index represents Providers. S&P Pharmaceuticals Select Industry Index represents Pharma. S&P 500 Health Care Equipment & Supplies Index represents Medical Devices. S&P Biotechnology Select Industry Index represents Biotech. S&P 500 Life Sciences Tools & Services Industry Index represents Life Science Tools. 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.

2023 was Tough for Healthcare Equity Performance, but 2024 Looks Promising

Higher rates and tighter capital spending, along with regulatory uncertainty and an ongoing hangover from COVID-19, weighed on healthcare share prices in 2023. Even the remarkable success of the weight-loss drugs turned into headwind for certain sub-sectors. Investors shunned the stocks of insulin, device, and heart medication makers assuming that the demand for them would decline as waistlines slim. Overall, 2023 marked the first earnings recession for healthcare shares in decades.

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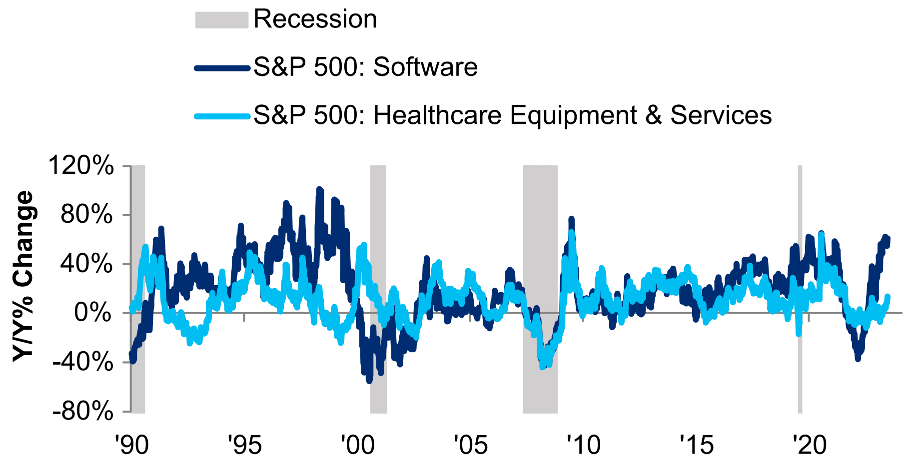
2 Patrick J. Kiger (December 27, 2023) What 65 is like as Boomers' 'silver tsunami' crests, AARP. Available at: https://www.aarp.org/retirement/planning-for-retirement/info-2023/silver-tsunami-late-boomers-turn-65.html#:~:text=Over%20the%20past%20several%20years,4.1%20million%20level%20through%202027.%E2%80%9D

3 Get the Facts on Healthy Aging (October 20, 2023) The National Council on Aging. Available at: https://www.ncoa.org/article/get-the-facts-on-healthy-aging

For those who recognize the twin unstoppable trends of longevity and innovation, 2023's downturn presents potential opportunities (see **FIGURE 4**). In our opinion, many of the issues that held back healthcare stocks are transitory. This creates possibility for sector outperformance in 2024. In fact, the market seems to embrace this view as initial healthcare performance is brightening.

FIGURE 4: US software outperforming healthcare equipment by most since late 1990s.



Source: Haver Analytics as of March 5, 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.

The Upturn Catalysts

After a year of headwinds and lagging performance, the healthcare sector looks to be on the cusp of a breakout in 2024. We see the following themes emerging likely to drive higher earnings this year:

The success of new weight loss drugs is likely to accelerate.

Last year, surging sales of the new generation of anti- obesity drugs (GLP-1 drugs) led to healthcare's "AI moment", with two leading drug makers dominating equity market performance. 2023Q4 earnings results confirmed that demand for GLP-1s continues to far exceed drugmakers' manufacturing capacity. In fact, consensus for GLP-1 drug sales is around $100bn by 2030[4].

GLP-1 drug makers are now racing to collaborate with life sciences tools companies to manufacturing capacity. In the immediate term, companies that are able to fill the shortages in supply should benefit. For example, firms that produce active pharmaceutical ingredients are seeing better gross margins. The injection pens used in the treatment rely on specialized contract development and manufacturing organizations (CDMOs) as well as on device component makers for autoinjectors.

In the medium term, companies that are able to facilitate oral methods of taking these drugs are likely to gain market share. To the extent that weight loss improves health outcomes and helps people live longer – still a key question but with promising early signs – we should see a pickup in demand for treatments associated with aging. The success of the GLP-1 drugs should therefore extend well beyond the leading two anti-obesity drug makers to the benefit of certain tools and device names, as well as other biopharma companies that focus on hormone-related conditions (see **FIGURE 5**).

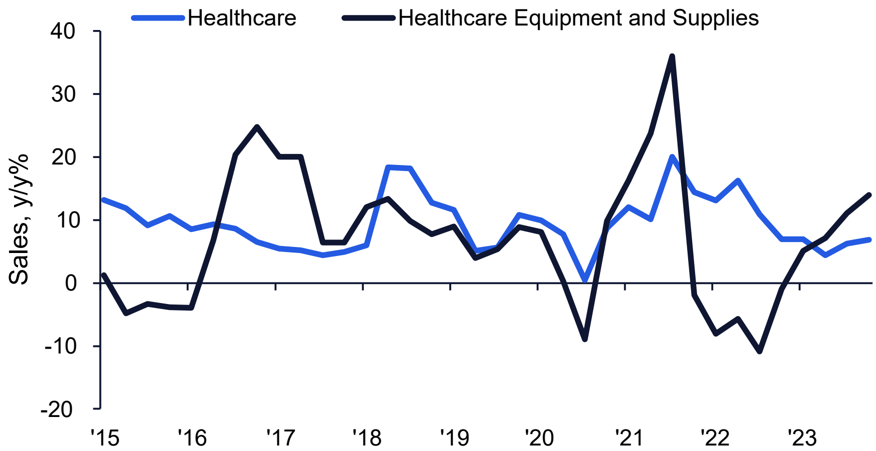
We expect a broad-based earnings recovery across MedTech

The medical technology industry is emerging from 2023's events that led to delays or cancelations of surgeries and medical procedures. But as 2023 went on, the industry saw a steady recovery in procedure volumes as patients returned. This cyclical rebound was confirmed by stronger-than-expected guidance from managements in 20234Q.

[4] Pham, L. and Barnert, J.-P. (October 17, 2023) Weight loss injections: Drugs are potential $100 billion market, Goldman says, Bloomberg.com. Available at: https://www.bloomberg.com/news/articles/2023-10-17/lilly-lly-and-novo-novob-seen-dominating-100-billion-obesity-market-in-2030

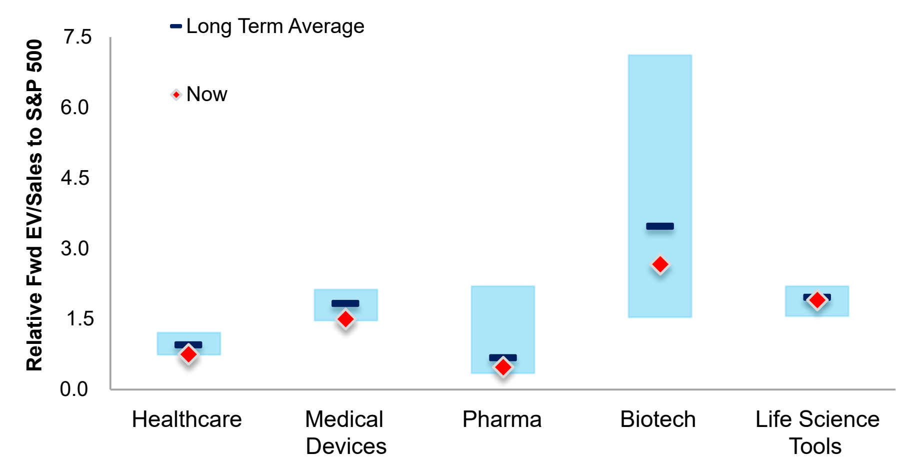
Nonetheless, MedTech is currently trading near the lows of its own historical valuation range, a potentially attractive entry point in our view (see **FIGURE 6**).

FIGURE 5: Sales of medical devices have recovered steadily



Source: Bloomberg as of March 7, 2024. S&P 500 Healthcare represents Healthcare, S&P Health Care Equipment Select Industry Index represents Healthcare Equipment and Supplies. 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.

FIGURE 6: Medical devices and life science tools historically trade at a premium to S&P 500



Source: Bloomberg as of March 7, 2024. S&P 500 Health Care Index represents Healthcare. S&P 500 Health Care Equipment & Supplies Index represents Medical Devices. S&P Pharmaceuticals Select Industry Index represents Pharma. S&P Biotechnology Select Industry Index represents Biotech. S&P 500 Life Sciences Tools & Services Industry Index represents Life Science Tools. 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 Innovation on Sale

We see deeply discounted valuations in the medical technology and tools segments. Atypically, both large and small companies have suffered. In the year ahead, cash-rich, now-cheaply-valued companies that help facilitate drug research and development, save costs, and improve patient outcomes look like a safe way to play the healthcare sector's convalescence.

Some of these companies are the necessary "picks and shovels" of the drug development ecosystem. They work in conjunction with their biopharma partners in the early stages of cell line production and later in the purification, formulation, and packaging of an approved drug. Other companies 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. And then there are further advancements in robotics-assisted surgery.

M&A activity in biopharma is likely to pick up in 2024, favoring small and mid-cap biotech

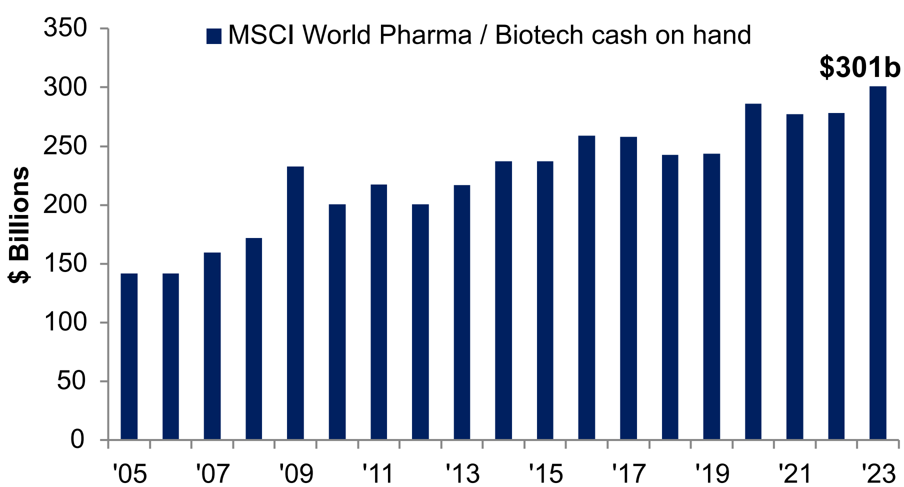
Better macro-economic conditions and changes in patent rules for certain drugs have many pharma companies going shopping for acquisitions. After a nearly two-year drought, healthcare M&A activity is picking up, especially in biopharma.

Although still short of pre-pandemic levels, dealmaking momentum is likely to build over the course of 2024. Global large- cap pharma and biotech companies sitting on significant dry powder are looking to fill pipeline gaps in the face of impending patent cliffs. Some of the largest biopharma companies are facing significant loss of drug exclusivity by 10% to 60% beyond 2025. Approximately$400bn of annual sales from large pharma players could lose exclusivity by the beginning of the next decade, increasing the urgency to make acquisitions.

With corporate cash balances reaching approximately $301bn by the end of 2023 (**FIGURE 7**), we have reason to believe M&A will continue to accelerate. However, regulators will not stand aside. Tighter anti-competition policies from the Federal Trade Commission (FTC) and the implementation of the Inflation Reduction Act (IRA) are two major policy changes.

We see several target rich areas for acquirers. Large biopharma companies may look to buy smaller biotech companies with promising drugs and true innovative capacities. Many smaller biotech firms rely on strategic collaborations to develop new drugs, and these can become marriages, if successful. This is why we see SMID biotech outperforming multiple **segments of the market since November**.

FIGURE 7: Global biopharma accumulated $301bn of cash by 2023.



Source: Bloomberg as of March 7, 2024. Full index name: MSCI World Pharmaceuticals, Biotechnology and Life Sciences 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.

MedTech investors: Don't fear an election year

We often hear investors and clients express concern about the prospects for healthcare stocks ahead of November's US election. Drugmakers are an easy punching bag for politicians on both left and right, and in previous cycles socialized medicine and drug pricing reform were key topics of debate.

There is little basis to assume that election rhetoric will hurt Medtech stocks. On average, healthcare has returned 3.5% during election years, slightly outperforming the S&P 500. Among subsectors, medical devices and biotech have outperformed S&P 500 the most, by 5% and 2% respectively, while pharmaceuticals typically lag (**FIGURE 8**). This historical observation is consistent with conventional wisdom that candidate debates usually center around basic welfare topics like drug pricing and healthcare access, while MedTech tends to garner a lower profile.

The most disruptive policy implemented by the Inflation reduction Act last year is granting Medicare to negotiate prices for a handful of major drugs. The negotiated prices for ten of the most popular drugs face discounts of 50% or so.

As this year's election season heats up, we believe other issues will be more dominant, including immigration, trade, and taxes. So, if left to its own devices (pun), MedTech looks to potentially flourish.

FIGURE 8: Healthcare performance during election years (1992-2020)

	1992	1996	2000	2004	2008	2012	2016	2020	Avg	Relative to SPX
Healthcare	-18.1%	19.7%	28.8%	0.2%	-24.5%	15.9%	-5.2%	11.4%	3.5%	0.4%
Pharma	-19.2%	23.6%	26.7%	-9.5%	-21.2%	12.0%	-5.1%	4.4%	1.5%	-1.7%
Biotech	NA	-6.2%	-4.7%	7.6%	10.3%	39.2%	-15.1%	5.9%	5.3%	2.1%
Medical Devices	-16.6%	16.6%	45.4%	12.1%	-28.4%	17.1%	4.3%	16.5%	8.4%	5.2%
Life Science Tools	NA	NA	NA	NA	-39.0%	27.0%	-6.6%	32.8%	3.5%	0.4%
S&P 500	*4.5%*	*18.7%*	*-7.4%*	*9.0%*	*-38.5%*	*14.3%*	*8.5%*	*16.3%*	*3.2%*	

Source: Bloomberg, as of February 16, 2024. S&P 500 Health Care Index represents Healthcare. S&P 500 Health Care Equipment & Supplies Index represents Medical Devices. S&P Pharmaceuticals Select Industry Index represents Pharma. S&P Biotechnology Select Industry Index represents Biotech. S&P 500 Life Sciences Tools & Services Industry Index represents Life Science Tools. 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.

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Bond credit quality ratings	Rating agencies		
Credit risk	**Moody's[1]**	**Standard and Poor's[2]**	**Fitch Rating[2]**
Investment Grade			
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

1 The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3, to show relative standing within the category.
2 The rating from AA to CC by Standard and Poor's and Fitch Ratings may be modified by the addition of a plus or a minus to show relative standings within the category.

(MLP's) - Energy Related MLPs May Exhibit High Volatility. While not historically very volatile, in certain market environments Energy Related MLPS may exhibit high volatility.

Changes in Regulatory or Tax Treatment of Energy Related MLPs. If the IRS changes the current tax treatment of the master limited partnerships included in the Basket of Energy Related MLPs thereby subjecting them to higher rates of taxation, or if other regulatory authorities enact regulations which negatively affect the ability of the master limited partnerships to generate income or distribute dividends to holders of common units, the return on the Notes, if any, could be dramatically reduced. Investment in a basket of Energy Related MLPs may expose the investor to concentration risk due to industry, geographical, political, and regulatory concentration.

Mortgage-backed securities ("MBS"), which include collateralized mortgage obligations ("CMOs"), also referred to as real estate mortgage investment conduits ("REMICs"), may not be suitable for all investors. There is the possibility of early return of principal due to mortgage prepayments, which can reduce expected yield and result in reinvestment risk. Conversely, return of principal may be slower than initial prepayment speed assumptions, extending the average life of the security up to its listed maturity date (also referred to as extension risk).

Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

An investment in alternative investments can be highly illiquid, is speculative and not suitable for all investors. Investing in alternative investments is for experienced and sophisticated investors who are willing to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks may include:

- loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices;
- lack of liquidity in that there may be no secondary market for the fund and none is expected to develop;
- volatility of returns;
- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
- less regulation and higher fees than mutual funds; and
- manager risk.

Individual funds will have specific risks related to their investment programs that will vary from fund to fund.

Asset allocation does not assure a profit or protect against a loss in declining financial markets.

The indexes 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.

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Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

Factors affecting commodities generally, index components composed of futures contracts on nickel or copper, which are industrial metals, may be subject to a number of additional factors specific to industrial metals that might cause price volatility. These include changes in the level of industrial activity using industrial metals (including the availability of substitutes such as manmade or synthetic substitutes); disruptions in the supply chain, from mining to storage to smelting or refining; adjustments to inventory; variations in production costs, including storage, labor and energy costs; costs associated with regulatory compliance, including environmental regulations; and changes in industrial, government and consumer demand, both in individual consuming nations and internationally. Index components concentrated in futures contracts on agricultural products, including grains, may be subject to a number of additional factors specific to agricultural products that might cause price volatility. These include weather conditions, including floods, drought and freezing conditions; changes in government policies; planting decisions; and changes in demand for agricultural products, both with end users and as inputs into various industries.

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