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TRENDS & IDEAS

SECTORS: HEALTHCARE- OUR 2016 OUTLOOK

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The health care sector has outperformed the broader market over each of the last five years. Over this time period, the S&P 1500 Health Care Index rose 130.7%, more than double the S&P 1500 Composite Index rise of 61.9%. As we look towards 2016, we see several challenges that may jeopardize this outperformance streak. However, we also have reasons for optimism that the sector may once again outperform the broader market.

TAKEAWAY: Although we see challenges for the sector in 2016, we see reasons for optimism the sector may outperform the broader market again.

POSITIVE IMPLICATIONS:

Celgene Corp	★★★★★	[CELG]
Gilead Sciences	★★★★★	[GILD]
Regeneron Pharmaceuticals	★★★★★	[REGN]

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The challenges we see include earnings growth deceleration, continued scrutiny over high drug prices, a likely decline in M&A deals, concerns over the number of people obtaining insurance via the healthcare exchanges, and presidential election year rhetoric that may increase perceived risks and increase uncertainty within the sector, including the survivability of the Affordable Care Act (ACA) or healthcare reform law.

In 2014, earnings for healthcare companies within the S&P 1500 rose a robust 16.9%. In 2015, earnings for these companies are seen rising 14.7%, which would represent the fastest rate of growth across all sectors. However, in 2016, we forecast a deceleration in earnings growth and see growth of 10.7%. Although respectable, it is a sharp decline from recent years and its forecasted rate of growth is slower than several other sectors, which may attract investors to those sectors.

Scrutiny over high drug prices will likely continue. In September 2015, stock prices within the health care sector took a significant hit following the infamous 5,455% price hike by Turing Pharmaceuticals of generic drug Daraprim. Other companies including Valeant Pharmaceuticals (VRX 88****) received subpoenas regarding drug price increases. The media backlash was quick and significant, leading to billions of dollars of market capitalization slashed from companies' valuations. Presidential candidate Hillary Clinton, spoke out against these high drug prices and vowed to rein in drug prices, if elected President. We expect drug prices and associated price hikes to remain a contentious issue throughout the presidential election cycle in 2016, potentially increasing volatility for drug companies.

Similar to high drug prices, consolidation and extensive M&A activity has garnered significant attention from the White House and the Treasury Department in an effort to rein in tax inversion deals, and from Presidential candidates concerned that consolidation will lead to less competition and therefore higher prices. One popular strategy in recent years has been for drug companies to limit supplies and distribution and to promptly raise the prices of some recently acquired drugs. However, due to the significantly increased scrutiny of this practice, Valeant Pharmaceuticals, one of the more prolific acquirers in the industry, stated it will significantly reduce or no longer pursue transactions of "mispriced" drugs.

By the end of the 2015 enrollment period for health insurance, approximately 11.2 million people obtained insurance through the public exchanges. However, due to the high deductibles and high co-payment required from many of the plans offered on the exchanges, many people terminated their insurance coverage throughout the year. By the end of 2015, approximately 9.2 million kept their exchange obtained insurance. It is anticipated that high deductible, high co-payment and narrow network plans will continue to be the majority of the plans offered through the public exchanges, which we believe will limit the number of enrollees. The Department of Health and Human Services now estimates 9.4 million to 11.4 million people will sign up in 2016, which is significantly lower than the 21 million people the non-partisan Congressional Budget Office projected in early 2015. We believe soft enrollment will have an adverse impact on sales growth across the healthcare sector.

Finally, we anticipate increased volatility as we believe healthcare will be a major focus of the presidential

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candidates. The Democrats have been arguing for cost containment, particularly for drug prices, and have voiced opposition to industry consolidation. The Republicans, on the other hand, have threatened to repeal and replace healthcare reform.

In spite of the challenges we see, we also have numerous reasons for optimism. We see continued solid sales growth as we believe the sector's fundamentals remain intact. In 2015, the FDA approved 45 New Molecular Entities (NMEs) or novel new drugs, including high profile drugs such as Ibrance, Repatha, and Praluent, that are expected to generate multi-billion dollars in peak sales. This was the highest number of NMEs approved in almost 20 years since a record 53 NMEs were approved in 1996 and follows the robust approvals in 2014 when 41 NMEs were approved (including immuno-oncology drugs Keytruda and Opdivo). Peak drug sales typically occur 5 years after a drug is approved and we believe the sales potential from recent approvals are significant.

We see the sector continuing to benefit from global expansion and believe international sales now account for over 50% of sales for most large multinational drug and equipment companies. We also expect foreign exchange impact will be less of a headwind in 2016. Demographics also remains a steadfast catalyst for the healthcare sector with a growing and aging population that drives demand for healthcare services and pharmaceuticals.

In spite of anticipated increased volatility from presidential election year rhetoric, we believe the risks are more headline risks and perceived risks rather than actual risks. Based on the current makeup of Congress with Republicans having the majority in both the House of Representatives and Senate, and with President Obama in office, we believe potential changes in healthcare legislation are limited. Further, Republicans do not have enough votes to overcome a Democratic filibuster in the Senate.

Overall, we believe the best scenario for healthcare investors is a Democrat, presumably Hillary Clinton, winning the Presidency, as we anticipate the Republicans retaining control of Congress. In this scenario, in spite of Clinton's numerous "threats" to rein in drug prices, allowing the re-importation of drugs, and allowing Medicare to negotiate drug prices, we believe it is highly unlikely Clinton will be able to pass these initiatives through a Republican controlled Congress. Conversely, the Republicans' efforts to repeal Healthcare Reform, would be thwarted by a Clinton veto as we do not anticipate the Republican obtaining the 2/3 votes to override a veto.

Lastly, we believe the sector's valuation is attractive. The health care sector is now trading at a slight discount to the broader market at 15.1X 2016 estimated earnings compared to 15.2X for the S&P 1500. Although slight, this is the first time the sector is trading at a discount to the broader market since 2011, which coincidentally is the year the sector began its tremendous streak of outperformance. Further, the S&P Biotechnology 1500 sub-industry, one of the best performing sub-industries over the past 5 years, is trading at a bigger discount at 12.9X 2016 estimated earnings. Biotech companies that we have buy and strong buy recommendations on include Celgene Corp. (CELG 104*****), Gilead Sciences (GILD 91*****), and Regeneron Pharmaceuticals (REGN 461****).

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