

Market commentary, December 20, 2023

## Are healthcare stocks poised for a comeback?

Hardly any investors have taken notice of the upside potential that the healthcare sector now offers. History has shown, however, that novel drugs and medical technology advances will always be a decisive factor in shaping the sector's market fortunes. Another factor is the currently low valuation of healthcare stocks. In his investment outlook for 2024, Cyrill Zimmermann, a member of Bellevue Asset Management's Executive Board and Head of Healthcare Funds & Mandates, explains why it is probably only a matter of time before healthcare stocks are rediscovered by the wider investment community.

The general performance of healthcare stocks was disappointing in 2023. For some companies whose sales surged during the pandemic, this simply reflects a post-pandemic normalization of growth. Leading diagnostics companies such as Roche and Thermo Fisher were clearly exposed to these shifting market currents. The significant increase in market interest rates was another major challenge, especially for fast-growing companies, because that also increased the discount rate applied to obtain the present value of their future cash flows. Biotechnology companies and companies developing and marketing digital health devices and services were affected the most by rising interest rates. Meanwhile companies that are not yet turning a profit found themselves confronted with higher equity risk premiums.

### Innovative power is intact

But the sector's innovation power is as strong as ever. Recent regulatory approval decisions in oncology, gene therapy and in the treatment of Alzheimer's and metabolic disorders are impressive proof of this. For example, the world's first drug based on genome-editing technology, also known as "gene scissors", was approved in the UK. In this procedure, defective fragments in the genome are cut out and replaced with new DNA building blocks, which are then integrated into the DNA strand using the body's own cellular DNA repair processes. This treatment called Casgevy could supplant stem cell transplants as the standard-of-care treatment for two rare inherited blood diseases. Casgevy was developed by Crispr Therapeutics and Vertex Pharmaceuticals.

But this successful breakthrough did not register with most investors. About the only news reports from the healthcare sector that caught the attention of the wider investment community concerned novel drugs for people with diabetes and obesity. The clinical trial data presented for these drugs was impressive. Shares of Eli Lilly and Novo Nordisk, both leading pharmaceutical companies in this field, surged as a result. This reflects the tremendous market potential for diabetes and obesity treatments. About 40% of the world's population is obese. And in the US, a whopping 21% of total spending on healthcare can be traced to obesity-related treatment. In view of this dynamic situation, Bellevue Asset Management launched Bellevue Obesity Solutions in November, a fund that invests in the most attractive companies across the entire value chain for obesity treatment and management.

The recent positive news about new treatment options for obesity also had a downside, though. Investors worried that these breakthroughs could have negative effects on the business of medical technology companies. The assumption here is that the strong sales growth of monitoring systems in diabetes or of hip replacements as a result of excess weight, for example, could be jeopardized by the new weight-loss pills. We believe medtech growth prospects are still intact. One reason for this is because diabetes increases with age and it is not caused by obesity alone. Moreover, obese patients with diabetes who lose weight will still require optimal insulin management.

Turning to the medtech sector as a whole, some companies have already given a positive outlook for 2024, which supports our scenario of an ongoing upturn in procedure volumes in 2024. The medtech sector's good sales growth will be sustained by the approval and launch of relevant new products. Examples here are Abbott's TriClip, AVEIR and Libre products, Boston Scientific's Farapulse PFA system and the next generation Da Vinci robotic surgery system from Intuitive Surgical. The medtech industry continues to exhibit strong pricing power, raising prices by a low single-digit percentage amount, and the negative effects of supply chain disruptions are subsiding, which spells additional margin improvement potential ahead.

#### Artificial intelligence a positive trigger

Artificial intelligence (AI) is a game-changer in the healthcare space. Healthcare will clearly benefit from the technological quantum leap made possible by the release of ChatGPT. AI could become a core element of digital medicine. We see tremendous potential behind the accelerating pace of healthcare digitization, leading to improvements in diagnostics, treatment quality and administrative efficiency. In addition, faster R&D processes and more targeted delivery of therapeutics will open the door to novel treatment methods.

According to Amgen, the largest biotechnology company in the world, the use of AI will lower its R&D spending by about 20%. AI can be used to identify and filter out specific patterns in clinical trials, especially during Phase II testing. This, in turn, will allow modifications in trial designs that reduce the risk of failure while speeding up the clinical trial process.

#### Conclusions

Innovation in the healthcare sector is as strong as ever. That is plain to see in the recent breakthrough treatments for obesity and diabetes, in the new drug approvals for Alzheimer's and cancer therapies, and in the launch of minimally invasive heart valve replacement systems. And yet the valuation of the entire healthcare sector is at historically low levels, both in industrialized countries and in Asia-Pacific. This is likely to stimulate M&A activity, especially in the biotech sector, a favorite hunting ground for pharmaceutical companies seeking external sources of innovation to strengthen their product portfolios or to shield themselves from patent cliffs by acquiring promising third-party products.

Meanwhile the healthcare sector should get some tailwind from interest rate cuts in the US, widespread investor repositioning, and the generally good prospects for non-cyclical sectors as clouds gather over the world economy. So it's probably only a matter of time before the sector starts trending higher again. Mid- and small-cap segments experienced the heaviest selling during the past year and they are projected to have most catch-up potential.

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