FEBRUARY 2025

A Prescription for Healthcare Stocks

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Long-term Performance

The needs of a globally-aging population, rising incidences of chronic conditions, and lifestyle decisions[1] continue to generate long-term growth for this segment. The healthcare industry continues to responded to the growing demand with a phenomenal innovation engine across all sectors. Over the long term, healthcare equities have also been financial market outperformers (Figure 3).

Valuation Lows?

Yet while these trends endure, share prices have been challenged since 2022 and the healthcare and biotech sectors have suffered significant equity investor outflows since early 2023.[2] Relative valuations now reaching 35-year lows in terms of earnings multiples (Figure 1). The sector trades on an approximate 20% discount to the market as of mid-January 2025.

1 Eg, rising global obesity. dei risultati futuri.
2 According to FactSet and Goldman Sachs, during 2023 and 2024, Healthcare saw more outflows than any other out of twelve sectors. Biotech suffered the third-greatest outflows.

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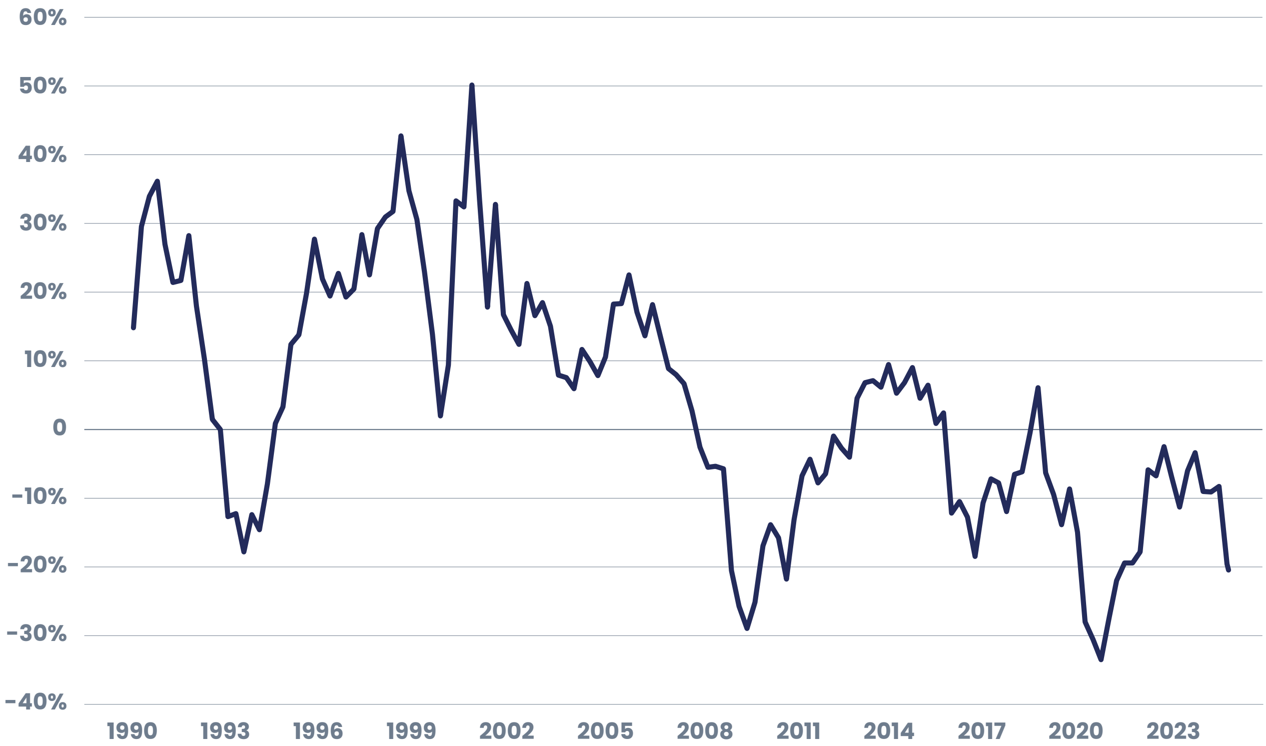
Has something changed to warrant these extremes of sentiment and valuation? Parts of the sector certainly over-earned during the Covid-19 period– for example, testing and therapeutic companies. Although it took some time, these fundamentals and earnings are mostly normalized and the exceptions are behind us. Today, controversies and questions centre on three key subjects, ***US healthcare policy, interest rates, and M&A.***

Figure 1:
Healthcare Relative Valuation 1990 to 2025
Price/Earnings Multiple 12 months forward for S&P Healthcare Index vs S&P 500



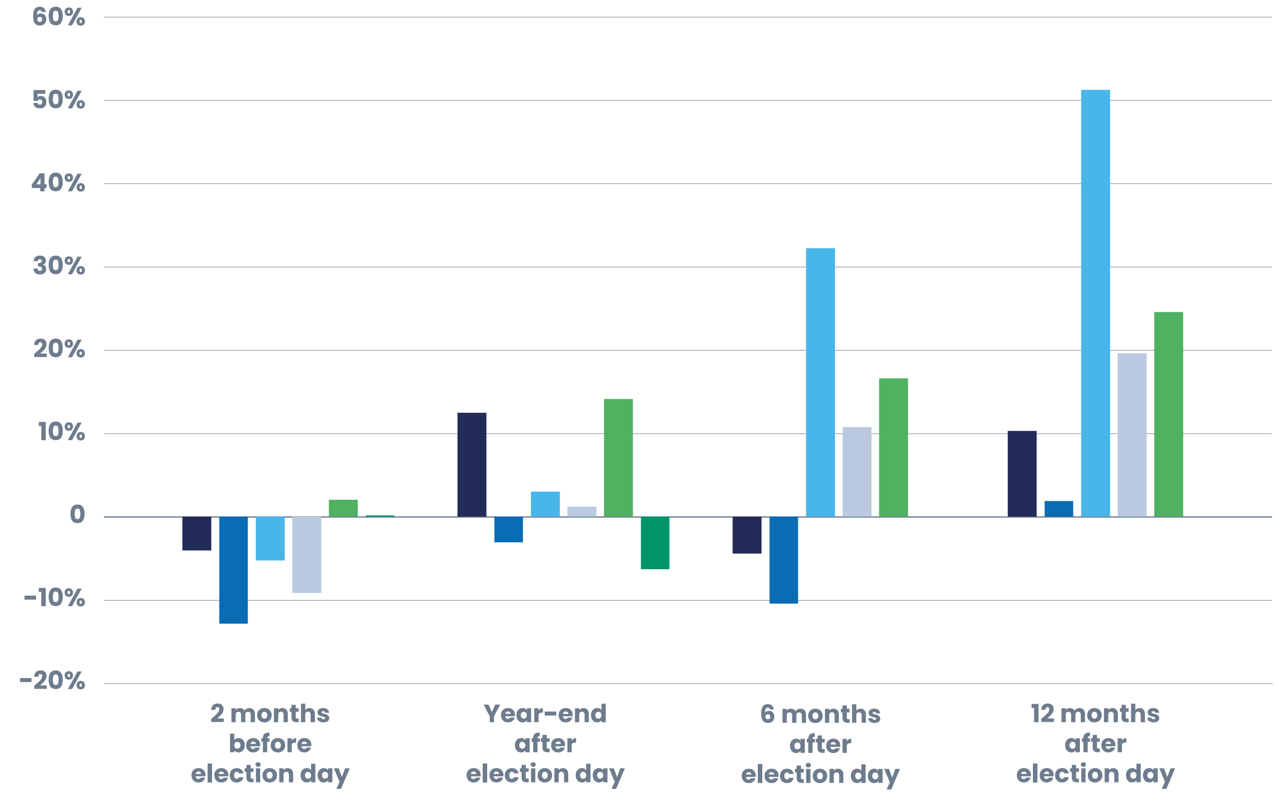
Source: Candriam, Bloomberg.

The Presidential Paradox

Changes in the US President and Administration logically add uncertainty for healthcare operations. The nomination of Robert F. Kennedy Jr. (RFK) as US Secretary of Human Health Services (HHS) and triggered a shock in the sector in late 2024. As RFK is a known critic of the industry and a long-time and vocal vaccine sceptic, his inclusion introduces uncertainty, although since the formal nomination of RFK, he and President Trump have assumed a milder tone in meetings with pharmaceutical industry executives. While predicting the potential policy actions of President Trump and his team is, to say the least, challenging, it is fairly clear that healthcare is not a top agenda item for the new Administration. Further, with relative valuations at 35-year lows, our analysis shows that share prices are clearly discounting a negative scenario. Nothing can be ruled out, but Trump's prior presidency was not a bad period for the sector.

Moreover, over the past five US election cycles, healthcare shares often traded with difficulty leading up to and shortly after the elections, yet each time they outperformed in the 12 months following the election (Figure 2).

Figure 2:
Global Healthcare Response to US Presidential Elections
MSCI World Healthcare Index versus MSCI World Index



Past performance is not a reliable indicator of future performances. Markets could develop very differently in the future.
Source: Candriam, Bloomberg.

Long-term Business, Long-term Rates

Higher interest rates have been a much-discussed headwind for healthcare equities over the past couple of years. Although they have limited impact on the business in the sector, higher rates can shift investor interest away from the 'longer-duration' segments such as biotechnology.

With the US 10-year yield near 15 year highs, this headwind is more likely than not to abate somewhat going forward.

An M&A Net Under the Patent Cliff?

What should we read into the moderating of M&A in 2024 (albeit versus the record M&A of 2023)? Transactions are inherently a bit stochastic, and it is not unexpected that M&A cools down following a period with many deals, particularly in the context of the policy uncertainty introduced by the US elections.[3] In 2024 we saw more private deals, and also more licensing deals, often involving Chinese assets. Again, to be expected when access to equity markets is more difficult.

With large biopharma companies heading into the largest patent expiry cliff in history over the next decade, these assets are insufficient to fill the pipeline. Biopharma companies are cash rich and M&A remains a much advertised part of their strategy, We are confident that M&A will return, likely sooner rather than later, while a less-restrictive US Federal Trade Commission (FTC) under the new Administration should support some larger transactions. For the strategies at Candriam, despite a relatively quiet M&A year in 2024, we did have several acquisitions of portfolio companies supporting performance (Longboard Pharmaceuticals, Morphic, MorphoSys, and Alpine Immune Sciences).

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3 For more on Candriam's overall outlook for the potential easing of M&A restrictions under the Trump administration, see our Outlook article, "M&A: Triple Trends for 2025?", https://www.candriamoutlook.com/article/ma-triple-trends-for-2025

Fundamentals: Meeting Global Market Needs

Fundamentals, the most important element, remain strong. While share prices have largely been disappointing, earnings growth remains solid in all of the healthcare subsectors. And consensus eps growth estimates for healthcare within the S&P500 are the second- highest of all sectors (after information technology).[4]

Further, the compelling innovation in the sector continues apace, with strategies to address the as-yet unmet needs of patients, with increasing impact. The obesity pandemic in the US appears to have taken a historical turn late last year with the Financial Times[5] publishing a chart showing that after decades of rising obesity, anti-obesity therapeutics may have helped to reverse this trend. If supported by longer-term data this may very well go into history as one of the largest achievements for the healthcare sector. Beyond weight loss these drug have demonstrated broader health benefits, with positive outcomes studies in cardiovascular, liver and kidney disease, as well as reducing sleep apnea. More speculatively, but with huge potential impact, 2025 might become the year where we add Alzheimer's disease to the list of newly-treatable conditions.

As if obesity were not enough of an achievement, the sector was also very productive in recent years as measured by US drug approvals. After a record year of approvals in 2023 by the US Food and Drug Administration (FDA), 2024 was again very successful with oncology, orphan diseases, and neurology as some of the standout therapeutic areas. Beyond therapeutics, we have witnessed remarkable advancements and launches in robotic surgery. Additionally, there have been significant innovations in the treatment of cardiovascular diseases. Several companies have reported positive data on implants designed to seal off the heart's left atrial appendage -- a small pocket within the cardiac muscle wall that can increase the risk of stroke in individuals with irregular heartbeats. These implants offer a safer alternative to blood thinners. This to just name a few of the innovations which are reaching patients.

The sector may very well remain volatile until the market has clarity on the policy front. But given the valuations, fundamentals, and sentiment, the current situation brings to mind the words of The Sage of Omaha: ***"Be fearful when others are greedy and [to] be greedy only when others are fearful."***[6]

4 Barclays, as reported in Investing.com, 10 January 2025, These are the current EPS growth estimates
5 Financial Times, 4 October 2024, We may have passed peak obesity, Weight loss drugs appear too be having an effect at the population level. https://www.ft.com/content/21bd0b9c-a3c4-4c7c-bc6e-7bb6c3556a56
6 Warren Buffet, Berkshire Hathaway Letter to Investors, 1986.

Oncology and Biotechnology: Engines of Earnings Growth

Our oncology investment strategy encompasses several healthcare subsectors, including medical technology, diagnostics, biopharma, and life science tools. Notably, President-elect Trump has shown a particular interest in the oncology segment during his recent discussions with biopharma leaders. Pfizer's CEO, Albert Bourla, highlighted this by stating: "*The President-elect is very much focused on cancer. He has seen a lot of his friends and people that he knew dying from cancer and he keeps asking every time I meet, what are we doing with cancer and can we cure it? I think that's an opportunity to try to build programs that will accelerate the cancer development.*"[7] We remain confident that innovative companies addressing serious, unmet needs will thrive. This applies both to oncology and across the broader biopharma landscape.

The broad biopharma sector, including biotechnology, is the innovation engine of the healthcare sector. Most traditional pharmaceutical companies have become increasingly reliant on biotech drugs for growth in recent years. Biopharma sits at the cutting edge of the next medical breakthrough, and its commercial businesses are lucrative. Successful products are often protected by clinical differentiation, low competition and intellectual property, providing companies with freedom to operate. And at scale, they can generate 85-90%-plus gross margins and be highly cash-generative.

The early stage of the innovation lifecycle is extremely robust, and the funding eco-system remains healthy. Much opportunity remains across hundreds of human diseases for better, differentiated therapies. Despite the broader macro-economic concerns, capital markets remained open to providing new cash to biotech companies during 2024 (follow-on offerings approached their all-time high).

Within the secondary equity markets, however, the sector has posted two subsequent years of underperformance relative to broader US equities, and limited absolute performance over the five years since the start of the pandemic. Everything we have laid out about healthcare also speaks directly to the biotechnology sector specifically – a (no-longer-valid) Covid hangover, US political uncertainty, higher interest rates (in a longer-duration sector), and the perception that other sectors offer lower risk and/or better growth. But also the facts that it operates with sound structural underlying growth drivers, robust R&D pipelines, significant commercial opportunities, M&A optionality and a supportive regulator in the FDA.

7 Albert Bourla, presenting at 43rd Annual J.P. Morgan Healthcare Conference, published by Bloomberg 11 Jan, 2025.

Diagnosis? Stock Selection!

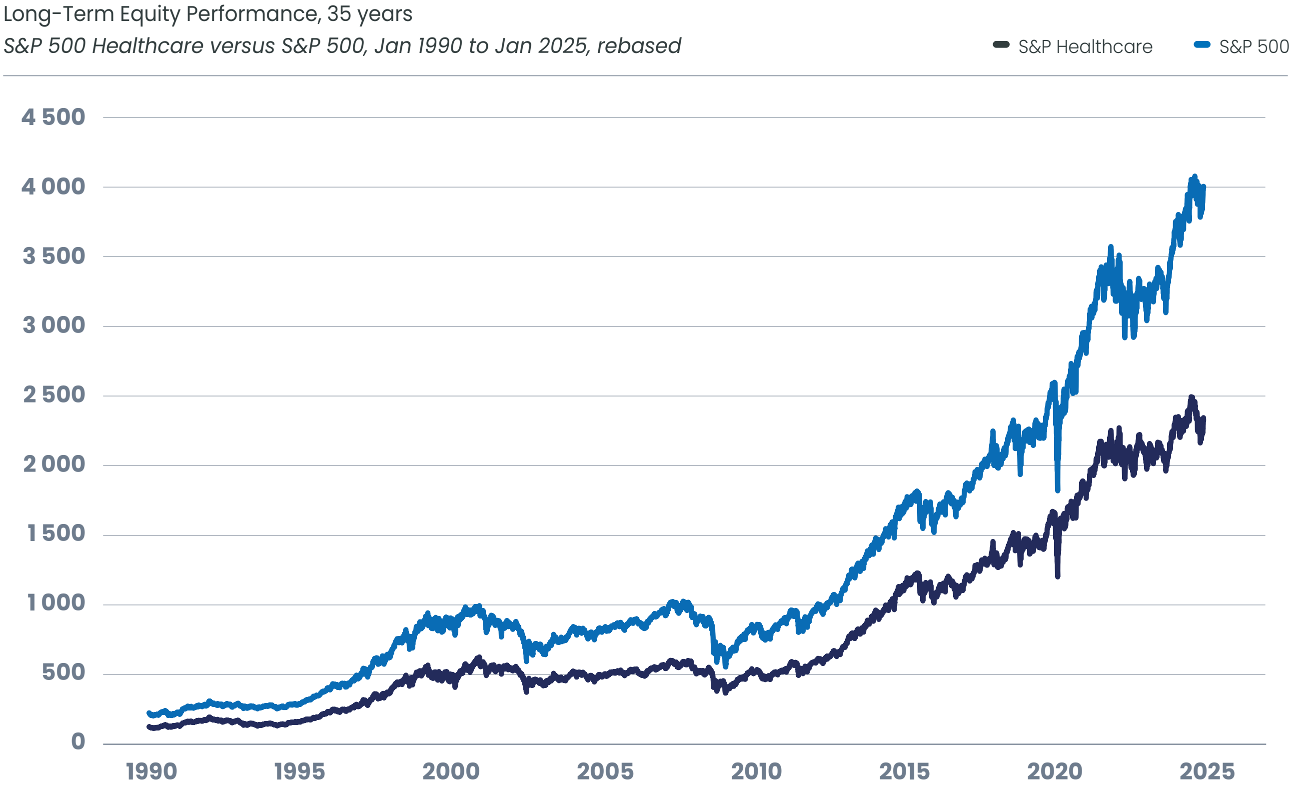
Typically, healthcare equities respond well to robust clinical data and commercial launch updates, and we continue to see share prices welcoming these types of positive developments. We believe that the historically low valuations and the outlook for new products offer a good stock-picking environment, especially for dedicated portfolios.

Biotechnology offers investors the opportunity to participate in innovation across compelling therapeutic areas. We expect M&A to accelerate during 2025.[8] Up to $400 billion of biopharma revenues are at risk from patent expirations over the next eight years, and large-capitalization biopharma utilizes M&A as a key strategic pillar to augment its R&D pipeline. Further, those smaller firms with good pipelines which are not acquired, have the ability to raise equity and build their businesses, potentially providing greater long-term returns for investors. We believe share prices in the sector are discounting a worst-case scenario for US political risk, which could offer a relief as the year progresses. Fundamentals today are sound, and to our view, only the share prices are 'difficult'. The catalyst for share price momentum is hard to predict, but can arrive quickly in this sector.

Figure 3:

Long-Term Equity Performance, 35 years

S&P 500 Healthcare versus S&P 500, Jan 1990 to Jan 2025, rebased



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