Invesco Global Insights

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Taking the pulse of the health care sector as US Election Day nears

As Election Day nears in the United States, investors are looking for clues into what the outcome might mean for certain sectors and industries. Health care has been a particular focus, as candidates have pledged to repeal the Affordable Care Act (ACA), reform drug pricing, expand insurance coverage and make other changes. On Oct. 11, several of our health care sector experts – from across the US and Europe and representing various asset classes – discussed the state of the sector today, and what might be in store for the future.

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How has election season affected the health care sector so far?

Derek Taner: We had four years of great performance that was unprecedented. And then on Sept. 21, 2015, at 10:56 a.m., Hillary Clinton sent out a tweet criticizing drug pricing. (Figure 1). From that point onward, health care has underperformed, which is unusual considering that the market is being largely led by defensive stocks and health care historically has been a leader in this kind of market (Figure 2). But while the market clearly didn't appreciate those comments, I think there are some other factors that contributed to the sell-off. Many investors were overweight the space before the tweet and were taken by surprise that drug pricing would be an election issue. Other contributing factors were a broader sell-off in momentum stocks like biotechnology and growing fear of an interest rate hike. So there was a whole compilation of things that came together that led to the sell-off.

Elizabeth Bernstein: Mid - and small-cap health care have outperformed every year from 2011 through 2015.[1] And from a valuation perspective, we were quite stretched. And so just to quantify that a little bit, health care overall was trading over two times standard deviation above any type of historical norm. So, it's not surprising how quickly – fr om a single tweet let's just say – that investors got spooked. The magnitude, of course, is always a little more emphasized within small cap. Health care within small cap has underperformed 1000 basis points versus the Russell 2000 Growth Index from Jan. 1 to Oct. 11, 2016.[2] Mid-cap underperformance has been a little narrower, and I believe that's the case because we have real cash flow – positive cash flow – by which to frame valuation.

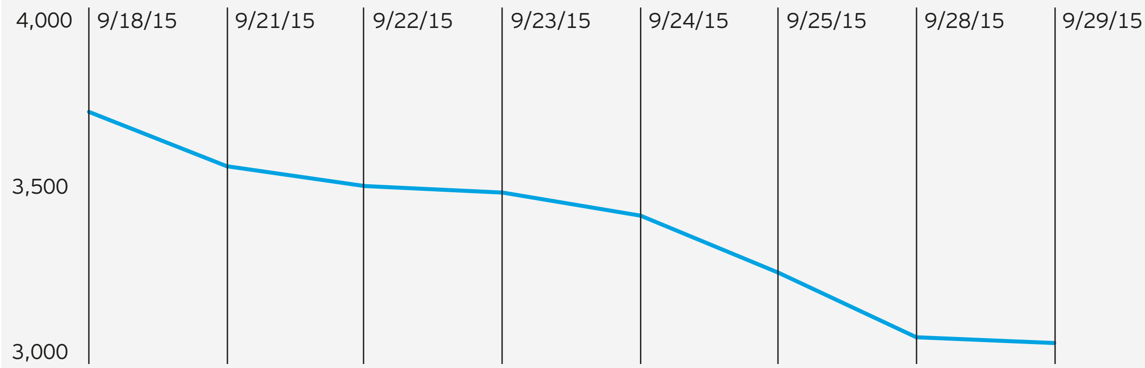
John Burrello: Hillary Clinton's September 2015 tweet caused some uncertainty around drug pricing, and that has definitely created a jump in hedging costs during that time. This may still be driving the elevated biotech option prices, which in turn is making the broader health care sector more expensive to hedge than the S&P 500, which is unusual when we look back at the last 10 years or so.

1 Source: Bloomberg, L.P. Based on the Russell Midcap Healthcare Index versus the Russell Midcap Index, and the Russell 2000 Health Care Index versus the Russell 2000 Index.
2 Source: FactSet Research Systems Inc.

"Price gouging like this in the specialty drug market is outrageous. Tomorrow I'll lay out a plan to take it on."

- Hillary Clinton at 10:56 am on Sept. 21, 2015, via Twitter

Figure 1: A pledge to address drug pricing contributed to a downward turn in biotech
Nasdaq Biotechnology Index from Sept. 18, 2015, to Sept. 29, 2015



Source: Bloomberg, L.P.

Figure 2: After that pledge, health care lagged while defensives in general outperformed
Sector data from Sept. 21, 2015, to Oct. 13, 2016
■ Health care lagging in a market led by defensives is unusual

		Price performance 9/21/15-10/13/16		Price performance 12/31/15-10/13/16	
	Sector name	**Absolute (%)**	**Relative (%)**	**Absolute (%)**	**Relative (%)**
	S&P 500	8.4		4.3	
	Cyclicals	10.1	1.7	4.9	0.6
	Near-cyclicals	7.4	-1.0	7.4	3.1
	Defensives	9.6	1.2	5.5	1.1
Cyclicals	Information technology	16.8	8.4	9.8	5.5
	Consumer discretionary	3.9	-4.5	1.0	-3.3
	Industrials	11.8	3.4	6.5	2.2
	Materials	9.6	1.2	5.9	1.5
	Real estate	8.5	0.0	1.5	-2.8
Near-cyclicals	Financials	3.8	-4.6	-0.3	-4.6
	Energy	11.0	2.6	15.2	10.8
Defensives	Consumer staples	9.9	1.4	3.5	-0.8
	Health care	0.1	-8.3	-2.8	-7.1
	Telecommunication services	15.3	6.9	10.3	6.0
	Utilities	13.2	4.8	10.8	6.5

Source: FactSet Research Systems Inc. Past performance is not a guarantee of future results. Returns shown are price returns.

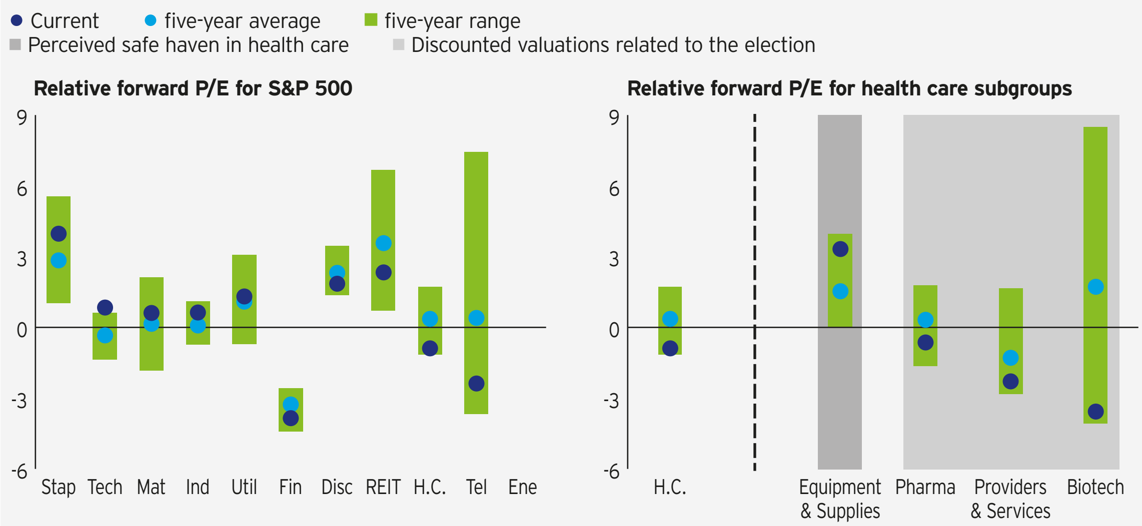
Given the drop in performance from September 2015, how do equity valuations look today?

Derek Taner: Figure 3 illustrates the five-year range of the relative forward price-to-earnings ratios for each sector, as well as for the health care subsectors. It also indicates their five-year average and current valuations. Overall, the current valuation for health care is under its five-year average and is in the low end of the five-year range. Within the subsectors, we see that equipment and supplies is valued at the high end of the range, as it's perceived to be defensive within health care – it 's not part of this discussion around drug pricing, and it's not part of the ACA exchanges that are also in the crosshairs. ACA exchanges are health insurance marketplaces where consumers can shop for coverage. They were mandated by the Affordable Care Act of 2010, but have been the subject of much controversy over the past six years. On the other hand, the other subsectors, particularly biotech, are at the low end of the historical valuation, reflecting the concerns in the market.

Elizabeth Bernstein: Looking forward from where we are now in the small- and mid-cap health care space, valuations are back within the historical band. They're not cheap, per se, but they're within an average. So, that gives me some comfort. I am of the camp that regardless of the election's outcome, we can now start shifting into looking at the fundamentals. And so for health care, I think it's worth noting that it has low correlation with macroeconomic conditions. And so in a time when we don't have macroeconomic certainty, I think that's one in health care's court. And then second, health care overall – broadly speaking – is expected to show revenue and earnings per share growth leadership for 2017. So, I also think that's another reason that fares very well for why we could see somewhat of a rebound in the sector as we look into year-end and 2017 and enables us to refocus on health care's fundamentals.

Stephanie Butcher: In Europe, while the sector has de-rated from its highest levels, it certainly is not as cheap as we got to in 2010. For the Invesco Perpetual European Equities Team, this is important, because valuation is our key starting point when evaluating investments. Currently, our team's bottom-up stock-picking process would not lead us to an overweight position in European health care.

Figure 3: Most of the health care sector is currently undervalued compared with its five-year range
Sector data from Jan. 31, 2010, to Sept. 30, 2016



Source: FactSet Research Systems Inc.

Do you foresee this election leading to major new legislation for the health care sector?

Derek Taner: Enacting legislation is very difficult, particularly in health care. Multiple special interest groups, diverging political philosophies and strong lobbying efforts make passing laws difficult. So it's important to keep in mind the framework of what we think we're looking at with the elections. We believe the House of Representatives is likely to be controlled by the Republicans. In the Senate, there are 24 Republican seats and only 10 Democratic seats up for election, which means the Senate is likely to go Democratic. Importantly, neither party is expected to hold 60 Senate seats, which would facilitate bringing bills to the floor. This is important to understand: If anything's going to get done, you're going to need bipartisan support because the Congress is probably going to be split. It's difficult to turn a bill into law. I think that gets lost – how difficult it is to get anything done legislatively in the United States.

How the Invesco Global Health Care team views the presidential election
While there are no guarantees that the candidates' stated platforms will come to pass, these are the items that Derek Taner and team will be watching closely after the election.

If Hillary Clinton wins:

- Drug pricing action could weigh on pharma, biotech, specialty pharma and distributors.
- Generic drugs could benefit from increased approvals.
- Hospitals could benefit from increased access.
- Life sciences tools could benefit from increased funding.
- Mega-mergers and inversions could be hampered.

If Donald Trump wins:

- His health care agenda looks uncertain, at present.
- Drug pricing could become a topic, which has not historically been the case with a Republican president.
- He could look to repeal the Affordable Care Act.
- Repatriation could spur more domestic M&A.

Has health care historically performed better under Democratic or Republican presidential administrations?

Derek Taner: Historically, no matter which party was in the White House, health care generally outperformed in the long term (Figure 4). Starting in 1985, Republican administrations presided over an average annual performance of 11.1% f or the health care sector, as seen in the chart below, which represents 5.7% in outperf ormance over the S&P 500 Index. Democratic administrations presided over an 18.1% a verage annual return for the S&P Health Care Index, which represents 4.4% in outperf ormance over the broad market. Short-term performance, however, can be impacted negatively if there's some major health care initiative by the federal government that leads to market uncertainty, and some of these initiatives are highlighted in the margins of Figure 4.

Figure 4: Health care's long-term outperformance over the market has been nonpartisan

In the long term, the sector has outperformed the S&P 500 Index under both parties, while short-term performance has been impacted by major new health care initiatives

Democratic administrations

	Year	President	S&P 500 Index (%)	S&P Health Care[1] (%)	Relative (%)
Bill Clinton forms a task force to reform health care	1993	Clinton	7.1	-11.0	-18.0
	1994		-1.5	10.2	11.8
	1995		34.1	54.5	20.4
Health Insurance Portability and Accountability Act (HIPAA)	1996		20.3	18.8	-1.5
	Term average		15.0	18.1	3.2
	1997		31.0	41.7	10.6
	1998		26.7	42.3	15.6
Medicare Prospective Payment System	1999		19.5	-11.6	-31.2
	2000		-10.1	35.5	45.7
	Term average		16.8	27.0	10.2
Passage of the Affordable Care Act	2009	Obama	23.5	17.1	-6.4
	2010		12.8	0.7	-12.1
	2011		0.0	10.2	10.2
	2012		13.4	15.2	1.8
	Term average		12.4	10.8	-1.6
	2013		29.6	38.7	9.1
	2014		11.4	23.3	11.9
	2015		-0.7	5.2	5.9
Hillary Clinton campaigns on drug pricing reform and ACA expansion	1H 2016		2.7	-0.5	-3.1
	Term average		10.7	16.7	6.0
	Average performance under Democrats		13.7	18.1	4.4

Republican administrations

Year	President	S&P 500 Index (%)	S&P Health Care[1] (%)	Relative (%)	
1985	Reagan	26.3	50.7	24.4	
1986		14.6	27.6	12.9	
1987		2.0	33.3	31.3	
1988		12.4	14.7	2.3	
Term average		13.8	31.6	17.7	
1989	Bush (GHW)	27.3	33.2	5.9	
1990		-6.6	14.1	20.7	
1991		26.3	50.2	23.9	
1992		4.5	-18.1	-22.5	Bill Clinton campaigns on health care reform
Term average		12.9	19.9	7.0	
2001	Bush (GW)	-13.0	-12.9	0.1	
2002		-23.4	-20.0	3.4	
2003		26.4	13.3	-13.1	Medicare Prescription Drug, Improvement, and Modernization Act
2004		9.0	0.2	-8.8	
Term average		-0.3	-1.8	-4.6	
2005		3.0	4.9	1.9	
2006		13.6	5.8	-7.8	Tax Relief and Health Care Act and Massachusetts health care reform
2007		3.5	5.4	1.9	
2008		-38.5	-24.5	14.0	
Term average		-4.6	-2.1	2.5	
Average performance under Republicans		5.5	11.1	5.7	

Sources: Thomson Reuters and Morgan Stanley Research. Returns shown are price returns.

Looking through the lens of the high yield bond market, where are you seeing the most volatility in the health care sector?

Michael Kelley: Two of the more volatile subsectors in the US have been specialty pharmaceuticals and the hospitals. Looking at specialty pharmaceuticals, at today's levels, these names are still cheap for the rating. But now with all the controversy we have with price increases, the companies are no longer able to aggressively raise prices and are also seeing an increase in generic competition with the US Food and Drug Administration (FDA) approving applications more rapidly than it has in the recent past. So, given that backdrop, many of the companies are left with high levels of debt, and the market is really concerned with a couple of things. The first: Will we continue to see further price erosion in the near term? And then two: What's the asset coverage on the debt now that the growth has come way down? What's the ultimate durability of the portfolio? On the positive side, most of the drugs offered by these firms do generate decent free cash flow, and the companies are now focused on debt reduction.

1 Before 1990, health care performance is measured by a Morgan Stanley created proxy index.

Regarding drug prices, given that most of these high yield companies are not at the forefront of innovation, they will likely remain in the crosshairs of the pricing controversy, not only from legislators, but from industry self-policing as well.

Moving to hospitals, most of the large public hospitals, and then some of the for-profit private hospitals, all issue in the high yield market. So, it's a fairly large part of high yield health care. If we look at the higher-quality bonds, the double-B hospitals are trading roughly in line with where they have historically. For the lower-quality bonds, this segment has really been dominated by company-specific issues, with major companies increasing leverage to make acquisitions.

To sum it up for hospitals, we haven't seen spread widening across the board due to elections per se, but more due to company-specific issues and the fact that the ACA tailwinds, mainly Medicaid expansion, are now fading. I would say, though, that we aren't pricing in a Clinton victory, either, which should be positive for hospitals assuming that Medicaid expansion will continue and the ACA stays in place down the road.

How do exchange-traded funds affect pricing in health care stocks?

Peter Hubbard: There are 50 exchange-traded funds (ETFs) with 100% exposure to the health care sector, either broadly or through health care sub-industries and specific themes, and 49 of them are passively managed.[1] So what can ETFs tell us about the health care sector? Over the past year, health care ETFs have seen negative performance and outflows commensurate with the current downturn in the sector overall.[1] ETFs are often blamed for driving price action in the underlying stocks, but given that ETF assets are only 1% of the health care market,[2] we believe it is more accurate to say that ETFs can be the leading indicators of price movement rather than a mechanism for price manipulation. When we look at the current health care ETF market as we move into the November elections, we are not seeing much in the way of positioning. Short interest remains low in the largest ETFs, and shares outstanding have leveled off at this point in the year.

In the options market, are conditions much different today than they were during the 2012 US election?

John Burrello: Like 2012, we can now see heightened uncertainty around the elections manifested in equity option pricing. This time, however, the ratio of the health care sector to the S&P 500 implied volatility is actually 20% higher than it was in 2012, potentially driven by drug pricing uncertainty in biotech.[3] By Nov. 11, option markets expect a move of about 4% for the S&P 500, which is roughly in-line with historical averages – over a one-month period, a one standard deviation move for the S&P 500 has been slightly over 4% when we look at that long term.[3] The option markets are pricing in about a 4.5% move for the broad health care sector, and a 9% move for biotech by the end of the election week.[3] If there were no kink in the volatility curve though, the biotech sector would only be expected to move by approximately 7.5%.[3] So, there's a 1.5% premium in terms of the expected risk around the election in biotech specifically. We know that uncertainty and volatility are generally not good for stocks. So if the post-election outlook for health care is less worrisome than expected, we should see hedging costs become cheaper for health care stocks, and maybe even some relative recovery in biotech.

Has the US election impacted the European perspective on health care?

Stephanie Butcher: For the Invesco Perpetual European Equities team, valuation is our key starting point from an investment perspective. So we were very overweight in the sector in the 2009/2010 period, and then went quite heavily underweight by 2015 with the sector having at that point reached close to a 25% premium to the European market. Now with recent moves and the de-rating, a number of the portfolio managers on the team are beginning to get intrigued again, and we're actively kicking the tires on the sector. We've generally been underweight a lot of the long-duration defensive assets, which obviously have re-rated on the back of the general scarcity of growth. But we feel that that's gone too far now, and the very tight correlation to US Treasuries and German bunds is making us concerned. But pharma is the one defensive grouping that has really underperformed and hasn't participated. So, it is piquing interest.

1 Source: Bloomberg, L.P., as of Sept. 30, 2016
2 Sources: Bloomberg, L.P. and the Financial Times, as of October 2016
3 Source: Bloomberg, L.P., as of Oct. 7, 2016

We're being told by most that the de-rating in the sector is a function of the presidential election, with the Clinton tweet as an example. I think it was exacerbated by positioning at the time. The sector was very over-owned and well-loved, certainly in the European context. I guess what we're tackling and trying to get comfortable with is whether this is just a classic election cycle swoon, and do we get our bounce post the election, or is this something different? Is this about US pricing pressure genuinely stirring, which clearly would impact growth and have ramifications for multiples?

Opinions expressed are as of Oct. 11, 2016, are based on current market conditions, and are subject to change without notice.

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Elizabeth Bernstein is a Portfolio Manager with the Invesco Mid-Cap Growth team.

Prior to joining Invesco in 2012, Ms. Bernstein was with Allianz Global Investors Capital as an equities analyst covering the global health care and consumer sectors. Before that, she was with Banc of America Securities as an analyst covering pharmaceuticals. She also worked as an analyst with Wachovia Securities and Morningstar, Inc., covering biotechnology and pharmaceuticals, respectively. She entered the industry in 1997 as a management associate with MetLife, Inc.

Ms. Bernstein earned an MBA from the University of Michigan – Ross School of Business, with an emphasis in strategy and finance. She also earned a BA degree in history, cum laude, from the University of Pennsylvania. She holds the Series 7, 63, 86 and 87 registrations.

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John Burrello currently serves as a Portfolio Manager for Invesco's Global Asset Allocation team, which focuses on alternative investment strategies including risk parity, risk-balanced commodities and active-balanced solutions.

Mr. Burrello began working in the financial industry at UBS O'Connor in 1999. Prior to joining Invesco, he was a partner at Continental Advisors, a hedge fund firm. He joined Invesco in 2012 and the Global Asset Allocation team in 2016.

Mr. Burrello earned his BA degree from Indiana University and is a CAIA charterholder.

Stephanie Butcher
Based in Henley-on-Thames, Stephanie Butcher is responsible for a number of European equity portfolios for Invesco Perpetual, specialising in European equity income investing.

She began her investment career at Lazard Asset Management as a graduate trainee in 1993 and progressed to become a US fund manager responsible for institutional and retail portfolios. Ms. Butcher then joined Aberdeen Asset Management in 1997, initially as a US portfolio manager responsible for insurance and institutional funds, and then onto its European equities desk in 1998 as a fund manager responsible for a number of retail funds. She joined our company in 2003.

Ms. Butcher earned an MA (Cantab.) in history from Cambridge University.

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Peter Hubbard is a Vice President, Director of Portfolio Management for the PowerShares by Invesco family of exchange-traded funds (ETFs). In his role, Mr. Hubbard manages a team of eight portfolio managers. His responsibilities include the facilitation and management of all portfolio monitoring processes associated with more than 150 equity, fixed income, commodity and alternative funds listed in the US, Canada and Europe.

Prior to joining the firm in May 2005, Mr. Hubbard was a research analyst and trader at Ritchie Capital, a hedge fund operator.

He earned a BA degree in business/economics from Wheaton College.

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Mr. Taner joined Invesco in 2005. Previously, he worked for Franklin Advisers, Inc. as a portfolio manager on Franklin Templeton's health care team from 2002 through 2005 – the final two years as lead manager. He began his investment career in 1993 as a fixed income analyst with Franklin Templeton and was promoted to assistant portfolio manager in 1997. In 2000, he joined the firm's equity department and was named co-manager of its equity-income product.

Mr. Taner earned a BS degree in business administration with an emphasis in accounting and finance and an MBA from the Haas School of Business at the University of California (Berkeley). He is a CFA charterholder.

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