DWS

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Marketing material

Defensive, innovative, growing: the healthcare sector

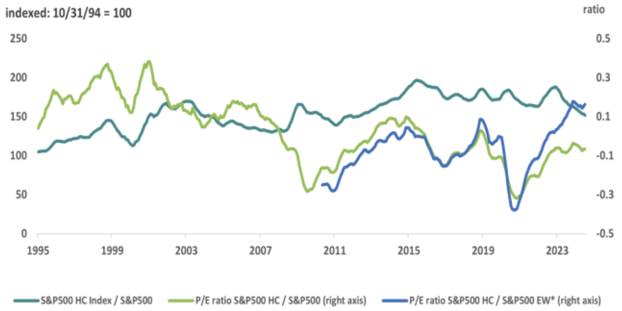
In theme 7 of our series, we look at what the healthcare sector has to offer in times of lackluster economic data and falling interest rates.

Investing in the healthcare (HC) sector in a U.S. presidential election year is normally a no-go. To understand why, one first has to know that U.S. companies account for 71% of the MSCI World Healthcare Index market value. And that the U.S. spends more on healthcare per capita, as a percentage of GDP and in absolute terms, than any other country.[1] The U.S. elections are therefore very important for this sector, and often do not bring it good news. The question of how much the sector should contribute to financing new government plans is often at stake. Although the industry is trying to defend itself – it lobbies like no other in the U.S.[2] – there are limits. The fact that the sector's average operating margin has fallen from over 20% to 14% over the past 30 years, while the S&P 500's operating margin has risen from 12% to 14% over the same period, is likely to be partly due to this (in Europe the margin has fallen from 25% to 16% over the past 20 years).[3] However, we think the elections this year will result in less harm for the sector than usual for two reasons: 1. The Democrats, the party that is more critical of the pharmaceutical industry, are already in the White House. 2. Healthcare policy is not the focus of this election campaign for either party.

A number of factors make HC attractive: 1. Innovation. The potential for new products to boost share prices was recently demonstrated by the introduction of anti-obesity drugs, which resulted in a manyfold increase in the share prices of both market leaders.[4] While that is certainly extraordinary, there are many areas in which markets worth billions of dollars could rapidly develop. For example in cancer, dementia and gene therapies. 2. In addition, AI could advance the sector in many ways, with productivity gains in the development of new drugs, reduced failure rates in clinical trials, and improved diagnostics and support for patient care. 3. The aging society suggests that HC spending will continue to grow disproportionately. 4. Corporate bond yields have been falling again for about two years, which should help smaller and younger companies in particular to raise funds more cheaply.

For shareholders, we believe the sector's combination of defensive qualities and growth potential is particularly appealing. But the former only applies to the sector as a whole. The sector's constituents are subject to the same profit volatility as cyclical stocks.[5] Performance is also very heterogeneous: the S&P 500 HC gained 20% over the past 12 months, but the strongest HC stock gained 60%, while the weakest lost 40%.[6] This reinforces our conviction that stock selection is essential in healthcare. Success or failure at the company level can hinge on one drug.

Relative price and valuation history of HC sector



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 10/9/24. *S&P500 EW is the equal-weight S&P500

As the chart shows, the U.S. HC sector has mostly performed similarly to the S&P 500. The discrepancy over the last 18 months is mainly due to the strength of the big U.S. tech stocks.[7] The picture is similar when it comes to valuations. The sector is trading at a slight discount to the overall market and below its historical relative valuation. However, it is trading at a slight premium to the equal-weight market.[8] In our opinion, this is also justified. The current economic cycle is difficult to grasp. We do not rule out a U.S. recession, and the goods industry is contracting. Then there are the serious geopolitical conflicts. That's why the defensive qualities of healthcare are tempting, even if a major U.S. downturn is not yet visible. At the same time, we expect only low growth in developed markets in the medium term. Here, too, individual healthcare sectors are partly immune, as we expect them to enjoy structural growth. Noushin Irani, DWS Equity Sector Head Healthcare, currently prefers biotech stocks and the major pharmaceuticals.[9]

Footnotes

Unless otherwise noted, all price and balance-sheet figures are from Bloomberg L.P. as of 10/9/24.

[1] Source: OECD, as of 2022
[2] Source: Statista. October 2024. Last figures for 2023, when the sector spent USD 740m on lobbying in the US. It has been one of the top three lobbyists since 2000 and has been top of the league since 2016.
[3] Data for S&P 500, S&P 500 Healthcare, Stoxx 600 and Stoxx 600 Healthcare. Source: Bloomberg Finance L.P.; as of 10/9/24
[4] Within five years, the share price of US company Eli Lilly has increased almost ninefold, while that of Danish company Novo Nordisk has increased almost fivefold. Source: Bloomberg L.P. As of: 10/9/24.
[5] Many stocks in the sector have also seen rising debt levels recently, which has also contributed to higher volatility in earnings and share prices.
[6] Due to better available data and its dominance, we often refer to the S&P 500 and the S&P 500 Healthcare in this context, but the opinions in the text refer to the global sector.
[7] The equal-weight S&P 500 reduces the distortions caused by the heavyweights in technology and media stocks.
[8] The equal-weight S&P 500 valuation is less distorted by single dominant stocks than the market-cap-weighted S&P 500 valuation.
[9] Within the MSCI World Healthcare, pharmaceuticals account for 42% of the index market value, and biotechnology for 14%. Source: MSCI, as of 10/9/24

Glossary

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The MSCI AC World Health Care Index captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Health Care sector.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The S&P 500 Health Care Index captures the companies listed in the S&P 500 Index from the health care sector.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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