Although political uncertainty continues to surround the healthcare industry, there is much to consider about the long-term prospects for the sector as an investment. Over the past decade many investors have flocked to healthcare stocks as a refuge (especially after the financial crisis), a potential source of income and as a potential area of high growth. Yet valuations still look reasonable. Because healthcare has higher dispersion and lower stock correlation than other sectors, investors may want to selectively consider different subsectors based on long-term demand, waning regulatory pressures and industry growth potential.

Long-term demand

The need to care for aging populations means healthcare may be a growth business. As costs rise, healthcare spending totaled more than 16% of GDP in 2015, up from single digits in the 1970s and about 12% in 1995, according to OECD.

- The challenge for drug makers is that politicians, regulators and consumers are increasingly clamoring to curb growth in drug prices, which saw their largest increase last year since 2001, according to the Bureau of Economic Analysis.

- This makes pharma and biotech easy political targets, particularly given average gross margins greater than 90% in the latter, according to Bloomberg data as of March, 2017.

Despite negative political sentiment, we believe any impending systemic changes to U.S. drug pricing policy is unlikely – a potentially positive scenario for biotech and pharma companies with strong growth pipelines – impacting the long term demand for healthcare.
Industry growth

We see M&A activity acting as a catalyst for industry consolidation although many big drug makers are struggling to maintain past rates of growth.

• With most large-cap pharma companies in the “mature” stage of product development, many are seeking to buy growth. We think M&A could pick up in the healthcare sector after dipping in 2016.

• The House Republican’s initial healthcare bill has been officially pulled and the new administration seems poised to focus on tax reforms, which could include a one-off tax on overseas cash. This could prompt companies to bring significant cash back to the U.S., providing a potential catalyst for another wave of industry consolidation.

What happens if few deals get done? Companies might return more cash to shareholders in the form of dividends or share buybacks, which could create opportunities for income-oriented investors.

Conclusion

We see long-term demand for healthcare products and services rising despite the changing political landscape. Worries about drug pricing and other policy risks are largely reflected in valuations, in our view. We see potential opportunities in biotech, big pharma with promising drug pipelines and the managed care sector, which includes some insurance providers that may benefit from potential deregulation and efforts to curb overall healthcare costs.

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<td>IHE</td>
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