

Health Care

Q1 2020 Outlook: Ignore Washington, Focus on the Fundamentals

1Q 2020	Q2 2020	Q3 2020	Q4 2020
Overweight	TBD	TBD	TBD

Sector Rating Rationale

We initiate Health Care Overweight despite 2020 election headline risks and the potential for near-term relative underperformance. While we expect continued pressure on the health care sector due to efforts to lower costs, the risk of drastic changes to health care business models is already priced in. The sector's strong fundamentals, reasonable valuation, and defensive characteristics are attractive as the economy slows, trade issues run on, and the market hits all-time highs.

More Attractive If... Congress remains split, forcing Washington D.C to find a compromise to address rising health care costs instead of tearing down the current system and starting over.

Less Attractive If... Actions to lower costs reshape health care business models and create financial volatility and uncertainty for companies.

Investment Outlook

↑	Fundamentals — Strong 2020 sales & earnings growth estimates; Attractive fundamentals amid trade issues
↑	Valuation — Attractive valuations relative to S&P 500; Slightly above 10Y historical average
↔	Earnings — NTM sales & EPS up/down revision ratios slightly lower, but remain attractive relative to other sectors
↑	Technicals — Break above rising channel indicates bullish trend; Strong A/D momentum strength in November
↑	Sentiment — November first month of net inflows since March 2019; 52wk high-low index surging

Industry Commentary

Performance — Top performing industry: 3M - Managed Care, LTM - Providers & Services; Bottom performing industry: 3M - Equipment & Supplies, LTM - Managed Care

Valuation — More than half of health care industries are undervalued relative to their 15Y averages. Biotech and Providers & Services are the most undervalued health care industries.

NTM Estimates — Analysts forecast positive NTM Sales & EPS growth for all healthcare industries except Biotech. Biotech has the highest NTM sales estimate. Life Sciences has the highest NTM EPS estimate.

Technicals — Most Positive 50dma vs 200dma gap (near-term strength): Biotech; Most Negative 50dma vs 200dma gap (near-term weakness): Equipment & Supplies

Investor Debates - Our Take

- **Medicare For All Risk:** Medicare for All will be difficult to pass due to high costs & operational complexity
- **Value Based Care Initiatives:** An opportunity for health tech companies to improve quality of care
- **Managed Care Industry Oversold:** Fears of a private health care system demise are over exaggerated

Relative Performance vs S&P 500 (Last 6 Quarters)





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Fundamentals

Key Takeaways

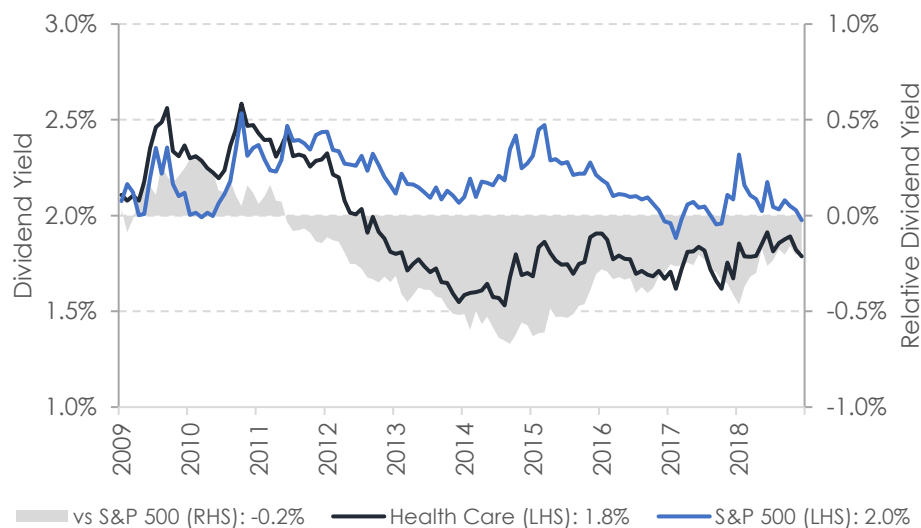
Analysts forecast slightly below average 2020 sales growth and strong earnings growth for the health care sector (Fig. 1). Sales are forecasted to grow +7.0% in 2020 after averaging +8.6% over the past 3Y. Earnings are forecasted to grow +8.6%, above the 3Y average of +5.2%. With the exception of sales, health care's 2020 estimates trended higher the past 3M.

Health care's NTM margin forecasts are down from 2018 levels. Fig. 4 shows the NTM gross and net margins decreased the last 3M. The health care sector is facing regulatory uncertainty, which is likely contributing to analysts' margin downgrades across the sector. Debt/equity levels remain near decade highs, while interest coverage continues to trend downward (Fig. 5).

Looking at the sector's Piotroski F-Score across companies, health care companies' financials deteriorated over the past year (Fig. 3). However, health care is likely to be attractive due to its defensive characteristics as trade issues remain elevated.

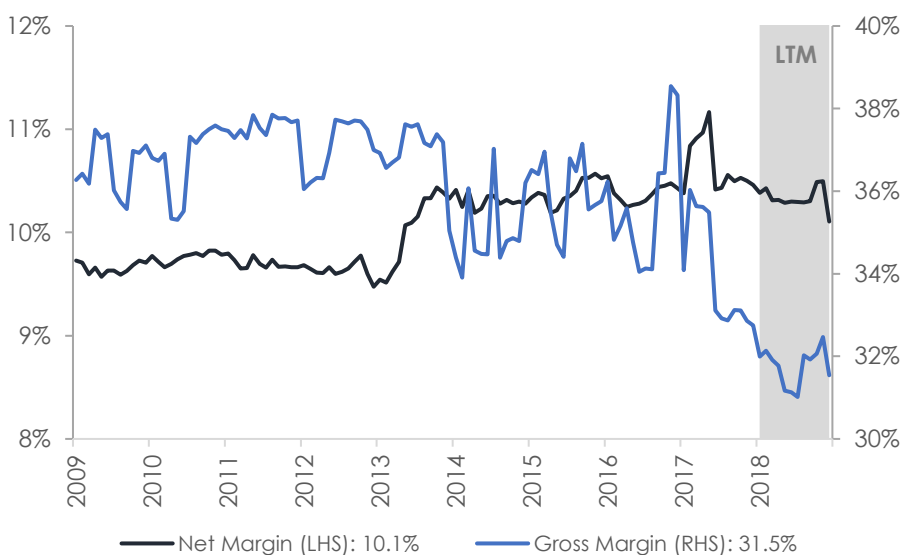
Health Care's Relative Dividend Yield More Attractive

Figure 2: Absolute Yield & Relative Yield vs S&P 500



NTM Gross & Net Margin Estimates Heading Lower

Figure 4: NTM Gross & Net Margin Estimates



Healthy Financials with 2020 Improvement on Horizon

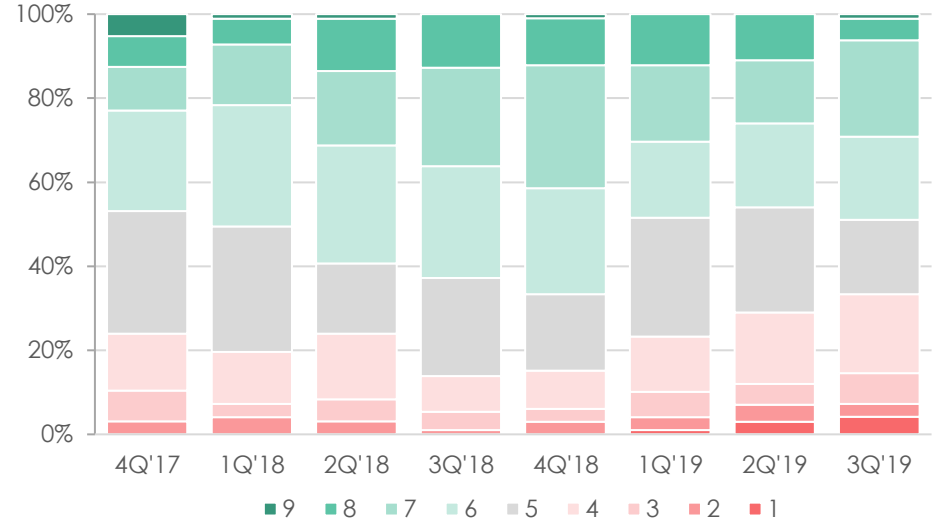
Figure 1: Income Statement & Balance Sheet Snapshot

Income Statement	10Y History	3Y Growth Avg	2020e Growth	2020e 3mo % Chg
Sales		8.6%	7.0%	↓ -1.4%
EBITDA		4.4%	8.9%	↑ 1.4%
Free Cash Flow		6.2%	-	-
Earnings		5.2%	8.6%	↑ 0.8%
Dividends		9.0%	7.2%	↑ 0.4%

Margins	10Y History	3Y Growth Avg	2020 Margin Estimate	2020e 3mo % Chg
Gross Margin		33.3%	-	-
FCF Margin		7.8%	10.2%	↓ 0.0%

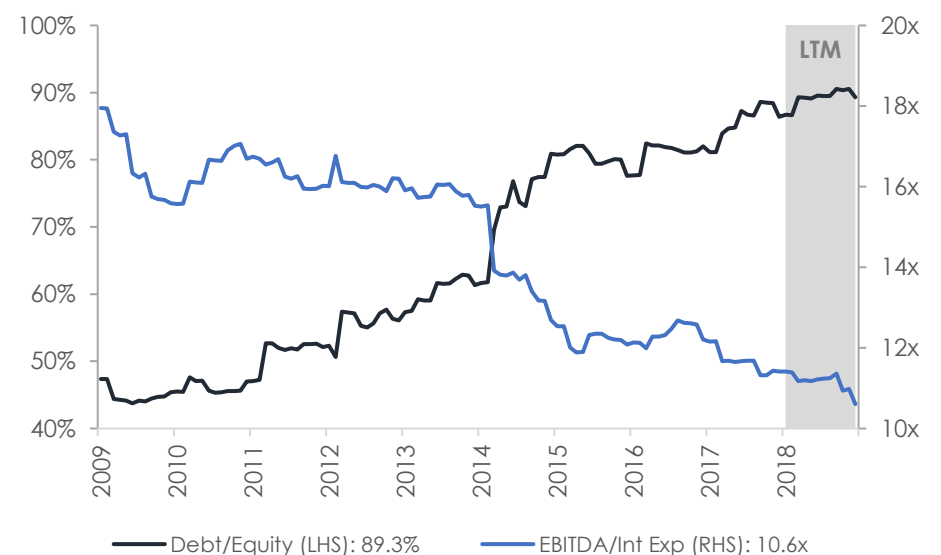
YoY % of "Weak" Companies up from 5% to 16%

Figure 3: Sector Piotroski F-Score Breakdown (9 = Strong, 1 = Weak)



Debt/Equity at Decade Highs; Interest Coverage Slipping

Figure 5: Debt/Equity Ratio & EBITDA Interest Coverage Ratio



Valuation

Key Takeaways

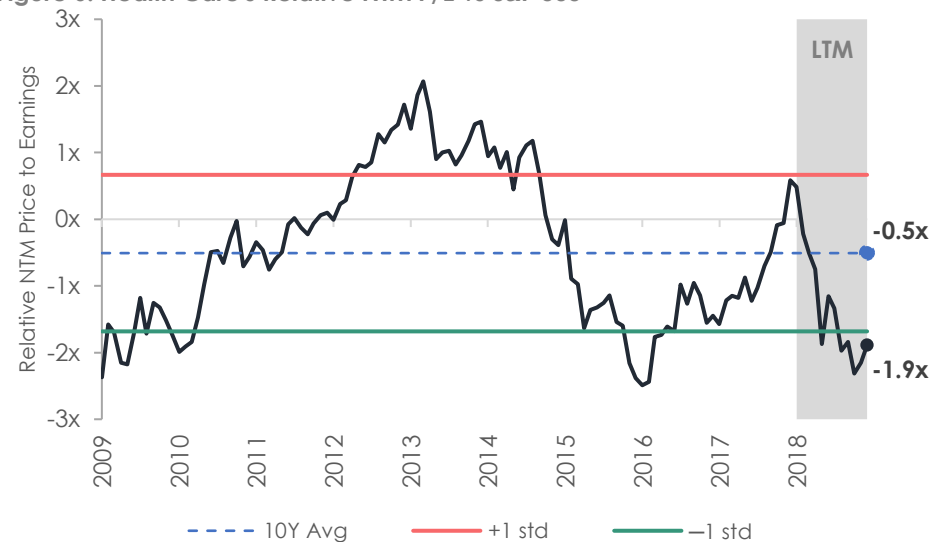
Health care valuations continue to trade below the green line (-1 stdev) (Fig. 6). The sector historically trades at a NTM P/E discount of -0.5x relative to the S&P 500. Today, health care stocks trade at a -1.9x discount vs the S&P 500, which is near all-time lows from 2010 and early 2017. Across most valuation metrics, health care trades at relative discount to the S&P 500 (Fig. 8) However, the sector trades at a premium to its 10Y historical average.

Health care trades +1.0 stdev above its 15Y valuation composite (Fig. 7). The S&P 500 trades +1.9 stdev above its 15Y average. The relative gap between the two valuation composites remains near 15Y lows. Looking at the sector's FY2 P/E ratio, health care stocks trade +0.7 stdev above their 3Y sector average (Fig. 10).

More health care stocks are net overvalued for the first time since 3Q18 (Fig. 9). There were a net 14 stocks undervalued at the end of 3Q19. As of early December 2019, there are now a net 4 stocks overvalued. This is the highest net overvaluation since 3Q18.

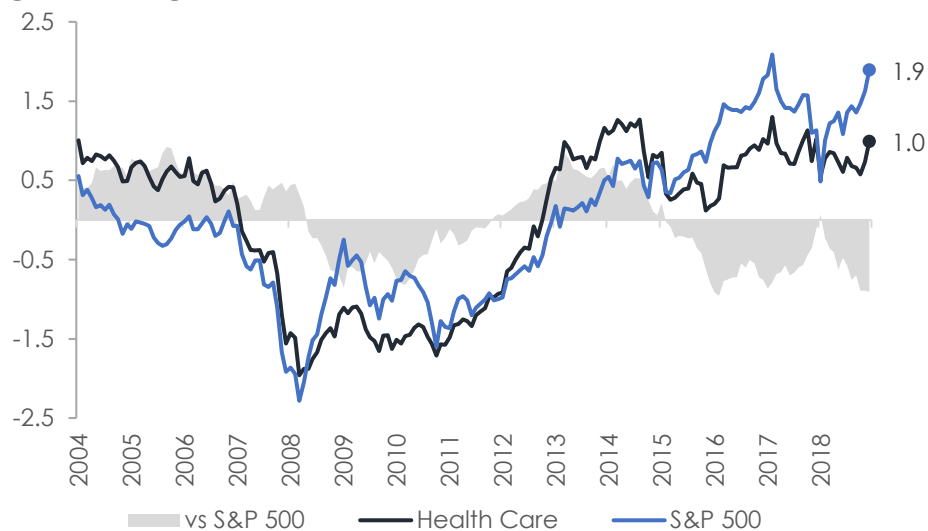
Health Care's Relative NTM P/E is -1 Stdev Below 10Y Average

Figure 6: Health Care's Relative NTM P/E vs S&P 500



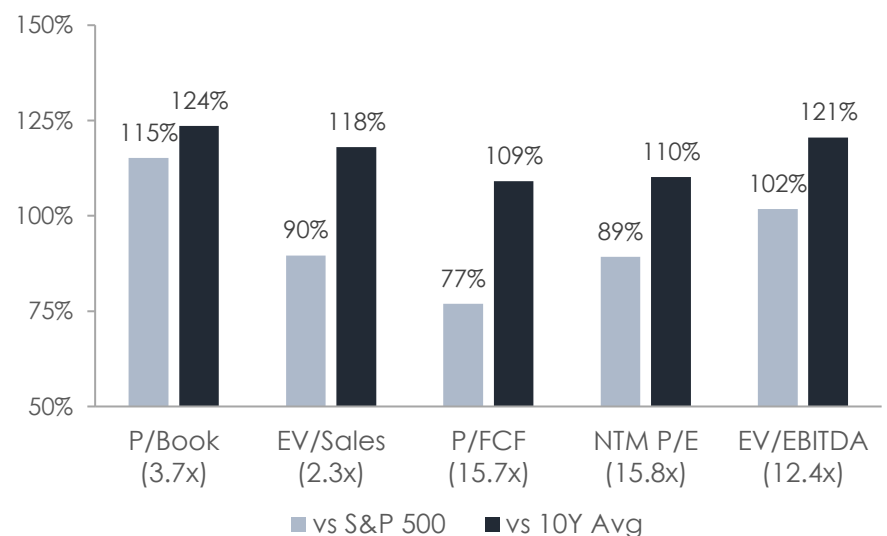
Valuation Composite Gap Relative to S&P 500 Near 15Y Low

Figure 7: Average Z-Score of LTM P/E, NTM P/E, P/B, EV/S, and EV/EBITDA



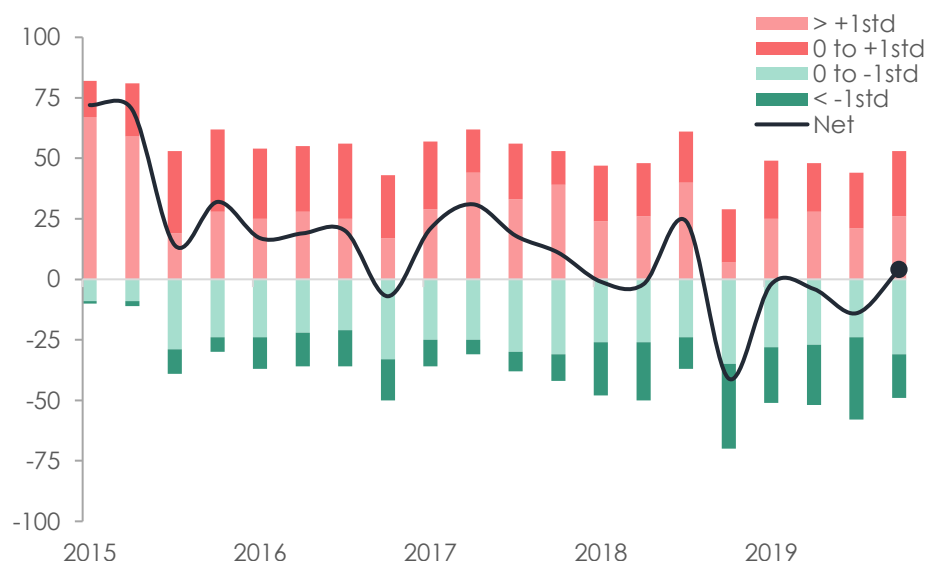
Less Expensive than S&P 500; Slightly Above 10Y Valuation Avgs

Figure 8: Relative Valuations vs S&P 500 & 10Y Sector Average



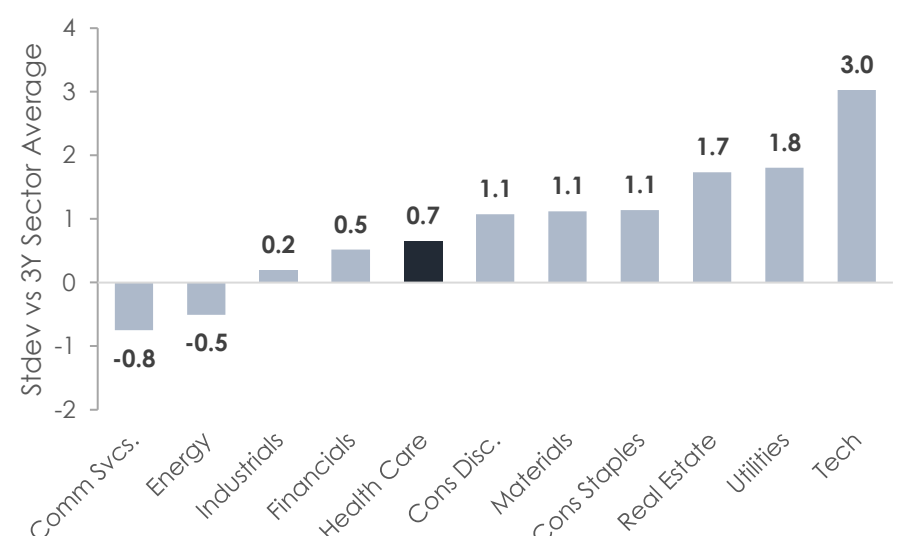
More Health Care Stocks Overvalued for First Time Since 3Q18

Figure 9: # of Companies Trading Above/Below 5Y Avg NTM P/E



Health Care Less Expensive than Other Defensive Sectors

Figure 10: 2021 P/E Valuation Relative to 3Y Sector Average



Revisions & Earnings

Key Takeaways

~53% of health care companies experienced negative EPS estimate revisions the past 3M (Fig. 11). Health care's up/down EPS revisions ratio was the second most positive across all sectors, with only tech more positive.

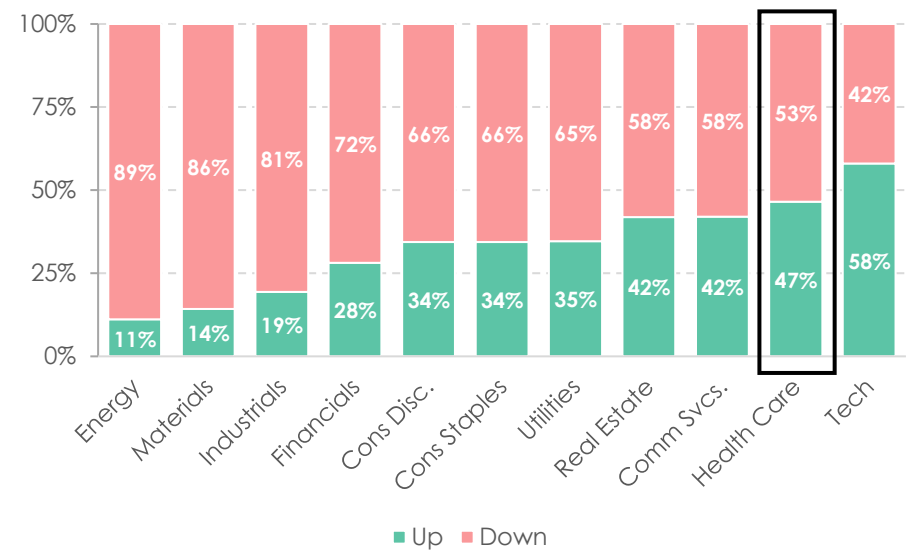
Figs. 12 & 13 shows the sales and EPS up/down revision ratios remained positive but was lower in December. Both the sales and EPS 1M revision ratios dipped as the intensity with which analysts upgraded companies slowed. It should be noted health care valuations have not kept pace with the sector's strong sales and EPS up/down revision ratios throughout 2019.

Health care's YoY LTM growth rate continues to surge (Fig. 14). The surging growth rate is due to margin expansion and 2017 tax reform's one-time earnings impact distorting sector earnings.

The % of companies beating sales and EPS estimates improved during 3Q19 (Fig. 15). It's good to see the health care sector sales and EPS beat %'s increase last quarter, even as analysts increased estimates throughout 2019.

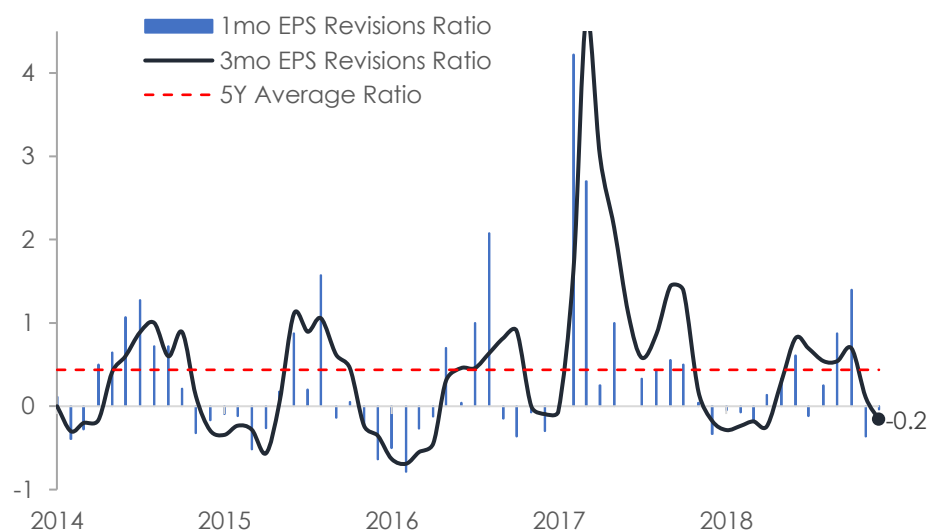
Health Care Revisions Healthier Than Most Sectors

Figure 11: % of Companies with Up/Down EPS Revisions by Sector (Last 3M)



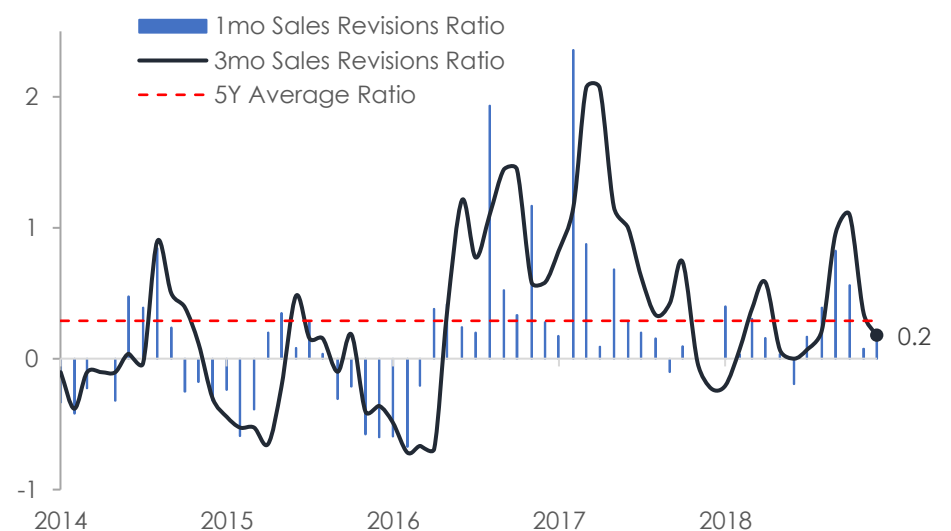
Up/Down EPS Estimate Revisions Ratio Lower Last Month

Figure 12: NTM EPS Estimate Revision Ratio (Up vs Down Revisions)



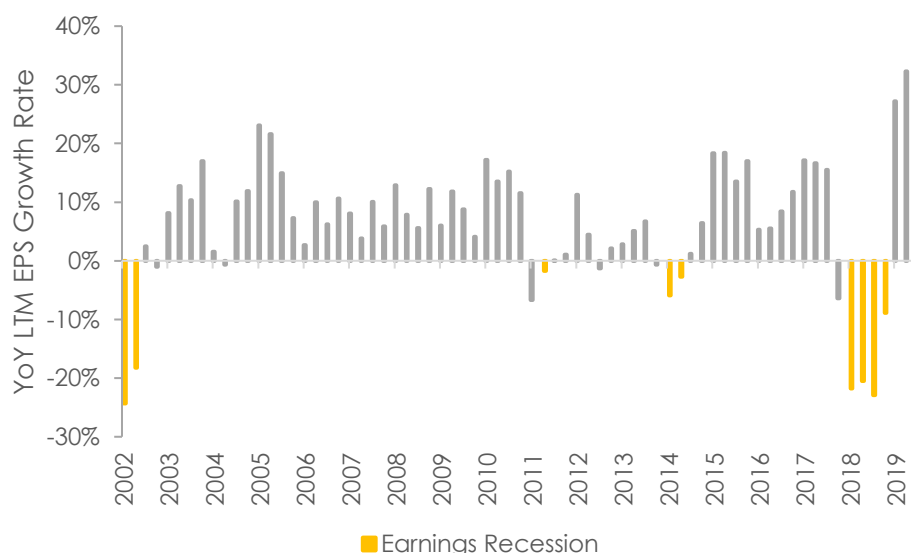
Up/Down Sales Estimate Revisions Ratio Lower Last Month

Figure 13: NTM Sales Estimate Revision Ratio (Up vs Down Revisions)



YoY LTM EPS Growth Rate Surging

Figure 14: Sector LTM EPS Growth & Earnings Recessions (yellow)



EPS and Sales Beat %'s Rebound from 2Q19 Levels

Figure 15: % of Companies Beating Sales & EPS Estimates



Technicals & Breadth

Key Takeaways

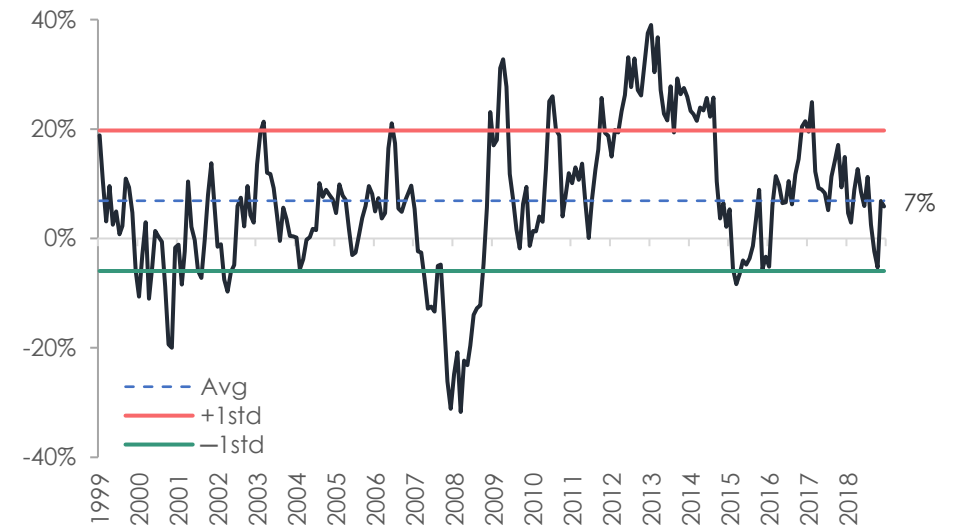
Health care's rolling LTM return is inline with its 20Y average of 7% (Fig. 16). The sector bounced off its green line (-1 stdev) during 3Q19. If the historical trend continues, bouncing off the -1 stdev could mean strong sector returns ahead.

Health care recently broke above a rising channel on the weekly charts (Fig. 18). Breaks above rising channels are generally a bullish indicator. The breakout coincides with more positive health care sentiment as investors lower the risk of Medicare for All. Fig. 20 shows overall trading volume in the sector was average, which indicates broad investor buying. A divergence of weak volume and outperformance should be monitored, as it could signal buyer exhaustion.

Fig. 17 shows the health care sector's recent highs are being made on strong breadth. Fig. 19 shows an increase in the percentage of health care stocks outperforming the S&P 500. This is positive and could signal health care is finally finding a bid after 12 months of elevated policy risks.

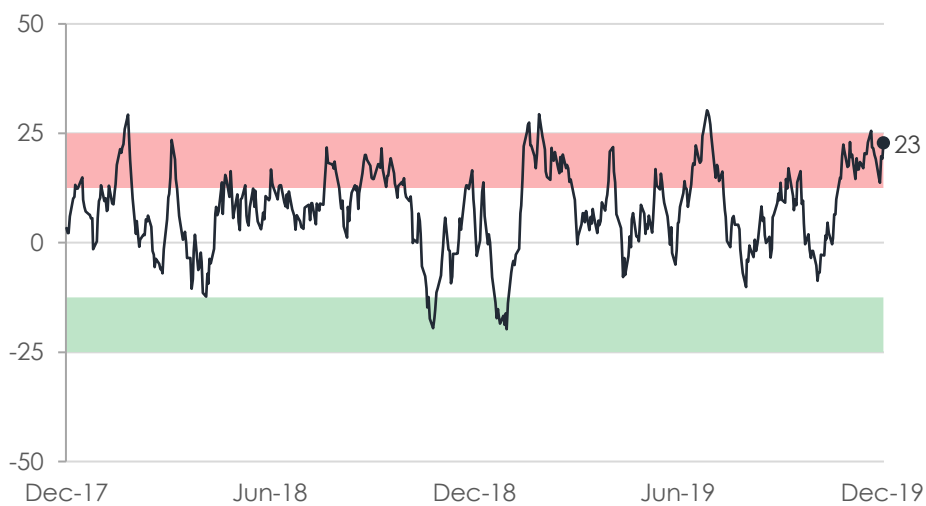
Rolling LTM Return Remains within Historical Bands

Figure 16: Historical YoY Price Return



A/D Momentum Strong in November 2019

Figure 17: 21-day Average of Health Care Sector Net Advance/Decline Line



Breakout of Rising Channel is Bullish

Figure 18: Technical Analysis of Price Movement (Weekly Candles)



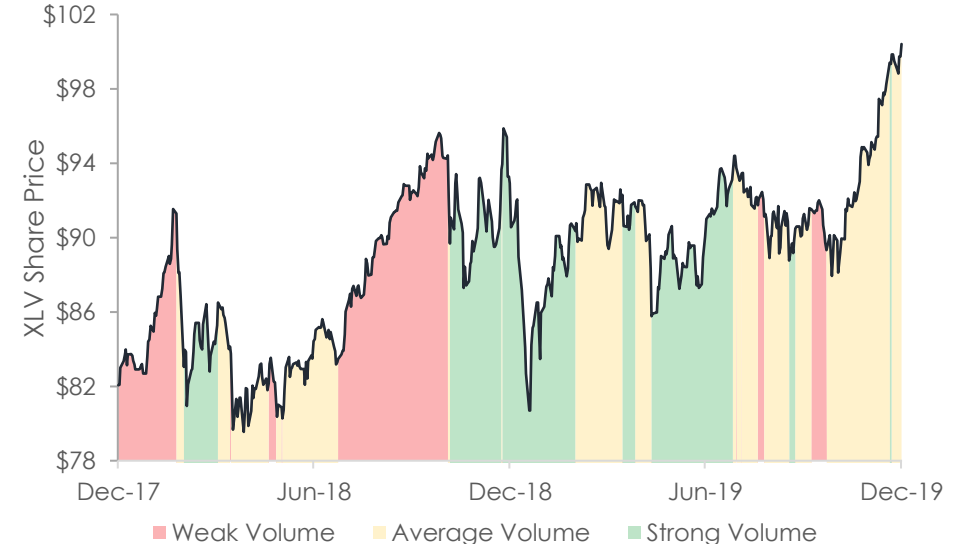
% of Outperforming Health Care Stocks Hits 2Y Low

Figure 19: % of Sector Outperforming the S&P 500 LTM Return



Recent Highs Reached on Average Volume

Figure 20: Performance & Trading Volume Strength





Sentiment & Positioning

Key Takeaways

Fig. 21 shows health care experienced strong outflows over the past 12 months. The net outflows correlate to policy risks ahead of the 2020 presidential election. Health care sector outflows are now slowing, with November 2019 registering the first month of net inflows since March 2019.

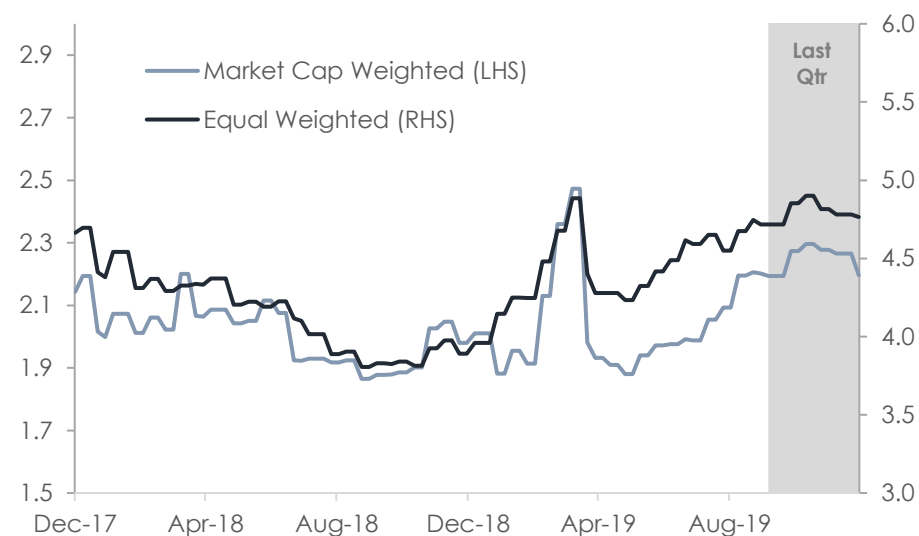
Investor sentiment toward health care spiked bullish the last 3M. The equal weighted and market cap weighted short interest levels are both down from just 2M ago (Fig. 22). The put/call ratio now tilts bullish after tilting bearish throughout most of 2019 (Fig. 23).

Fig. 25 shows the 52wk High-Low Index surged higher during October and November. This indicates strong positive sentiment as the number of stocks hitting 52wk highs far outpaces those hitting 52wk lows.

Insider Selling remains inline with historical averages. Providers & Services, which includes hospitals and nursing facilities, insiders sold the most stock last quarter. The above average selling occurred as the Trump administration pushed for price transparency among providers, which could pressure revenue at the companies.

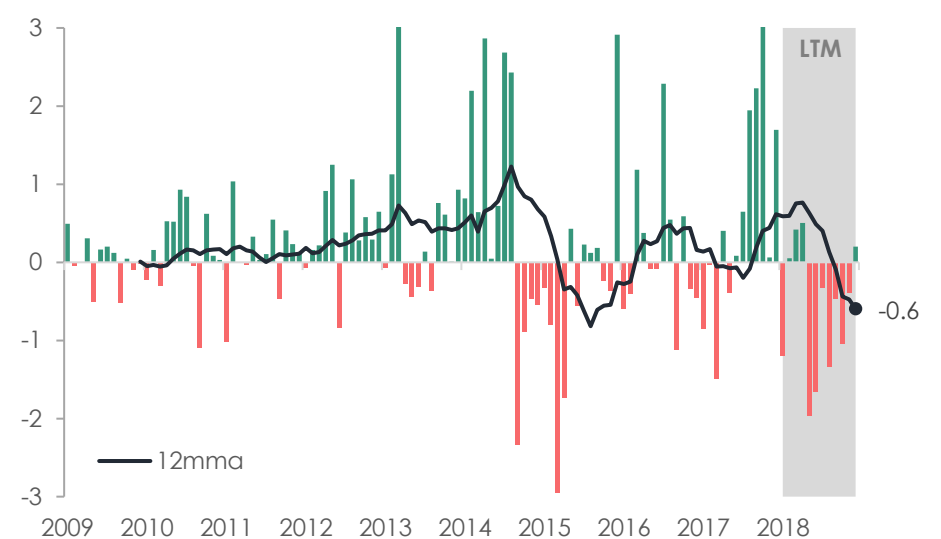
Short Interest Levels Less Bearish from Late 3Q19/Early 4Q19

Figure 22: % of Short Interest vs Float (# of shares available to trade)



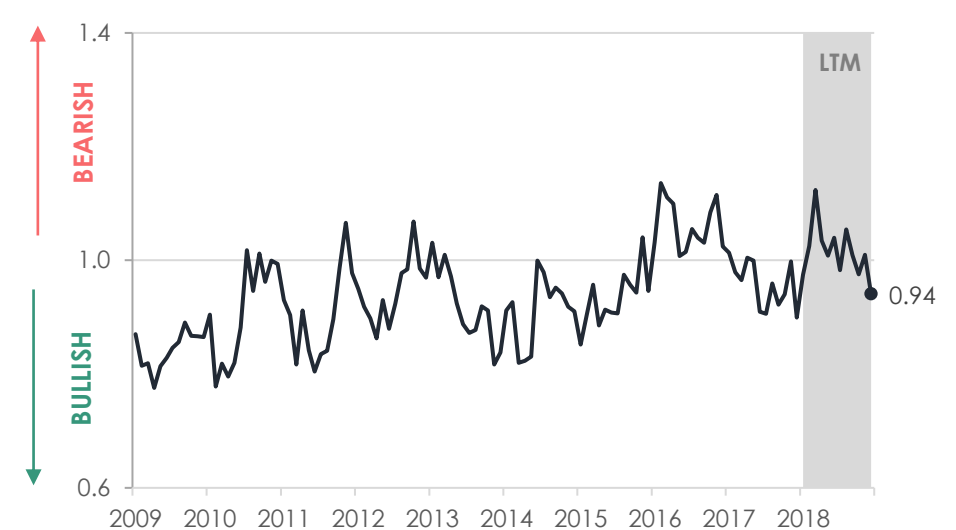
Net Outflows from LTM Turned to Net Inflows in November

Figure 21: ETF Inflows (Green) and Outflows (Red) - Billions in USD



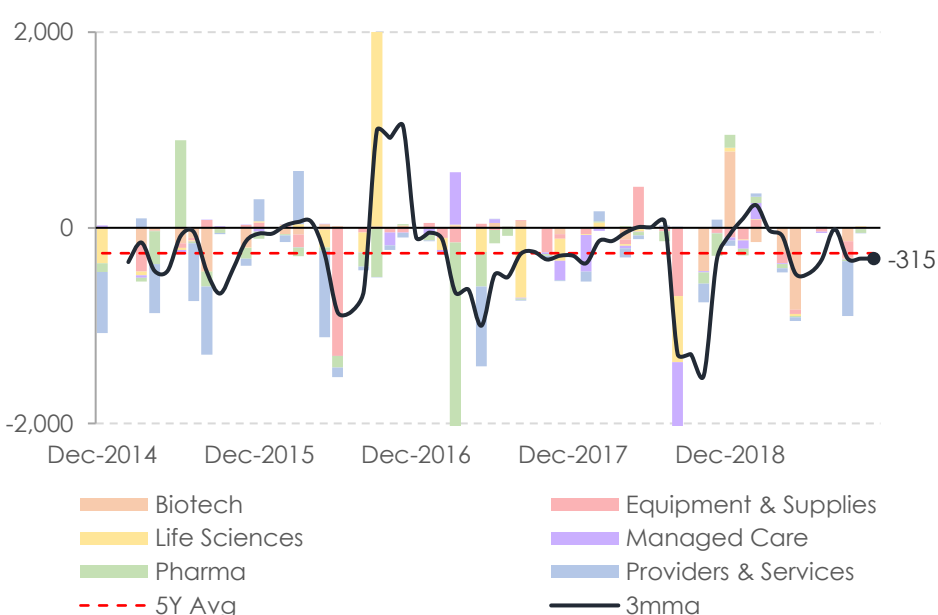
Put/Call Ratio Spiked Bullish the Last 3M

Figure 23: Sector Put/Call Ratio



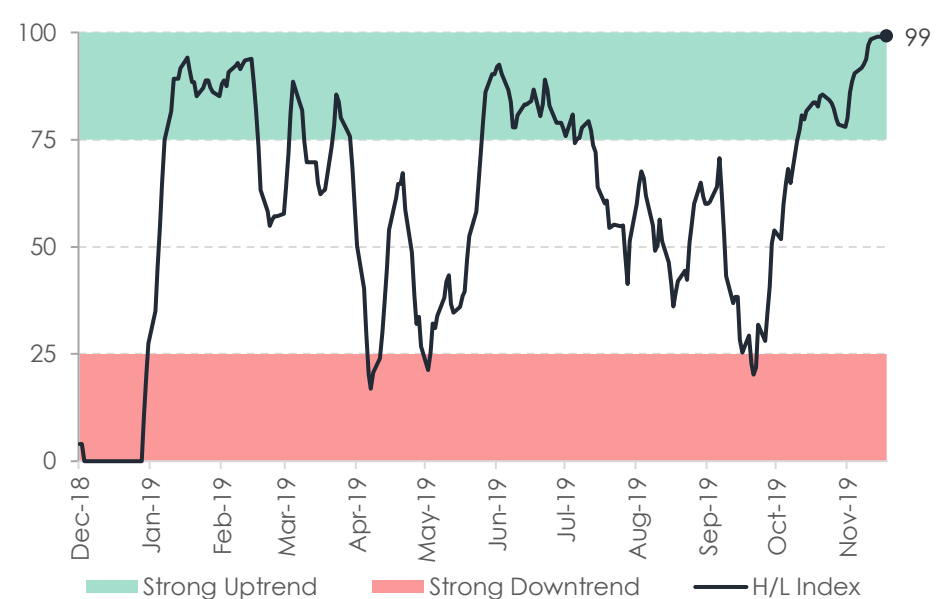
Providers & Services Insiders Strong Net Sellers Last 3M

Figure 24: Insider Buying/Selling (\$ Millions)



Strong Positive Sentiment as 52wk High-Low Index Surges

Figure 25: High-Low Index (% of New 52wk Highs vs New 52wk Lows)



Health Care Industries

Key Takeaways

Providers & Services is the top performing industry over the LTM (Fig. 27). Managed Care and Providers & Services outperformed the last 3M, while Equipment & Services underperformed.

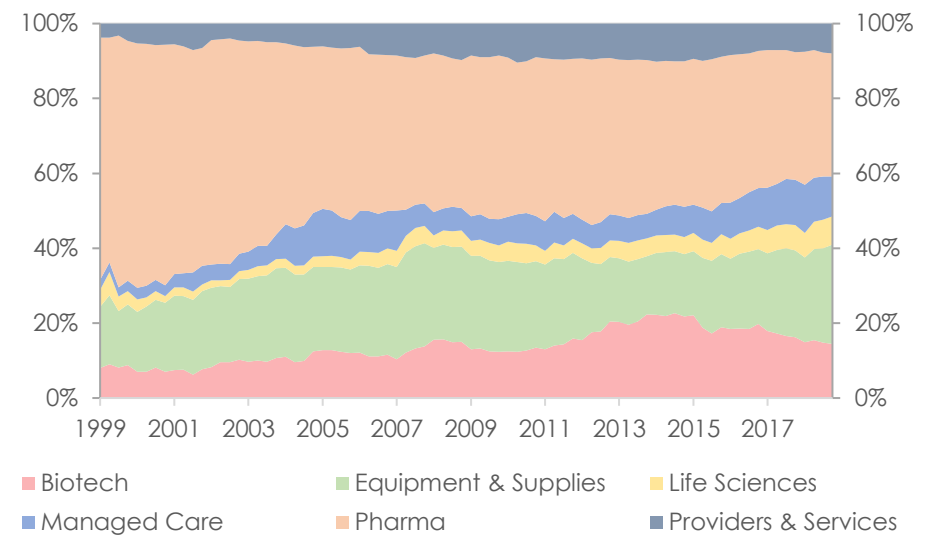
Fig. 28 shows the majority health care industry valuations are below their 15Y averages. Biotech and Providers & Services are the most undervalued. Managed Care valuations made the biggest positive move last quarter, while Pharma made the smallest move.

Analysts project positive NTM Sales and EPS growth for all health care industries except biotech, where EPS is expected to decline as sales grow (Fig. 29). Biotech has the highest NTM sales growth estimate, while Life Sciences has the lowest. Life Sciences has the highest NTM EPS growth estimate.

Fig. 30 shows health care's technicals are strong (Fig. 30). After the recent health care rally, no industry's 50dma is below its 200dma. Biotech has the highest positive 50dma and 200dma gap, which indicates technical strength.

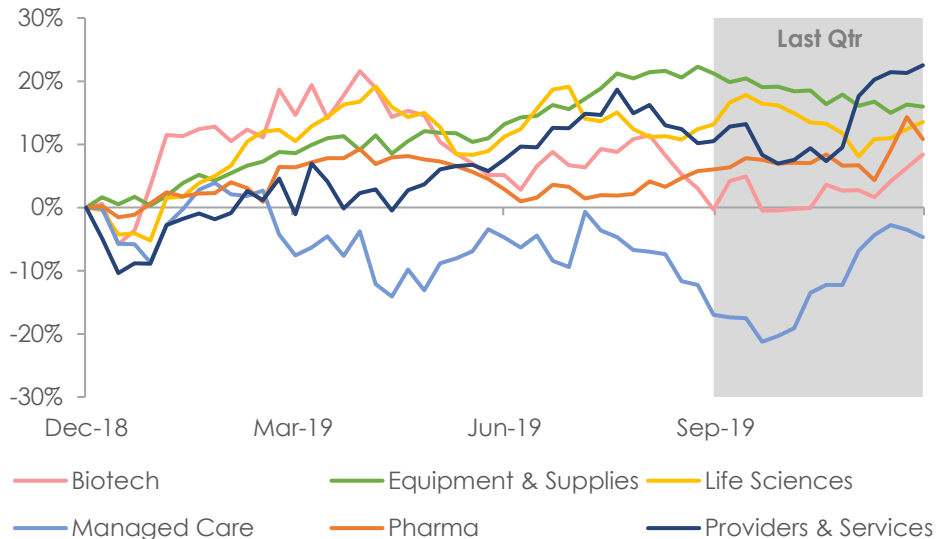
Historical Health Care Industry Breakdown by Market Cap

Figure 26: Historical Industry Composition by Market Cap



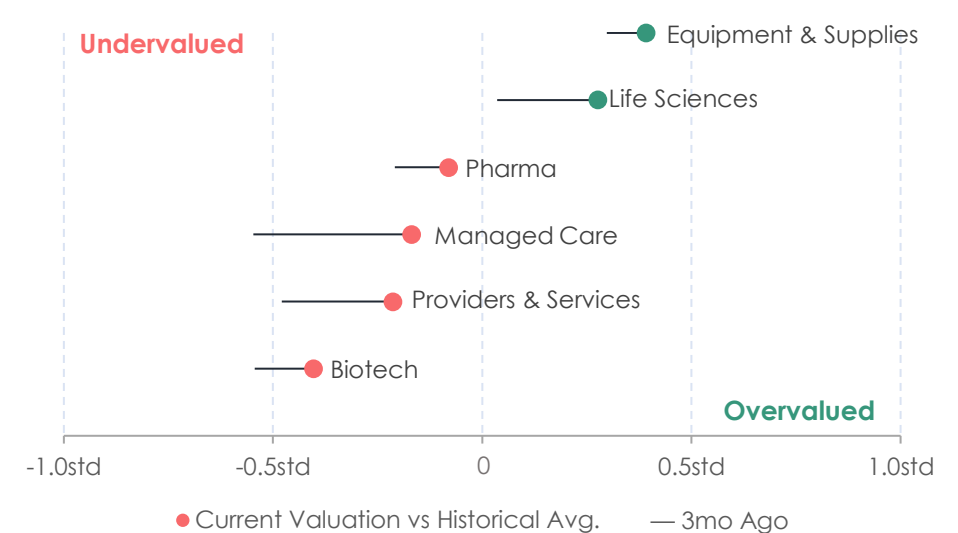
Managed Care, Providers & Services Surge Higher Last 3M

Figure 27: Relative Industry Performance vs Sector



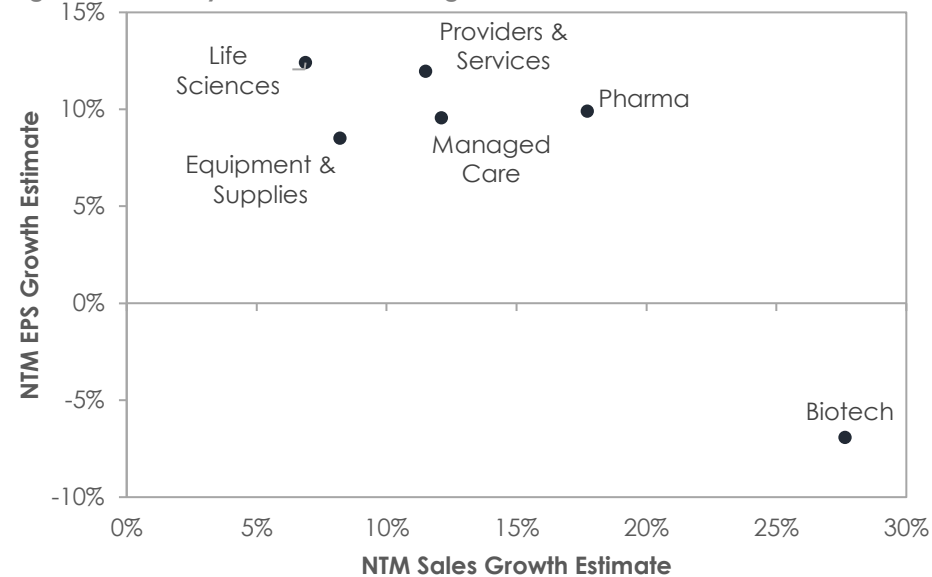
Industry Valuations Attractive Across the Board

Figure 28: Industry Valuation Composites vs Average Since 2004



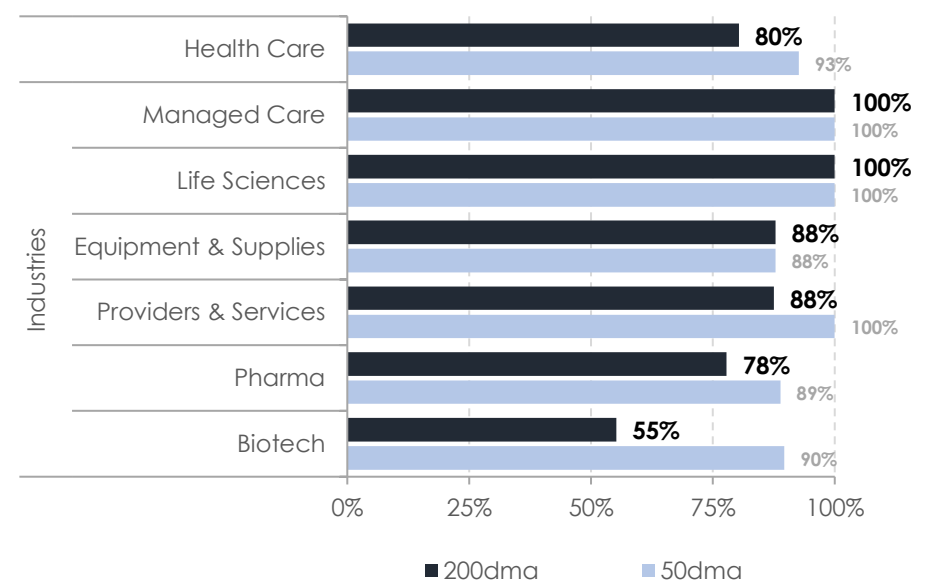
Positive Growth Estimates; Biotech Negative EPS Growth

Figure 29: Industry NTM Sales & Earnings Growth Estimates



Managed Care Technicals Strong; Biotech Weak but Improving

Figure 30: % of Stocks within each Industry Above 50dma | 200dma





Definitions

Daily Moving Average (dma): A daily moving average is an simple moving average calculated by adding the closing price of the security for a number of time periods, and then dividing this total by the same number of periods. **Overbought / Oversold (OB/OS):** OB is short for Overbought. OS is short for Oversold. Overbought (Oversold) = +1 Standard Deviation Above (Below) 50dma. **Relative Strength (14d RSI):** The relative strength index (RSI) is a technical indicator used in the analysis of financial markets. The RSI is most typically used on a 14-day timeframe, measured on a scale from 0 to 100, with high and low levels marked at 70 and 30, respectively. **EPS:** Earnings per share is the portion of a company's profit that is allocated to each outstanding share of common stock, serving as an indicator of the company's financial health. **P/E Ratio:** The price-to-earnings ratio is the ratio for valuing a company that measures its current share price relative to its EPS. **52W High / Low:** A 52-week high/low is the highest and lowest price at which a stock has traded during the previous year. **Street Rating:** The average stock rating across Wall Street in which analysts rate a stock as a Buy or Overweight when they have a positive outlook for a company and a Sell or Underweight rating when they have a negative outlook for a company. **Basis Point (bp):** A unit of measure used in finance to describe the percentage change in the value or rate of a financial instrument. One basis point is equivalent to 0.01% (1/100th of a percent).

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