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HEALTHCARE'S UNEXPECTED EDGE

Robert Moffat of Middlefield group is bullish on healthcare with its robust earnings growth and innovation breakthroughs

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Throughout the closing months of 2022 and early 2023, a significant number of leading Wall Street experts were calling for a recession to impact the US economy in the current year. As 2023 comes to a close, the forewarned economic downturn remains elusive. In a somewhat surprising development, the economic landscape is exhibiting robust signs – marked by a decline in inflation, unprecedentedly low unemployment figures, and solid consumer spending.

Robert Moffat, portfolio manager at Middlefield Group highlights the significant role that sectors like consumer discretionary and technology have had in boosting the market. However, he notes a twist: while these sectors surged, traditional defensive sectors like healthcare and utilities have underperformed due to a misjudgment regarding the economy's 'soft landing'.

For 2024, Moffat envisions what many were calling for in the previous year. Not ready to flash a giant red worry signal, Moffat doesn't predict a severe recession, but rather a deceleration from the high growth rates seen recently, such as the 5.2% GDP growth in the third quarter of 2023. This scenario brings forth a comeback story for defensive sectors like healthcare, expected to excel in the late-cycle

Significance of the healthcare sector

As reported on Nov. 30, the S&P 500 healthcare sector has returned -2.2% year-to-date and has lagged the S&P 500 Index by more than 22%. However, Moffat says, "2024 should be a much better year as healthcare is expected to deliver some of the best earnings growth in the entire market.".

"This comes after a year of negative earnings growth, where companies saw inflated profits related to COVID-19 roll off. During the pandemic, companies benefited from extensive spending on COVID vaccines, therapeutics, testing equipment, and related areas. However, in 2023, this spending decreased due to government austerity and cutbacks in R&D. Now, 2024 looks promising as a year of recovery, with healthcare poised to lead the market in earnings growth."

Moffat particularly points to GLP-1 agonist drugs, developed by Eli Lilly and Novo Nordisk, as significant disruptors. He believes the market is undervaluing certain Med-tech companies, like Dexcom and Stryker, poised for growth as perceptions around GLP-1 agonists realign.

Investment strategies in healthcare

Moffat expresses a bullish outlook on GLP-1 agonist drugs, developed by Eli Lilly and Novo Nordisk. He is particularly confident in Eli Lilly, given its projected earnings growth and the potential of its GLP-1 agonist drugs for treating diabetes and obesity.

"Eli Lilly is projected to grow earnings by almost 40% per year for the next five years. Based on the disruptive nature of these drugs and given that growth profile, this is a name that that you need to own in the sector," highlights Moffat.

Eli Lilly has established a strong track record of earnings growth, primarily driven by its diversified portfolio of drugs in critical therapeutic areas such as diabetes, cancer, immunology, and neuroscience. Its recent foray into the obesity setting, stemming from its weight-loss drug Zepbound receiving FDA approval in November 2023adds to the company's long-term growth outlook.

Interestingly, Zepbound is not an entirely new molecule, but rather a new name and brand for its previously successful Type 2 diabetes drug, Mounjaro. Mounjaro gained rapid blockbuster status since its approval in spring 2022, partly because doctors began prescribing it not only for diabetes but also for weight loss. This off-label use for weight management significantly contributed to its popularity and demand and helped build a market for Zepbound before it was approved to treat obesity.

The high demand for weight loss drugs in recent times has been so substantial that supply shortages have occurred. Zepbound's entry into this market, with its dual utility for both diabetes and weight management, positions it well in the current pharmaceutical landscape. Its approval and subsequent market performance could further strengthen the company's financial growth and prominence in the pharmaceutical sector, capitalizing on the increasing demand for effective weight management solutions.

The wild success of GLP-1 drugs has impacted other areas of the sector. Healthcare equipment & devices stocks, or MedTech, have been particularly impacted by the promising effects of reducing diabetes and obesity across the population. Moffat believes that current concerns are overblown, and that MedTech stocks are attractively valued and positioned to outperform in 2024. He expects that the impacts from weight-loss drugs will take decades to play out, and that medical procedures and surgery volumes will continue to grow steadily over the medium term.

While the sector is in a slump currently, Stryker shares are up. Stryker, headquartered in Kalamazoo, Michigan, stands as a prominent name in the medical technology industry. If you've ever been hospitalized, there's a good chance you've encountered their products, as they are one of the world's largest manufacturers of hospital beds and joint replacements.

They are also at the forefront of medical technology, offering a range of advanced products including its robotic-arm assisted surgery platform, Mako. This diversity in product offerings underscores Stryker's significant role in modern medical care and their contribution to advancing medical technologies.

Moffat's portfolio isn't limited to the usual suspects. He reveals an intriguing investment in Chartwell Retirement Residences, a Canadian senior housing operator, highlighting its unique position as a healthcare-real estate hybrid and its strong performance post-pandemic.

"The long-term tailwinds from aging demographics are clearly there, and I think the short-term earnings growth simply from occupancy recovering from the pandemic; are in place for another 12 months at least," says the portfolio manager.

In his final remarks, Moffat underscores three reasons to invest in healthcare: its late-cycle resilience, historical performance in periods of falling inflation, and a strong earnings growth narrative for 2024.

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