ClearBridge Investments

The New Normal: Health Care Innovation Earns Validation

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Key Takeaways

- Select health care companies are seeing a strong bid from the race for potential treatments, a vaccine and testing for COVID-19, but we believe their success in these efforts will have more impact in reopening the economy than as long-term stock catalysts.
- Biopharmaceuticals should see limited disruption from the pandemic and help the health care sector maintain a market leadership position.
- Managed care companies are also well-positioned to endure COVID-19-related and recession risks, while select medical tools makers could continue to benefit from their diversified business models.

Health Care a Key Part of Solution to COVID-19

Health care has been the best-performing sector since the U.S. market peaked in February. This is reasonable because 1) the underlying demand for a large proportion of health care goods and services, particularly biopharmaceuticals, has not changed and 2) the political outlook for the sector has potentially improved with the exit of Bernie Sanders from the Democratic presidential race.

We're watching efforts by health care companies to develop solutions to help the world deal with COVID-19. Many large capitalization pharmaceutical companies, including Johnson & Johnson, Pfizer, and GlaxoSmithKline, are making progress on a vaccine, and there are a number of other biotechnology companies working on solutions as well:

- Thermo Fisher Scientific, Roche, Becton Dickinson and Danaher are among the first companies to launch commercially available COVID-19 tests.
- Gilead Sciences' remdesivir has demonstrated some benefit for hospitalized patients in clinical trials, although there is still room for better pharmaceutical interventions.
- Roche is testing Actemra to help manage severe cases of COVID-19.

We continue to expect biopharma to lead the health care sector. These stocks have made up almost all of the ground they lost in March, but only returning them to valuations that reflected modest pipeline success. We have owned these stocks for some time because we believe they offer long-term value, not because of their very recent work on COVID-19-related solutions. Rather, the growth of biopharma companies is idiosyncratic, undiminished by COVID-19 and independent of the economy. Amgen and BioMarin Pharmaceutical, for example, have significant opportunities for revenue growth driven by products in clinical trials, while Ultragenyx Pharmaceuticals could soon validate the potential for two gene therapy programs. Roche is also well-positioned due to newly launched and near-term pipeline products.

We will monitor three areas for potential challenges going forward: 1) sales growth of drugs during their launch phase, as reduced physician visits have deferred new prescription starts; 2) COVID-19-related disruptions to the timing and conduct of clinical trials; and 3) the availability of financing for smaller capitalization companies. We view any pause in demand growth as temporary, and we do not expect this to impact peak sales potential.

Deferral of Medical Procedures Hits Some Areas Harder than Others

We also see upside in managed care companies, such as UnitedHealth Group. At the start of the market decline in mid-February, the subsector already reflected a discounted valuation relative to history and its growth potential, primarily due to political concerns. The group further declined on worries over costs to treat COVID-19 and the possible impact of a recession on membership. Comments from management teams suggest savings from deferred noncritical procedures could offset or possibly exceed direct costs to treat the virus. More importantly, we believe that worst-case political scenarios for managed care are significantly less likely under either Joe Biden or Donald Trump, which could allow group multiples to trend back toward pre-election levels. Recessionary impacts on membership should be manageable, with diversified companies offsetting commercial weakness with Medicaid strength, and possibly lower attrition than expected since job losses will be concentrated in service industries that often do not offer health benefits, like restaurants.

Medical device makers are seeing the most direct impact from the deferral of elective procedures due to COVID-19. The level of disruption is company-specific and dependent on core markets. Becton Dickinson, for instance, will see less impact to its core businesses from deferrals of procedures than peers and its diagnostic businesses could provide some positive offset. Alcon (ophthalmology) and Boston Scientific (cardiac), meanwhile, will see near- to medium-term pressure as hospitals initially canceled elective surgeries. Tools makers also have some sensitivity to COVID-related disruptions, but less than medical devices, which will be partially offset by virus testing. Thermo Fisher Scientific and Danaher remain well positioned in the group due to strong long-term fundamentals, top-tier management teams and diversified business models.

We are closely watching companies across health care as it is critical to see how quickly they can develop vaccines, antibody tests or other treatments for COVID-19, then get approvals and ramp up production. These are key inputs into how fast the economy can reopen. Our macro view is that some level of reduced social interaction is going to be required until we have herd immunity — either through a number of people having gotten sick and recovered or through having been immunized with an active vaccine that will reduce the risk of transmission.

Most people assume that the world can return to a healthy economy by the second half of the year, but we are concerned about the virus rebounding and the necessity of continued social distancing measures.

Overall, we believe health care can maintain market leadership due to noncyclical earnings durability, a return to valuations that reflect limited pipeline success and the potential for the industry to deliver health technologies to end the COVID-19 crisis.

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