



MORNING BRIEFING

April 25, 2019

Health Care for Socialists

See the [collection](#) of the individual charts linked below.

(1) Health care stocks sickened by “Medicare for All,” which investors fear is “traditional insurance for none.” (2) Single-payer health care is an old idea getting new legs. (3) Bernie’s Buddies: Lots of Dem POTUS candidates are for socialized medicine. (4) The disruptive impacts on insurers and other health care industries could be HUGE. (5) Two new health care technologies have disruptive potential as well: drug compounding and 3D joint printing.

Health Care I: Feeling the Bern. Medicare for All has made investors in S&P 500 Health Care sector stocks ill. It doesn’t matter that the bill stands no chance of passing in the current Congress. Nor does it matter that the presidential election is still a year and a half away. The mere thought of the government providing health care insurance for all Americans, private insurance being gutted, and potentially immense pricing pressure coming to bear on health care services and prescription drugs sent investors heading for the exits.

The S&P 500 Health Care sector is the worst performing of the S&P 500’s 11 sectors ytd. Here’s the performance derby ytd through Tuesday’s close: Information Technology (27.2%), Industrials (22.4), Consumer Discretionary (22.0), Communication Services (21.5), Energy (19.6), S&P 500 (17.0), Financials (15.0), Real Estate (14.4), Materials (14.1), Consumer Staples (12.0), Utilities (8.5), and Health Care (0.9) ([Fig. 1](#)).

Medicare for All isn’t a new idea. Senator Bernie Sanders (D-VT) professed the need for universal health care while running for president in the 2016 election. And Democrats in the House of Representatives introduced their Medicare for All bill in [February](#).

But as one of our favorite Wall Street sayings goes: “It doesn’t matter ’til it matters.” And this month, Medicare for All mattered. Investors seemed to focus on Sanders’ proclamations at high-profile events, and the S&P 500 Health Care sector, which had been underperforming all year, hit the skids, falling 4.9% in April so far compared to the S&P 500’s 3.5% gain ([Fig. 2](#)).

I asked Jackie to examine the progression of events that have left Health Care stocks bloodied before the first presidential debate kicks off. Here’s what she learned:

(1) *Bernie begins.* A look at the stock chart for the S&P 500 Health Care sector shows that 2019 started off with modest gains in the 5% area until the slide began in mid-April. On 4/10, Senator Bernie Sanders (D-VT) introduced the latest version of Medicare for All legislation, describing health care as a right for all Americans.

“The Medicare for All Act would provide health insurance to all Americans under a single plan run by the government and financed by taxpayers; private insurers could remain in business but could only provide benefits, such as elective surgery, not covered by the government. The 2019 version includes

coverage for long-term care, perhaps increasing its appeal but also its cost,” a 4/10 NYT [article](#) states.

(2) *Bernie on Fox*. Health care investors got their second scare on 4/15, when Senator Sanders appeared in a Fox News [town hall](#). Anchor Bret Baier asked audience members—who ran the political spectrum—whether they’d be willing to transition from their private insurance to the government-run system championed by Sanders. The response: enthusiastic cheers. After Sanders explained the plan a bit, another round of enthusiastic cheers followed.

(3) *UNH CEO weighs in*. The following day, UnitedHealth Group’s CEO David Wichmann waded into the Medicare for All debate during the company’s earnings [conference call](#): “The wholesale disruption of American health care being discussed in some of these proposals would surely jeopardize the relationship people have with their doctors, destabilize the nation’s health system, and limit the ability of clinicians to practice medicine at their best. And the inherent cost burden would surely have a severe impact on the economy and jobs, all without fundamentally increasing access to care. The path forward is to achieve universal coverage and it could be substantially reached through existing public and private platforms.”

The fact that he spoke so emphatically spooked Wall Street, as if by addressing the elephant in the room, he gave it credibility—tacitly acknowledging that single-payer health care has a real chance of being adopted. It struck us as unwise for a health insurance company’s CEO to jump into the debate against Medicare for All on a call announcing a 22% jump in earnings, \$3 billion share repurchase, and \$860 million paid out in dividends in Q1.

The Health Care sector has enjoyed huge returns and above-market pricing power in recent years, observed Jones Trading Chief Market Strategist Michael O’Rourke in his 4/17 [The Closing Print](#) commentary, noting annualized returns of more than 13% over nine years, amid “exorbitant drug price increases, an industry created opioid crisis, and ever rising insurance premiums and hospital bills”; faster-than-CPI inflation for every health-care-related component of the Consumer Price Index; and a contribution to GDP growth that “has averaged 40 basis points per quarter [which] represents a significant contribution. In the 5 years prior to the passage of the Affordable Care Act, the Medical Spending average quarterly contribution to GDP was half as much.” If reversions to the means are in the offing, that could hurt!

(4) *Will Bernie win?* It’s far too early to call the 2020 Democrats’ presidential candidate, especially with 19 declared candidates in the fray. That being said, a Monmouth University poll found that 27% of Democratic voters who are likely to attend Iowa’s caucuses in February are likely to pick former Vice President Joe Biden and 16% Sanders, according to a 4/11 NYT [article](#). Sanders’ results fell since last month, when 25% of voters considered him their first choice in a poll by the *Des Moines Register* and CNN.

But even if Sanders doesn’t win the nomination, Medicare for All is being supported by many other Democrats running for the nomination. Co-sponsors of the bill include presidential contenders Senator Kirsten Gillibrand (D-NY), Cory Booker (D-NJ), Elizabeth Warren (D-MA), and Kamala Harris (D-CA). And the issue has legs: The Monmouth poll found that about half of respondents ranked health care as their top policy priority.

Still, the Democrats would have to win the White House, turn over the currently Republican-controlled Senate, and retain their majority in the House of Representatives. Then they’d have to figure out how to pay for the program.

(5) *Dare we talk dollars?* The biggest hurdle that Medicare for All faces is its sheer expense: \$32 trillion

over 10 years, according to two reports (by George Mason University in June 2018 and the Urban Institute in 2016). And this major expense would occur as existing federal programs are running on fumes. Social Security's costs are expected to exceed its income in 2020 for the first time since 1982, and by 2035 trust funds for both Social Security and Medicare will be depleted in the wake of Baby Boomers' retiring, according to a 4/22 *WSJ* [article](#) citing trustees of the funds.

The Medicare fund's sad state will likely force politicians from both sides of the aisle to come up with various ways to save money. The Trump administration has pushed for faster approval of generic drugs and earlier this year proposed eliminating the rebates that drug makers give pharmacy-benefit managers, which negotiate drug prices on behalf of Medicare and health insurers. The government would like those rebates to go directly to consumers. Doing so could hurt the largest pharmacy-benefit managers, including Cigna's Express Scripts, CVS Health's Caremark, and UnitedHealth Group's Optum RX, and it has weighed on their stocks.

Sanders argues that Medicare for All can be paid for with money that's already being spent in the health care system. A 4/12 MarketWatch [article](#) explains: "Americans already are paying for trillions of dollars in health costs—to a combination of private insurers and the federal government. An entirely government-run health-insurance program, as Sanders imagines, would by definition shift those costs onto the federal government."

Sanders also has proposed new funding sources: a 4% income-based premium paid by employees and a 7.5% income-based premium for employers; a marginal tax rate of up to 70% on those making above \$10 million; taxing earned and unearned income at the same rate; limiting tax deductions for those in the top tax bracket; taxing extreme wealth; and making the estate tax more progressive, including a 77% top rate on inheritance above \$1 billion.

(6) *Potential impact.* A single-payer health care system could give the government substantial negotiating leverage in drug price negotiations. The government could theoretically claw back patents if companies refused to give the government its desired price, a 4/11 MarketWatch [article](#) suggested. Hospital pricing could also come under pressure since currently Medicare pays much lower prices than private insurance plans. And the government would essentially displace the private insurance industry as it currently exists. Private insurers would be allowed to offer supplemental insurance, but that market is much smaller than their current services universe.

That's why so many industries within the S&P 500 Health Care sector have tumbled as the focus turned to Medicare for All. Here's how poorly some of the industries have fared this month through Tuesday's close: Managed Health Care (-7.7%), Health Care Facilities (-7.0), Health Care Equipment (-6.1), Health Care Distributors (-2.5) and Health Care Services (-2.3) ([Fig. 3](#) and [Fig. 4](#)).

The Managed Health Care industry, filled with insurers that face the largest existential threat from Medicare for All, now has a forward P/E of 13.3 which is less than its expected forward earnings growth of 15.7% ([Fig. 5](#) and [Fig. 6](#)). Last week's *Barron's* ran a favorable [article](#) on the health insurers suggesting that investors with 12- to 18-month horizons should consider buying because Medicare for All has only a 5% chance of being enacted.

At 8.6, the Health Care Services industry's forward P/E has fallen to its lowest point in 15 years even though its earnings are expected to rebound from sluggish 3.7% growth this year to 9.0% growth in 2020 ([Fig. 7](#) and [Fig. 8](#)). Likewise, the Health Care Facilities industry is expected to see its punk earnings growth of 3.2% this year improve to 10.2% next year ([Fig. 9](#)). However, its forward P/E is only a smidge higher at 11.1 ([Fig. 10](#)). For brave long-term investors, there are many sickly stocks to consider.

Health Care II: Custom-Made Drugs & Health Equipment. If there ever was a sector ripe for disruption, it's health care. Many patients have no idea what they're paying for products and services, nor can they measure the quality of the service. But there are changes occurring at the margins. Here are two news items—on drug compounding and 3D joint printing—that caught our eye:

(1) *Battling high drug prices.* Some dermatologists are looking at the sky-high prices of drugs as an opportunity. They're buying inventory of drugs manufactured by drug outsourcing companies and selling them at prices that are reportedly far below what consumers would pay at the pharmacy, with or without insurance.

Compounding drugs outside the traditional system has a spotty history. Contaminated drugs dispensed in 2012 by the New England Compounding Center resulted in 76 deaths when more than 800 patients receiving a steroid injection contracted meningitis. Congress responded in 2013 with The Drug Quality and Security Act, a new law that allowed physicians to purchase drugs on a shortage list from a FDA-registered 503B outsourcing facility and dispense them directly to patients, a 2/25 [article](#) in *Dermatology Times* states.

Critics worry that doctors are more likely to overprescribe drugs or charge more for them when they profit from the drug sales. Supporters say patients would be more likely to fill prescriptions at a doctor's office, and doctors could charge prices below a pharmacy's. If the drug prices at both the pharmacy and the doctor's office were listed on the Internet, it's easy to see how patients could come out ahead.

(2) *3-D knees.* 3D printing has come to orthopedics. A number of companies are making joints specifically tailored to patients' knee and hip joints. One such company, Conformis, uses CT scan data to design a personalized joint—adjusting for bone spurs, cysts, and flattening of the joint—and then produces it using a 3D printer. Normally, hospitals carry joints in various sizes that have been mass produced.

Theoretically, 3D printing should be a big win for patients and hospitals. The individualized joint should fit better, and the just-in-time manufacturing should reduce hospitals' inventory and costs. However, 3D joints haven't been widely adopted primarily because they're costly and because patients generally enjoy good outcomes using prefabricated joints.

A 4/13/17 *U.S. News and World Reports* [article](#) stated: “[I]n general, the vast majority of patients who undergo traditional total joint replacement do well in regards to reducing pain and improving range of motion and mobility. Because of that, research evaluating a large group of patients would likely be needed to home in on even small differences in improvement.”

One [study](#) of knee replacements published in the 5/25/18 edition of the *Journal of Knee Surgery* found that customized implants eliminate two sources of pain after total knee arthroplasty: tibial sizing and tibial rotation. “With approximately 20% of total knee patients not satisfied after the procedure,” said Dr. Gregory Martin, “customized implants need to be taken seriously.” Dr. Martin co-authored a study discussed in a 7/16/18 [article](#) in *Orthopedics This Week*.

CALENDARS

US. Thurs: Durable Goods Orders Total, Ex Transportation, and Core Capital Goods 0.7%/0.2%/0.1%, Kansas City Fed Manufacturing Index 9, EIA Natural Gas Report. **Fri:** Real GDP & PCE 2.2%/1.0%, GDP & PCE Core Price Deflators 1.3%/1.3%, Consumer Sentiment Index 97.0, Baker-Hughes Rig Count. (DailyFX estimates)

Global. Thurs: Japan Industrial Production 0.0%*m/m*/-3.8%*y/y*, Japan Retail Trade 0.0%*m/m*/0.8%*y/y*, Japan Jobless Rate 2.4%, Japan CPI Headline, Core, and Core-Core 1.1%/1.1%/0.7% *y/y*, BOJ Rate Decision & 10-Year Yield Target, BOJ Outlook Report. **Fri:** Japan Housing Starts 946k. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): The Bull/Bear Ratio (BBR) continued to rebound this week, climbing to its highest reading since early October, as both bullish and bearish sentiment fell during the week. The BBR had been in a volatile flat trend before jumping from 2.52 to 2.90 the past four weeks; it was at 0.86 at the end of last year—which was the lowest since mid-February 2016. Bullish sentiment slipped to 53.4% this week after rising 13 of the prior 15 weeks, by 24.9ppts, from 29.9% (which was the fewest bulls since February 2016) to a near seven-month high of 54.8% last week. It's the 10th reading above 50.0%. Meanwhile, bearish sentiment dropped to 18.4% this week (the fewest bulls since mid-October); it was at 34.6% during the final week of last year, and bounced in a range between 20.4% and 21.5% from late January through late March. Meanwhile, the correction count climbed to 28.2% after falling the prior three weeks from 27.4% to 26.0%, still not far from its 25.5% reading five weeks ago—which was the lowest since early October. The AAI Ratio slipped to 63.2% last week after climbing the prior two weeks from 55.0% to 66.4%. Bullish sentiment decreased to 37.6% after rising from 33.2% to 40.3% the previous two weeks, while bearish sentiment increased to 21.8% after falling from 28.3 to 20.4% the prior week.

S&P 500 Earnings, Revenues, Valuation & Margins ([link](#)): Consensus S&P 500 forward revenues edged down w/w to 0.2% below its record high in early April, but forward earnings improved to 1.4% below its record high in early December. Analysts expect forward revenues growth of 5.6%, unchanged from a week earlier. However, forward earnings growth edged up 0.1ppt to a 13-week high of 6.7%. Forward revenues growth is down 0.7ppt from a seven-year high of 6.3% in February 2018, but is up from a 31-month low of 5.0% in mid-February. Forward earnings growth is down 10.2ppts from a six-year high of 16.9% last February, but that's up from a 34-month low of 5.9% in late February. Prior to the passage of the Tax Cuts and Jobs Act (TCJA), forward revenues growth was 5.5% and forward earnings growth was 11.1%. Turning to the annual growth expectations, analysts expect revenues growth to slow from 8.3% in 2018 to 5.1% in 2019 and 5.5% in 2020. They're calling for earnings growth to slow sharply from 24.1% in 2018 to 3.2% in 2019 before improving to 11.3% in 2020. The forward profit margin remained steady w/w at a 12-month low of 12.0%, and is down 0.4ppt from a record high of 12.4% in mid-September. Still, that's up from 11.1% prior to the passage of the TCJA in December and compares to a 24-month low of 10.4% in March 2016. The S&P 500's forward P/E has moved higher in 14 of the past 16 weeks, and rose 0.1 point w/w to a six-month high of 16.9. That's up from 14.3 during December, which was the lowest reading since October 2013 and down 23% from the 16-year high of 18.6 at the market's valuation peak in January 2018. The S&P 500 price-to-sales ratio rose 0.01 point w/w to 2.03 and is up from 1.75 during December. That was the lowest since November 2016, when the ratio was down 19% from its then-record high of 2.16 in January 2018.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins ([link](#)): Consensus forward revenues rose w/w for six of the 11 S&P 500 sectors, and forward earnings rose for five sectors. Health Care, Real Estate, and Tech were the only sectors to have both measures rise w/w. Forward revenues and earnings are at or around record highs for 4/11 sectors: Consumer Discretionary, Health Care, Industrials, and Tech. Energy's forward earnings is beginning to edge higher now after tumbling about 25% from November to February. Forward P/S and P/E ratios are now well above their multi-year lows during December 2018 for all sectors, and are near or above their 2018 highs for four sectors: Communication Services, Real Estate, Tech, and Utilities. Due to the TCJA, the profit margin for 2018

was higher y/y for all sectors but Real Estate. The outlook for 2019 shows higher margins are expected y/y for just 3/11 sectors: Consumer Discretionary, Financials, and Industrials. The forward profit margin was at record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Since then, it has moved lower for nearly all of the sectors, but early signs of a bottom are appearing. During the latest week, the forward profit margin rose 0.1ppt for Energy and edged down 0.1ppt for three sectors: Communication Services, Consumer Discretionary, and Materials. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (22.1%, down from 23.0%), Financials (18.5, down from 19.2), Real Estate (15.4, down from 17.0), Communication Services (14.7, down from 15.4), Utilities (12.9, down from 13.0), S&P 500 (12.0, down from 12.4), Health Care (10.4, down from 11.2), Materials (10.3, down from 11.6), Industrials (10.1, down from a record high of 10.4 in mid-March), Energy (7.0, down from 8.0), Consumer Discretionary (7.5, down from 8.3), and Consumer Staples (7.3, down from 7.7).

S&P 500 Sectors Net Earnings Revisions ([link](#)): The S&P 500's NERI was negative in April for a sixth straight month, but improved for a second straight month. That follows 18 months of positive readings through October, which had been its longest positive streak since a 26-month string ending August 2011. NERI rose to -4.4% from -6.2% in March, which compares to a record high of 22.1% in March 2018. NERI improved m/m for 6/11 sectors and was negative for all 11 sectors (compared to eight improving and 11 negative in March). Consumer Staples has the worst track record, with 12 months of negative NERI, followed by Materials (7). All of the sectors are down from their TCJA-boosted highs during early 2018. Here are the sectors' April NERIs compared with their March readings: Health Care (-0.6% in April, up from -2.1% in March), Tech (-2.2, -7.3), Consumer Discretionary (-3.0, -2.8), Energy (-3.1, -14.2), Utilities (-3.3 [32-month low], -2.2), Communication Services (-4.5, -4.9), Industrials (-4.5, -3.3), Consumer Staples (-6.0, -5.1), Real Estate (-6.4 [11-month low], -5.9), Financials (-7.1, -8.5), and Materials (-18.3, -19.9).

S&P 500 Q1 Earnings Season Monitor ([link](#)): With over 26% of S&P 500 companies finished reporting revenues and earnings for Q1-2019, the y/y growth rates in revenues and earnings have slowed substantially from Q4. The revenue surprise metrics have weakened substantially, but earnings continue to beat forecasts. Of the 132 companies in the S&P 500 that have reported through mid-day Wednesday, 79% exceeded industry analysts' earnings estimates. Collectively, the reporters have averaged a y/y earnings gain of 4.8%, and exceeded forecasts by an average of 5.4%. On the revenue side, just 53% of companies beat their Q1 sales estimates so far, with results coming in 0.6% above forecast and 4.9% higher than a year earlier. Q1 earnings growth results are positive y/y for 72% of companies, vs a higher 78% at the same point in Q4, and Q1 revenues have risen y/y for 72% vs a higher 82% during Q4. These figures will change markedly as more Q1-2019 results are reported in the coming weeks. Looking at earnings during the same point in the Q4-2018 reporting period, a lower percentage of companies (72%) in the S&P 500 had beaten consensus earnings estimates by a lower 2.1%, but earnings were up a higher 12.7% y/y. With respect to revenues at this point in the Q4 season, a higher 59% had exceeded revenue forecasts by a similar 0.6%, and sales rose a greater 9.3% y/y. The early results for Q1 indicate a slowdown in revenue and earnings growth from Q4, but that comes as no surprise to investors. Q4-2018 had marked the tenth straight quarter of positive y/y earnings growth and the 11th for revenue growth. Looking at the Q1 results ex-Financials and Real Estate, the earnings surprise would still be 5.4%, the same as with all sectors included, but y/y earnings growth falls to 4.2% from 4.8%. The ex-Financials and Real Estate revenue surprise would still be 0.6%, also unchanged from the rate with all sectors included, but revenue growth excluding Financials and Real Estate would improve to 6.0% from 4.9%.

GLOBAL ECONOMIC INDICATORS

Germany Ifo Business Climate Index ([link](#)): "The Germany economy continues to lose steam.

Companies are less satisfied with their current business situation. March's gentle optimism regarding the coming months has evaporated," according to Ifo President Clemens Fuest. Sentiment this month sank to 99.2, holding near February's three-year low of 98.7. The index has dropped every month but March since reaching its recent high of 104.1 last August. Over the eight-month period, the present situation component has dropped from 107.2 to 103.3 (the lowest reading since March 2017), while the expectations component slumped from 101.1 to 95.2—remaining above its recent low of 94.0 in February for the second month. Manufacturers are the most pessimistic, with their sentiment (to 4.0 from 6.7) sinking to the lowest reading since the end of 2012, reflecting their exposure to global trade tensions and slowdowns in the emerging markets like China. Among the remaining three sectors, confidence rose slightly for both services (26.3 from 26.1) and construction (21.4 from 20.4) companies, while trade (7.1 from 8.2) sector deteriorated slightly, bouncing around its lows in recent months.

Contact us by [email](#) or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823

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