Health Care’s Maladies

See the collection of the individual charts linked below.

(1) From best to worst. (2) Trump attacks Obamacare and will fix it in 2021, maybe. (3) Drug pricing has become a political piñata. (4) Taking out some benefits from pharma-benefits managers. (5) AI will start suggesting you have fries with your order based on your license plate. (6) AI is micromanaging inventories. (7) Unlike Google, AI can do evil. (8) Mark Cuban keeps a book on AI for dummies next to his water closet.

Health Care: In Sick Bay. The S&P 500 Health Care sector has gone from the best-performing of the S&P 500’s 11 sectors in 2018 to the worst-performing sector in 2019. Some disappointing drug trials, political squabbling over drug prices and insurance, and the stock market’s new focus on growth and offense has led to the sector’s underperformance this year.

Here’s the performance derby for the S&P 500 sectors ytd through Tuesday’s close: Information Technology (21.4%), Industrials (19.0), Real Estate (17.3), Consumer Discretionary (16.6), Energy (16.2), Communication Services (15.7), S&P 500 (14.4), Materials (11.8), Financials (10.5), Consumer Staples (10.0), Utilities (9.2), and Health Care (6.0) (Fig. 1).

Last year, the Health Care sector’s performance wasn’t any better, but the market was rewarding defensive investments, so the sector was the top dog (Fig. 2). Here’s the performance derby for the S&P 500 sectors for 2018: Health Care (4.7%), Utilities (0.5), Consumer Discretionary (-0.5), Information Technology (-1.6), Real Estate (-5.6), S&P 500 (-6.2), Consumer Staples (-11.2), Financials (-14.7), Industrials (-15.0), Communications Services (-16.4), Materials (-16.4), and Energy (-20.5).

I asked Jackie to take a look at what has made the Health Care sector so sickly. Here’s what she found:

(1) Obamacare battle continues. The tussle over the Affordable Care Act (a.k.a. ACA or Obamacare) has continued during the Trump presidency. Until this week, President Trump was planning to introduce a Republican replacement for Obamacare. He backed off his plans Tuesday after Senator Mitch McConnell privately warned the President that the Senate would not address health care before the November 2020 elections, a 4/2 NYT article reported. As a result, we can look forward to a year of haranguing about health insurance from both parties during the course of the presidential campaign.

The Trump administration is also supporting US District Judge Reed O’Connor’s ruling last month that the ACA is unconstitutional. The ruling stated the ACA “became unconstitutional following Republicans’ move in 2017 to eliminate the individual mandate penalty,” a 3/26 CNBC article explained. The judge’s decision is now being appealed.

Health insurance companies benefitted from the implementation of Obamacare as more people with health insurance sought services. Since Obamacare was signed into law on March 23, 2010, the S&P 500 Managed Care stock price index has risen 489.3%, making it the third-best-performing industry that
we track. It easily outpaced the S&P 500’s 144.2% return.

The threat of unwinding Obamacare has hurt the S&P 500 Managed Health Care stock price index, which has fallen 0.3% ytd (Fig. 3). The industry is expected to post forward revenue growth of 10.6% and forward earnings growth of 15.8% (Fig. 4 and Fig. 5). The strong growth makes the industry’s forward P/E of 15.2 seem reasonable if you can stomach the political wrangling over the next year and a half (Fig. 6).

(2) Drug prices are a piñata too. Drug prices continue to be one of politicians’ favorite targets. Senator Bernie Sanders (D-VT) told “Face the Nation” that he’d cut prescription drug prices in half if elected president. And, he warned, if the pharmaceutical companies don’t like it, then “we’ll take a look at their patents,” a transcript of the 3/31 TV program on RealClear Politics stated.

Senator Sherrod Brown (D-OH), who’s considering a presidential run, and Senator Amy Klobuchar (D-MN), who is running for president, co-sponsored a proposal allowing the federal government to negotiate Medicare drug costs with drug companies, a 2/17 article in the Dayton Daily News reported. He also introduced another bill with presidential contender Senator Kirsten Gillibrand (D-NY) requiring drug companies to report and justify price increases to the government. And Senator Elizabeth Warren (D-MA) has a plan to manufacture generic drugs when the market fails.

Fundamentally, the biotech industry has benefitted from a number of acquisitions early in 2019. Bristol-Myers Squibb offered $74 billion to acquire Celgene, and Eli Lilly purchased Loxo Oncology for $8 billion. Earlier this week, Novartis announced the $1.6 billion deal for IFM TRE, which develops anti-inflammatory drugs, and Roche Holdings offered $4.8 billion for gene therapy company, Spark Therapeutics. Weighing on the industry was news that Biogen and Eisai halted late-stage studies of an Alzheimer’s drug. Biogen shares fell by almost a third on the news and have yet to recover.

(3) Moderately happy pills. The S&P 500 Pharmaceuticals and Biotechnology industries have been top performers in the health care sector. Analysts aren’t expecting much from the pharmaceuticals industry, which has appreciated 4.9% ytd (Fig. 7). Forward revenue is expected to inch up by 1.7% and forward earnings by 2.6% (Fig. 8 and Fig. 9). Earnings growth is expected to pick up in 2020 (by 8.1%) and 2021 (9.4%). For those who can wait, the industry’s forward P/E of 15.4 may seem reasonable (Fig. 10).

Growth in the Biotech sector is slightly better. The industry’s stock price index is up 3.4% ytd (Fig. 11). Analysts forecast forward revenue growth of 3.2% and forward earnings growth of 7.6% (Fig. 12 and Fig. 13). The industry’s forward P/E, at 11.0, is near 20-year lows (Fig. 14).

(4) Middle men under fire, too. President Trump is also promising to lower drug prices, but he has proposed doing so by ending the annual rebates drug makers give pharmacy-benefit managers that work with Medicare and Medicaid. The three largest pharmacy-benefit managers are UnitedHealth Group’s OptumRX, which is in the S&P 500 Managed Health Care industry, and Cigna’s Express Scripts and CVS Health’s Caremark, which are both part of the S&P 500 Health Care Services industry. A number of industry executives are expected to testify on Tuesday before the Senate Finance Committee about the role of pharmacy benefit management, or PBM, contracts in drug price increases.

Yesterday, Cigna may have taken a step toward mollifying critics. It lowered the out-of-pocket cost of insulin for some of its members to $25 for a 30-day supply, down from $41.50. The lower price will cover non-government Cigna plans for employers, unions, and individuals, a 4/3 CNBC article reported. Last month, Eli Lilly introduced a generic version of its rapid-acting insulin at half the price of its brand-name drug.
The S&P 500 Health Care Services industry is among the worst-performing industries we track, having fallen 13.2% ytd (Fig. 15). The poor stock price performance of CVS and Cigna has more than offset the stronger results of DaVita, Quest Diagnostics, and Laboratory Corp. of America Holdings. The industry is expected to have 36.4% forward revenue growth and 5.2% forward earnings growth (Fig. 16 and Fig. 17). Its forward P/E of 9.1 is at a 15-year low (Fig. 18).

**Disruptive Technology: Businesses Adopt AI.** Artificial intelligence (AI) is quickly moving from being debated in theory to being implemented by businesses—and we’re not just talking about tech companies. McDonald’s recently purchased an AI company to suggest what you might like to order in addition to a Big Mac. Likewise, Food Lion and its related grocery stores are using AI to help order food from suppliers. And Mark Cuban told Recode why it’s imperative for businesses to get up to speed on AI. Hint: It’s going to be bigger than the Internet. Let’s take a look:

(1) **AI with that hamburger?** McDonald’s is acquiring Dynamic Yield for more than $300 million to create a more personalized experience for customers. The AI company’s technology will be brought to 1,000 McDonald’s locations in the next three months, and to the company’s remaining US and international restaurants over time.

The goal is to increase sales by using data about the environment and customers to determine which items to highlight on the mobile app, at the drive-thru, and at self-service kiosks. “Dynamic Yield can allow McDonald’s to take action based on information like popular items, weather, time of day, and other demand trends by using algorithms and other AI capabilities. ... The restaurant could even eventually recognize consumers’ license plates and consider their purchase histories for a more personalized experience,” a 3/28 Business Insider article reported.

After an order is taken, the program can suggest additional items in which a customer might be interested. The AI program can also help improve operations. For example, if the drive-thru is moving slowly, the menu can prioritize simple items to serve to speed up the line. Conversely, if the line is running smoothly, it can suggest more complex items. Dynamic Yield, which counts IKEA, Forever 21, and Fendi as customers, will continue to operate independently.

(2) **AI does the ordering.** Food Lion and its five related US grocery chains will use AI when ordering food from suppliers. The retailers, which are owned by Dutch company Koninklijke Ahold Delhaize, believe the system will “improve how buyers predict demand and get perishables and other products to store shelves faster,” a 3/27 WSJ article explained.

Buyers using the software can order for all six of the US grocery store brands at once. Brands include Stop & Shop, Giant Food, and Food Lion. Tests showed the system improved inventory precision and reduced the amount of extra stock kept on hand. Food moved through the distribution centers faster, reducing the amount of food that needed to be sent out to stores for quick sale because it was nearing the end of its shelf life.

“The technology incorporates functions that had been spread across multiple systems and automates some steps, such as checking inventory levels at stores and distribution centers, that can take workers several hours to perform. Algorithms update recommended order quantities daily, factoring in variables if product gets refused at the warehouse” or weather, the WSJ piece added.

(3) **Sometimes AI is evil.** The ability to use algorithms and AI to micro-target customers also has its downsides. The Department of Housing and Urban Development (HUD) accused Facebook of violating the Fair Housing Act by restricting who saw housing-related ads. HUD also asked for more information
from Alphabet, Twitter, and others about their ad systems.

HUD claims Facebook allowed ad buyers to exclude people who fit into hundreds of thousands of categories—a high-tech twist on redlining. For example, ad buyers could exclude those who expressed interest in an assistance dog, mobility scooters, or deaf culture, a 3/28 WSJ article reported. Those interested in Puerto Rico Islanders, Hijab Fashion, and Hispanic Culture could also be excluded.

Proving liability might be difficult, the WSJ noted, because laws enacted in the 1990s give online platforms immunity from liability for the actions of their users.

(4) Mark Cuban: AI will be big. In a 3/12 Recode podcast, Mark Cuban was extremely excited about the future of AI and Alexa/Google Home. First on AI, Cuban gushed: “As big as PCs were an impact, as big as the internet was, AI is just going to dwarf it. And if you don’t understand it, you’re going to fall behind. Particularly if you run a business. I mean, I get it on Amazon and Microsoft and Google, and I run their tutorials. If you go in my bathroom, there’s a book Machine Learning for Idiots. Whenever I get a break, I’m reading it. Seriously, you have to know it.”

There will inevitably be downsides, he warned. First, if the code used to design AI is in a black box, people won’t understand it and won’t know if it’s doing its job. Second, AI’s reliance on heaps of data gives large businesses and China an advantage. Large businesses have more data and more resources to learn how to use AI than do small businesses.

And China, as we’ve warned before, will have an advantage because it has tons of data and no government restrictions on privacy. “If you connect data with ever-improving processors, with ever-increasing speeds of 5G and other communication mechanisms, then there’s unlimited things that can go wrong. We’ll just have to be more vigilant,” he said.

Cuban was less worried about AI causing the disappearance of jobs, because new jobs will be created. The increasing use of robotics will mean that manufacturing will return to the US from Asia, requiring the hiring of people to maintain, manage, and monitor the robots.

CALENDARS

US. Thurs: Jobless Claims, Challenger Job Cuts, EIA Natural Gas Report, Mester. Fri: Total, Private, and Manufacturing Payroll Employment 175k/183k/13k, Unemployment Rate 3.8%, Average Hourly Earnings 0.2%m/m/3.4%y/y, Consumer Credit $17.5b, Baker-Hughes Rig Count. (DailyFX estimates)

Global. Thurs: Germany Factory Orders 0.3%m/m/-3.1%y/y, Japan Household Spending 2.0% y/y, ECB Publishes Account of March Meeting. Fri: Germany Industrial Production 0.8%m/m/-0.8%y/y, Canada Employment Change & Unemployment Rate -10k/5.8%, Japan Leading & Coincident Indexes -10k/5.8%. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (link): The Bull/Bear Ratio (BBR) rebounded this week to its highest reading since mid-October 2016. The BBR had been in a volatile flat trend the past few weeks before jumping from 2.52 to 2.75 this week; it was at 0.86 13 weeks ago—which was the lowest since mid-February 2016. Bullish sentiment has increased 11 of the past 13 weeks, by 23.5 points, from 29.9% (which was the fewest bulls since February 2016) to 53.4% this week, back near its recent high of 53.9% two weeks ago. It’s the seventh consecutive reading above 50.0%. Bearish sentiment dropped to 19.4%—the lowest since mid-November—after bouncing in a range between 20.4% and
21.5% the prior 10 weeks. Meanwhile, the correction count ticked down to 27.2% after increasing last week for the first time in eight weeks from 25.5% to 27.4%; it was at 25.5% in mid-March—which was the lowest since early October. The AAII Ratio slumped to 55.0% last week after jumping the previous week from 51.1% to 61.4%, as bullish sentiment fell from 37.3% to 33.2% and bearish sentiment rose from 23.4% to 27.2%.

**S&P 500 Earnings, Revenues, Valuation & Margins (link):** Consensus S&P 500 forward revenues rose back to a record high in the latest week for the first time since early January, but forward earnings remained 2.1% below its record high in early December. Analysts expect forward revenues growth of 5.6% and forward earnings growth of 6.1%, little changed compared to week-earlier readings. 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 10.8ppts 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 8.4% in 2018 to 5.5% in 2019 and 5.5% in 2020. They’re calling for earnings growth to slow sharply from 24.2% in 2018 to 3.6% in 2019 before improving to 11.4% 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 lower in just two of the past 13 weeks, edging down w/w to 16.5 from a five-month high of 16.6. Still, 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 late January. The S&P 500 price-to-sales ratio slipped w/w to 1.97 from 1.99, but is up from 1.75 during December. That was the lowest since November 2016 and down 19% from a record high of 2.16 in late January.

**S&P 500 Sectors Earnings, Revenues, Valuation & Margins (link):** Consensus forward revenues rose w/w for six of the 11 S&P 500 sectors, but forward earnings rose for just three. Utilities was the only sector 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 stabilize now after tumbling about 25% since early November. Forward P/S and P/E ratios are now well below their 2018 highs for all sectors, and had been at multi-year lows during December for five sectors: Energy, Financials, Industrials, Materials, and Tech. Energy’s forward P/E of 17.4 is higher than usual due to its earnings deterioration. Due to the TCJA, the profit margin for 2018 was higher y/y for all sectors but Real Estate, but that sector’s earnings includes gains from property sales, which typically are infrequent. 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 rolled over for all of the sectors. The outlook for 2019 shows lower margins are now expected y/y for 7/11 sectors: Communication Services, Consumer Staples, Energy, Health Care, Materials, Real Estate, and Tech. During the latest week, the forward profit margin fell for Communication Services and was steady for the rest. Nine sectors are down from their highs in late 2018. Here’s how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (22.0%, down from 23.0%), Financials (18.4, 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), Materials (10.5, down from 11.6), Health Care (10.4, down from 11.2), Industrials (10.1, down from a record high of 10.4 a week earlier), Energy (6.7, down from 8.0), Consumer Discretionary (7.5, down from 8.3), and Consumer Staples (7.4, down from 7.7).

**US ECONOMIC INDICATORS**

**ADP Employment (link):** “The job market is weakening, with employment gains slowing significantly
across most industries and company sizes. Businesses are hiring cautiously as the economy is struggling with fading fiscal stimulus, the trade uncertainty, and the lagged impact of Fed tightening. If employment growth weakens much further, unemployment will begin to rise,” according to ADP’s March report. Private industries added only 129,000 to payrolls last month, the slowest pace since September 2017, following an upward revision to February (to 197,000 from 183,000) and a downward revision to January (264,000 from 300,000) gains, for a net loss of 22,000. This month, service-providing industries increased payrolls by 135,000, while goods-producing industries cut payrolls by 6,000—the first decline since December 2016. Within goods-producing, construction payrolls were reduced by 6,000 and manufacturing by 2,000 last month—following gains of 699,000 and 458,000, respectively, from December 2016 through this February. (The March decline in manufacturing was the first since December 2016; construction’s was the third.) Meanwhile, the increase in service-providing payrolls was widespread, led by health care/social assistance (42,000), professional & business services (41,000), education (14,000) and leisure & hospitality (13,000). Medium-sized companies (63,000) retained the number-one spot, but barely, with large companies (60,000) a close second. Medium-sized companies’ payrolls have been slowing steadily from the 119,000 gain at the start of this year, and this last reading was the smallest gain since October 2017. Meanwhile, small companies (6,000) remained in the cellar, posting the smallest gain since September 2017.

Auto Sales (link): Motor vehicle sales in March rebounded from an 18-month low as domestic light truck sales returned to its cyclical high recorded at the end of last year. Total sales jumped nearly 1.0mu last month, climbing from 16.6mu to 17.5mu (saar), as light-truck sales climbed from 9.0mu in January to 9.8mu (saar) last month—which along with December was the fastest pace since July 2005. Domestic car sales was little changed around February’s cyclical low, at 3.8mu (saar); it has been in a virtual freefall since peaking at 6.1mu during August 2014. Sales of imports, at 3.8mu (saar), continues to fluctuate just below last May’s peak of 4.0mu—which was the strongest pace since August 2009.

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs (link): Global economic activity accelerated slightly again in March after posting its slowest growth since September 2016 in January, as the service sector rose at its fastest pace since November, more than offsetting a stagnant manufacturing sector. The JP Morgan Global Composite Output Index (C-PMI) rose to a four-month high of 52.8 from 52.6 in February and a 28-month low of 52.1 in January; it was at a 3.5-year high of 54.8 during February 2018. The Global NM-PMI (to 53.7 from 53.3) improved to a four-month high—after posting its slowest growth since September 2016 at the start of this year. Meanwhile, the Global M-PMI (unchanged at 50.6) remained at its weakest reading since June 2016. Looking at the C-PMIs, growth in the developed (52.7 from 52.9) economies virtually matched that of the emerging (52.8 from 51.6) ones—though the latter accelerated to its strongest pace since February 2018 while the former decelerated. March C-PMIs show the US (to 54.6 from 55.5) remained the main engine of growth, though its pace slowed. Meanwhile, growth accelerated in Russia (54.6 from 54.1), Brazil (53.1 from 52.6), and China (52.9 from 50.7). Weighing on the Global C-PMI was weaker growth in the Eurozone (51.6 from 51.9), Japan (50.4 from 50.7), stagnation in the UK (50.0 from 51.5), and contraction in Australia (49.5 from 49.1).

Within the Eurozone, C-PMIs for Spain (55.4, 10-month high) and Italy (51.5, 6-month high) saw an acceleration in growth, while Ireland’s (54.1, 2-month low) and Germany’s (51.4, 69-month low) showed a deceleration, with France’s (48.9, 2-month low) contracting for the third time in four months.

Global Non-Manufacturing PMIs (link): March saw the rate of expansion in the global services economy gain momentum for the second straight month, driven by an acceleration in emerging economies. JP Morgan’s Global NM-PMI (to 53.7 from 53.3) picked up along with the NM-PMI (53.6 from 52.1) for emerging economies, while the NM-PMI for developed economies was unchanged at 53.7. The report notes that the majority of the nations covered saw activity increase during March, with
Spain (56.8, 13-month high) and Germany (55.4, 6-month high) in the top two positions; Ireland (55.3, 2-month low) and the US (55.3, 2-month low) tied for third, though both showed softer growth. Meanwhile, growth improved in the Eurozone (53.3, 4-month high) as a whole, China (54.6, 14-month high), and Brazil (52.7 from 52.2)—with the latter matching its fastest growth in over six years—while growth slowed slightly in Japan (52.0, 2-month low).

**US Non-Manufacturing PMIs** (link): Both the ISM and IHS Markit measures show growth in the US service sector slowed in March, though still expanded at a robust pace. ISM’s NM-PMI (to 56.1 from 59.7) slowed to a 19-month low, though according to the report, “Respondents remain mostly optimistic about overall business conditions and the economy. They still have underlying concerns about employment resources and capacity constraints.” Of the four components, only the employment (55.9 from 55.2) gauge accelerated, though barely. Meanwhile, both the business activity (57.4 from 64.7) and new orders (59.0 from 65.2) measures fell back below 60.0 after soaring above in February—remaining at elevated levels. The supplier deliveries component (52.0 from 53.5) has fluctuated just north of 50.0 the past four months, averaging 52.1. IHS Markit’s NM-PMI (55.3 from 56.0) also showed continued robust growth, despite March’s slowing. According to the report, “The rate of expansion was broadly in line with the series average and rounded off a strong start to 2019. The first quarter average signaled the fastest service sector output growth since the second quarter of 2018. Moreover, March data indicated the second-quickest upturn in business activity since July 2018, with firms linking this to robust client demand.”

**Eurozone Retail Sales** (link): Retail sales rebounded the first two months of this year to within 0.1% of November’s record high. Sales for February advanced 0.4% after a revised 0.9% (from 1.3%) increase during January and a 1.4% drop in December. Sales of non-food products (excluding auto fuel) recorded the biggest gain in February, and over the two-month period, rising 0.9% and 2.5%, respectively, to a new record high. Sales of food, drinks & tobacco edged up 0.1% during each of the past three months, nearly reversing November’s 0.4% decline, and is only fractionally below its cyclical high. Meanwhile, sales of automotive fuel contracted 0.7% in February after jumping four of the prior five months by 3.0%. February sales are available for three of the four largest Eurozone economies, with Germany (0.8% & 3.8%) and Spain (0.7 & 1.2) posting impressive gains in both February and over the first two months of this year—with the former soaring to a new record high. Sales in France remain volatile around August’s record high, dipping 0.1% in February, following a 0.3% gain and a 0.8% loss the prior two months. Among the Eurozone countries for which data are available, the largest increases in retail sales were registered in Belgium and Latvia (both up 1.6%); the largest decreases were observed in Slovakia (-1.5) and Portugal (-1.0).