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The healthcare sector is currently grappling with significant changes including political shifts, macroeconomic pressures, and structural changes. As a result of this uncertainty, it has recently underperformed relative to broader markets, with five of the past six years producing lower returns compared to the S&P 500. Most recently, this underperformance versus the broader markets has widened, with the sector lagging the S&P 500 by 2200 basis points in 2024 alone.

Despite this underperformance, healthcare offers compelling long-term opportunities, particularly in leveraging artificial intelligence (AI) to transform the sector. As investors navigate these uncertainties, it is important to balance short-term risks while maintaining a focus on the sector's undervalued growth potential.

### ➤ Current Major Concerns

#### 1. Political and Regulatory Shifts:

- The incoming administration is expected to play a transformative role in healthcare policy, raising concerns about sweeping regulatory changes. Shifts in funding priorities may influence which diseases receive government focus, affecting approval schedules and financing for emerging technologies and treatments.
- Weight-loss drugs, such as GLP-1 therapies highlight how policy skepticism might hinder growth in addressing critical public health needs. These drugs, while addressing critical public health concerns, face resistance from government funding, with suggestions that patients find alternative, non-drug weight-loss methods.
- Potential changes to Medicaid and Medicare policies could increase pressures on hospitals, managed care organizations, and the broader healthcare system.

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#### 2. Economic and Market Dynamics: Interest Rates and Sector Weight Trends

- Rising interest rates over the past few years have amplified investor concerns, particularly within high-risk, money-losing subsectors such as biotech and specialty pharmaceuticals. This created valuation pressures and fueled skepticism about the sector's near-term prospects.
- The increase in interest rates also raised concerns about funding for small health care companies both through bank loans and venture capital firms. In addition, venture capital funding has been held back by a lack of exits with existing portfolio companies.
- The shift of investor focus to the technology sector, particularly AI, has compounded valuation challenges and funding concerns for healthcare. However, the integration of technology and AI in healthcare offers opportunities for innovation-focused companies to regain investor interest.

### 3. Challenges in Key Sub-Sectors

- **Microcap pharmaceuticals and biotech:** These companies struggle with limited institutional backing and waning investor interest in early-stage development stories. As a result, many struggle to secure the funding needed for clinical trials and commercialization.
- **Vaccines:** The focus on innovative therapies has reduced interest in legacy vaccines, straining revenue for established players.
- **Contract Research Organizations (CROs):** Rising clinical trial costs and tougher reimbursement environments weigh heavily on these companies, which are integral to drug development.

## ➤ Drivers of Long-Term Resilience

### 1. AI in Healthcare

The integration of AI in diagnostics is rapidly transforming the sector:

- AI-driven tools enable faster, more accurate drug development and decision making. Industry estimates show that drug development time could be reduced from years to months with better efficacy as well as increased efficiency.
- AI-driven personalized medicine and advancements in diagnostics and service management may finally help reduce healthcare costs.
- These factors could not only reduce the cost burden on healthcare but could also improve patient outcomes.

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### 2. M&A Activity

- Consolidation remains a bright spot, particularly in biotech. Robust pipelines promise significant advancements in oncology, diagnostics, and AI-integrated treatments.
- Expectations for increased deal activity into 2025 add to the bullish case for this subsector.

### 3. Regulatory Support

- Recent regulatory nominees have expressed intentions to expedite approval processes.
- An increase in FDA approval highlights a favorable trend for innovation, with new therapies and devices gaining market access at an accelerated pace.



4. Historical Resilience

- The sector’s ability to recover from past downturns offers optimism. For example, healthcare’s recovery following the dot-com bubble highlights its ability to adapt and thrive during challenging periods.
- The sector remains under-owned by investors, particularly growth focused ones, creating opportunities as its performance rebounds.

Conclusion

The healthcare sector sits at the crossroads of uncertainty and opportunity. Political and regulatory shifts, interest rate pressures, and competition from other sectors present near-term challenges. Yet, these very dynamics create openings for innovation, M&A activity, and small-cap growth to lead to the sector’s recovery.

For investors, the path forward lies in balancing caution with strategic focus. By focusing on undervalued opportunities and leveraging the transformative potential of AI and innovation, the healthcare sector’s long-term potential becomes clear. Now is the time to look beyond the headwinds and selectively invest in healthcare’s future.



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