The Equipment & Supplies industry is poised to benefit from U.S. resilience corresponding with a recovery regime, in addition to the secular intersection of innovation and demographics. Meanwhile, Providers & Services, especially health insurers, face mounting challenges as a generational "perfect storm" of regulatory tailwinds reverses.

We are upgrading Equipment & Supplies to overweight and downgrading Providers & Services to underweight, in a long/short pair-trade to capture these shifts. U.S. elections in November represent a natural catalyst, with a Republican lean in Washington likely to further reinforce the expected divergence.

ALPINEMACRO
A Unique Mind On The Markets

EQUITY STRATEGY

October 23, 2024

Healthcare: Equipment Checks Out, Providers To Infirmary

The Equipment & Supplies industry within Healthcare is in unique position to benefit from the cyclical tailwind of U.S. economic resilience alongside the secular intersection of innovation and demographics. Meanwhile, Providers & Services should remain under pressure as the tide goes out from what was a lucrative "perfect storm" of regulatory intervention.

We advise investors overweight S&P 500 Equipment & Supplies and underweight Providers & Services.

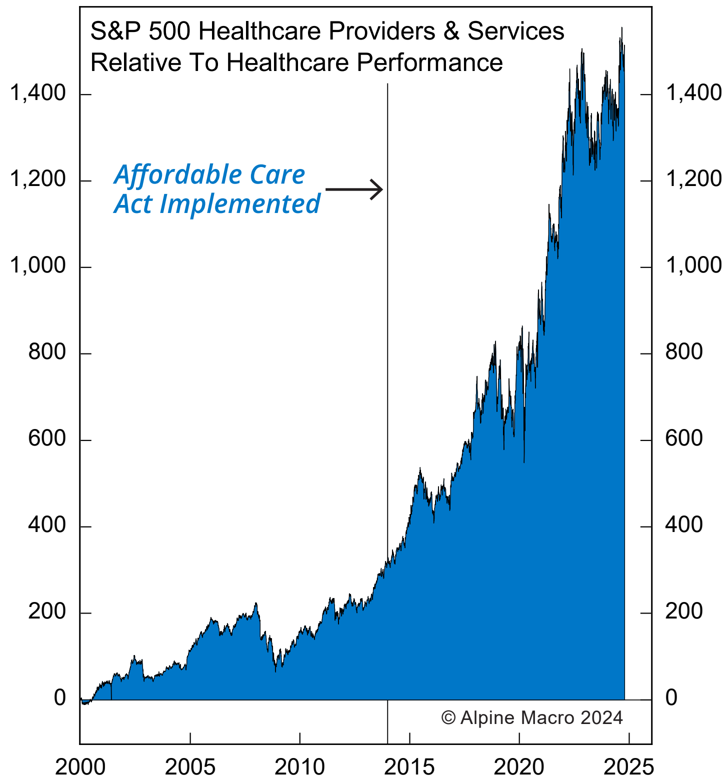
Not Your Traditional Defensive

Healthcare is often regarded as a traditional defensive sector, however the nuances that provide for those characteristics differ across time periods and industries.

Since 2000, the big winner within Healthcare has been the Providers & Services industry which is overwhelmingly comprised by health insurers. However, gains in the space have been less about countercyclicality or resilience and more about the coalescence of transcendent regulatory and demographic factors that have largely played themselves out.

As **Chart 1** shows, 61% of the relative outperformance for Providers & Services has accrued since 2013 which represented an inflection point given a major expansion of government involvement in the U.S. Healthcare system.

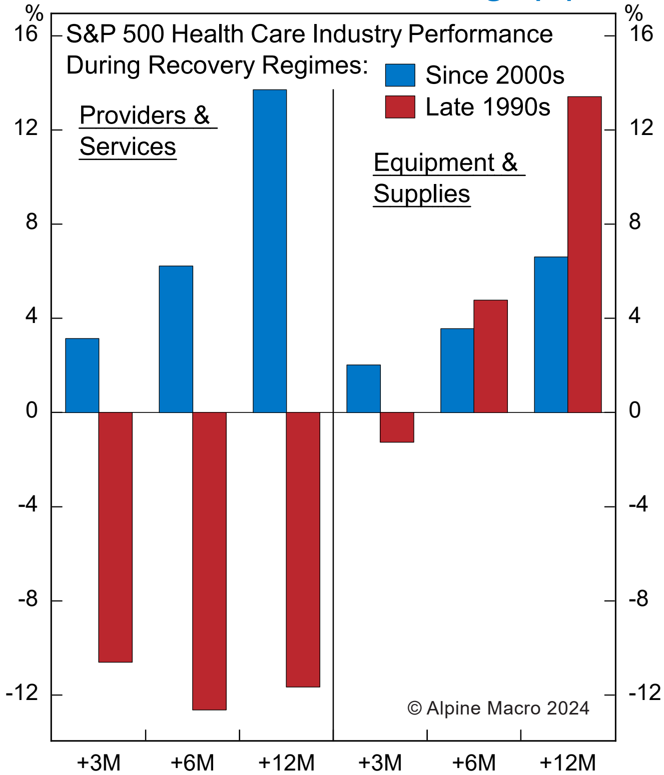
Chart 1 Government Initiatives Drives Providers Outperformance



Back To The 90s?

The Providers & Service industry was largely "dead money" in the 1990s as sources of innovation and more cyclicality surged, including Equipment & Supplies. Companies within this industry tend to be the "earners" of the Healthcare spend cycle as opposed to the "payers." While the "payers" benefit as the number of insured members increases and the mix-shift of procedures is less expensive, the

Chart 2 Expect 90s Style Recovery Performance Benefiting Equipment



Note: Recovery regimes are defined as periods of easing policy & strengthening profit

"earners" thrive when procedures ramp up and innovation prompts investment into new tools.

In our view, the current "recovery" regime characterized by easing policy with broadening profit growth— and buttressed by Mega Tech "Mania" candidates— promotes a backdrop most akin to the late-90s as opposed to the past two decades. This will benefit the innovation-rich and cyclically oriented Equipment & Supplies industry relative to Providers, which outperformed in recent decades largely off idiosyncratic forces set to stall.

Chart 2 shows Equipment & Supplies strongly outperformed Providers & Services during the Recovery periods of the 1990s, prior to the idiosyncratic supports of the last 20 years.

Investors are in the early stages of realizing this gap in opportunity, with Equipment & Supplies outpacing Providers & Services by 10% since August, yet there's more room for the dispersion to run.

Time To Turn On Ailing Insurers

The market has begun to digest the realization that the "carrot" for insurers related to certain federal government programs is wearing off with the "stick" left to cram down revenues and profits. The shift is broken into two components:

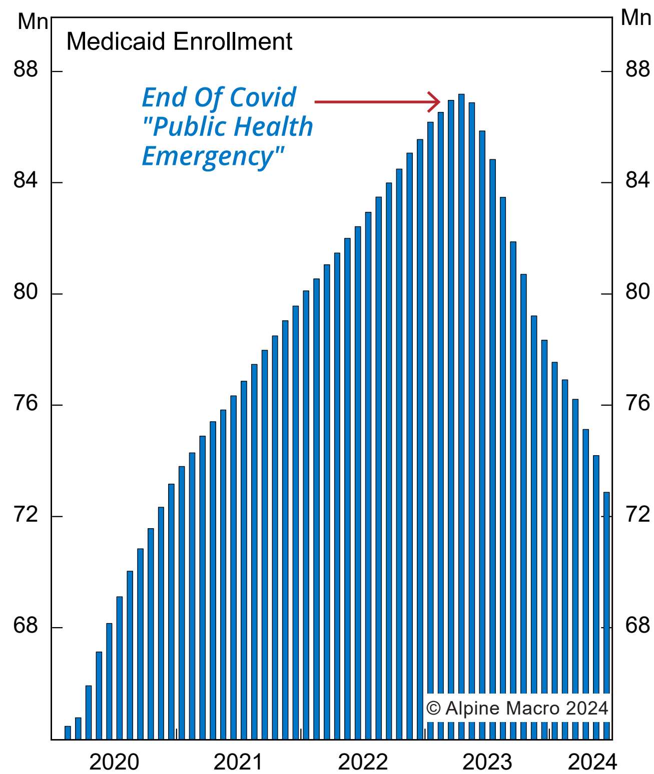
1. The insured pool is shrinking as Medicaid eligibility is enforced and the labor market weakens

Commercial plans are generally more profitable for insurers however the sheer increase in volume of enrollment through Medicare (elderly) and Medicaid (low-income, youth) propelled a decade of strong growth for industry. Since 2014, the enrollment of Medicare and Medicaid has grown by 24% while the overall U.S. population has grown by just 5%.

The two main catalysts powering government insured gains were the Affordable Care Act (ACA), which expanded eligibility to prime-age individuals without disability in 2014, and the Families First Coronavirus Response Act (FFCRA) of March 2020. The latter waived eligibility enforcement until the public health emergency was declared over in March 2023. Medicaid enrollment surged by 35% during that timeframe. It's declined by 16% since, as states begin to enforce eligibility requirements (Chart 3).

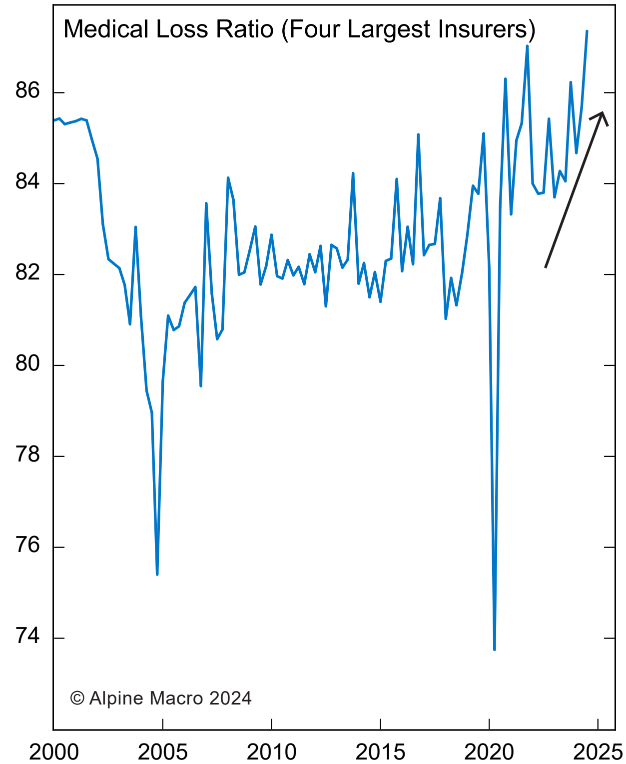
The losses to federally subsidized insured pool are compounded by a cyclically weakening labor market, putting downward pressure on the rolls

Chart 3 The Return Of Eliigibility Requirements Have Cratered Medicaid Enrollment



Source: KFF

Chart 4 Medical Loss Ratio Has Reached All Time Highs



Source: Bloomberg Finance L.P.

of the most profitable insured segment. We don't expect the labor market to materially weaken further but a reacceleration is not yet in sight.

2. Payments to policyholders are rising faster than premiums

Insurers enjoyed a boom period of premium intake outpacing the benefits paid out during COVID as: 1) patients avoided elective procedures and more expensive treatment plans, and 2) federal programs boosted the reimbursement rate to states that expanded Medicaid to previously uncovered individuals.

This latter point introduces a degree of moral hazard. The ACA provides that the federal government reimburse 90% of states' expenditures for Medicaid expansion enrollees, disincentivizing states from efficiently managing costs. The pandemic-era American Rescue Plan doubled down on federal assistance, offering states that expanded Medicaid a two-year, 5% increase in reimbursement share for new non-expansion enrollees. As this sunsets, states foot an increasing share of the bill prompting them to cram down prices and profits for insurers.

Meanwhile, a massive mix-shift is taking place in the acuity of Healthcare needs with greater patient utilization of expensive procedures and drugs than insurers projected. Costs for treatment are increasing at 3-5x historical averages, far outpacing rates contracted at the state level on stale data which puts major stress on the benefit expense ratio for insurers.

Finally, elements of the Inflation Reduction Act promote increased prescription drug utilization which accelerates in 2024 and settles in 2025. There will be some amelioration as rates reset in coming periods, but the timing vulnerability is likely to persist in the immediate term.

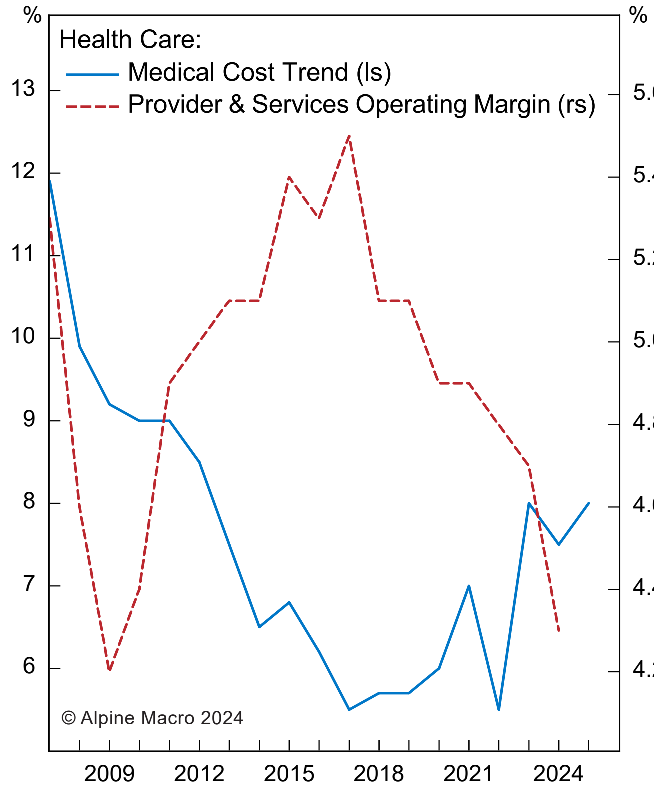
Chart 4 shows the medical loss ratio, or % of premiums paid out in benefits, of U.S. insurers while Chart 5 shows the inverse relationship between medical cost trends and insurance margins.

Bottom Line: Health Insurers are moving into a bust period following a boom produced by a perfect storm of federal intervention. Technicals appear washed out so there's potential for slight short-term relief, but a fundamental inflection point is unlikely until the mid-point of 2025 when renewal rates "catch up" with cost increases. Insurers slightly mitigate pressure by pushing efficiencies through value-based initiatives and A.I. deployment.

Equipment & Supplies: Mega Tech Of Healthcare

The Equipment & Supplies industry is in unique position to benefit from the cyclical tailwind of U.S. economic resilience alongside the secular intersection of innovation with demographics. While valuation is extended based upon the current consensus outlook, the potential for any incremental improvement in Europe or Asia would present a meaningful upside surprise.

Chart 5 Costs Up = Insurance Margins Down



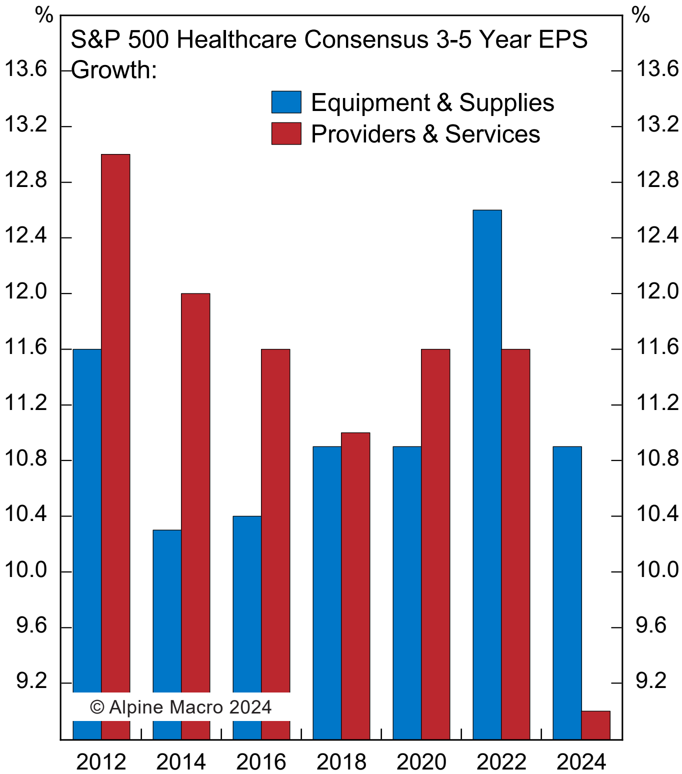
Source: PwC, Bloomberg Finance L.P.

Chart 6 shows the faster growth rate of Equipment & Supplies relative to Providers.

The fundamental drivers of Equipment & Supplies involve the demand for procedures utilizing relevant products in addition to the capital spend cycle of care providers.

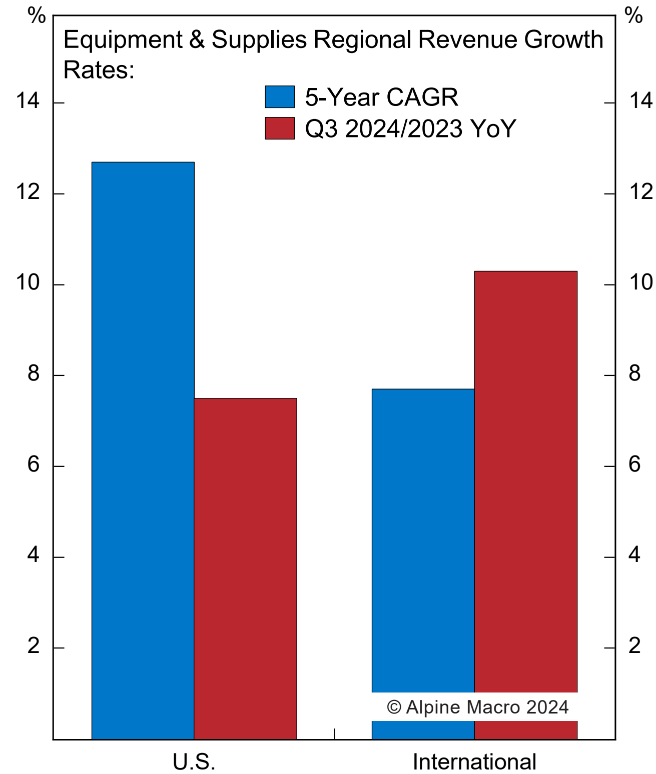
Procedure demand involves cyclical elements influenced by macro effects in addition to the slower burn of demographics, which acts as a throttle to medical interventions. Additional consideration must be paid to regulation including the approval and/or reimbursement of certain devices on a regional basis, governing the deployment of new technologies which could be major drivers of revenue and efficiency.

Chart 6 Expected Growth Stalling For Providers Relative Equipment & Supplies



Source: Bloomberg Finance L.P.

Chart 7 Unexpected International Recovery Would Boost Equipment Revenues



Note: Inclusive of top four companies by market cap; source: Bloomberg Finance L.P.

The current demand outlook is slightly supportive with much greater upside potential relative to downside, as the U.S. economy exhibits surprising resiliency while end markets in Europe and Asia remain weak and are lagging in the regulatory approval of novel equipment packages critical to major components of the S&P 500 Equipment & Supplies market cap.

In sum, the industry is thriving even as its yet to fire on all cylinders. Eventual improvement in the macro backdrop of these regions, with consideration of exciting new innovations moving through the regulatory pipeline, should be a tailwind.

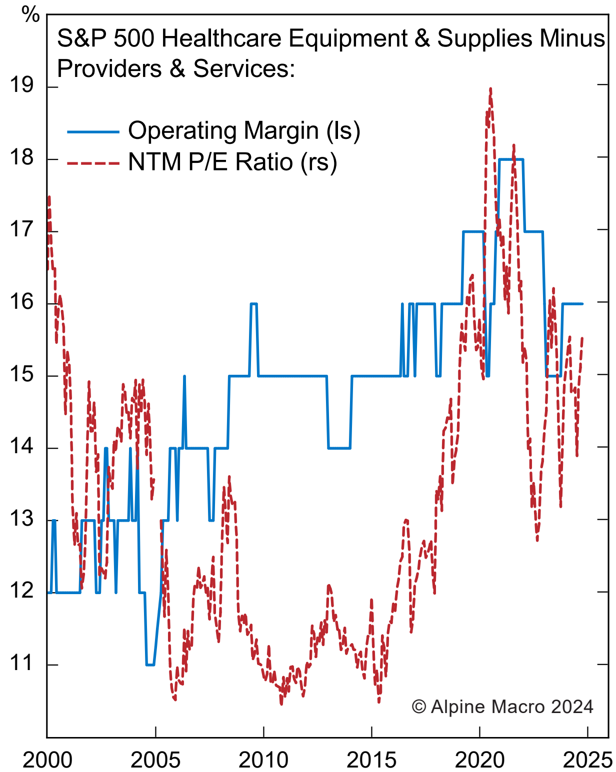
Chart 7 shows the dispersion in revenue growth rates for the U.S. segments of large Equipment & Supply companies relative to international growth.

Lower Rates And Secular Tailwinds For Equipment

Lower rates in advanced economies should provide an assist, by stimulating procedural demand and also by lowering the cost of capital funding providers' spend cycle. With the selling cost of certain robotic surgical devices averaging close to $1.4mn, the ability to lease or purchase systems at lower borrowing rates is a major boost.

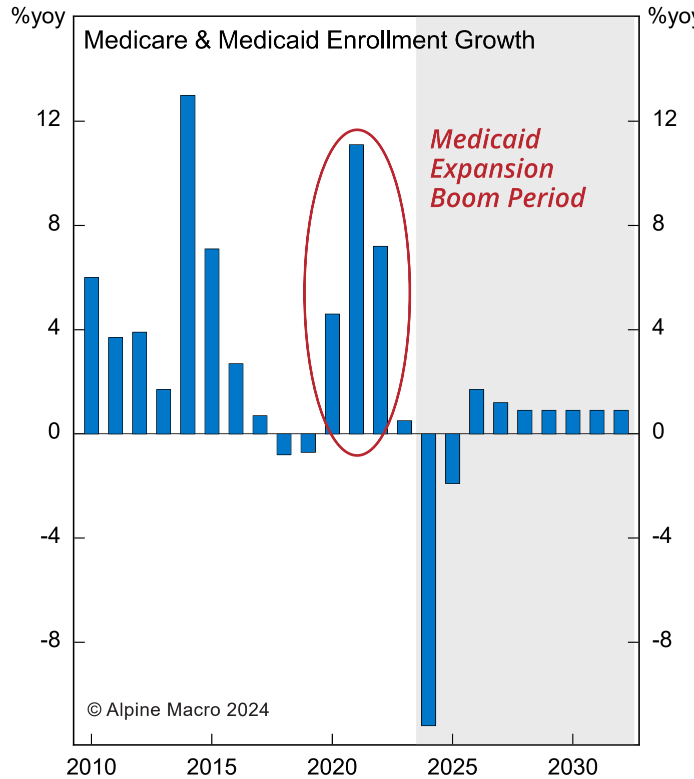
Finally, two secular trends further support the growth outlook for Equipment & Supplies: 1) aging demographics require more frequent and expensive interventions, and 2) the theatre of the administration of health procedures continues to evolve, with a shift away from large hospitals towards a cheaper

Chart 8 Equipment Is Expensive But Brings Greater Profitability



Source: Bloomberg Finance L.P.

Chart 9 Enrollment Growth In Public Health Programs Is Tapering Off



Note: Shaded area denotes estimate period; source: Centers for Medicare & Medicaid services

but larger footprint of smaller ambulatory surgical centers ("ASCs") which necessitates more supplies and equipment.

The risk for Equipment & Supplies is in a scenario where investors become more discerning of valuation and growth multiples, given the aggressive growth assumed within analyst models. It's important to note, however, that these companies are very profitable and of high quality, which sets a high fundamental floor for any potential downside.

Chart 8 illustrates that valuation is extended for Equipment & Supplies relative to Providers, although its justified by higher profitability.

Election Impact

The likelihood of consequential Healthcare legislation changing is best evaluated through the lens of popularity, practicality, and price(cost). Given these considerations it's highly unlikely that the basic contours of the ACA or certain provisions within the Inflation Reduction Act, such as limiting out-of-pocket drug costs for Medicare in 2025, are dismantled.

However, a Trump presidency and/or Republican control of Congress is likely to resist anything resembling price controls while promoting domestic R&D and manufacturing. This would favor Equipment &

Table 1 Presidential Election Results Will Have A Varied Impact

Health Program	Harris Proposals	Market Impact	Trump Proposals	Market Impact
Affordable Care Act	Increase subsidies Reinstate reinsurance to providers	+ : Insurers, Providers, Discretionary, Staples	Allow subsidies to expire (2025) Allow risk pooling	- : Discretionary, Staples, Insurers, Providers
Medicare	Copay limits Out-of-pocket drug limits Drug price negotiation ramp-up	+ : Discretionary, Staples - : Biopharma, Insurers	Some copay limits International drug pricing Expand Medicare Advantage	+ : Insurers, Equipment & Supplies, Biopharma
Medicaid	Enhance federal reimbursement Expand eligibility Family planning coverage	+ : Insurers, Providers, Discretionary, Staples	Enforce eligibility/work requirements Reduce reimbursement/ cap fed funding	- : Insurers, Providers, Discretionary, Staples
Other	Out-of-pocket limits Eliminate medical debt Long-term care & contraceptives	+ :Providers, Discretionary, Staples, Senior Housing	Limit gender affirming care coverage	

Supplies. Alternatively, Republicans have a track record of not bolstering elements of the ACA when given the opportunity, hampering the program through omission which is a headwind for Providers & Services as this limits the ranks of the government insured (Chart 9).

A Harris presidency likely entails further efforts to expand the breadth of government provided Health-care through eligibility requirements, enforcement, and federal subsidies. It may also include additional price controls. This would likely boost Providers & Services while potentially putting downside pressure on Equipment & Supplies as payment for procedures becomes regulated down.

Finally, tariffs and taxes are wildcards. Higher tariffs risk weak international trade activity, of which Providers are much more insulated relative to Equipment. Alternatively, higher taxes and a shift back towards a territorial international regime would be a headwind for Equipment.

In Table 1 we map out impacts of perspective Harris and Trump administrations on major health programs.

Conclusion

We favor a long/short position in the S&P 500 Equipment & Supplies industry relative to Providers & Services given our view that the secular tides are shifting away from insurers in favor of innovation, while a cyclical upswing should provide unappreci-ated tailwinds for procedure demand.

The U.S. election is likely to have acute affects on this industry pair-trade. A Republican lean in D.C., as our Geopolitical Service considers slightly more probable, is favorable for our position.

From an implementation perspective, we favor expressing these views through the cap-weighted benchmark although we provide similar ETF alternatives, as well.

Long: S&P 500 Healthcare Equipment & Supplies: ABT, ISRG, SYK, BSX, MDT, BDX, EW, GEGC, IDXX, RMD, DXCM, STE, ZBH, COO, HOLX, BAX, PODD, ALGN, SOLV, TFX

(ETF: XHE US Equity)

Short: S&P 500 Healthcare Providers & Services: UNH, HCA, ELV, CI, CVS, MCK, COR, CNC, HUM, CAH, LH, MOH, DGX, UHS, DVA, HSIC

(ETF: IHF US Equity)

Nick Giorgi
Chief Equity Strategist

Investment Recommendations				
Strategic Recommendations (6 - 12 months)				
Recommendations	**Open Date**	**Performance**		**Active Return**
		Vehicle	**S&P 500**	
Long S&P Industrials	5/29/2024	12.85%	10.55%	2.30%
Long S&P Utilities	6/12/2024	17.34%	7.40%	9.94%
Long S&P 600	6/24/2024	8.61%	6.86%	1.75%
Short S&P Materials	7/24/2024	7.16%	7.29%	0.13%
Long Regional Banks (KRX)	8/21/2024	4.78%	3.57%	1.21%
Long/Short S&P 500 Healthcare Equipment & Supplies/Providers & Services*	10/23/2024			

*New trade

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