April 19, 2021 - Market Overview and Pharm/Med-Tech Sector Update

BMO Nesbitt Burns

Week in **Review**

BMO Wealth Management
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Year to Date Market Overview:

The TSX, now up 10.9% YTD has equaled the Tech dominated US S&P 500, also up 10.9% (9.3% in C$) due to the strength of the C$. The TSX 's financial sector representing (35% by market cap) was up 14.4%, while the smaller yet influential Energy sector (7% of the index) was up 32%. This more than offset the more modest +7% info-tech sector gain (11% of the index) where most notably, Shopify was up 5% YTD.

The US dominant Tech sector while lagging in Q1, gained 9% while industrials, energy and banks all logged double digit gains. The $1.9T Covid relief package is now passed and the proposed $2.3T infrastructure packages being proposed in the US, combined with faster than expected recovery in GDP growth, have particularly benefited the economically sensitive and financial sectors. The steepening yield curve (higher long term yields vs. short term yields) due to inflation fears is especially beneficial to the banks allowing higher profit margins. Conversely the higher long term yields are viewed as negative for the richly valued Tech stocks as future earnings get discounted at a higher rate, lowering the present value of the business. We should note that the Tech sector remains very healthy with high growth rates but the rise in share prices may slow from recent years as the valuations are still at the high end and likely facing further headwinds if interest rates rise further. The Pharma sector has been flat in 2021, despite high profile vaccines in wide use and an improving economy. We discuss the Pharma sector in more detail below but note that valuations remain reasonable and historical returns have been solid.

The rapid rise in bond yields with the 10 year US Treasury yield jumping from 0.90% (end of 2020) to now 1.5% and similar trends in Canada, has made returns in the bond markets all negative YTD. Furthermore, the expected additional shots of government spending both in the US and Canada and rebounding economic growth suggest longer term interest rates will continue to rise. As such it is hard to see significant returns in bonds for the next several years. Conversely preferred shares have rebounded higher this year with the index tracking ZPR ETF, up 11% as the rate reset prefs that dominate the market benefit from now higher yields on reset dates which occur every five years.

Portfolio Positioning:

We are fully invested in our equity allocations with a slight overweight in Canadian equities due to the more attractive valuation vs. the US markets. As well we are slightly underweight Tech and Tech like stocks with no Tech holdings in Canada, preferring the major US Tech names instead.
On fixed income we have reduced longer term bond holdings and increased preferred share exposure as rising interest rates are negative for longer term bonds while positive for rate reset preferred shares. The bonds we hold are all short duration bonds or cash to minimize the effect of rising rates.

Pharma/Med-Tech Sector Overview:

We continue to view pharma as an attractive sector for investment with demand for drugs growing worldwide and new improved drugs being developed on a continual basis. All of the leading pharma companies are global in nature and financially very strong. Healthcare represents 15% of the US S&P 500 and there are no Canadian healthcare/pharma names that we would recommend. We note that most of the leading names have 50% or more of their sales outside the US and should get an additional tailwind if the US$ declines against other world currencies. One area of concern is the political pressure for pharma companies to lower their prescription drug costs as leading Democrats are critical of the high drug costs in the US. While the margins are very high (in the 70%+ range) for these drugs, they are argued to be required to induce the high risk of developing and approving new drug treatments.

We note that valuations remain modest as can be seen in the schedule below of the leading Pharma companies and in contrast to the Tech sector all companies (except Medtronic) have p/e's below the market

Thomson/Boomberg estimates			Current	5 Year	Ann.	Ann.		%	2020	2021	2022	2023	2024	2021	2022	2023	2021- '24
15-Apr-21	Symbol	Pr. Tg.	Price	Ann. Returns	High	Low	Mcap	Yield	eps	eps	eps	eps	eps	p/e	p/e	p/e	EPS Gr.
Pharma\MedTech				From													
				Dec. 31, 2015													
Johnson & Johnson	JNJ-US	185	160.51	**11.7%**	173.7	133.7	423	2.52	8.03	9.51	10.31	10.96	11.65	16.9	15.6	14.6	**7.4%**
Abbvie	ABBV-US	122	106.79	**16.9%**	113.4	79.1	188	4.87	10.56	12.46	13.88	12.09	11.48	8.6	7.7	8.8	**-1.5%**
Merck	MRK-US	96	76.57	**10.5%**	87.8	71.7	194	3.40	5.94	6.57	7.31	7.56	8.24	11.7	10.5	10.1	**7.3%**
Medtronic (FYE 04/30)	MDT-US	133	125.81	**11.8%**	124.9	87.7	170	1.84	4.59	4.34	5.72	6.37	8.86	29.0	22.0	19.8	**21.2%**
Novartis (in SF's)	NVS-N	105	87.20	**4.9%**	98.5	77.0	215	3.87	5.78	6.35	6.77	7.30	7.58	13.7	12.9	11.9	**7.2%**
Pfizer	PFE-US	41	37.65	**7.7%**	43.1	30.0	210	4.14	2.22	3.32	3.03	3.10	3.35	11.3	12.4	12.1	**-3.4%**
Bristol Myer Squibb	BMY-US	75.94	64.59	**1.5%**	67.16	54.07	144	3.04	6.44	7.49	8.03	8.45	8.52	8.6	8.0	7.6	**6.2%**

Johnson and Johnson:

JNJ is the largest and most diversified of the major US Pharma names. Its pharmaceutical offerings account for 61% of profits, medical devices and diagnostics make up 29%, followed by consumer products at 10%. JNJ's drug offerings cover a broad spectrum including immunology, infectious diseases, neuroscience, oncology and cardiovascular applications, while its Med-Tech division includes cardiovascular, diabetes, vision care and orthopaedic devices. Lastly, its consumer business comprises of baby care, oral care, beauty and women's health products. JNJ reported positive Q4 results with organic pharma revenue growing 5%, a 7% growth in medical devices and a slightly negative consumer sales growth.
JNJ's growth will continue to be driven by its broad suite of existing and developing drug offerings. Of note its oncology division, representing 20% of its pharma revenue, grew 37% last year. As one of only 2 US companies to retain a AAA credit rating, JNJ's financial strength and ability to ride out difficult markets is unmatched. Its dividend payout ratio of 43% (of earnings) is easily sustained so we would expect to see dividend growth in the 5%+ range as earnings grow. JNJ's multiple on 2021 eps of 17x's, is in line with historical ranges. We note that JPM has a $175 target, somewhat lower than the consensus $185. In 2020 JNJ provided a 11.3% total return (including dividends) and an average 11.7% annualized return over the past 5 years. In 2021 JNJ also had a boost from the approved 1 shot vaccine that it developed, although now halted in the US although it is not a major earnings item, in the context of JNJ's overall business. **We continue to hold JNJ in our model Portfolio and would add on weakness.**

Medtronic:

Medtronic is one of the largest medical technology providers globally with 53% of its sales in the US It is a leader in four areas, based on revenue as follows:

- Cardio vascular (Arrhythmia and heart valve replacement) 36%
- Respiratory, Gastrointestinal and Renal 30%
- Brain and spinal related 27%
- Diabetes related 7%

Medtronic revenues were hard hit because of reduced elective surgeries during the Covid shutdowns, however with the reopening in the US and elsewhere calendar 2021 (fiscal 2022) should see a return to normal and strongly growing earnings off a still low FYE April 30 2021 base. Valuations while high on a trailing basis are forecast to return to the 20 p/e range by Calendar 2022 (Fiscal 2023). With a forward p/e of 20x's, a broad suite of proprietary products, and strong forward looking growth rate we note that JPMorgan has a positive view of Medtronic and we plan to stay invested in this name in our model portfolio.

Merck (MRK):

Merck is a leading US and global provider of a broad suite of drugs covering cancer, diabetes, cholesterol, hepatitis, HIV, vaccines for infectious disease and animal health drugs. Merck's leading cancer treatment drug, Keyruda, representing 32% of current revenues is considered the key to Merck's future growth At a current valuation of only 12x's 2021 eps and an 8%+ growth outlook, combined with a 3.4% yield we see Merck as

attractive at current prices. Having said that, we acknowledge that Merck's business is more concentrated than that of JNJ, and therefore would hold it as a secondary (smaller) position. JPMorgan is particularly positive on Merck, given further tests reinforcing the benefits of its cancer fighting Keyruda drugs. JPM forecasts a 7% topline growth and a 21-23 earnings growth of 11%. Their price target of $105 is above the $96 consensus as they forecast higher growth than the consensus. Given this strong growth outlook, solid yield of 3.4% and modest valuation of 11.7x's 2021 eps, we would add Merck as a Pharma position in our Portfolios.

Other Pharma names:

We have not reviewed in detail updates to the other pharma names in the schedule and have not held these names as core holdings in the last few years. *While Novartis (reported in Swiss Francs) and Pfizer have shown decent returns over the past 5 years; they have not outperformed the names in our model portfolio. Moreover, Bristol Myers Squibb has shown poor performance in this same time frame.*

In summary we plan to keep JNJ and Medtronic as core pharma/medtech positions and would add Merck as a secondary position.

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Sources: Bloomberg, JP Morgan, Thomson & BMO Nesbitt Burns research

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