

Subject: FW: US Equity Insights - Rx for healthier productivity
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Sent: Sunday, September 25, 2016 5:06 PM
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Subject: US Equity Insights - Rx for healthier productivity

Deutsche Bank - Equity Research - North America

US Equity Insights - Rx for healthier productivity
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Download the complete report: <http://pull.db-gmresearch.com/p/2003-9E1F/-96505735/0900b8c08bc6470e.pdf>

Necessity is the mother of invention: US healthcare needs more productivity

If the US is to improve its labor productivity, it must do so in the largest and fastest growing segment of its economy: Healthcare. We think Medical Drugs & Devices have the best chance to boost productivity of healthcare workers and US labor broadly. We're encouraged that more productivity enhancers will be found by the high R&D spending at S&P Biotech, Drugs & Devices. This R&D is one of the few areas where US investment is strong and the good ROEs and sales growth at these firms suggest that it is value added to both company and customer alike. In a world where investors prize dividends and politicians prize populism, we hope the value of this R&D investment is appreciated.

Life is the economy and health is wealth: Healthcare's forever rising GDP share

From food & shelter to health & longevity, and all the experiences in

between, the economy is about improving life. Whatever the trend pace of GDP growth, the healthcare trend will be stronger. Healthcare is now 16% of US GDP and 23% of PCE with solidly above average mid single-digit growth and about 14% of jobs. This means that HC firms will have a better opportunity than most to invest for growth, but growth in their profits will still be a function of the returns earned on investment. About 80% of healthcare spending is towards practitioners, facilities and other services and about 20% toward drugs, devices and equipment. We expect the share of medical drugs, devices and equipment of total HC spending to rise; driven by a kind of intangible capital deepening similar to increased tangible capital seen per manufacturing worker. Like industrial and info tech capital goods producers in the past, we expect producers of better healthcare tools to earn attractive returns on investment.

R&D: An accountant's expense, an optimist's high risk/high reward investment

US GAAP still requires expensed R&D, however gov't reports (BEA) treat it as intangible investment, which is now 20%+ of US investment ex. construction and the fastest growing piece. This note identifies the highest R&D spenders in the S&P and compares this to sales, non-GAAP net income, ROEs & PEs. We don't advocate adding back R&D to profits, as much R&D is maintenance R&D, required to support existing profits into perpetuity, but where R&D is high and ROE is high, we think a significant part of the R&D is value enhancing investment that warrants a PE multiple well above steady-state (1/real CoE).

S&P industries and stocks where R&D & ROE are high and the PE is under 22

S&P industries that stand out with high R&D/sales and high ROE include: Biotech, Pharmaceuticals, HC Tech, HC Equipment & Supplies, Life Science Tools, Software, Internet Services, IT Services, Internet Retailing, Auto Components, and Aerospace & Defense. On page 7, we provide a basket of 28 stocks (DBUSHRRD) with: R&D > \$3bn or R&D/sales > 6%, ROE > 18%, PE < 22, 2016 EPS growth > 0%, 2016 sales growth > 0%, debt/mkt cap < 50%.

Unless tax cuts appear on the horizon, we favor Health Care & Tech (GARP)

Despite higher Dec Fed rate hike chances, Banks 2017 EPS outlook continues to deteriorate given the further fall in expected 2017 avg FF rate and ~1.6% 10yr yield. Existing and potential oil supply suggests that prices struggle to avg above \$50/bbl in 2017. Energy is trading at ~25x its likely EPS at \$55-60/bbl oil. Recent macro data suggests growth will be very slow at both S&P Consumer sectors and Industrials in 2H16. Unless large fiscal stimulus w/- tax cuts appears on the horizon, we favor growth stocks at a reasonable PE over cyclicals.

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