The Weekly Letter

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- **A Recovery for Health Care:** Among equity sectors, Health Care hasn't performed as anticipated since the election, turning in the second worst-performance. We see significant long-term tailwinds, however, in innovation and new product development and in the inexorable aging of the world's population. We believe U.S. drug pricing, while not perfect, works better than many perceive in rewarding innovation and allowing competition to lower prices. We do see risks, including efforts to repeal or replace the Affordable Care Act and an increased level of leverage.
- **Markets in Review:** Last week, equities mostly fell, with the S&P 500 declining 0.9% and international equities, as represented by the MSCI EAFE Index, falling 0.2%. Bonds were mixed on the week, with the 10-year Treasury yield at 2.38%, up from 2.36% on Friday of the prior week. Commodities overall, as measured by the Bloomberg Commodity Index, rose 2.4%, led by WTI crude, which jumped 12.2% to $51.68 per barrel. Meanwhile, gold fell by 0.5%, to $1,177.43 per ounce.
- **Looking Ahead:** In the U.S., indicators of interest this week focus on business investment and labor demand. Meanwhile, China is scheduled to release economic data, highlighted by new yuan loans.

A Recovery for Health Care

In our November 22 Weekly Letter, "**Washington Flips**," we identified Health care as a sector benefitting from both the president-elect's proposals and long-term tailwinds, while anticipating some volatility around the government transition and healthcare legislative initiatives. We believe that despite the sector's lackluster performance since the election, our longer-term thesis remains intact.

The overall market's rise since November 8, with the S&P 500 up 2.5%, has masked wide dispersion and volatility across sectors. The difference between the best-performing sector, Financials, and the worst-performing one, Utilities, has been an astonishing 18%.

Financials, Energy and Industrials rallied after the Republican sweep, consistent with expectations. The one sector that hasn't performed as investors anticipated is Health Care. Key discussion points for the candidates included the fate of the Affordable Care Act (ACA) and drug pricing, and a Republican sweep was presumed to be a positive for the sector. However, over the last four weeks it has been the second worst-performing group of industries, trailing the S&P 500 by 2.6 percentage points, putting it 12.6 percentage points behind the index year-to-date.

Pharmaceutical and biotech companies account for 62% of the sector's market value, and both have weighed on it. The biggest overhang heading into the election and throughout the year was the prospect of increased scrutiny of drug pricing. The Republican sweep potentially moves this overhang to the back burner for the time being.

The centerpiece of Trump's approach to health care has been the proposed repeal, or more recently partial repeal, of the ACA, substituting alternatives that we view as broadly neutral for pharma and biotech. House Budget Committee Chairman Tom Price, designated to become Secretary of Health and Human Services, and Paul Ryan, the Republican speaker of the House of Representatives, have proposed similar replacement plans.

PROS		CONS	
Valuation	Price-earnings (P/E) ratio relative to other sectors has fallen to a multi-year low	**Political**	A Republican-controlled Congress leaves many unanswered questions
Growth	Fundamentals in terms of earnings and sales continue to surprise to the upside	**Sector Rotation**	Cyclical sectors may continue to draw flows from defensive sectors
Pipeline	7,000 medications in development globally	**Debt overhang**	A spike in M&A activity over the past couple of years has led to increased leverage
FDA Approvals	Approvals for 2014 and 2015 are twice the average from 2005-2009	**Affordability**	Select cases of egregious drug price increases are a negative for the whole industry

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The macro trend remains a headwind

The key challenge for the traditionally defensive Health Care sector, outside of the changing political winds, is likely to be the continuation of a broad market rotation from defensive to cyclical sectors since the summer. The outperformance of cyclicals over defensives accelerated after the election as a result of investment in areas that could benefit from the pro-growth and potentially inflationary proposals of the new administration. We believe the challenge is largely already reflected in stock prices.

Innovation is a major tailwind

On the other hand, we see significant long-term tailwinds. Advances in medications and medical tools have transformed lives around the globe for the better. Life expectancy has increased from 47 to 78 years in the past century, with help from new drugs. The Pharmaceutical Research and Manufacturers of America (PhRMA) has suggested this trend should continue with more than 7,000 medications in development globally.

Like many other industries, those in the Health Care sector go through cycles. The pharma/biotech group was less than remarkable from 2005 to 2009, with new drug approvals falling to multi-year lows—an average of 22 per year. In 2014, however, the FDA approved 41 drugs, and in 2015 it approved 45, the most in 19 years. This year an industry publication, Nature Reviews, observed that "success rates as well as the overall pipeline quality have started to improve," citing a shift from a quantitative approach, more innovation from smaller firms and effective partnering by large ones.

Demographics also lend support

In another tailwind, investors can be confident in the inexorable aging of the global population. Between 2015 and 2050, populations aged 65 and over are expected to grow by 38 million in the U.S., 46 million in Western Europe, 136 million in India (more than in the entire developed world) and 199 million in China. In the U.S., two-thirds of spending on health care is for people over the age of 65.

Affordability remains an issue

The debate on U.S. drug prices hasn't gone away. It will likely remain a key topic of discussion, prompting some self-regulation from fear of a public outcry. We continue to believe that U.S. drug pricing, while not perfect, works better than many perceive in rewarding innovation and allowing competition to dramatically lower prices where novelty or differentiation is lacking.

We add these points: 1) Drug price inflation is lower than many perceive due to large rebates to pharmacy benefit managers. 2) Drug spending as a percentage of health care spending is flat and expected to remain so through 2024, according to the Centers for Medicare & Medicaid Services, a federal agency. 3) Of U.S. prescriptions, 90% are filled generically at significant discounts (85%-99%), hence expenditures are mainly on novel, patent-protected therapies.

Valuations look attractive though risks remain

In terms of valuation, we see Health Care as the inexpensive defensive sector, with the potential to re-rate. Its price-earnings (P/E) ratio relative to other sectors has fallen to a multi-year low on election risks, and it trades near an all-time low relative to another defensive sector, Consumer Staples. However, the overhang to the pharma/biotech group is reduced with the expectation of less scrutiny of drug pricing under Trump. Both areas are cheap from a historical perspective too, with pharma offering yield at a reasonable price and biotech offering growth at a reasonable price.

In other positives, Health Care has seen the biggest outflows from mutual funds of any sector over the last 12 months, and fundamentals continue to surprise to the upside in terms of earnings and sales, with solid revision and guidance trends (though they have begun to decelerate).

We do see risks. One is uncertainty over the ACA; the health care team at BofA Merrill Lynch Global Research expects efforts to repeal or replace significant portions of it in 2017, a negative for hospitals and medical device companies, though these efforts could face hurdles in the Senate. In addition, leverage has increased, chiefly due to mergers and acquisitions, but it remains low relative to other sectors.

Biotech and Pharma are cheap vs. history

Health Care Industry (# of S&P 500 firms)	Forward P/E Relative to S&P 500: Current	Forward P/E Relative to S&P 500: Average*
Biotechnology (8)	0.74	1.27
Equipment & Supplies (16)	1.16	1.21
Providers & Services (17)	0.82	0.94
Health Care Technology (1)	1.40	1.37
Life Sciences Tools & Services (6)	1.30	1.13
Pharmaceuticals (11)	0.91	1.08

Source: FactSet, BofA Merrill Lynch U.S. Quant Strategy.
* January 1986 through October 2016.
Past performance is no guarantee of future results.

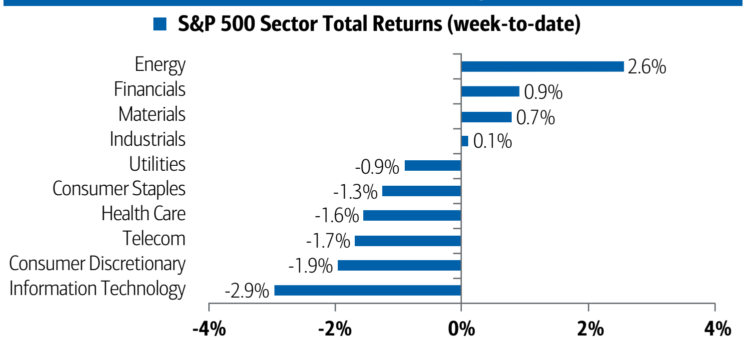
Portfolio Considerations: Health Care, like many of the sectors in the S&P 500, includes different sub-groups. Pharmaceutical and biotech companies are influenced by a completely different set of factors than managed care or hospital companies. Potential changes to the Affordable Care Act may have an outsized influence on the sector over the next couple of years, but investors with a longer time horizon should not be dissuaded by its poor performance in 2016 or the political uncertainty going forward. Pharma and biotech companies account for more than 60% of the health care index and hold great promise for continued innovation. The sector offers the potential for market-leading top-line and bottom-line growth and increases in dividends at attractive valuations.

Markets in Review

Trailing Economic Releases

- The U.S. Bureau of Economic Analysis released its October Core Personal Consumption Expenditure (PCE), an indicator of consumer inflation watched by the Fed. The 0.1% month-over-month (MoM) increase was in line with the BofAML Global Research estimate.
- The U.S. Bureau of Labor Statistics reported 178,000 net new jobs in November, with average hourly earnings falling 0.1% MoM and the unemployment rate dropping to 4.6%. BofAML Global Research expected 170,000 new jobs, a 0.2% increase in wages and unemployment steady at 4.9%. The mixed report suggests job creation continues with little slack left in the workforce but inflationary pressures from wage growth remaining in check.
- Eurostat released a preliminary report on Eurozone consumer price inflation for November. Year-over-year (YoY) growth of 0.6% and 0.8% for headline and core inflation were in line with the BofAML Global Research estimates.

S&P 500 Sector Returns (as of last Friday's market close)



Equities

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
DJIA	19,170.4	0.2	0.3	12.9
NASDAQ	5,255.7	-2.6	-1.3	6.2
S&P 500	2,192.0	-0.9	-0.3	9.5
S&P 400 Mid Cap	1,624.8	-0.9	-0.2	18.0
Russell 2000	1,314.3	-2.4	-0.6	17.3
MSCI World	1,708.9	-0.7	-0.2	4.8
MSCI EAFE	1,630.6	-0.2	0.1	-2.3
MSCI Emerging Mkts	853.1	-0.3	-1.1	9.7

Fixed Income

		Total Return in USD (%)		
	Yield (%)	WTD	MTD	YTD
ML US Broad Market	2.52	0.0	-0.1	2.4
ML 10-Year US Treasury	2.38	-0.1	-0.1	1.0
ML US Muni Master	2.69	-1.0	-0.3	-1.0
ML US IG Corp Master	3.40	0.1	-0.1	5.2
ML US HY Corp Master	6.55	0.3	0.1	15.3

Commodities & Currencies

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
Bloomberg Commodity	175.9	2.4	1.2	11.1
WTI Crude $/Barrel[1]	51.7	12.2	4.5	39.5
Gold Spot $/Ounce[1]	1,177.3	-0.6	0.3	10.9
Level	Current	Prior Week End	Prior Month End	2015 Year End
EUR/USD	1.07	1.06	1.06	1.09
USD/JPY	113.51	113.22	114.46	120.22

Source: Bloomberg.[1] Spot price returns. All data as of last Friday's close.

Past performance is no guarantee of future results.

Looking Ahead

Upcoming Economic Releases

- On Tuesday, the U.S. Census Bureau reports factory orders for October. The consensus expectation is for MoM growth of 2.5%. Factory order growth on a YoY basis has been recovering since the third quarter of last year on stabilizing energy prices.
- On Wednesday, the U.S. Bureau of Labor Statistics releases its Job Openings and Labor Turnover Survey (JOLTS). The consensus estimate is for 5.5 million new job openings. Generally demand has remained steady at these levels, which suggests further job creation over the coming months.
- BofAML Global Research expects China's new yuan loans for November, released on Friday, to come in at 750 billion yuan, an increase from last month's level of 651 billion. Credit growth in China has come under more scrutiny after slowing this year.

BofA Merrill Lynch Global Research Key Year-End Forecasts

S&P 500 Outlook	**2016 E**
Target	2,100
EPS	$118.50
Real Gross Domestic Product	**2016 E**
Global	3.1%
U.S.	1.6%
Euro Area	1.6%
Emerging Markets	4.1%
U.S. Interest Rates	**2016 E**
Fed Funds (eop)	0.63%
10-Year T-Note (eop)	2.35%
Commodities	**2016 E**
Gold ($/oz-period average)	$1,260
WTI Crude Oil ($/bbl-eop)	$54.00

All data as of last Friday's close.

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