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Healthcare: the discount begins to close

In June healthcare traded at its steepest discount to the market in about thirty years. Since then the policy fog has largely lifted and the sector has started to recover. The longer case, built on innovation and demography, has barely begun.

26

drugmakers have signed pricing deals with the US administration, covering 90% of the branded market

\$130bn

of biopharma takeovers in the first half of 2026, almost matching all of 2025

331

AI-enabled medical devices cleared by the FDA in 2025, against 6 in 2015

How a good sector went on sale

Healthcare has lagged the market for three years, and three forces did the damage. The first was the hangover from COVID. Life-science and vaccine makers built capacity for pandemic demand that later faded, while insurers that enjoyed quiet hospitals during the pandemic are now paying for patients who come back sicker. The second was a wall of policy fear after the 2024 election: tariffs on imported medicines, threatened Medicaid cuts and, above all, the Most Favored Nation push to bring US drug prices down toward the levels other wealthy countries pay. The third was artificial intelligence, which drew in nearly every marginal dollar of investor money. To size the neglect: by mid-2026 the entire US healthcare sector was worth about 4.8 trillion dollars, barely more than a single chipmaker, Nvidia.

The price

In June healthcare changed hands at about sixteen times expected earnings, against twenty-two for the broad market. BlackRock put the relative discount at about sixteen percent, the steepest in roughly thirty years, for a sector that has historically commanded a premium. When a quality sector is priced like a troubled one, an owner does not need heroic assumptions. The fears only have to fade and the earnings only have to show through.

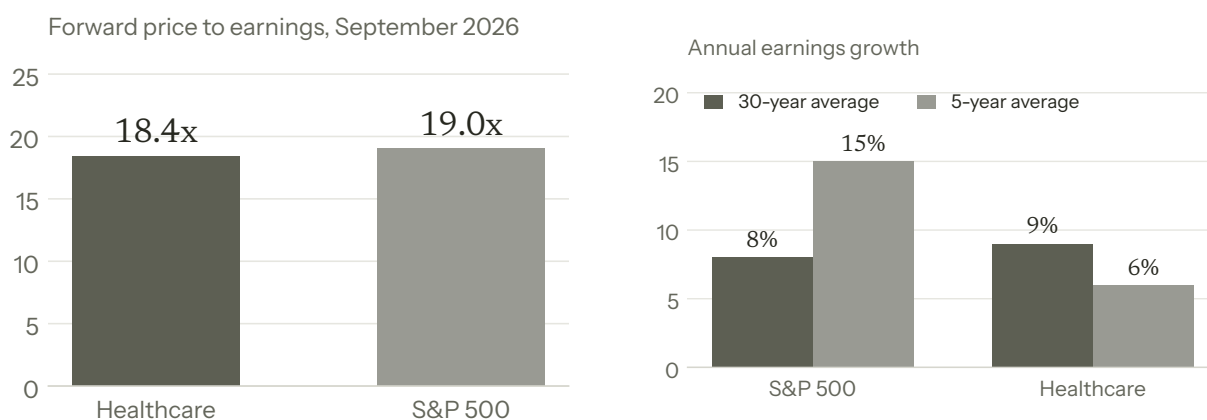
The first half of that has happened. By the end of September healthcare traded at 18.4 times expected earnings against 19.0 for the S&P 500, and in the three months to mid-October the sector rose more than nine percent, second only to energy, touching record highs. Most of the valuation gap has closed, partly because healthcare rose and partly because the broad market cheapened. The second half has not happened yet. Third-quarter healthcare earnings are still expected to fall about 2.6 percent from a year earlier, the only sector expected to decline. The recovery so far rests on fading fear, not on rising profits.

The fog is lifting

The drug-pricing overhang has cleared the way these things usually clear, through negotiation. Seventeen of the largest drugmakers had signed voluntary pricing agreements by June. Nine more followed at the end of August, bringing the total to twenty-six and, by the administration's count, ninety percent of the branded US market. In September the most-favoured-nation price was extended to every state Medicaid program. The near-term cost remains small: the Medicaid part is projected to save the government about sixty-five billion dollars over a decade, because Medicaid is a modest and already discounted slice of drug sales. Tariffs have quietened, with three-year exemptions tied to US manufacturing commitments, and the budget bill passed in July 2025 left the non-Medicaid market largely undisturbed. Policy risk has not vanished, but the worst outcomes have come off the table one signature at a time.

The earnings are real

A cheap stock with falling earnings is a trap. This is not that. Eighty-nine percent of S&P 500 healthcare companies beat expectations across the four quarters of 2025, and every healthcare company that had reported third-quarter 2026 results by mid-October beat as well. Over thirty years healthcare grew earnings slightly faster than the market, nine percent a year against eight. The last five years, six against fifteen, were the COVID hangover, not a change in the nature of the business.



Source: J.P. Morgan Asset Management Guide to the Markets (4Q 2026), FactSet, BlackRock Fundamental Equities. Forward P/E as at 30 September 2026; earnings growth by sector as at December 2025 (full-year 2026 not yet reported).

Buyers are returning

Large drugmakers face more than 150 billion dollars of revenue losing patent protection by 2030, around a third of sales for the average large company, and the cheapest way to refill a pipeline is to buy the smaller firms that did the science. Buyers have done exactly that. IQVIA counts 130 billion dollars of biopharma takeovers in the first half of 2026, almost the 133 billion of the whole of 2025, with the average deal larger than in any year since 2021.

What the market is not paying for

Underneath the noise, the science is moving faster than ever. The FDA cleared six AI-enabled medical devices in 2015 and 331 in 2025. Behind the innovation sits the most reliable tailwind in investing: by 2030 one American in five will be over sixty-five, and that group spends two to three times more on healthcare per person than the young. People do not stop needing medicine when the economy slows.

The risks

The deals tie new drug launches to the lowest prices in peer countries, which could weigh on the returns of tomorrow's medicines. The patent cliff is real, clinical setbacks are ever present, and reimbursement remains a political football: part of the recent rally reflects bets that the midterm elections of 3 November could soften planned cuts to federal health spending, and bets on elections can unwind quickly. And with most of the valuation discount gone, the easy gains have been made. These risks argue for selectivity and patience, not for looking away.

Our view

The best purchases are usually quality bought while it is unloved, and in June healthcare was as unloved as it had been in a generation. Since then the crowd has started to notice, which is how a discount closes. It rarely closes all at once, and it rarely closes on earnings that have not yet arrived. A sector that heals people, earns through recessions and rides the surest demographic trend there is still has years of work ahead of it. That is where patience is paid.

SOURCES

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