JARVIS® NEWSLETTER: TURNAROUND 2024: FINANCIALS AND HEALTHCARE

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OVERVIEW

This week we turn the page on what ultimately was a successful year for investors in 2023. As the market dug itself out of the bear market of 2021-22, outperformance from the "Magnficent Seven" and a general sense of optimism around the theme of artificial intelligence drove markets to a strong year, with the S&P 500 posting a return of more than 24%.

We share in the optimism around AI and we have been positioning clients accordingly to take advantage of what we think is an ongoing technological revolution, still in its infant stages. With that being said, we think the story of AI as an investment theme is well-worn territory at this point and the financial media has sufficiently covered the theme. We may return to this topic in future editions of the letter with our specific spin on the trend.

Key Takeaways

In this first newsletter of 2024, we wanted to spend our column inches on two sectors that have flown somewhat more under the rader and were two of the weaker performers in 2023, health care and financials. The financial sector faced two related challenges last year that drove underperformance in its component stocks. These were a rising interest rate environment, along with the mini-banking crisis early in the year which began with the high profile failures of regional banks Silicon Valley Bank, First Republic, and Signature Bank. These two challenges led to a 2023 return in the S&P financial sector of 9%, far below that of the overall market.

The healthcare sector had an even more underwhelming return in 2023, with the S&P Health Care sector earning just 0.30% in 2023. The reasons for healthcare underperformance are less obvious than those in the financial sector. With so much money migrating to information technology (up 56.39% in 2023), relatively defensive sectors like healthcare, consumer staples, and utilities were left behind. The biggest growth segment of healthcare, biotechnology, gained just 7.58% in 2023, surprising given the 42% gain in the broader NASDAQ Composite!

In this month's letter we will give you a bit more color on why we like the financial and healthcare sectors as strong turnaround candidates for 2024. While we continue to like some of the better performing sectors of 2023 (information technology, communications services, semiconductors), valuations may challenge returns there. We think the combination of earnings growth and potential multiple expansion could combine to create really exciting returns in these downtrodden sectors from 2023.

Finally we will introduce a new recurring feature of the Jarvis newsletter, the "Income Security of the Month". With interest rates still elevated historically speaking, we think the opportunity for income investors to lock in generous rates of return for the next 5-20 years remains attractive. But as rates begin to fall (the US 10-year treasury hovers just above 4% after touching 5% in October 2023), the window of opportunity is closing quickly. In today's letter, we discuss a bond-like equity with a dividend yield in excess of 11% at its current price. Fittingly for this month's letter, the security touches both the financial and healthcare spaces.

We know that investors have been seeking shelter in short-term cash alternatives which are paying much higher rates of return than at any time in the last 20 years. The question we have been asking these investors over the past year is "what is your plan for when rates begin to fall?" Given that the phenomenon of reinvestment risk is quite likely to reenter the lexicon as interest rates continue falling, we think now is the time for investors to get serious about moving out of cash and taking advantage of high rates. (Reinvestment risk is is the risk that when an investment matures, there is not an equivalent investment to replace the return that the original investment, such as a CD, previously offered.)

We have been preaching to investors to move out of cash into fixed instruments quite loudly for the better part of the last 12 months. As we deploy capital for our clients, we have anecdotally noticed that the opportunity set available in high-quality, high-yielding bonds is much smaller than it was even a mere three months ago!

If you want to discuss ways you can take advantage of high interest rates before your window of opportunity closes, set time directly on my calendar and I would love to walk you through our strategy for taking advantage of high fixed rates of interest and attractive opportutnities in our income securities portfolio. We also think right now is a great time to take a close look at your more complete financial picture. That means reviewing your outstanding life insurance and annuity policies, along with your estate plan and retirement income strategy. If one of your New Years' resolutions was to get your financial house in order, don't hesitate to set a time for a no-cost, no-obligation first consultation!

Head to our website and sign up for our mailing list, so you can receive our weekly updates in your inbox every Saturday morning. If you are starting to think about building and/or preserving your wealth, we think this is a great place to begin setting your mindset toward growing your assets.

Cash Alternative	Current Yield (%)
1-Year CDs	5.18
10-Year US Treasury Bond	4.15
Tax-Free Municipal Bonds (HYD)	4.14
5-Year Fixed Annuity	5.75
High Yield Corporate Bonds (HYG)	5.73
High-Yield Savings Account	5.10

Sources -- Bankrate.com, Yahoo! Finance, NerdWallet.com

With that all being said, let's get into it!

FINANCIALS – WILL FALLING RATES ACTUALLY HELP?

As we mentioned in the intro, there were two major drivers of underperformance in financials last year, rising interest rates and the associated regional banking failures in March 2023. It is interesting that this is the case, since the conventional wisdom is that a rising rate environment tends to be positive for banks. Because their business model revolves around borrowing short-term money and lending it out long term, as interest rates rise, usually the spread between short-term rates and long-term rates will widen.

In the most recent interest rate cycle, we saw the opposite occur. Due to reforms that came out of the financial crisis, banks have been limited in the types of assets (loans) they can hold on their books. This led to banks holding large amounts of US Treasuries on their balance sheets. Ordinarily, there would be nothing to fear from this type of "safe" asset. Unfortunately, the Federal Reserve raised interest rates so rapidly in 2022 and early 2023 that these Treasury bonds quickly fell in price and put bank balance sheets under threat – this is precisely the reason for the handful of bank failures we saw in early 2023. Fortunately, after Silicon Valley Bank, Signature Bank, and First Republic failed, we have not seen any subsequent bank failures.

The **iShares 20+ Year Treasury Bond ETF (TLT)** tracks the prices of long-dated US Treasury bonds. Because bond prices and interest rates have an inverse correlation, the **TLT** fell precipitously as interest rates rose in 2023. The **Financial Select Sector SPDR Fund (XLF)** tracks the performance of stocks in the market's financial sector. As you can see in the chart below, the charts of the **TLT** and the **XLF** tracked each other in near lockstep throughout 2023:

XLF (Blue) charted against the TLT (Orange) -- Source: TradingView

The implication from what we see in the 2023 chart above is that as interest rates rose, financial stocks fell, but that when interest rates fell, financial stocks surged. This is a dynamic that belies the historical relationship between financial stocks and interest rates. In our view, we think this new relationship will persist as the Federal Reserve ultimately unwinds its most recent interest rate hiking cycle. Should we be correct in our view, we expect strong performance in financials in the coming years.

Note also the fact that financials tend to be a highly economically sensitive sector of the economy. When the economy is in recession, demand for loans decreases and banks tend to take credit losses on their existing books of loans. The year 2023 was well-known for the persistent calls for recession coming from the market's loudest talking heads. As fears of recession recede, we expect to see higher demand for financial shares.

At Left Brain, we are discerning in our investments in financials. We tend not to prefer investing in the big money center banks like **Bank of America (BAC)** and **Wells Fargo (WFC)**, just because their sheer size and oversight from regulators constrain their ability to grow profits. Instead, we are more interested in non-banking financial firms from a couple different industries: so-called FinTech (Financial Technology) and insurance. In FinTech, we like a number of stocks from the well-established like **Visa (V)** to the more speculative **Block (SQ)**. In insurance, there is much to like, but one example is property and casualty insurer **Chubb (CB)**.

HEALTHCARE – OUR TURNAROUND SECTOR FOR 2024

On a relative basis, healthcare outperformed in 2021 and 2022. In the context of a very weak overall market, this is not surprising. Healthcare spending is recession-resistant, given its required nature – no matter the economic environment, health problems always arise.

In the strong market environment of 2023, healthcare was left behind. Perhaps investors rotated out of their defensive positioning (consumer staples also struggled), but for whatever reason, healthcare fell out of favor. One of the most economically sensitive corners of the healthcare sector is biotech – which has historically been cast as on the "risk on" areas of the market. Despite the 42% upside the NASDAQ achieved, biotech gained just 7.58% in value last year.

We think investors of different types will be looking to healthcare in 2024 as a turnaround play, simply due to its underperformance last year and we tend to agree. But that is a macroeconomic-focused view and that is not the way we roll at Left Brain – we focus on the business fundamentals driving stock prices.

There are breakthroughs all over the healthcare marketplace that are exciting, from cancer treatments, to vaccines, to treatments for rare diseases and many other areas of the medical field. But there is one very high-profile breakthrough that has investors excited (ourselves included) -- glucagon-like peptide 1 antagonists, more commonly known as GLP-1 drugs. These drugs are designed to mimic the action of a naturally-occurring hormone called glucagon-like peptide 1, which stimulates the body to produce insulin and lower blood sugar. Initially indicated to help manage symptoms for type-2 diabetics, the effectiveness of these drugs to help curb food cravings and to aid in weight loss has been observed in many patients.

With obesity and diabetes two of the biggest health risks in the US and in many other (mostly Western) countries, the market for these (now) injectable drugs is enormous and growing. Sales in these drugs, including Wegovy, Mounjaro, and Ozempic was on the order of $3 billion in the first 9 months of 2023 (the first full year the drugs have been publicly available). An analysis from JP Morgan Research estimates sales of nearly $100 billion in the year 2030, as the drugs become more widely available and presuming that Medicare begins to cover the cost of these drugs. With a potential for 30 million Americans to use the drug by the end of this decade, we think the growth opportunity is massive and hard to ignore.

Two stocks have benefitted greatly from this potential revolution in the treatment of diabetes and obesity – **Eli Lilly (LLY)**, which is up 71% since the beginning of 2023 and **Novo Nordisk (NVO)**, which has gained 56% in the same period. **LLY** is the maker of Mounjaro and has another similar product just hitting the market in Zepbound. **NVO** produces the best-known drug in the space, Ozempic, along with Wegovy. Patients taking Lilly's new drug, Zepbound, lost an average of 48 pounds in the recent clinical trials. Novo Nordisk is now out with an oral version of a GLP-1 drug in Rybelsus, which seems to have similar effects. Data like this show the sheer size of the opportunity here in the GLP-1 space for explosive growth.

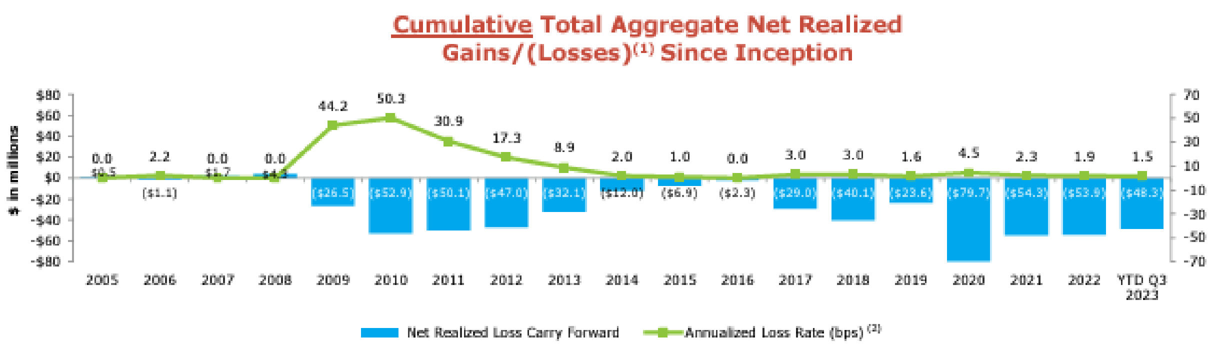
We expect healthcare stocks as a whole to perform well in 2024, but we are focused on a potentially game-changing technology in these GLP-1 drugs that may not only change lives, but offer impressive profit opportunities to investors.

INCOME SECURITY OF THE MONTH -- HTGC

Hercules Capital (HTGC) is a stock we initially found attractive back in the days of near-zero interest rates, as we looked for ways to find income for clients in or near retirement. Throughout the five years in which we've followed the stock, it has persistently paid a dividend to shareholders in the neighborhood of 10%, which was hard to replicate with any other securities, especially with interest rates so low.

HTGC is a non-bank lender that provides financing to venture capital-backed companies at all stages of development. Their concentration is in the life sciences, which is why we say the company sits at the intersection of financials and healthcare. With that said, HTGC also is active in other sectors, including technology and renewable energy.

Hercules is one of the largest business development companies (BDCs) in the marketplace today. We like the fact that the company does the vast majority of its lending deals using floating rate notes, which means that the business is not directly exposed to losses in rising interest rate environments. The company has a durable business model and disciplined lending process, which has served to minimize losses over time. As you can see in the below chart from the latest investor presentation:



HTGC has an Annualized Loss Rate of 0.015% in 2023 -- Source: HTGC Investor Presentation

HTGC earns not only from interest income, but also does retain equity upside in some of its financing transactions. In Q3 2023, the company earned $0.52 per share in net investment income and the net Earnings Per Share for the last twelve months was $2.00, implying a price to earnings ratio of 8.47 based on the 1/18/2024 closing share price of $16.93.

We like the diversification and the discipline behind the business, as well as the obvious benefit to shareholders of the large annual distribution. At current dividend payout levels, HTGC is offering investors a forward dividend yield of 11.34%. Of course we like the payout for income investors, but we think this is a stock that investors of all types can consider, given that the company holds equity upside in some of its investments.

Interesting to note is the stock price action from 2023. During the mini-banking crisis that we mentioned above, the shares fell dramatically in price, from $16.25/share on 2/17 to $11.52/share on 3/17. In retrospect, this represented a golden opportunity for investors to take a position in **HTGC**. In practice of having followed the stock for a number of years, now, we have seen many occasions when the stock has fallen significantly on minimal news flow. As a result, **HTGC** shares are often a candidate for buying on weakness.

Stock chart of HTGC from January 2023 to today -- Source: TradingView

We like HTGC for the markets in which it operates (life sciences, technology, renewable energy), offering investors the chance to gain exposure to pre-IPO market deals in high-tech industries without directly investing in venture capital. The company's business model is strong and its history of paying out generous dividends is robust.

TAKEAWAYS

As we turn the page on 2023 and move into 2024, we remain optimistic in the sectors that did well last year, namely information technology and communications services. With that in mind, we wanted to direct our attention to other areas of the market where we have seen underperformance in the last year, namely financials and healthcare.

Financial stocks should benefit from the normalization of interest rates from a historically high point achieved in 2023. Though this flies in the face of previous relationships between financials and interest rates, we are concentrating our efforts on non-traditional financials like insurance and FinTech.

Breakthroughs in drugs around weight loss and diabetes have us excited for the possibilities of a multi-year growth theme playing out over the next decade. We also think biotech has a chance to do well over the next few years.

We want to convey to our readers, clients, and friends, that we think there is an urgency to put cash and short-term fixed income money to work in long-dated fixed rate securities and income securities like **HTGC**. Early in 2023, we communicated that we thought investors had a number of months to put a long-term fixed income strategy in place. With interest rates finally beginning to come down, we think the time is now to move away from cash into instruments that offer predictable yields.

If you are an investor looking to preserve wealth and secure a comfortable retirement, an income strategy locking in passive revenue streams is essential. Fortunately, now is the time to put the idea into practice, while we have the chance to lock in passive income for the next 10-25 years. If you want to learn more about how you can take advantage of high interest rates while they are still in place, get in touch with us and we can walk you through some of our thoughts on how you can put a strategy together in 2024 to help you achieve your financial goals.

If you are ready to put our thoughts into action, contact me directly at (630) 547-3316 or briand@leftbrainwm.com, or schedule time directly on my calendar if you want to engage a professional money manager like Left Brain to help you secure your retirement. We can offer either income opportunities like the ones mentioned here or growth stocks that we think could be strong performers in the long run.

Thanks again for your continued support of the Jarvis Newsletter.