After a strong mid-year rally, stocks in the Drug Industry sold off sharply during the fourth quarter with the most pronounced declines occurring in December. Intensifying macroeconomic concerns tied to trade, tariffs, and rising interest rates appeared to be the primary drag on equity markets as a whole, but renewed political scrutiny related to drug pricing likely created additional pressure for pharmaceutical makers. All told, the XLV ETF, which tracks the performance of the broader healthcare industry, has declined roughly 13% in value since September 30th, compared to a 15% decrease in the Dow Jones Industrial Average and a 17% pullback on the S&P 500.

Drug Pricing

Drug pricing has been one of the most hotly-debated topics on Capitol Hill in recent years. With healthcare costs soaring to uncomfortable and seemingly unstable levels, the Trump Administration has targeted the large pharma group and has been vocal about bringing changes to the industry's pricing practices. The emergence of several high-profile cases where patients could no longer afford potentially life-saving/lengthening drugs did little to help matters.

While both sides of the aisle agree that something needs to be done, the consensus seems to be that the left-leaning politicians would be more aggressive on this front and more likely to pursue some sort of regulation. Hence, when the Democrats recently took control of the House, some speculated that drugmakers would face additional pressure that could lead to dips in equity prices. On the other hand, a divided Congress may have a difficult time advancing significant legislation on pricing and reimbursement.

Pfizer and *Glaxo* Link Up

On December 19th, the two drug giants announced an agreement to merge their expansive consumer health businesses into a single entity. The non-cash transaction would create the largest over-the-counter medicines supplier in the world with combined sales in the range of $13 billion a year. Under the terms, *GlaxoSmithKline* would receive a 68% controlling stake (*Pfizer* 32%) in the new company, which will eventually be listed on the U.K. stock exchange. The deal is subject to shareholder approval and customary closing conditions, and completion is tentatively scheduled for the second half of 2019.

New Look *Novartis*

After a lengthy strategic review, the Swiss drugmaker is moving forward with plans to divest 100% of its Alcon eye care division into a separately-traded standalone company. In 2017, leadership estimated that the unit could be valued as high as $35 billion, but more recent analyst projections put in the $15 billion-$23 billion range. All in all, the spinoff is expected to be completed in the first half of 2019 and should enable *Novartis* to strengthen its focus on innovative pharmaceuticals. In September, the company also agreed to sell selected portions of its Sandoz portfolio to Aurobindo Pharma for $0.9 billion in cash plus $0.1 billion in potential earnouts. The assets include the U.S. dermatology business and generic U.S. oral solids unit, which comprise about 300 products that generated $0.6 billion in sales during the first half of 2018. This transaction is also expected to close this year and will enable Sandoz to focus on higher growth areas like complex generics and value-added medicines and biosimilars.

INDUSTRY TIMELINESS: 68 (of 97)

Cannabis Stocks Enter the Fold

Easing regulations on cannabis across the United States, coupled with full legalization in Canada, has created a new and potentially lucrative opportunity for investors. While the industry was highly volatile in 2018, due in part to its youth and limited track record, some experts believe the U.S. market alone could skyrocket to $50 billion by 2026, which is a hard figure to ignore. In this Issue, *Canopy Growth*, *Tilray*, and *Aurora Cannabis* all make their debuts in *The Value Line Investment Survey*.

Dividends

The Drug Industry has developed a reputation of paying consistent and relatively generous dividends to its shareholders, specifically within the large pharma space. Several of these equities also maintain strong scores for Safety and Price Stability, which enhances investment appeal for those seeking to reduce risk within their portfolios. Some attractive options in this Issue include *GlaxoSmithKline* (5.4%), *Novartis* (3.6%), *Pfizer* (3.6%), and *Merck & Co.* (3.1%).

Conclusion

Based on our Timeliness Ranking System, the Drug Industry has moved up the charts in recent months, gaining 15 spots since our October report. Despite the improvement, the group remains in the bottom third of sectors under *Value Line's* coverage (68th out of 97) in terms of year-ahead relative price performance. As a result, the majority of the equities herein are pegged to either track or underperform the broader market in 2019, but there are a few standouts including industry heavyweights *Pfizer* and *Merck*, both of which garner our Highest rank (1). *Zoetis* is another appealing option for investors seeking a pure play in the increasingly attractive animal health segment.

Michael Ratty