WANT DRUGS? WAIT 'TIL NOVEMBER; BIG PHARMA STOCKS COULD HAVE A RALLY BREWING, BUT THAT MAY DEPEND ON THE PRESIDENTIAL ELECTION.

By Alexandra Twin

The drug sector, along with other defensive plays, has underperformed the broader stock market over the last year, and some analysts say this makes it attractive.

But it's a tough sales pitch. The stocks could do well this year, analysts say, if the stock markets keep slipping, the labor market keeps struggling, interest rates rise and attempts to lower drug prices fail. Then again, the sector may just stall for a while. Now, who wants to invest?

"It's difficult to be clear about the near-term outlook for the sector," said Kris Jenner, manager of the T. Rowe Price Health Sciences Fund (PRHSX: down $0.26 to $22.36, Research, Estimates). "On the one hand you have all the highly-publicized challenges, on the other hand, that may already be reflected in the valuation. In my fund, I am not making a bet either way at this point."

The challenges include two issues that speak to drug pricing and partisan politics, and are therefore directly tied in with the outcome of the presidential election in November.

The first is the Medicare Prescription Drug, Improvement and Modernization Act, signed into law last December, and scheduled to go into effect in 2006. Critics, including many Democrats, say the law benefits the pharmaceutical industry more than it benefits recipients. Ahead of this, Medicare discount cards will be offered to seniors starting in June of this year.

The second is drug re-importation, which remains a political and regulatory powder keg. Re-importation refers to the illegal and very popular trend of U.S. consumers buying prescription drugs from Canada and other nations -- mostly via online pharmacies -- drugs, that were previously imported for the purpose of serving those countries' populations.

The drug makers argue that this is eating into their profits, and have attempted to combat the trend by limiting supplies to wholesalers in Canada and elsewhere. But opponents says that's not necessarily the case.

A recent study put out by the Boston University School of Public Health and published in the Boston Globe showed re-importation does not hurt drug company profits. More often, it has little impact on profits and in some cases adds to them, as
it sometimes spurs consumers to try less essential medications that would otherwise be financially unthinkable.

The ongoing debate is in itself a negative for the sector, and one that will come up in any election year discussion about health care.

Of elections and interest rates

"There's two trends for the sector," said Elizabeth Bernstein, an equity analyst at Morningstar. "The negative is stocks tend to trend down in an election year because there's always talk of cutting health care costs, and people worry about how that might impact earnings and profit margins.

"The positive for the stocks is that they are a defensive play and they tend to do well in a rising interest rate environment," she added.

Studies show that pharmaceutical stocks tend to do well in the six months following the first rise in interest rates, the analysts said. (Click here for a look at how drugs and other sectors tend to perform as interest rates rise.)

Bernstein says she expects the positives to edge the negatives over the next 6 to 12 months, giving the stocks a lift, because the pharmaceutical companies have been artificially deflated due to the political considerations. The sector was one of S&P 500's worst performers in 2003.

"As rates rise and you start to see a sector rotation within equities, we would expect some of that money flow into big pharma," said David Moskowitz, an equity analyst at Friedman, Billings & Ramsey.

But other analysts aren't so sure.

"I don't expect much from the stocks this year," said Scott R. Henry, a pharmaceutical analyst with Oppenheimer & Co. "The sector will continue to perform defensively, outperforming when the market is weak and underperforming when the market is strong."

Jenner says assuming a Republican victory, and a rate hike, the stocks could outperform the broader market for a period of 6 to 12 months. "But I can't say it's a no-brainer that these stocks will grow, because they face so many challenges."

Among them are all the usual suspects: patent expirations, generic competition and the limited number of drugs in the pipeline at any given time.

"Longer-term, the big issue has been research and development productivity," Henry said. "That continues."

But if you do want to invest

Pfizer (PFE: Research, Estimates) is the best name in the sector for investors
looking to make a defensive play, analysts say.

The world's largest pharmaceutical company, Pfizer recently reported first-quarter earnings that topped estimates and grew from a year earlier, due to strong sales of its treatments for cholesterol, hypertension and epilepsy. On the downside, Viagra and Prozac sales were less bullish than had been expected.

The stock trades at 17 times 2004 earnings, which the analysts say makes it inexpensive.

"Low valuation plus continued new drug launches suggest that Pfizer should do well over the next 12 months," Henry said.

Morningstar's Bernstein also suggests investors look at Novartis (NVS: Research, Estimates), while Moskowitz suggests Eli Lilly (LLY: Research, Estimates) and Wyeth (WYE: Research, Estimates).

Peter Brodie, senior vice president and director of investments at Bryn Mawr Trust Wealth Management said his firm has an "overweight" rating on healthcare, but "we've been looking more to add the smaller names, rather than big pharma.

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