Most global equity markets moved higher in the third quarter. The S&P 500 advanced 8.9%. Foreign stocks, as measured by the MSCI All Country World Ex USA Index, appreciated 6.3%. Small- and mid-cap U.S. stocks moved higher, with the Morningstar U.S. Small-Mid Cap Index gaining 7.2% for the quarter. Dividend stocks were up slightly, with the Dow Jones U.S. Select Dividend Index up 2.3%.

**Pockets of Euphoria During a Recession**

The sharp rebound of the equity markets from the late March lows is not necessarily reflective of the Main Street economy which still faces material challenges in recovering from the ongoing coronavirus pandemic. U.S. unemployment was 8.4% in August, an improvement from 14.7% in April, but still far above the 3.6% rate in January. According to the Mortgage Bankers Association, the percentage of U.S. residential mortgages in forbearance was 6.9% in September versus 0.3% at the start of the year.

The stock market reflects future expectations, so it’s not unusual for current market sentiment to differ from the current state of the economy. Therefore, the market rally from the March lows—that is, that there was a rally and stocks didn’t stay down—has not surprised us, but the strength of the rally has been stronger than we’d have anticipated given that the shape and timing of the economic recovery remain open questions.

Looking back, the government’s rapid response to provide aggressive stimulus was necessary and likely spared the economy from most worst-case scenarios. The wide-ranging fiscal stimulus has included increased unemployment benefits, direct payments to individuals, and temporary relief to distressed borrowers. The Federal Reserve initiated several aggressive monetary actions which included lowering short-term interest rates to nearly zero and intervening in the bond market to buy corporate and housing-related debt in large quantities to ensure the financial system had ample liquidity.

These fiscal and monetary measures have been massive in size and scope, but the sustainability and the long-term implications of such actions remain unknown.

In our view, some short-term impacts of stimulus have come to light in recent months. Beyond the intended economic boost, the Federal Reserve’s actions were meant to inspire confidence and spark optimism for investors, who severely lacked these characteristics in March as the equity markets were selling off sharply with the economic shutdown on the horizon. In some cases, we think the pessimism/optimism pendulum may be starting to swing too far, with overdone investor euphoria in certain pockets of the equity market.

One grouping where we see this is with

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high-growth stocks that have gone public within the past two years as well as recent offerings in the initial public offering (IPO) market, which has heated up since April. According to The Wall Street Journal and Dealogic, 235 new companies were listed in the U.S. public markets in 2020 through Sept. 25, which puts this year on track for the most since 439 companies went public in 2000. Many of the most popular and highly valued growth firms have benefitted from the disruption caused by COVID-19, which has accelerated the level of digital transformation that was already underway. Some of the best-performing high-growth stocks are trading for well over 20 times their trailing 12-month sales (not earnings!), so a lot must go right in the future for such companies to justify their current price.

Additionally, we’ve recently seen the prices of two popular large-cap stocks appreciate materially based solely on the announcement of stock splits, even though this action creates no economic value for shareholders. A more extreme example of speculative behavior occurred when investors bid up the shares of a highly levered firm that had already declared bankruptcy. In this case it’s eye-opening to see speculators willing to gamble on shares that are likely worthless in the hope they can sell the shares to someone else for quick gains.

Our approach to equity investing stands in stark contrast to speculating for a quick gain. We invest for the long run and, when we buy a stock, we invest as if we were buying a whole business. The value of that business will be determined by its long-term cash-generating power. Therefore, we think like an owner of a business, putting in a great deal of thought into buy and sell decisions. We prefer to invest in high-quality businesses — those we believe have durable competitive advantages, strong balance sheets, shareholder-oriented management teams, and history of generating free cash flow — but not at any valuation. In some cases, we’ve waited many years before making an initial investment in a business that we had analyzed and monitored while waiting for what we see as an appropriate price.

**Potential Fourth-Quarter Volatility**

Our portfolio management process does not involve handicapping the outcome of the U.S. elections in order to make investing decisions. We raise this point as the elections are right around the corner in early November. As long-term investors, our time horizon extends well beyond this year’s voting. Recent history demonstrates that election outcomes are hard to predict in advance. We focus our attention on the long-term fundamentals of the businesses we own or are looking to own in the future. Of course, the election could have an impact on different segments of the market depending on the results of the presidential and congressional contests. Both political parties have divergent views on many issues, including, but not limited to, taxation, trade, healthcare, and regulation.

Given we are living through a pandemic that has brought on unique business and economic challenges, it’s possible an event like the U.S. elections could cause market volatility to spike over the next few months. As portfolio managers, we embrace volatility given it can create more opportunities to buy and sell stocks at what we believe are favorable prices especially when prices are moving due to excessive fear or greed.

We recognize that it can be easy to get distracted during times of heightened market volatility. That’s why we recommend consulting with your financial advisor, who can help you make sure your current asset allocation plan is appropriate for your risk tolerance and is on track to help you reach your long-term financial goals.

As always, we thank you for your business.