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Recent Market Volatility Commentary

Market participants around the world are bracing for what comes next for financial markets when they re-open Monday. Financial markets experienced a brutal selloff that was accentuated by the Dow Jones Average closing at session lows amid heavy volume on Friday. At the close on Friday the Dow was off over 500 points or more than 3 percent. The Dow is now off more than 10% from its previous high taking it into correction territory. Losses in other markets around the world were even larger, including international equities, emerging market currencies and oil.

The excuse for Friday's sell-off was more adverse news out of China, with the worst contraction in Chinese industrial activity in 77 months. Concerns are intensifying that China's economy, the second largest in the world, is slowing faster than expected. This increases the risk of a broader global slowdown. In our view, this is just one factor contributing to recent, and likely continuing, volatility.

Prior to this week the S&P 500 had been range-bound for all of 2015, not deviating by more than 3% above or below where it started the year. It appeared on the surface the index was weathering the turmoil from several factors, including Greece, the strong U.S. dollar and a more than 60% drop in oil prices (from the previous high). However, market fundamentals have been steadily weakening and market leadership has been narrowing. Transport stocks entered a bear market in spite of lower oil, along with industrials and consumer discretionary stocks. Recently, the media sector experienced an upheaval. Even the most prominent market leader in recent years, Apple, has shown a significant share price decline. Among the S&P 500, nearly 30% of the index is down 20% from the 52 week high and a staggering 50% of the index is down more than 10%. While the headlines will highlight this week's market losses, the majority of companies have already undergone deep sell-offs. This observation is consistent with our view that we are in a "stock-pickers" market.

With international equity markets, oil, emerging market currencies, the Russell 2000 small-cap index and now the Dow Jones Industrial Average—all in correction territory—it seems plausible that the S&P 500 will also test these grounds. However, please note that corrections are completely normal in capital markets. The U.S. equity markets have not experienced a 10% correction in over four years. From a historical perspective, equity markets correct every 12-18 months. The current extended period of slow and steady gains is atypical and we believe is a result of the constant and continued support of the Federal Reserve—which is bound to change in the near future.

Where do we go from here?

We believe that it is crucial to maintain perspective during times of market stress; the volatile and asymmetric returns that are experienced on a daily basis are smoothed over longer investment horizons.

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While a lot of damage has occurred in a short period of time, many sectors and groups are likely close to bottoming. On Friday we saw some signs of panic selling and capitulation. Much will depend of the evolving global economic growth picture and how that impacts corporate earnings. At some point lower oil and commodity prices will be a positive for economic growth. China remains the wild card and they have much to lose if their economy deteriorates much further. We do not rule out a "shock and aw" move by the Chinese central bank or a potential delay in an interest rate increase in the U.S. Either circumstance could put a floor in the recent sell-off.

But instead of forecasting or relying on the actions of government officials and central bankers, Bridgewater continues to adhere to our core discipline of measuring three key factors: valuation, growth and liquidity. Valuations are at or slightly above fair value. Growth remains strong in healthcare and domestic sectors, such as housing and technology. Europe remains to be in the early stages of recovery, with earnings still 30% below peak earnings pre-financial crisis. Liquidity becomes a more important factor during disruptions. As such, we have reduced emerging market exposure early this year and eliminated positions in commodities. It is hard to predict, but we would not be surprised to see emerging markets underperform developed markets for some time to come, given the stressed macro environment in China, weakness in commodity prices, and U.S. dollar strength.

Thus, while volatility may persist in the coming trading sessions and the bears will come out of the woodwork to expound their position, we believe the bull market and growth story in both the U.S. and developed markets—such as continental Europe and Japan—remain intact. We do not see the usual indicators of recession in the U.S. The cash we hold serves as a ballast in down markets and offers optionality as opportunities arise.

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