Written by Rob Copeland
Tuesday, 23 August 2011 09:45 - Last Updated Tuesday, 23 August 2011 09:56

August 2011 is on pace to become the roughest and most volatile month for the stock market in almost three years. Where exactly will this correction bottom out? How long will buyers stay on the sidelines?

Two crucial questions await answers – but before turning to those questions, consider the developments that really hurt equities in the middle of August.

Morgan Stanley and JPMorgan Chase forecasts depressed investors. On August 18, Morgan Stanley said it had cut its global growth forecasts, citing "policy errors" on the part of the U.S. and European Union. It now anticipates global growth of 3.9% for 2011 (down from the previous estimate of 4.2%) and it sees the global economy expanding by 3.8% in 2012 (down from its previous forecast of 4.5%). JPMorgan Chase revised its 4Q 2011 U.S. GDP projection down to 1.0% from the previous 2.5% on August 19; on the same day, Goldman Sachs cut its 4Q GDP prediction to 1.5%.1,2,3

Morgan Stanley stated that America and Europe could slide into a recession in 6-12 months – not one as severe as the downturn of 2007-09 given that many household, corporate and bank balance sheets are healthier today, but a recession nevertheless.1

The EU's latest attempt to curb sovereign debt looked weak. On August 16, German chancellor Angela Merkel and French president Nicolas Sarkozy offered three new measures to address the European Union's debt crises. They proposed requiring all 17 EU nations to craft and pass constitutional amendments requiring balanced budgets. They also mentioned enacting an EU-wide tax on financial transactions in 2012, and creating a new joint-governance council that would convene every 6 months to assess and plan to fine-tune the EU economy.4,5

This was not what Wall Street wanted to hear. The proposals seemed inadequate to many analysts. Rather than revising the business model of the European Union, Merkel and Sarkozy reaffirmed a commitment to the euro and implied that the biggest EU economies (read: Germany and France) would be taking the hit for the mistakes of their poorer, more indebted brethren. As some of these proposed measures will have to be approved by popular vote in Germany and France, who knows if they will be adopted.4

If stocks are to rebound in the near term, the answers to two major questions will both have to be "yes".

Q: Can the EU make decisive moves to combat its debt crises? Wall Street (and many economists) would like to see the EU create a "Eurobond" – a euro-denominated debt security backed by the EU as a whole. An EU-wide debt security could result in lower interest rates in the most debt-plagued EU nations. (Bond yields vary widely from nation to nation in the EU at present.)6

The EU could make another strong move by bolstering its euro stability fund. At present, Sarkozy and Merkel believe that the fund's 440-billion-euro balance is acceptable, and they do not think that a Eurobond would be the silver bullet to solve the crisis.4

Q: Can American consumers keep spending? We can't predict the future, but the July retail sales figures from the Census Bureau are encouraging. Overall retail sales were up 0.5% in that month, more than double the increase economists widely forecast. There were notable monthly gains in auto and auto parts sales (+0.4%), electronics and appliance sales (+1.4%), clothing store sales (+0.5%), furniture sales (+0.5%) and online retail purchases (+0.9%). So we are seeing some good signals in terms of the more discretionary kinds of spending, in addition to the 0.5% July increases in spending on food and the 1.7% advance in retail gasoline sales. Factor in the pullback in gasoline prices we've seen recently, and consumers might have even more money for discretionary purchases in August.7

Regardless of the near-term answers, exiting stocks might not be wise. While past performance says nothing of future results, a newly released Fidelity study really illustrates the merits of perseverance. Fidelity looked at 7.1 million 401(k) accounts within its employer-sponsored retirement savings plans to compare returns for investors between October 1, 2008 and July 1, 2011. It found that plan participants who set equity allocations to 0% sometime between October 1, 2008 and March 31, 2009 have seen account balances increase an average of 2% since that decision, while investors who simply left asset allocations in stocks unchanged during those 6 months saw their account balances rise by an average of 50%.8

Many market bears thought it would take years for Wall Street to recover from that downturn, and some thought the post-Lehman "new normal" would be a Dow in the 8000s – or the 4000s. Then the gloom lifted, earnings and indicators improved and stocks took off.

There's an old saying that you don't want to miss the best market days. While there's no telling if those days are weeks, months or years away, investors who stay in stocks have a chance to capture their potential.