A RECESSION IN PINK
by John Mauldin

Recessions and depressions are usually the result of a catastrophic event, either natural or man-made. Wars and droughts, plagues and governmental stupidity have all been a cause for economic hardship.

But sometimes it is simply the rise and fall of the economic tide, each wave either bringing us closer to the shore of prosperity or further away. Looking at long periods of economic history, we can see those waves. Especially since the industrialized period, those waves have become quite pronounced.

This weekend, I was with my 10-year-old son, sitting rather awkwardly on a surfboard at La Jolla Beach, listening to a young surfing god (Ralph West) teach my son about catching the wave. They come in sets, and it is important to wait for the right wave - to look out over the horizon and see what swells are coming.

The swell determines the nature of the waves. Is it a New Zealand or a Hawaiian swell? Will it break to the right or to the left? Do you need a long board or a short board? Do you need fins? Will the swells be 5 or 15 minutes apart? Will you be able to find the green room, that special place where the wave curls and you ride through the tube? Will you be stuck in the whitewash, a garbage day fighting the wind and weather?

Or will the surf be so small and timid that only the very good or the very light can catch a wave, and for only a few seconds? Such was the case last week, and thus I felt comfortable going into the surf with my son. Six-foot waves would have kept this old body on the shore. One must know one's limitations.

And thus it is with economic patterns. Is it an inflationary or deflationary swell? Is it a secular bear or a secular bull wave? Knowing where you are in the cycles is important.

Taking a long-term view, we are in a secular bear cycle. The stock market will eventually, over the coming years, find its way to below-trend valuations (P/E ratios) probably somewhere in the low teens, if not lower.

On the intermediate term, we seem to be in a range-bound trading cycle. As Bill King noted today: "Most everyone realizes that stocks have traded sideways for 2004. The DJIA's 8% range for the past seven months is a historically tight range. The venerable Richard Russell recently noted that the 8% range equates to the 1972 market. Mr. Russell adds that the historic bear market of 1973-74 ensued. The Amex, which then housed the speculative issues and small caps, lost 89% of its value.

"... Comstock Partners sees a similarity in some of the major indexes' 2004 actions with their respective 2000 action. Comstock acknowledges that 2004's range is tighter because it is a mini-bubble, compared to the 2000 grand bubble."

There has never been a true long-term bull market that started from the valuation levels at which we find ourselves today. You can get substantial bear market rallies, as we did in 2003. As I have noted before, the market goes up 50% of the years within a secular bear market.

As Russell noted, the nasty 1973-74 bear market followed that tight trading range-bound market of 1972. The trigger for that bear was an oil shock and a nasty recession.

We could, and probably will, see a range-bound market for some time. But the next major turn of the market will be down, pushed over the cliff by a slowing economy and/or a recession.

On average, the stock market drops 43% in a recession. That means a Dow in the 6,000 range. The Nasdaq will be ugly, as it is the most overvalued of the indexes.

In the "for what its worth" department, my friend Gary Scott sends me his daily letter, full of interesting ideas on investing and the occasional odd tidbit.

He likes looking for trends, so in yesterday's letter, he reminded me of a very serious group called the Williams Inference Center, which sifts through mountains of reports and data looking for disparate anomalies that taken together may tell us of some new trend. They have a good track record of drawing attention to trends before they become mainstream.

He shared some of their current thoughts, like a slowdown in U.S. business around the world due to unfavorable world opinion and reaction to Iraq; that individuals will overtake corporations as the drivers of change; that there will be a surge in demand for genetically modified grain crops, especially in India and China, etc., where the middle class is rising and restrictions are few; and growth in low-cost sensor technology (such as radio tags).

They also mention that Saudi Arabia (the major source of U.S. imported oil) - not Iraq - will present the most problems in the Mideast: big debt...a handful of aged ruling families...a shrinking middle class and declining per-capita income. Any problems there could easily and drastically impact U.S. oil interests.

I find myself nodding with interest, as these all seem reasonable enough, and indeed, I also think they are true. Then we come to the last one: "The rise in the popularity of the color pink may foretell a harsh stock market reaction - pink (psychologically) symbolizes delusion and denial. Pink is the equivalent of rose-colored glasses."

Not remembering any pink shirts in my closet, I asked my daughter, who works across the hall, if pink was showing up any more than usual. "It's really big now, especially overseas," Tiffani reported, just coming back from six months in Cypress and Eastern Europe.

Intrigued about this unusual inference from what is a rather scholarly, staid and usually skeptical outfit, I called James Williams and asked about the danger in the color pink.

"Pink," he says, "is regarded in the psychiatric literature as the color of denial. And we have been seeing a rise in the use of pink in clothing for the past few years. People are buying pink clothes for their dogs. I even have a clipping where men are buying women's shoes so they can wear pink shoes." So far, that latter trend has skipped Texas, but when I am in London and Paris next month, I will keep an eye out and report back to you.

(I just turned around and saw Jim Cramer on Kudlow & Cramer (CNBC) wearing a pink shirt - at least it was pink on my set. Yet another confirmation anomaly for Mr. Williams. Is Cramer in denial? Or maybe it's his wardrobe manager? He did look good in it, though.)

Williams then drew my attention to three areas of denial: debt, age and law. People deny they are in debt, and add more. They deny they are getting older. And they deny the law, breaking it with no compunction. He has cabinets full of stories confirming the tsunami of denial breaking over our collective minds.

In the '90s, people ignored risk. After the market crash and the recession, they now verbally acknowledge risk, but essentially deny it is there. They press forward as if the denial of a secular bear market will cause it to go away. The biggest trend in TV, Williams notes, is now reality TV. We seek our reality in our entertainment and deny the reality in our lives.

"It is all quite entertaining," says friend Bill Bonner, "watching the masses create another bubble, denying the risk, telling themselves they are getting rich as their paper wealth grows along with their debt."

But it will not be so amusing for those in denial come the next recession, whenever that takes place. It takes two, and sometimes three, bear markets to bring reality back to a bubble-intoxicated market. At least that's what the psychologists who study such things tell us.

The next recession may bring the end of denial, at least for this cycle. It will also destroy a lot of paper wealth in the process.

Surf's up...or is it down?

Regards,

John Mauldin
for The Daily Reckoning

Editor's Note: John Mauldin is the creative force behind the Millennium Wave investment theory and author of the weekly economic e-mail Thoughts From the Frontline. As well as being a frequent contributor to The Daily Reckoning, Mr. Mauldin is the author of Bull's Eye Investing (John Wiley & Sons, 2004), which is currently tracking on The New York Times business best seller list.

In his easy-to-read, straightforward style, Mauldin spots the big market trends - and shows you how to profit from them. Bull's Eye Investing is a must-read road map if you want to avoid the pitfalls of the modern investing landscape...