Barton Biggs runs Traxis Partners, a multi-billion dollar macroeconomic hedge fund based in New York City. He was formerly the Chief Global Strategist for Morgan Stanley and was with that firm for 30 years. He was often ranked as the number-one US investment strategist by the Institutional Investor magazine poll. His most recent book, Wealth, War & Wisdom, is available via the link below.

We spoke with Biggs on December 8.

In your book, you say investors should worry about truly worst-case scenarios, which you call the “barbarians at the gate” that could lead to a breakdown of civilization’s infrastructure. In this context, what concerns you most in today’s environment?

I am most concerned whether, for any reason – newer and bigger credit problems than we now envision, or the amount of deleveraging that still has to occur – we could go into a double-dip in the economy. Obviously, a lot of the ammunition [specifically fiscal and monetary supply options] has been spent. You could certainly make case, as some of the bears do, like Roubini, that we could get into a cascading stock market and economic decline. Along with that could come some very serious anarchy.

We have to be alert to the canaries in the coal mine, such as what was going on in Iceland and Turkey in 2007 and in the mortgage industry in the US beginning in 2002.

Is what’s happening now in Dubai and Greece, for example, a canary in the coal mine? In Greece, there is real chaos and anarchy, with mobs on the street. If Dubai goes down the drain, there’s going to be serious trouble, because they have a million or so imported workers from third-world countries. They are working their butts off, and they have been cheated for years, in terms of what they are paid and their food allowances. There are going to be real problems there.

You can make the case that it is not inconceivable that the barbarians could be at the gate in Europe, Japan and the US. It’s one chance in ten that’s going to happen.
but, as a person with wealth, you must ask what type of insurance to take out against that.

You suggest taking a “survivalist” posture to protect against these calamities. What steps should investors take now?

It sounds simplistic, but there’s nothing the matter with having some kind of self-sufficient farm that is not close to the big cities. It sounds almost stupid, but it sure paid off in occupied Europe during World War II. I don’t think periods of anarchy are going to last a long time in countries like the US. But could we have four or five months of anarchy? I think there’s one chance in ten that could happen.

How should investors treat the possibility of uncontrolled deficit expansion and runaway inflation? Is that one of the barbarians at the gate? How likely is that, and how should investors protect against it?

I’m not particularly worried about that in the near future. We’ve had a tremendous monetary expansion. But, on the other hand, we have a tremendous output gap and the rate of increase in wages is declining. We think that this year we will reach a point where there will be no increases in wages. In Japan, wages are actually declining. It’s unlikely we are going to have runaway inflation in that kind of environment for the next couple of years. Beyond that, we have to wait and see.

Do you worry about the decline in the dollar? Has this led you to be more diversified across currencies that you were perhaps a few years ago?

To some extent, yes, but in the long run the trade-weighted dollar is very close to a long-term secular low that goes back 50 years. I’m not concerned about breaching that low.

In terms of currencies, people are going to buy another piece of paper, one that is highly liquid and has a call on real assets and earnings power and has, in addition, a yield. That currency is called high-quality large-capitalization stocks in the US, Europe, Japan and the emerging markets. They may become a substitute, to some extent, for dollars and currencies.

You are on record as not being a gold bug. Do any commodities serve as effective hedges against declines in the financial markets?

It’s hard for me to conceive of commodities as hedges against the equities markets. Just like the equities market, commodity prices are very sensitive to economic conditions. The thing that will bring down the equity market is a real disappointment or a collapse in the economic environment. I don’t see them as hedges.
So are high-quality large-cap stocks a better hedge than gold?

Yes, much more so. What’s the P/E ratio on gold? What’s the yield on gold? It doesn’t have one, whereas I can prove to you that US high-quality, large-cap stocks are as cheap relative to value and to their history as they have been in hundreds of years.

As Winston Churchill once said of one of his political opponents – who was a vegetarian, a teetotaler and very liberal – the same is true of gold: it “has all the virtues I dislike and none of the vices I admire.”

Bill Gross of PIMCO says we are headed to a New Normal of muted returns, and that returns from the last 30 years were artificially inflated by leverage, lack of regulation, and financial innovation. Is he wrong?

I think that what he says about the New Normal is very rational, and the New Normal is the normal pattern after a big stock market bust and then a very substantial rally. Usually, in the 19 secular bear markets we’ve studied in the last 110 years, you then have a 5-7 year period of slow growth and nothing much happening in the economy.

It’s all very logical and sensible. But Gross’ thesis has been so embraced by everyone, and is now so much the consensus that everyone’s heads nod when you talk about it, that it’s going to be wrong for one reason or another.

You are in the v-shaped recovery camp, and have said that the steepness of the economy’s decline should lead to an equally steep recovery. Are you still confident that the shape will be “v” and not “w” or some other letter?

I’m confident, but I’m also looking at the data.

Are we getting some canaries in the coal mine? They were there in 2007 in Turkey and, in particular, in Iceland. That was the beginning of the serious issues that led to the financial crisis. Is what is happening in Dubai and what’s starting to happen in Greece? The numbers today [December 8] from Germany of a substantial decline in industrial production, instead of a substantial increase, are worrisome.

What economic and market indicators are you looking at to confirm (or contradict) your view of the direction of the market?

We believe that the PMI [purchasing manager indices] data are the single best indicator of what is happening in the economy, so we watch those very closely. Employment and what is happening to existing single-family home prices are the two other really important factors.
Where do you see employment heading? Will this be a jobless recovery?

We are following a pattern that is a little stronger in terms of employment growth than what occurred in 2003 and 2004 and in the early 1990s, but not as strong as the early 1980s. We will see continued improvement. It is not going to be really dramatic, but it will be better than the last two cycles.

Do US equity valuations, particularly among the S&P 100, already incorporate the v-shaped recovery?

No, they don’t. They are undervalued. The overall market, including small-cap and medium-cap stocks, is about fairly valued based on normalized earnings the way we calculate them, but big-cap stocks, like the S&P 100, are about one standard deviation cheap.

How are you calculating those normalized earnings?

We are normalizing using five years of history with a forward earnings component for 2010.

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