January 2015

Leave Them Laughing When You Go
By John D. Mueller

That’s what I hope to do by retiring now after more than 26 years crunching LBMC’s monthly economic and market forecasts. Stipulating of course that Joni Mitchell meant laughing with, not at (or cursing)—like many in these turbulent years. In this final issue of LBMC’s Economy Watch, I’ve compiled the recent summary of LBMC’s history and methods in Economy Watch and Market Watch, as a sort of coda.

Also as a thank-you from ‘M’ to those with and from whom I’ve been privileged to work and learn, starting with ‘L’ (Lewis E. Lehnman), ‘B’ (Jeff Bell) and ‘C’ (Frank Cannon), our clients, and ‘R’—‘L’s’ great mentor Jacques Rueff, whose analysis of the dollar’s ‘reserve currency curse’ (July & Oct 14 EW) and Rueff’s Law of Unemployment (Sept & Dec 14 EW) we tried to implement. If I had to cite one contribution to economic forecasting, it’s using the ‘World Dollar Base’ to predict the commodity-led price inflations (Aug14 EW) that triggered recessions in 1991, 2001 and 2007. It’s LBMC’s strategy for stock-market investing in market forecasts (Aug 14 MW & chart below). I plan to keep applying such principles at the nonprofit Ethics and Public Policy Center (www.eppc.org/programs/economics) to fix public policy.

S&P500 Total Real Return vs LBMC Strategy
(S&P500/CPI, D59=1; Investment in S&P500 on "buy,"; Treasury bills on "sell")

Last signal: "buy" based on data reported 15 November 2011.
An LBMC Retrospective: The Rueffian Synthesis

LBMC has been in business for 26 years, for the last 13 as LBMC LLC. LBMC originated in 1988 as Bell Mueller Cannon, Inc., becoming Lehrman Bell Mueller Cannon, Inc. in 1990 when joined by LBMC’s chairman Lewis E. Lehrman. All four original principals had backgrounds in American politics including connections with then-Congressman Jack Kemp, who persuaded Ronald Reagan to adopt the basic economic principles of his two presidential administrations. Lehrman nearly became governor of New York in 1982; Bell defeated N.J. Senator Clifford Case in 1978 and is now GOP candidate for U.S. Senate. Mueller was Kemp’s economist from 1979-1988; Bell and Cannon played key roles in Kemp’s 1988 run for president. In part, the formation of LBMC LLC recognized and formalized the logical separation of for-profit forecasting and non-profit public policy applications. What successes we’ve had are due in large part to the successful translation of the ideas of the great French economist Jacques Rueff (1896-1978: see January 2000 LBMC Report, available at http://eppc.org/ publications/jacques-rueff-political-economist-for-the-21st-century/) In coming months we plan to summarize the principles of what Mueller described in the June/July 1991 LBMC Report as “The Rueffian Synthesis”: http://www.thegoldstandardnow.org/the-rueffian-synthesis). These have permitted LBMC’s predictions of commodity-led inflations (e.g. the 1988-90 and 2000-2008 energy spikes which triggered the 1991-2 recession and Great Recession of 2007-9) as well as our longer- and shorter-term stock and bond market forecasts.
As I noted in the June 2014 issue of LBMC’s Market Watch, in coming months we plan to summarize the principles of what I once described as “The Rueffian Synthesis”—named for the great French economist Jacques Rueff (1896-1978), whose protege was LBMC’s chairman Lewis E. Lehrman (http://www.thegoldstandardnow.org/the-rueffian-synthesis). LBMC’s pre-history included a 1986 Wall Street Journal Op-Ed article, “The Reserve-Currency Curse,” which (following Rueff) described the peculiarities of the U.S. dollar’s role as the world’s chief official reserve currency. Since the article’s implications were chiefly for public policy rather than investing—I was then-Congressman Jack Kemp’s staff economist when I wrote it—the article can still be viewed on the website of the non-profit Ethics and Public Policy Center: http://eppc.org/publications/the-reserve-currency-curse/)

Having failed despite many years of trying to convince U.S. economic policymakers to change the policy, we founded LBMC to predict the consequences of that failure, as they work their way through the world’s markets for money (p. 3), prices (pp. 4-7) and real quantities of goods (pp. 8-10) .

Forecast summary: page 2; economic policy: page 3; inflation: page 5; real growth: page 8.
In one of three 1997 papers analyzing plans to “privatize” pay-as-you-go Social Security, we showed that “the stock market, apart from random variation, is largely determined by...the rate of economic growth, the varying size of generations, and the market’s volatility risk” (http://eppc.org/publications/if-economic-growth-falls-to-1-4-what-happens-to-the-stock-market/). It concluded that the Social Security “actuaries’ projections imply that the same factors that drove average real stock market returns up to 10% in the past 20 years will drive returns down to 1.5% in the next 20 years — almost exactly like the periods from 1901 to 1921, from 1928 to 1948, and from 1962 to 1982.” Also, “the same projections imply an average real return on the stock market of 3.2% over the next 75 years.” The chart compares the model with the stock market’s performance since, measured relative to real GDP. Also shown: the widely used (but wildly optimistic) extrapolation of equity returns since 1926.

S&P 500 Return Relative to GDP

vs. 1997 LBMC prediction based on generation size and market volatility

LBMC LLC (previously Lehrman Bell Mueller Cannon, Inc.)
Relative stock market return: S&P500 total return/GDP, risk adjusted; 2000=1

As I noted in the June 2014 issue of LBMC’s Market Watch, for the rest of this year we plan to summarize the principles of what I once described as “The Rueffian Synthesis”—named after the great French economist Jacques Rueff (1896-1978), whose protege was LBMC’s chairman Lewis E. Lehrman (http://www.thegoldstandardnow.org/therueffiansynthesis). Our first big call applying Rueffian analysis predicted a jump in CPI inflation, then about 4%, to a peak of 7%, triggering a mild recession when the Federal Reserve applied the brakes; both duly followed as predicted. (Due to its public policy implications, the Wall Street Journal article can still be viewed on the website of the non-profit Ethics and Public Policy Center: http://www.eppc.org/docLib/20050921_muellerscan4.pdf). Our early Rueffian analysis was far simpler than it is now, yet still good enough to predict a major episode of commodity-led inflation and recession most other forecasters missed. We have continued ever since to predict the consequences of U.S. policymakers’ failure to reform the monetary system, as they work their way through the world’s markets for money (p. 3), prices (pp. 4-7) and real quantities of goods (pp. 8-10).

Forecast summary: page 2; economic policy: page 3; inflation: page 5; real growth: page 8.
Continuing our retrospective overview of LBMC’s basic methodology, we focused last month on our long-term (75-year) forecast of the U.S. equity market, which we first elaborated in a series of reports beginning in October 1997. Though remarkably prescient in anticipating the stock market’s peak by 2000 and subsequent decline, any method based on annual data necessarily falls short when advising whether to be long the stock market at any given moment. Three years later, in the April 2000 LBMC Report, we put forward “A Rational Explanation for P/E Ratios” (later summarized in the nearby Barron’s article—which didn’t appear until June 2001). Then in the April 2001 LBMC Report we posed the question, “Is Equity-Market Timing Possible?” We answered with “a qualified ‘yes,’” showing how to convert the relationship between producer output prices to input costs into what is now LBMC’s Equity Buy/Sell Signal (pages 6-7).

As noted in the June 2014 issue of LBMC’s Market Watch, for the rest of this year we are summarizing the principles of what I once described as “The Rueffian Synthesis”—named after the great French economist Jacques Rueff (1896-1978). One of the most fruitful is “Rueff’s Law”—the relation between the share of labor income in total national income, and the unemployment rate, with which Rueff explained the unprecedented appearance of chronic unemployment in the U.K. in the 1920s and 1930s. We explained and updated Rueff’s Law in a series of LBMC Reports in 1993-94, including ‘How Can Wages Fall While Unemployment Rises?’ (March 1994: http://eppc.org/publications/how-can-wages-fall-while-unemployment-rises/), demonstrating the relation for the United States, and ‘A Challenge to Conventional Labor Market Wisdom’ (May 1994: http://eppc.org/publications/a-challenge-to-conventional-labor-market-wisdom-the-wedge-versus-social-wage-comment/), showing the same relationship in the U.K. (Samuel Brittan summarized the latter in the Financial Times, above). An updated U.S. chart is shown at the top of page 9, also compared with the pre-tax, pre-transfer measure used by French socialist Thomas Piketty in Capital in the 21st Century.

Forecast summary: page 2; economic policy: page 3; inflation: page 5; real growth: page 8.
Continuing our retrospective overview of LBMC’s basic methodology, we focused in July on our 1997 long-term (75-year) forecast of the U.S. equity market, and in August on LBMC’s short-to-medium-term Equity Buy/Sell Signal (pages 6-7). Like the 1997 long-term stock forecasts, our 1999 long-term bond forecast was made in debate about ‘privatizing’ pay-as-you-go Social Security retirement pensions (http://www.gpo.gov/fdsys/pkg/CHRG-106hhrg57507/pdf/CHRG-106hhrg57507.pdf, 87-110). The Social Security Administration Trustees’ advisory committee assumed long-term Treasury bond yields 2.8 points above long-term nominal GDP growth. We pointed out that this would violate a basic ‘stability condition,’ by requiring public and private debt to mushroom without limit. Our alternate forecast was that long-term Treasury bond yields would stay below the trustees’ projections for nominal GDP growth. So far, ours has been far closer to reality (chart below).

### Long-term Bond Yields vs. Average GDP Growth

In the past, yields were usually at or below average GDP growth.

![Graph showing Long-term Bond Yields vs. Average GDP Growth](chart.png)


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An LBMC Retrospective: The Reserve Currency Curse Abroad
By John D. Mueller

As we noted in the June 2014 issue of LBMC’s Market Watch, for the rest of this year we are summarizing the principles of “The Rueffian Synthesis”—named after the great French economist Jacques Rueff (1896-1978). Rueff was the first economist to describe the drawbacks of John Maynard Keynes’s plan to use one nation’s domestic currency, like the U.S. dollar, as an international reserve asset. Predicting episodes of commodity-price inflation using the World Dollar Base has been our bread and butter (page 5). But we’ve noted similar peculiarities when monetary authorities issuing currencies not typically used as official reserve currencies borrow from other central banks—for example, the European monetary system in 1992 (http://lehrmaninstitute.org/economic-policy/articles/1993%2001%2004%20%20WSJ%20The%20Curse%20of%20Being%20a%20Reserve%20Currency.pdf), Mexico in 1996 (https://archive.org/stream/), and Israel. The same was true also of Argentina’s 2001 peso crisis, which scarred a generation of Argentines, including then-Cardinal Jorge Bergoglio—now Pope Francis. As the chart below shows, Argentina erred by trying to peg its peso to the U.S. dollar, not by acquiring but rather borrowing official dollar reserves—using the proceeds to finance domestic lending, chiefly to the government.

Argentina’s Official Reserve Assets & Liabilities

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Continuing our retrospective overview of LBMC’s basic methodology, we focused in July 2014 on our 1997 long-term (75-year) forecast of the U.S. equity market; in August on LBMC’s 2001 short-to-medium-term Equity Buy/Sell Signal (pages 6-7), and in September on our 1999 long-term (75-year) bond forecast. We now complete the cycle with the methodology of our short- to medium-term bond forecasts. Our 1999 analysis had shown that long-term Treasury bond yields have stayed below the long-term average of actual nominal GDP growth, so our 1999 forecast predicted that they would stay below the Social Security trustees’ nominal GDP projections. And this has been far closer to reality than the advisory committee’s much higher projections. Our January 2001 LBMC Report (“Bond Forecasting to Maximize Investment Results”) showed that most bond forecasts are systematically biased, and we have used this knowledge since then to predict long-term bond yield fluctuations around that trend (chart below).

As we noted in the June 2014 issue of LBMC’s Market Watch, for the rest of this year we’ve been summarizing the principles of “The Rueffian Synthesis”—named after the great French economist Jacques Rueff (1896-1978).

Though LBMC has updated and applied Rueff’s ideas to forecasting the economy and markets, we have also proposed U.S. economic policy reforms we believe are in the public interest. We proposed the “LBMC Plan” for income tax and social security reform to the 1995-96 National Commission on Economic Growth and Tax Reform. And in December 2012, we summarized a comprehensive economic plan to update the four basic principles of all economically and politically successful American economic policy. We called it “The Agenda: What Is to Be Done.”

As we noted in the December 2012 Economy Watch, “We think the agenda will update and apply these successful principles as follows:

1. “Instead of taxing income when received by workers and investors, all labor and property income will be taxed when first paid by businesses, governments or non-profit foundations, at a single flat rate, with no exclusions or credits (including capital gains and capital consumption allowances). A single credit for ‘human maintenance,’ based solely on family size, will rebate income and payroll taxes up to the poverty level.

2. “Current Social Security, Medicare and Medicaid benefits will be balanced by current payroll taxes and premiums. But if legal abortion continues—which caused the entire prospective deficits by cutting the workforce and U. S. total fertility rate (from 2.5 to 1.9 children per couple)—benefits will be proportional not only to past contributions but also to the number of children each worker has raised.

3. “Unemployment insurance—which added more than 3 percentage points to the unemployment rate when it was extended to as many as 99 weeks—will be restored to its original 26-week limit.

4. “Automatic open-ended financing of Federal deficits by the Federal Reserve and foreign central banks will be ended, by defining the dollar again as a weight of gold, while refunding existing official dollar and other foreign currency reserves, much as Alexander Hamilton refunded the massive Revolutionary War debt.” The November elections offer The Agenda new promise.
In the June 2014 issue of LBMC’s Market Watch we began summarizing the principles of “The Rueffian Synthesis”—named after the great French economist Jacques Rueff (1896-1978). In founding Lehrman Bell Mueller Cannon, Inc., of which LBMC LLC is the successor, we were motivated not only by the desire to earn a living but also to settle policy disagreements among former staffers and advisers to then-Congressman Jack Kemp (1935-2009) that could not be settled by differing theories alone. Lewis Lehrman had been Rueff’s protégé, The Lehrman Institute had published Rueff’s complete works in French, and Lew persuaded Rueff to write his autobiography. At LBMC we updated and tested Rueff’s theories with empirical evidence. LBMC’s first big call was to predict, based on the 1986-1988 expansion of the World Dollar Base, the sharp rise in PPI and CPI inflation in 1989-90 (p. 2), the Fed’s response of interest rate hikes, and ensuing 1991-92 recession. When Jude Wanniski at Polyconomics, Inc., disputed the prediction, I wrote a long LBMC Report, “The Rueffian Synthesis,” which tried to explain how we at LBMC had applied Rueff’s analysis, and responded to Jude’s objections. I showed the basic trouble with his proposal of targeting the price of gold: the policy involves buying and selling dollar securities, initiating a roundabout arbitrage in the financial markets and real economy, while the gold standard ultimately involves buying or selling gold, tying monetary policy directly to the commodity market. The lag between World Dollar Base changes and their effect of commodity markets, including the gold price, is simply too long to make gold-price-targeting feasible, since the Fed would in effect be reacting to echoes of what it and other central banks had done one to three years earlier. Lew and I co-authored a ‘Rueffian’ Wall Street Journal op-ed article: “How the ‘Reserve’ Dollar Harms America,” http://online.wsj.com/news/article_email/how-the-reserve-dollar-harms-america-1416527644-lMyQjAxMTI0NDI4MTcyNjE2Wj

As we proposed in the June 2014 issue of LBMC’s Market Watch, for the rest of this year we’ve been summarizing the principles of “The Rueffian Synthesis”—named after the great French economist Jacques Rueff (1896-1978). In a series of LBMC Reports beginning in 1993 (and continuing through 2014), we focused on an issue that has increased steadily in salience (most recently by the French socialist Thomas Piketty): the “middle-class squeeze.” In developing our thesis we applied ‘Rueff’s Law’: the close relationship, first demonstrated by Rueff, between the share of labor income in total national income (measured after taxes and social benefits) and the unemployment rate. As we noted when analyzing Piketty’s thesis in the April 2014 issue of LBMC’s Economy Watch (“Monsieur Piketty, Meet Monsieur Rueff”), Piketty measures income before the sort of steeply redistributive policies he proposes. “Workers’ take-home pay has been reduced,” we showed, “—but by expanded shares to the unemployed and those outside the labor force—not ‘capitalists’.”

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