

March 14, 2014

Dear clients and colleagues,

Labor inflation is a hot topic in emerging countries. Wages in China and India are expected to increase by 10% or more in 2014. In Asia Pacific, salaries are expected to rise 7%. According to Hay Group, salaries in Europe are expected to rise 3.1% on average. However, in the US the real wage rate has hardly changed over the last forty years, and the picture is the same in Britain and Germany where wages have been flat for a decade.

This week's commentary will focus on the debate over minimum wage increase in the US, and its potential economic impact throughout the country.

The Positive

The Median family income in the US is at its lowest level since 1995. Real average hourly earnings have also steadily declined. The gap between the rich and the poor has widened. The average person has not benefitted from the so-called recovery, and in most cases it is the economic elite who have benefited from any financial rebound.

To address this growing inequity, the Obama administration has suggested increasing the federal minimum wage from \$7.25 to \$10.10 in increments over several years. There are currently more than 16M low-wage workers, and according to the Congressional Budget forecast, raising the minimum wage would lift almost a million of them out of poverty.

Another benefit to raising the minimum wage could be lower job turnover. This would help employers reduce costs because they will have less training expense, more committed employees, and most importantly they will not lose business over staff shortages.

A large and thriving middle class is a positive for long-term economic growth. After all, if customers don't have money, businesses won't have customers.

The Negative

Current recovery in the US has produced the least amount of jobs in the past 50 years. While some of the frailty can be related to weaker demand, a large portion can also be attributed to lack of visibility created by politicians. Employers face uncertainty such as health care costs, increased regulations - particularly in the financial sector, tax rates, and now increases in labor cost.

Is raising wages the answer? According to Adam Smith's invisible hand theory, we should let the market decide and not impose an arbitrary compensation amount for employees. Basic economics states that if you

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increase the price of an item and keep the price of everything else constant, you will lose demand for that same item. The labor market is no different.

If there is a wage increase, employers may hire fewer workers or simply turn to automation. The impact of such a change would be felt most by low-skilled workers. Teenagers might find it difficult to get their first job, which could be a stepping stone to greater financial mobility. Companies may decide to relocate to other countries.

Another effect would be an increase in prices - the historical consequence to arbitrary wage increase. In the end, increasing the minimum wage could be worth a lot less due to inflation.

Portfolio Impact

If minimum wages were to increase, companies would evaluate alternatives to increase productivity. Just as an ATM has replaced a bank teller, technological innovation may make a lot of jobs redundant. However, the outlook is not all doom and gloom. In fact, industrialization did not end up eliminating the need for human workers, but rather gave life to a new and vibrant economy.

At Global Alpha technological innovations and productivity improvement have always been favored investment themes, and continue to provide substantial investment opportunities. Our portfolio is well aligned to benefit from any shift that may occur due to wage increases, whether it results in automation or outsourcing.

Conclusion

In our opinion wage increase will not be the solution to end income inequality. Education, training and opportunity are what make the real difference in people's lives. Individuals need to invest in the training and education that is currently in demand. After all, machines can only replace tasks that are repetitive. Automation cannot replace a golf instructor, dentist, engineer, recreational therapist or actor - just to name a few. As for machines with artificial intelligence, let's leave that subject for another week.

Enjoy the weekend,

The Global Alpha team

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