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INVESTMENT SERVICES

Weekly Relative Value

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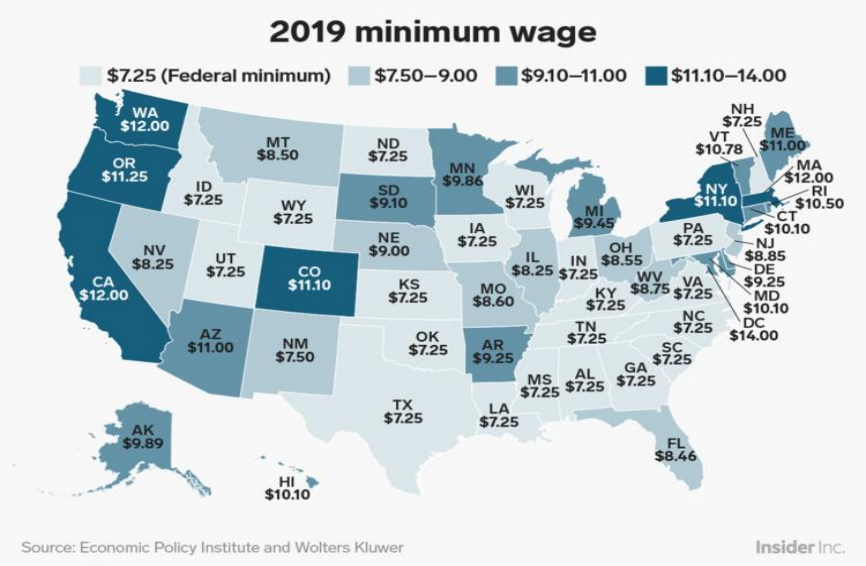
Be Careful What You Wish For

The Biden administration is advocating that the minimum wage be raised to $15 an hour. While the federal minimum wage of $7.25 per hour has not changed since 2009, many states have set their minimum wage above that level.



Bond bears worry that raising minimum wages will lead to higher inflation. Is that really true? Would lifting wages for the lowest rungs of the income ladder materially influence prices? The short answer is no.

First and foremost, only 2% of all hourly workers are earning the federal minimum wage of $7.25 (or less), a small share of the total labor force. And who really gets paid that? Teenagers? Gig economy workers?

But there is another segment of the population making between $7.25 and $15 per hour given that 29 states have minimum wages above the federal level. In total, the Congressional Budget Office (CBO) estimates that changing the federal minimum wage to $15 would increase the wages of 17 million workers (6.5% of all workers in the U.S) in 2025.

If the minimum wage bill were passed (highly doubtful) the higher wages would put upward pressure on labor costs and compress margins. In the immediate aftermath of the wage hike, businesses would look to maintain output, meaning compressed margins or higher

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PORTFOLIO STRATEGY

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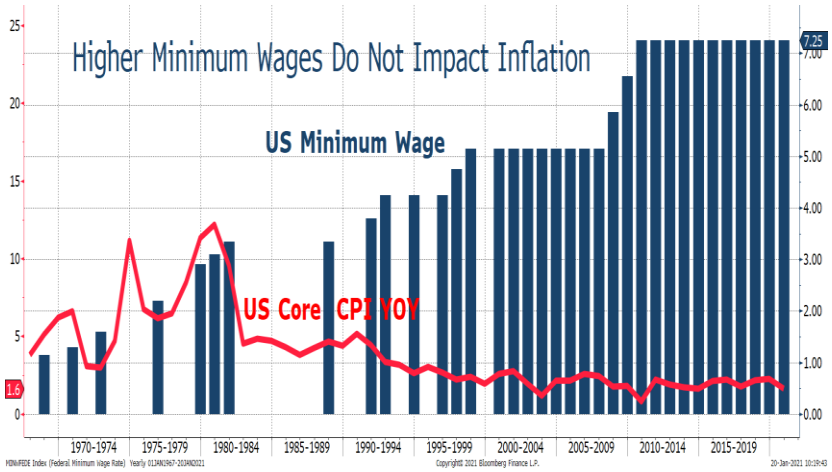
prices. Then with a lag, employers would look to decrease their workforce where possible via automation to compensate for increased wages.

Ultimately, the CBO estimates that hiking the federal minimum wage from $7.25 to $15 per hour will eliminate up to 3.7 million workers who would otherwise be employed.

Obviously, those that keep their jobs will enjoy a substantial income boost (over 100%), but again, according to the CBO, the average wage gain for low-wage workers overall will be closer to 21%. The good news is these low-wage workers' family income would increase, which would lift some families out of poverty. But other low-wage workers would become jobless, and their family income would fall.

What about inflation? The graph below plots the minimum wage versus core Consumer Price Index (CPI) since the 1970s. For simplicity, let us look at the past four decades. In 1980, the minimum wage was $3/hour. It was raised several times, more than doubling to $7.25 an hour by 2009. Yet, inflation declined. In January 1980, core inflation was 12% and by July 2009, the inflation rate was 1.6%. Go figure.

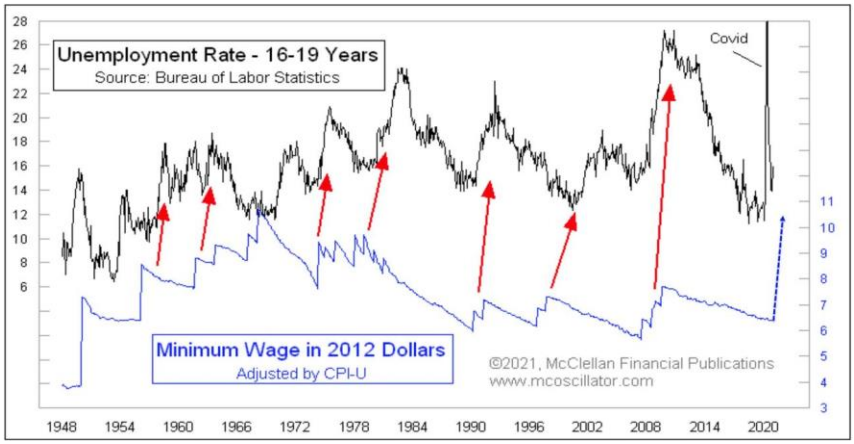


Regarding inflation, as shown above, the historical record shows any inflation linkage to be insignificant. Even if President Joe Biden manages to boost the federal minimum wage to $15, it will not spin the dial on inflation. Rosenberg Associates has modeled the potential minimum rate hike and concludes that inflationary pressure would add barely 0.2% per year during the transition period and have virtually no impact in the long run. The balance of the wage hikes would likely be absorbed by businesses through lower margins, and ultimately through automation. Bottom line: Inflation-phobes have bigger things to worry about.

"According to data from the Bureau of Labor Statistics, half of all workers in 20 states earned less than $18 per hour in 2019. In 35 states, the median hourly wage was less than $20. Setting a minimum wage so close to the median wage would price many workers out of the labor market. Indeed, in 47 states, 25% of all workers earned less than $15 an hour… A team of economists, including the University of Washington's Jacob Vigdor, have been studying the employment effects of Seattle's move to increase its minimum wage to $15. In 2016, Seattle — a high-wage city — had hit a $13 minimum, on its way to $15. The economists found that this led to a 9% reduction in low-wage jobs. The pay increase it generated didn't make up for the reduction in employment, and earnings fell for low-wage workers overall. The economists' subsequent research found that the gains from the higher minimum wage accrued to more experienced workers." – CBO

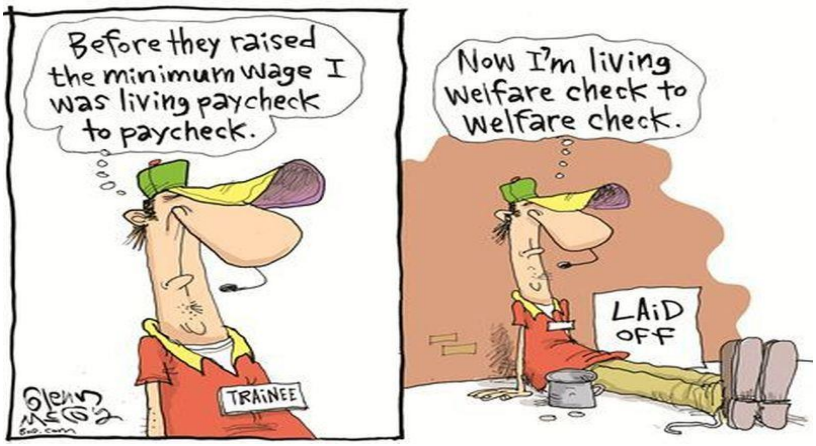
The CBO believes the impact on employment could be significant as rising minimum wages would lead to more labor market slack as firms accelerate the ongoing trend of automation. As such, employment will grow more slowly than expected with fewer workers demanded by firms.

Take a look at the graph below. Over the last 75 years, each increase in minimum wage has sparked a significant surge in unemployment for the lowest-skilled and lowest-earning members of the workforce (41% of minimum wage earners are teenagers).



This is the scoop. At $15 an hour, many unskilled workers simply will not be able to effectively compete against skilled workers and robots. Thus, by raising the minimum wage, we will have handicapped America's most vulnerable workers by taking away from them the most effective strategy they have: the ability to offer to work for a competitive wage that is consistent with their lack of skills. The cartoon below sums it up nicely.

Bottom line: Be careful what you wish for.



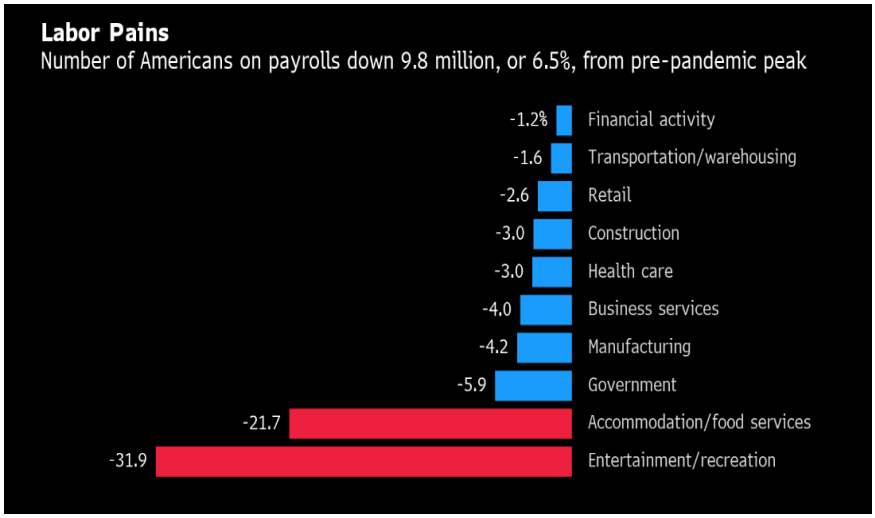
BLIND SPOTS

For years I have gone on record saying that inflation is under wraps primarily due to secular structural forces (i.e., massive deflationary debt, aging demographics, unprecedented wealth inequality, globalization and technology). I still believe these powerful secular trends remain in place.

Regardless, it is very important to look over your shoulder for differing perspectives. To that point, the Financial Times published an article titled, "US Inflation Pressure Cooker Builds Up Steam." According to the author, Gillian Tett, the factors that could unravel the secular inflation downtrend are 1) the end to cheap labor in China and Asia in general, 2) the weak trend in productivity, which boosts unit labor costs, 3) the reduced pace of globalization, cross-border trade and investment flows (aka Biden's "Buy America" policy), and 4) the pandemic-induced capacity destruction in many industries, which means any pick-up in demand could bump against supply-side bottlenecks.

These are very legitimate concerns and worth keeping an eye on, but I have not changed my view. In addition to the long-term secular forces, I remain in the low inflation camp for one big reason: the tremendous slack in the labor markets.

Today, there are over 10 million folks who are unemployed. Many economists believe that approximately seven million unemployed Americans are not going to be finding a new job any time on the horizon. There is no growth in the median wage, nor should there be, with one in eight Americans either unemployed or underemployed. With so much slack in the labor force, how can wages and inflation rise?



Source: Bloomberg

Leonardo Melosi, senior economist at the Chicago Fed, agrees and sees many years of sluggish inflation ahead.

"This is going to be a decade in which wages and inflationary pressures are likely to be moderate... I don't understand why markets see inflation around every corner... They [workers] find a job but it's not a job that fits their skills. And when a worker is in a bad job, they have lower bargaining power. Firms understand labor costs in the future are going to be low. Labor market slack is a multidimensional object — we study this particular dimension which is the degree of labor misallocation. I do not see why this type of slack would be removed going forward. I am talking about a large chunk of workers." – Leonardo Melosi

In addition to no wage growth, the consumer is in deleveraging mode with the savings rate almost double historical norms. The boom in the monetary supply is being offset nearly one-to-one by the accelerating contraction in money velocity. The impact of residential rents swamps any effects from the weaker dollar and rising commodity prices, and they will continue to dis-inflate in coming months and quarters under the weight of punishingly high apartment vacancy rates.

Rents. Wages. Credit. These are the three essentials you need to generate the inflation scenario that the bond bears are selling.

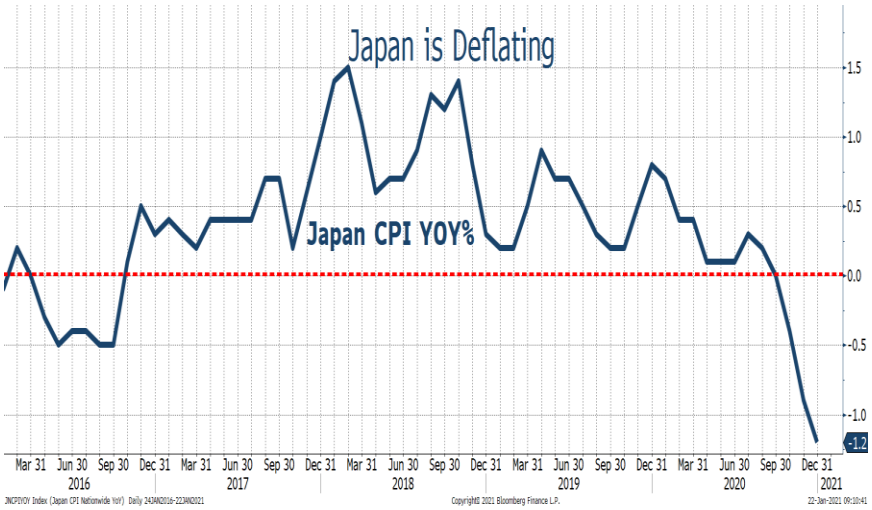
DISINFLATION IS GLOBAL

Research has proven country inflation is increasingly determined by what is happening globally and the wide global output gap (i.e., more supply than demand) is exerting deflationary pressure everywhere. Take a look at Japan, which has been the poster child for massive stimulus when it comes to negative rates, massive quantitative easing (QE) and rampant fiscal stimulus. Japan's government debt to GDP is at a mind numbing 235%. The Bank of Japan not only owns half of the JGB market, but also 7% of the stock market.

Maybe that's good news for financial inflation but there has been no impact on consumer inflation. In Japan, the CPI deflated 1.2% in December – the largest decline in 10 years. And it's not just Japan. The deflation/disinflation thrust is global in nature. In the eurozone, inflation is -0.3%. Switzerland is at -0.8% and has been deflating in each of the past 11 months. The U.K. inflation rate is 0.8% and in Canada it is 0.7%. Australia's inflation rate is the grand total of 0.7%. Previous inflation hot spots like Greece are seeing the year-over-year price trend at -2.3%; Spain at -0.5%; Italy at -0.2%; and Portugal at -0.2%!

This is a classic case of the law of diminishing returns.

The lesson being, once debt exceeds a certain level (which Japan, the U.S. and Europe have far surpassed) deflation instead of inflation becomes the primary risk.



FOREWARNED IS FOREARMED

"This time, more than in any previous bubble, investors are relying on accommodative monetary conditions and zero real rates extrapolated indefinitely." – Jeremy Grantham, co-founder of Bost-based GMO

Indeed!

"What were you thinking?" – Scott McNealy, CEO of Sun Microsystems

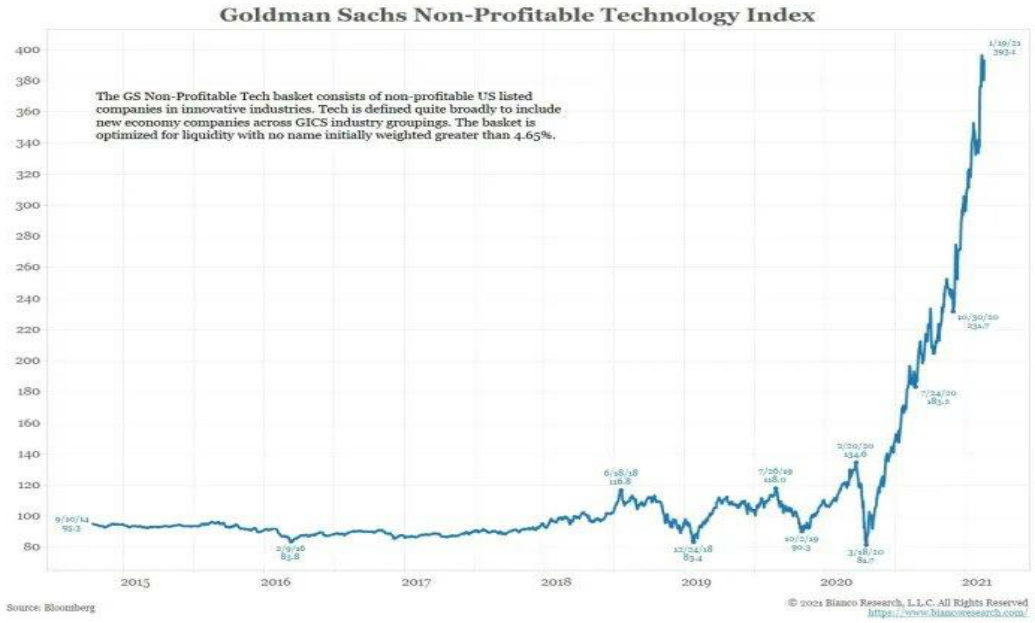
After the dot-com bubble burst, McNealy asked why investors would pay a "ridiculous" 10 times revenues for his stock at the height of the dot-com mania. Most likely, they were betting that the party would continue and someone else would pay even more. This is also known as the "Greater Fool Theory." But as we all know, the market ran out of fools and the Nasdaq fell 83%. Fast forward to today, nearly 60 of the companies in the S&P 500 Index trade at more than 10 times revenues. The poster child of extremism: Tesla trades at 30 times revenues.

Yet, despite the nosebleed levels, the venerable Goldman Sachs expects the market to rise an additional 15% in 2021.

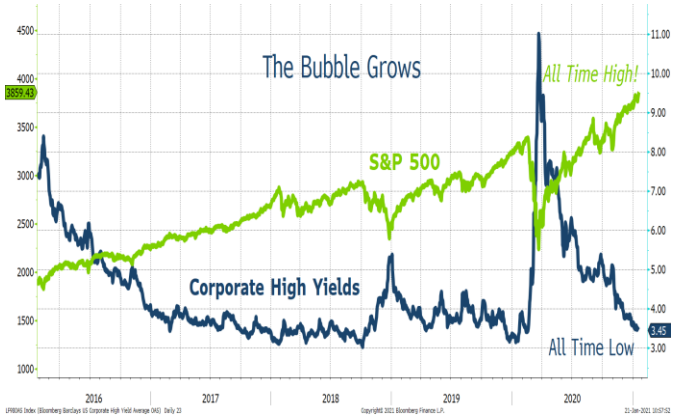
So why are investors driving prices even higher? The simple reason Wall Street remains optimistic is because everyone expects the Fed to be extraordinarily accommodative, interest rates will remain low and markets will still try to "extrapolate indefinitely."

Heck, maybe Goldman is right, and the market goes higher. Then again, maybe not. But what we do know with certainty is central banks have effectively broken the market. Capitalism is on sabbatical. Fundamentals do not matter.

The performance of a Goldman Sachs Group index of "unprofitable" companies is a case in point. This index of unprofitable companies increased almost five-fold from a record low on March 18 through last week. In this centrally planned market, earnings (at least for the time being) seem to matter not. From my perch, there's no telling when the current market will run out of fools this time, but, when it's all said and done, that last buyer may justly earn the title "greatest fool of all time."

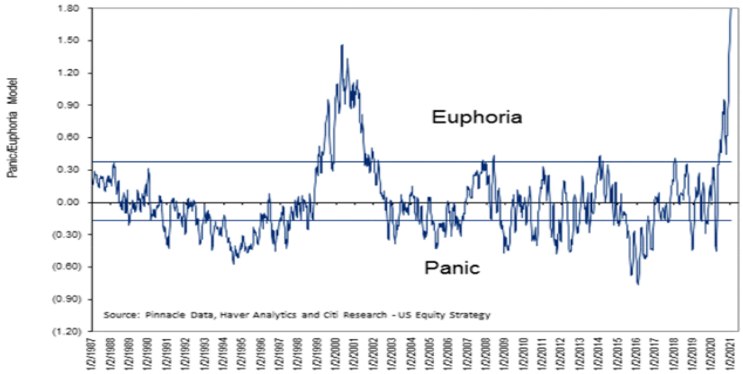


Or consider high yield bond (aka junk) markets. Interest rates are at a record-low of 3.45%. Apparently, there is not any credit risk in the junk bond market anymore. Truly amazing.



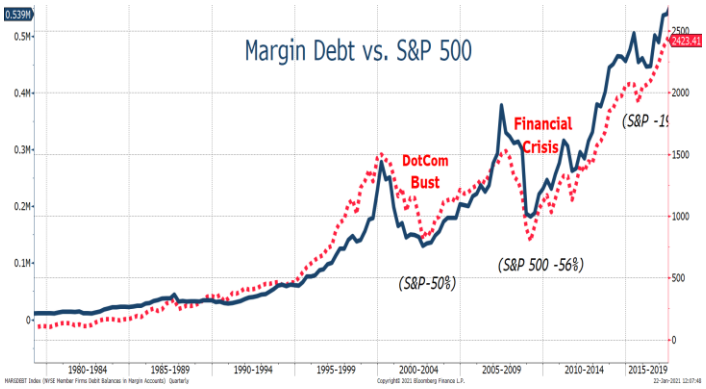
Speculation and complacency are off the charts. As with frogs in water that is slowly being heated to a boil, investors are being conditioned "not" to recognize the danger. In fact, investors are downright giddy. Throwing caution to the wind, investors believe that markets are bulletproof. The Fed will jump in and protect assets from deflating.

Maybe so, but historically, once investment sentiment reaches such an extreme level, the markets peak and reverse. Is this time different?



Source: Peter Boockvar

Here's another indicator highlighting how the markets have gone nuts. Margin debt spiked by $56 billion in December, after having already spiked by $63 billion in November, by far the two largest month-to-month increases on record, to $778 billion. Since March, this measure of margin debt surged by nearly $300 billion, or by 62%.

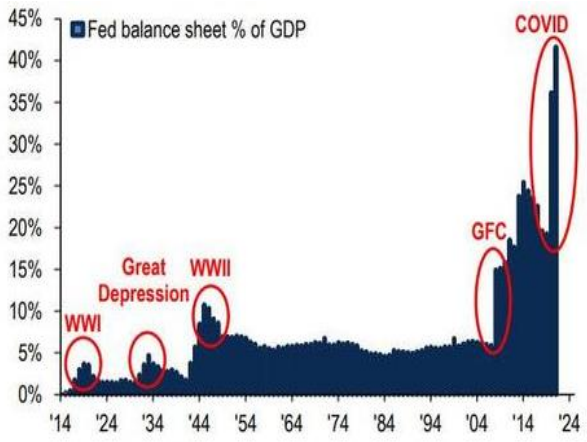


As annotated in the graph above, high margin balances tend to precede epic stock market selloffs. Everyone is chasing everything, and valuations be damned. But remember, while margin debt can enhance returns when the market is rising, it will also exacerbate the movements on the downside. There's an old Wall Street adage: "The market takes the stairs up and the elevator down." That's just a clever way of saying that the market tends to drop faster than it rises. We've seen this dynamic play out over the past two decades and it's likely to become more pronounced.

Grantham, a legendary value investor with over 50+ years of experience managing money, considers himself a student of bubbles. While early, he called the previous two bubbles. GMO exited Japan in 1987 and reduced its exposure to U.S. stocks in late 1997, dodging the dot-com wipeout. Grantham also raised concerns about housing prices ahead of the 2008 financial crisis. He now foresees a collapse rivaling the 1929 crash or the dot-com bust of 2000, when the Nasdaq Composite Index plunged almost 80% in 31 months.

"We will have a few weeks of extra money and a few weeks of putting your last, desperate chips into the game, and then an even more spectacular bust… When you have reached this level of obvious super-enthusiasm, the bubble has always, without exception, broken in the next few months, not a few years." – Jeremy Grantham

He also rejects the popular theory that the Federal Reserve can cushion or even reverse the next slide with the Fed pumping more liquidity into financial market. Consider the two graphs below courtesy of Bank of America. Fiscal and monetary stimulus have reached extreme levels. I suppose they can try to kick the can down the road a bit longer. But seriously, how much more can/will the government and Fed do? Even if they try will the market respond as it has in the past?



For the past decade, central banks have attempted to create consumer price inflation to no avail. But make no mistake, they have created asset inflation via immense bubbles in the stock market, housing market and bond market. In fact, the current bubble may well go down as the most momentum and speculation-driven asset mania in recorded history.

For now, however, stocks keep rising to records as even more stimulus may propel them to even higher heights. But make no mistake, the exponential increases in debt, leverage and speculation increase the risks of an epic bursting of a massive bubble. I have given up trying to figure out when, but it's out there.

Forewarned is forearmed.

Invest wisely.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Bloomberg's index of high-frequency data of the largest advanced economies suggest a resurgence of the virus and stricter social distancing measures are resulting in a stumbling of growth. The index, which measures energy consumption, public transport and mobility, has declined since mid-December. In the third week of January, economic activity fell across the board, moving lower in Germany, Italy, and Japan, remained somewhat stable in the U.S. and U.K., and showed modest improvement in Canada and Sweden.

Regarding stimulus, there doesn't seem to be bipartisan support for that $1.9 trillion fiscal relief plan. We will get something, but not that price tag. And it clearly is taking far longer than initially thought for the vaccines to roll out.

While there is light at the end of the tunnel, there is still a long and difficult road ahead before we are out of the woods. As long as the pandemic terrorizes part of the world, normality will not be restored anywhere. While U.S. and global growth is still on course to rebound from the recession of last year, it may take longer to ignite and not be as robust as previously forecast. In fact, double-dip recessions are now expected in Japan, the euro area and U.K. as restrictions are in place to curb the virus's spread. The World Bank already trimmed its prediction to 4% in 2021.

Also, there is significant financial strain with employment claims rising towards one million and, according to the Mortgage Bankers Association (MBA), the share of borrowers missing their mortgage payments has stopped declining and is stuck at approximately three million. Those folks unemployed or in forbearance are hardly likely going to be lining up for concerts, air travel or restaurants when it's safe to do so. The residual impact this has on the rest of us remains to be seen, but the expectations of some big pent-up demand economic rebound in the second half of the year are bound to be put to the test.

Finally, the data are telling us that inflation expectations are completely overdone. Thus, amid steady monetary policy, expect the long end of the Treasury curve to become anchored as uncertainty about the economic outlook and scope for further fiscal stimulus persists.

In terms of portfolio strategy perspective, reduce excess cash reserves, maintain a duration-appropriate, fully invested portfolio of high-quality fixed income securities. In terms of sectors, underweight traditional agency and CDs and overweight the higher yielding MBS and CMO sectors.

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For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at tom.slefinger@alloyacorp.org or (800) 782-2431, ext. 2753.

Tom Slefinger, Senior Vice President, Director of Institutional Fixed Income Sales, and Registered Representative of ISI has more than 30 years of fixed income portfolio management experience. He has developed and successfully managed various high profile domestic and global fixed income mutual funds. Tom has extensive expertise in trading and managing virtually all types of domestic and foreign fixed income securities, foreign exchange and derivatives in institutional environments.

At Alloya Investment Services, Tom is responsible for developing and managing operations associated with institutional fixed income sales. In addition to providing strategic direction, Tom is heavily involved in analyzing portfolios, developing investment portfolio strategies and identifying appropriate sectors and securities with the goal of optimizing investment portfolio performance at the credit union level.