OPPENHEIMER
INVESTMENT MANAGEMENT

Immigration and Its Impact on our Economy

A Brief Recap

The post-pandemic surge in inflation is now understood to be a result of a combination of factors. First, there was a big negative aggregate supply shock. Early in the pandemic, a very significant portion of the U.S. and world economy shutdown. The U.S. economy's Gross Domestic Product (GDP) contracted by -28% (quarter-over-quarter, annualized) in the second quarter of 2020. The United States labor force lost 6.3 million workers or 3.9% of the total in the month of April 2020 alone. The U.S. labor force did not recover to its February 2020 level until 30 months later in August 2022. The impacts of lost production on supply chains caused the FRBNY Global Supply Chain Pressure Index (GSCPI) to remain significantly elevated until early 2023. Second, there was a big positive demand shock. Stimulus bills approved by Congress pumped nearly $5 trillion of federal money into the economy. Economists debate whether, with the benefit of hindsight, this was too much, but the consequence of doing too little – depression - was unacceptable to all. With most of the population staying home, demand was disproportionately directed to goods purchases, exacerbating goods inflation pressure. Then as we began to venture out again to offices and restaurants, travel, etc. demand was disproportionately directed towards labor-intensive services, exacerbating services and wage inflation while the process of goods disinflation began.

Finding Answers for a Continued U.S. Economic Expansion

The economics profession has long sought to understand the inflation process in terms of overheating. Is the economy growing too fast relative to its long-term potential? Is hiring too rapid? Is the unemployment rate too low (labor market too hot) driving wage inflation? Are interest rates too high (restrictive) or too low (accommodative)? In 2023, many economy watchers were somewhat puzzled as economic data came in that challenged this overheating framework for understanding inflation. The Federal Open Market Committee (FOMC) had raised rates significantly (525 basis points) in a very short period (16 months). In early 2023, there was near unanimous agreement that a significant growth slowdown, if not recession, was imminent, as interest rates were now into restrictive territory. Instead, we got the opposite. GDP accelerated from 2022's 1.9% pace to 2.5% in 2023, with the strongest growth in the second half of the year when higher interest rates should have been having its greatest effect. The consensus view of sustainable or potential (non-inflation inducing) GDP growth was around 1.8%. Non-farm payrolls did slow somewhat, from 2022's blistering 377k average monthly rate to 2023's 251k average monthly rate, but this was still well above estimates of neutral payroll growth of around 100-150k. The unemployment rate in 2023 ticked higher from 3.5%, but remained a very low 3.7% (below neutral). One would expect the unemployment rate to decline given an above neutral rate of job growth. The Employment Cost Index (ECI), a measure of wage and benefit cost growth, declined from 2022's 5.1% pace to 2023's 4.2% pace, again unexpected given robust job growth and low unemployment. Finally, despite all the data warning of overheating and inflation, we saw the Fed's preferred measure of inflation, the Personal Consumption Expenditure (PCE) Core Price Index continue to decline from 2022's 4.9% pace to 2023's 2.9% pace.

What Happened? Immigration

Some things are understood and expected. Supply chains healed. Used and new car prices declined. Measures of housing inflation peaked in the first half of 2023 and have begun to slow, but not as much as expected. In early 2024, the Congressional Budget Office (CBO) released updated estimates of immigration that appear to explain at least some of the contradictions in the economic data. In 2019, the CBO projected net immigration in 2023 would total 1.0 million people. The updated estimate for net immigration in 2023 is now 3.3 million people. Immigrants are known to have high labor force participation rates, but their entry into the workforce can be delayed by months depending on status. The implications of a surge in immigration is a surge in labor force growth, which will allow faster non-inflation inducing consumer spending growth, GDP growth, and job growth. The surge in immigration has an ambiguous impact on overall inflation as both aggregate supply (of labor which accounts for ~70% of business costs in the economy) and aggregate demands (more people buying groceries, gasoline, clothing, homes) grow. A larger labor force will put downward pressure on wages, all else equal. Less so, when an economy is at full employment, as we are now. A rapid population surge would also be expected to temporarily support housing inflation, as building new housing stock, particularly in the dense urban environments where immigrants have typically settled, takes time. Higher potential GDP growth and labor force growth also means that interest rates are likely not nearly as restrictive as previously thought, at least in the short-term.

The CBO expects continued high rates of immigration in 2024 and then normalization over the 2027-2028 period. With this expectation, the mostly beneficial effects of immigration driven labor force growth are anticipated to continue over the near-term. Labor force growth is not the whole story on inflation, however. Recent higher than expected inflation reports have renewed concerns. We still see distortions from the pandemic. For example, motor vehicle insurance is up 22.2% year-over-year in March 2024, catching up to higher prices for new and used automobiles over the past few years, but which are now declining. We believe robust consumer demand growth and the supply/demand balance for labor are still probably a bit inflationary, but not as much as previously thought. Additionally, monetary policy is perhaps not quite as restrictive as previously thought, undermining expectations for the timing and magnitude of rate cuts in 2024-2025 and beyond.

Investment-Grade Corporate Bond First Quarter Performance

U.S. investment-grade corporate bonds traded roughly sideways during the quarter, down -0.4%, as the rise in U.S. Treasury yields was mostly offset by continued spread tightening. Per the Bloomberg U.S. Credit Index, investment grade corporate credit tightened by 9 bps versus comparable U.S. Treasury yields in the first quarter. The Bloomberg U.S. Credit Index measures the investment grade, U.S. dollar denominated, fixed-rate, taxable corporate and government-related bond markets. There are no positions in the portfolios with any credit or sustainability concerns through the market cycle.

High Yield Bond Sector First Quarter Performance

High yield fixed income bonds returned a modest 1.5% in the first quarter but was also the best performing domestic fixed income asset

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class. Lower rated credits outperformed from a quality perspective, with CCCs returning 2.1%, followed by single-Bs at 1.4%, and BBs at 1.1%. High yield spreads started the quarter at 346 bps and ended at 319 bps, as continued strong economic data combined with the market's expectation of a Fed pivot drove spreads tighter. High yield bond data is representative of the U.S. High Yield Corporate Bond Index which is designed to track the performance of U.S. dollar-denominated, high-yield corporate bonds issued by companies whose country of risk use official G-10 currencies, excluding those countries that are members of the United Nations Eastern European Group (EEG).

Monetary Policy: We believe the Fed has exceeded the neutral rate after completing eleven quarter-point increases since March 16th of 2022 resulting in the current Fed Funds rate of 5.25-5.50%. The most recent Fed meeting on March 20, 2024 led to no surprises as members were steadfast in their comments that they remain data dependent and not in a hurry to cut interest rates, keeping with their measured approach. We have been proven correct that rate cuts would not come as quickly as the market expected at the beginning of the year. We anticipate their first cut may likely occur in September and that the Fed Funds rate will end the year in the 4.75-5.0% range with more cuts likely going into 2025.

Interest Rates:: It is our view that as a result of one or two 25 basis point Fed rate cuts during the later second half of 2024, the front end of the curve will decline. We maintain a bias for interest rates across the curve to drift lower from current levels later in 2024, resulting in a modest flattening of the curve. We now expect the 10-year Treasury yield to end the year between 3.75% 4.00%.

Investment-Grade Corporate Bond Outlook: Corporate securities remain top performers thus far in 2024. Strong technical factors are still in the driver's seat as demand for investment-grade credit remains overwhelming and supply is starting to ease off the earlier record pace. We believe this imbalance will continue to put downward pressure on credit spreads in the coming months. In our view, the core driver for this demand is simply attractive yields and so it is unlikely to subside even as spreads move to levels that are near all-time tights. As always, we believe credit selection will be paramount as the focus will shift toward fundamentals and the ability of corporates to navigate any macro uncertainty with U.S. economic growth risks tilted to the downside.

High Yield Bond Outlook: We anticipate taking some spread risk off the table and moving up in quality as valuations are near post-crisis tights and are not currently compensating investors for a potentially bumpy economic landing. We expect a very modest increase in high yield defaults during 2024 paired with modest spread widening. The long-term average high yield bond default rate (since 2017) is now at 2.1%.

Despite peak economic growth and interest rates behind us for this cycle, fixed-income remains an attractive asset class in 2024. In our view, investors have opportunities for increased income and yields in the future. These unique economic times require a steady hand and a consistent, thoughtful approach to investing. While never losing sight of the global and domestic economic environment, we believe our long only, research driven style of investing has historically delivered excellent results over the years with far less volatility than our peers. We have never departed from our investment philosophy, process and management style.

If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

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* **Past performance is not a guarantee of future results.** 6551044.1