

100 days of change

March 3, 2017

The importance of immigration

In brief

- Early actions and statements by the Trump administration suggest significant changes to both illegal and legal immigration into the U.S.
- Fewer illegal immigrants could lead to labor shortages and higher wages, particularly in domestic services, construction and agriculture, with some drag on overall economic activity.
- Reduced legal immigration, if it occurs, would have greater negative consequences for the overall economy, starving the economy of working-age persons at a time when the retirement of the “baby boomers” is contributing to slower economic growth.
- It is not yet clear if the administration’s policies will lead to a net decline in the pace of U.S. immigration. If it does, however, the implications would be negative for both U.S. equities and fixed income, underscoring the importance of international diversification.



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Laying the groundwork

In the early days of the new administration, no issue has been more controversial than immigration. The president’s statements on building a wall on the U.S. southern border, his actions on banning travel from specific countries and his heightened focus on deporting illegal aliens have generated a negative response from his opponents and a positive reaction from some of his supporters.

As with our entire *100 days of change* series, we will try to steer clear of political arguments. Policies in this area do have significant implications for both the economy and, ultimately, financial markets. So what actions has the president taken and advocated, how might these affect both illegal and legal immigration and what could this mean for growth, inflation and investment returns?

Tighter borders

So far, policy change on immigration in this administration has been in the form of executive orders:

- On January 25, the president issued an executive order calling for the “immediate construction of a physical wall on the southern border.” The administration has stated that the cost will eventually be recouped from Mexico.
- On January 27, the president issued an executive order temporarily banning travel from seven specific countries: Iran, Iraq, Libya, Somalia, Sudan, Syria and Yemen. The order has been suspended by the federal courts though it is currently being reported that the administration is drafting a new executive order on this issue and Iraq has since been removed from the list.
- On February 24, the president signed an executive order calling for additional headcount for Immigration and Customs Enforcement (5,000) and the U.S. Border Patrol (10,000), and directing both agencies to deport illegal immigrants charged with crimes. He also authorized the creation of an office within the Department of Homeland Security called Victims of Immigration Crime Engagement (VOICE), responsible for compiling and disseminating information on crimes committed by illegal aliens.

In addition, Republicans in the House of Representatives have introduced a bill restricting the issuance of H1B visas, used by foreign workers in “specialty occupations” requiring specialized knowledge, to those earning over USD 100,000.

Finally, in his address to a joint session of Congress on February 28, President Trump advocated a merit-based immigration system, similar to systems currently operating in both Canada and Australia, whereby highly skilled and employable immigrants are prioritized over those moving for familial purposes.

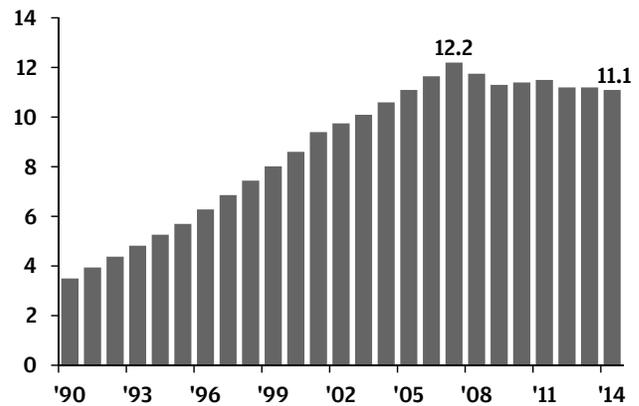
Potential impact on immigration

While the intent of these executive orders is clear - namely to deport current illegal aliens and prevent future illegal immigration - their effectiveness will depend on many aspects of implementation. **Exhibit 1** shows the estimated population of illegal aliens in the U.S. since 1990, and **Exhibit 2** shows the components of the net flow of these immigrants in 2015. A few key points emerge from these data.

First, the level of illegal immigrants in the U.S. has dropped in recent years, both because of a slower gross inflow and because of more aggressive deportation action. Second, most illegal immigration is achieved through people overstaying visas rather than illegally crossing the border. In this regard it is worth noting that the U.S. government issued over 11 million visas in 2015, including more than 7 million tourist visas and 0.5 million temporary worker visas.

EXHIBIT 1: ESTIMATED UNAUTHORIZED IMMIGRANT POPULATION

U.S. POPULATION OF UNAUTHORIZED IMMIGRANTS, MILLIONS

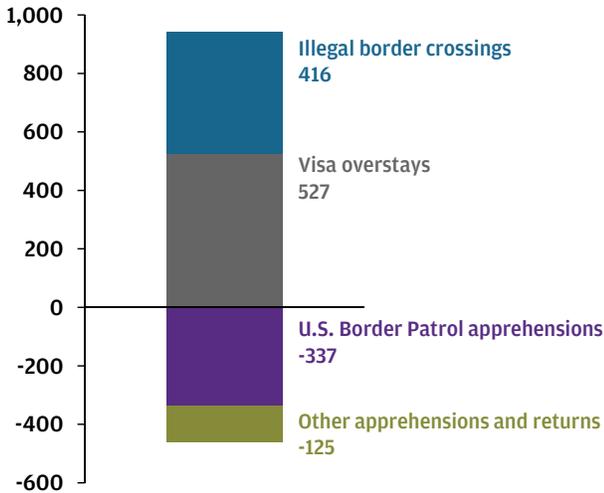


Source: Pew Research: *5 facts about illegal immigration in the U.S.*, J.P. Morgan Asset Management. Data are as of March 1, 2017. Note: Data actuals are for 1990, 1995, 2000, 2001, 2003, 2005, 2007, 2009, 2011, 2013 and 2014; all other data are estimates.

Because of this, while the construction of a wall may reduce some illegal immigration, it is reasonable to assume that, provided illegal immigration still makes economic sense to the immigrants, visa overstays will become more prevalent. Indeed, since the vast majority of illegal immigrants come to the U.S. in

search of work, the most effective way of reducing illegal immigration would be heavy fines, aggressively enforced against both individuals and companies that provide employment to illegal immigrants.

EXHIBIT 2: ESTIMATED NET UNAUTHORIZED IMMIGRATION COMPONENTS OF UNAUTHORIZED IMMIGRATION, 2015, THOUSANDS



Source: Department of Homeland Security Entry/Exit Overstay Report, Department of Homeland Security Annual Performance Report for Fiscal Years 2015-2017, J.P. Morgan Asset Management. Note: Illegal border crossings is an estimate based on reported U.S. Border Patrol apprehensions and an effectiveness rate of 81.01%, as provided by the Department of Homeland Security.

A second potential impact of new immigration policy may be reduced legal immigration, though it should be emphasized that this is by no means certain. However, restrictions on H1B visas would have that effect and, in addition, if attempts to prevent people overstaying their visas lead to fewer visas being issued, legal immigration would fall. Even if the government did not tighten restrictions on legal immigration, it may be the case that a more aggressive stance on illegal immigration has a chilling effect on legal immigration, as foreign citizens find America to be “less welcoming.”

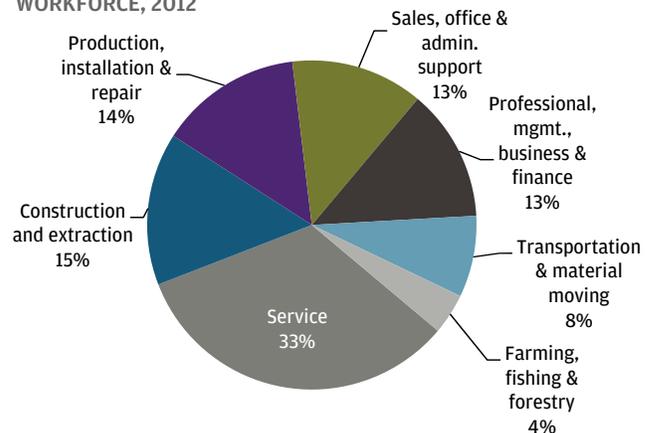
The implications of less illegal immigration

Increased enforcement action against employers may yet be coming and, if it occurs, along with other aggressive deportation measures, the illegal immigrant population in the U.S. may decline at a faster pace.

How would this affect the economy? The U.S. is currently estimated to be home to 11.1 million illegal immigrants, roughly 8.0 million of whom work. The total number of unemployed people in the U.S. is 7.8 million, and, given that there will always be a few million unemployed people at any time (due to people just having been laid off or entering the workforce), it is clear that a full deportation of illegal workers would result in a labor shortage.

This shortage would not impact all industries equally. As shown in **Exhibit 3**, illegal immigrants are much more likely to work in services, construction and agriculture. Significant deportations would likely push up wages in these industries and, moreover, could lead to some of the work simply not getting done. This could reduce overall construction activity, for example, or lead to an increase of prices in some consumable goods.

EXHIBIT 3: UNAUTHORIZED IMMIGRANT WORKFORCE BY OCCUPATION
PERCENT OF TOTAL U.S. UNAUTHORIZED IMMIGRANT WORKFORCE, 2012



Source: Pew Research: *Share of Unauthorized Immigrant Workers in Production, Construction Jobs Falls Since 2007*, J.P. Morgan Asset Management. Data are as of March 1, 2017.

Increased enforcement and building a wall along the U.S. southern border would also be expensive. Some of this cost could be offset by the corresponding reduction of spending on social services, education and incarceration of illegal immigrants. However, incarceration rates are significantly lower for immigrants than non-immigrants, and due to their age distribution and illegal status, illegal immigrants generally put a lower burden on the social service and education systems than the native-born population.

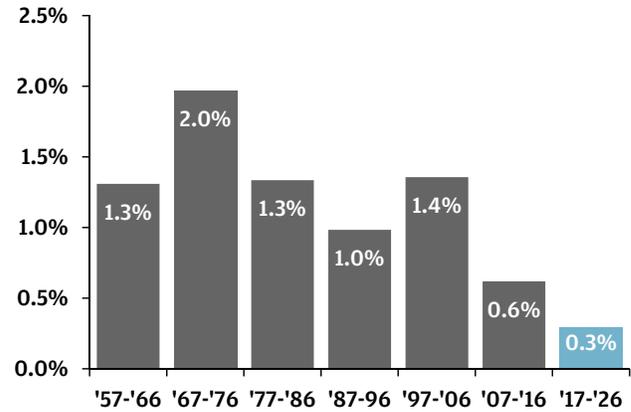
In terms of taxes, the loss of income-tax revenue should be very minor, as illegal immigrants rarely pay direct taxes. However, some loss in indirect taxes, such as sales taxes, would be inevitable.

The implications of less legal immigration

If legal immigration were to slow down or collapse, the consequences for the U.S. economy could be quite severe. As shown in **Exhibit 4**, the retirement of the “baby boomers,” which started in earnest in 2012, has decimated growth in the working-age population, and millennials have been unable to pick up the slack, due largely to a skills gap. From 1960 to 2010, the U.S. population aged 16 to 64 grew at an average pace of 1.3% per year, contributing the workers necessary to generate average real GDP growth of 3.5%. Since then, however, this growth has slumped to 0.5% per year and, over the next decade, is expected to grow by just 0.3%. Remarkably, roughly 85% of this growth is expected to come from immigrants.

Part of this can be attributed to simple math in terms of births, deaths and net migration. However, another key aspect of this is age distribution. **Exhibit 5** depicts how the retirement of the “baby boomers” has taken a bite out of the age distribution of the native-born population. Fortuitously, the immigrant population pyramid bulges out at just the point that the native-born population pulls in, almost like the missing piece in a demographic jigsaw puzzle.

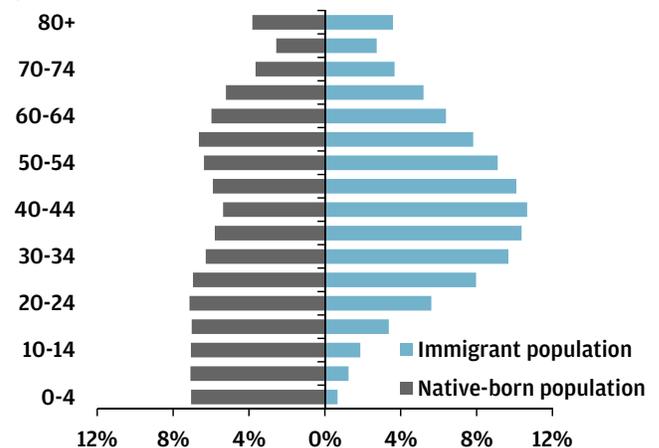
EXHIBIT 4: GROWTH IN WORKING-AGE POPULATION
PERCENT INCREASE IN CIVILIAN NON-INSTITUTIONAL POPULATION AGES 16-64



Source: Bureau of Labor Statistics, U.S. Census Bureau, Department of Defense, Department of Justice, J.P. Morgan Asset Management. Data are as of March 1, 2017.

Increased legal immigration, particularly over the next decade, could help smooth the age distribution of the U.S. population. Moreover, the nature of immigrant age distribution - mostly working age - would likely make legal immigration fiscally beneficial, with stronger growth from potential tax revenue offsetting increased spending on education or health care.

EXHIBIT 5: POPULATION DISTRIBUTION BY AGE
NATIVE-BORN VS. IMMIGRANT AGE DISTRIBUTION, 2016



Source: U.S. Census Bureau, J.P. Morgan Asset Management. Data are as of March 1, 2017.

It should also be noted that current immigration will not be enough to offset the vacuum created by the retirement of the “baby boomers,” and more would likely be needed to achieve stronger growth.

Alternatively, less immigration would seriously impede the administration's attempts to boost the U.S. real GDP growth rate to 3% per year (or more) from the anemic 1.3% growth seen over the past decade.

Conclusion and investment implications

The jury is still out on the future track of U.S. immigration. Democrats and Republicans generally agree that legal immigration, rather than illegal immigration, is better both for the immigrant and the economy. Moreover, both parties will have to balance a desire to treat existing illegal immigrants compassionately and bring them into the legal workforce with enacting policy that does not encourage others to follow in their footsteps.

However, as with the ongoing trade debate, investors can only hope that Washington does not let the perfect become the enemy of the good. Throughout history, both the American economy and American society have been enriched by waves of immigrants, eager to work hard and build a new life for themselves.

If the next few years see an ebbing of this tide, potential U.S. economic growth (which is comprised of productivity gains and labor-force gains) will be slower. This, on its own, would be a negative for U.S. stocks. Moreover, if this occurs at a time when fiscal stimulus is adding demand to a full-employment economy, it could lead to higher wages, higher inflation, higher interest rates and potentially squeezed corporate margins, inflicting damage on both stocks and bonds. For American investors, this may make overseas markets more attractive than domestic ones. In short, the direction of investment money in the next few years should be determined in part by the pace at which the world's workers flock to our shores.

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