KKR

Flash Macro Update

U.S. CPI | August 2024

Henry H. McVey
Head of Global Macro, Balance Sheet & Risk, CIO of KKR's Balance Sheet
henry.mcvey@kkr.com

Dave McNellis
Co-Head of Global Macro & Asset Allocation

Ezra Max
Associate, U.S. Macro

What You Need to Know

1 How are we thinking about the July U.S. CPI report?

Core inflation rose 0.2% m/m in July, which equates to 2.0% on an annualized basis. Importantly, two percent core inflation is right in-line with the Fed's longer run mandate. It also represents a notable cooling relative to the past year, over which core inflation rose 3.2%. We persist with our view that *Opportunity Knocks* for patient long-term investors, particularly in private markets. Inflation is cooling slowly, but enough to allow the Fed to initiate a gradual series of cuts starting in September that we think will take policy rates towards long-run neutral levels (low-three percent range) over the next year. Importantly, we see notable tailwinds persisting in areas including productivity, consumer wealth, and AI-related investment. The S&P 500 may continue to chop as it digests elevated valuations and good-not-great earnings trends. That said, other areas of the market across smaller and private company valuations, credit, infrastructure, and real estate look much more attractive from a valuation perspective. Furthermore, a cutting cycle should help spur capital markets activity, and over time, revive sentiment in the more rate-sensitive areas of the economy and markets.

WHAT WE THINK YOU NEED TO KNOW

Core inflation is slowing, but not in a straight line... Core goods deflation drove the benign CPI print in July, falling fully -3.7% at an m/m annualized rate. Meanwhile, core services inflation continued to moderate (+3.8% m/m annualized) vs. the prior-year trend (+4.9%). Some early market commentors have noted disappointment that services inflation isn't slowing faster, and particularly that shelter, vehicle repair/ insurance, and medical services inflation rekindled somewhat after slowing abruptly

in May-June. Our take is that shelter and other core services categories are lagging in catching-up to real time trends, so we always expected moderation to be a multi-month process. The services trends we are seeing look quite close to our expectations.

…So the Fed will cut, but not with abandon. We continue to think market pricing for four or five cuts over the next three months, implying at least one 50 basis-point cut, is too dovish for a world where GDP is tracking close to three percent and inflation remains above target. Indeed, 50 basis-point cuts typically happen in the context of spiking unemployment and/or sharply wider credit spreads, neither of which were seeing currently. *Exhibit 2* below shows that the most recent environments *where the Fed cut 50 basis points at meetings were hard landing environments including 1990-91, 2001, and 2008, which were quite different relative to the "rolling sector contractions and expansions" backdrop that we see today*.

No change to our CPI forecasts, or our Fed outlook for three cuts this year and six cuts in 2025. We maintain our U.S. CPI outlook of three percent for 2024 and 2.5% for 2025. Our forecasts are in-line with consensus for this year, and moderately above consensus (2.3%) for next year. In terms of rate policy, we look for the Fed to cut once at each meeting between now and mid-2025, before achieving a low-three percent neutral rate. Meanwhile, we continue to see bond yields trading in the 3.5-4.0% range in the near term, before centering on the four percent range over the longer term.

What would change this view? With the return of the Fed's dual mandate, growth data – including Thursday Retail Sales and Claims data – is becoming the most important input for the pace of Fed easing. Our base case is a turbulent, soft landing, but a big downshift in GDP would lead us to expect a more aggressive path of Fed cuts. As such, risks remain skewed to the downside for rates and yields, and our message is that now is not the time to take a big bet on floating rates persisting at today's elevated levels.

FURTHER CPI DETAILS

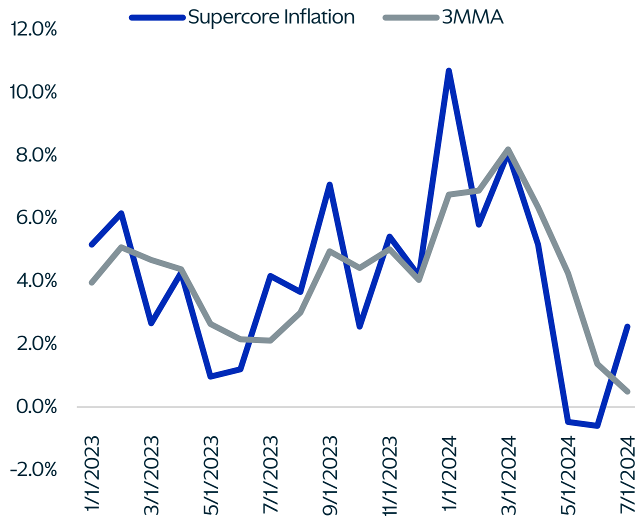
Core services inflation came in at +3.8% at a m/m annualized rate in July, up from +1.6% in June, but still nicely below the 4.8% core services inflation rate realized over the past year. Said differently, core services inflation is slowing, but not as quickly as in recent months. Beneath the surface, housing inflation has cooled, but appears to be stabilizing towards the three to four percent annualized range that our forecasts have long embedded. Meanwhile, so-called Supercore Services (ex-shelter and medical insurance), which remains a key measure for the Fed, ticked up to +2.5% at a m/m annualized rate, following two consecutive negative readings, driven by a reacceleration in medical costs. Today's data are consistent with our instinct that a structural shortage of housing and labor means that Services inflation will not cool as quickly or completely as markets expect.

Meanwhile, core goods prices fell fully -3.7% at a m/m annualized rate, which is the second-lowest reading so far this year. We continue to think that the U.S. is experiencing a 'turbulent' soft landing, with weaker demand and pricing in 'nice-to-have' consumer categories including durable goods. With that said, we do look for the deflationary impulse around Goods to tail off in coming quarters, which should support our view that CPI will remain above the Fed's two percent target this cycle.

We continue to think market pricing for four or five cuts over the next three months, implying at least one 50 basis-point cut, is too dovish for a world where GDP is tracking close to three percent and inflation remains above target.

Exhibit 1: Core Services Inflation Is Cooling, But Not in a Straight Line

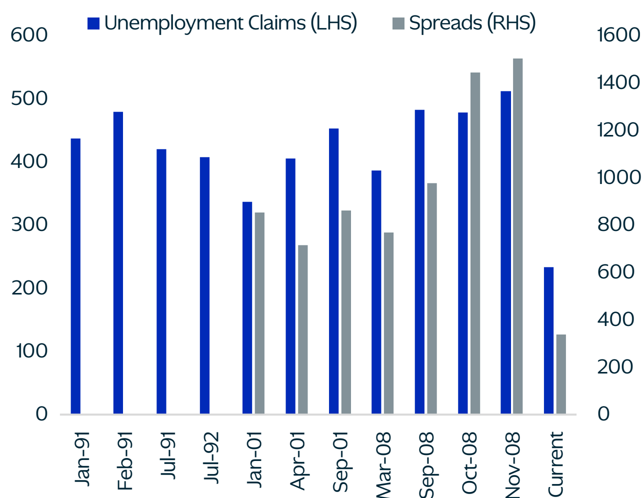
Supercore Inflation, % Annualized



Data as at July 31, 2024. Source: Bloomberg.

Exhibit 2: Growth and Markets Look Too Benign for the Fed to Cut Rates Aggressively

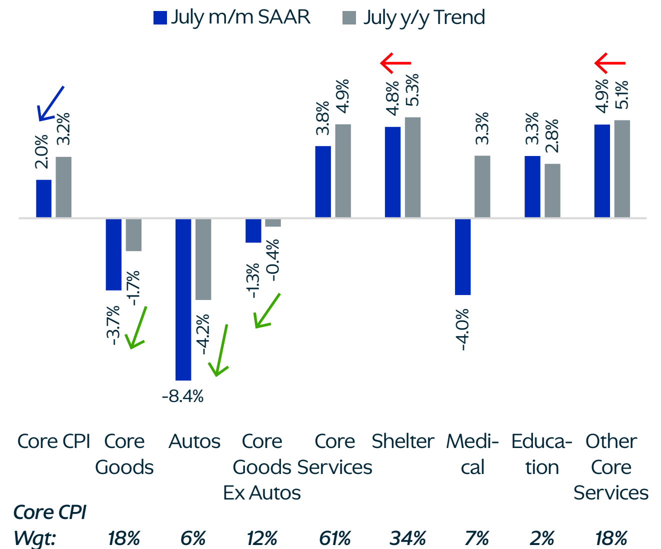
Unemployment Claims and Spreads on Weeks When Fed Cut -50bps



Data as at August 14, 2024. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 3: U.S. Core Inflation Continued to Moderate in July, Led by Goods Deflation

July U.S. Core CPI Detail



Data as at July 31, 2024. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

As such, risks remain skewed to the downside for rates and yields, and our message is that now is not the time to take a big bet on floating rates persisting at today's elevated levels.

Important Information

The views expressed in this presentation are the personal views of Henry McVey of Kohlberg Kravis Roberts & Co. L.P. (together with its affiliates, "KKR") and do not necessarily reflect the views of KKR itself or any investment professional at KKR. This presentation is not research and should not be treated as research. This presentation does not represent valuation judgments with respect to any financial instrument, issuer, security or sector that may be described or referenced herein and does not represent a formal or official view of KKR. This presentation is not intended to, and does not, relate specifically to any investment strategy or product that KKR offers. It is being provided merely to provide a framework to assist in the implementation of an investor's own analysis and an investor's own views on the topic discussed herein.

The views expressed reflect the current views of Mr. McVey as of the date hereof and neither Mr. McVey nor KKR undertakes to advise you of any changes in the views expressed herein. References to "we", "us," and "our" refer to Mr. McVey and/or KKR's Global Macro and Asset Allocation team, as context requires, and not of KKR. Opinions or statements regarding financial market trends are based on current market conditions and are subject to change without notice. References to a target portfolio and allocations of such a portfolio refer to a hypothetical allocation of assets and not an actual portfolio. The views expressed herein and discussion of any target portfolio or allocations may not be reflected in the strategies and products that KKR offers or invests, including strategies and products to which Mr. McVey provides investment advice to or on behalf of KKR. It should not be assumed that Mr. McVey has made or will make investment recommendations in the future that are consistent with the views expressed herein, or use any or all of the techniques or methods of analysis described herein in managing client or proprietary accounts. Further, Mr. McVey may make investment recommendations and KKR and its affiliates may have positions (long or short) or engage in securities transactions that are not consistent with the information and views expressed in this document.

This presentation has been prepared solely for informational purposes. The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this presentation has been developed internally and/or obtained from sources believed to be reliable; however, neither KKR nor Mr. McVey guarantees the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision.

There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Target allocations contained herein are subject to change. There is no assurance that the target allocations will be achieved, and actual allocations may be significantly different than that shown here. This presentation should not be viewed as a current or past recommendation or a solicitation of an offer to buy or sell any securities or to adopt any investment strategy.

The information in this presentation may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this presentation, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Performance of all cited indices is calculated on a total return basis with dividends reinvested. The indices do not include any expenses, fees or charges and are unmanaged and should not be considered investments.

The investment strategy and themes discussed herein may be unsuitable for investors depending on their specific investment objectives and financial situation. Please note that changes in the rate of exchange of a currency may affect the value, price or income of an investment adversely.

Neither KKR nor Mr. McVey assumes any duty to, nor undertakes to update forward looking statements. No representation or warranty, express or implied, is made or given by or on behalf of KKR, Mr. McVey or any other person as to the accuracy and completeness or fairness of the information contained in this presentation, and no responsibility or liability is accepted for any such information. By accepting this presentation in its entirety, the recipient acknowledges its understanding and acceptance of the foregoing statement.

The MSCI sourced information in this presentation is the exclusive property of MSCI Inc. (MSCI). MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.

KKR

Kohlberg Kravis Roberts & Co. L.P.
30 Hudson Yards
New York, New York 10001
+ 1 (212) 750.8300
www.kkr.com