KKR

Flash Macro Update

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Henry H. McVey
Head of Global Macro & Asset Allocation, CIO of the KKR Balance Sheet
henry.mcvey@kkr.com

Dr. Changchun Hua
Chief Economist for Greater China

Allen Liu
Analyst, Asia Macro

What You Need to Know

1 How are we thinking about the recent global capital markets volatility in Japan?

We have been receiving a slew of questions on Japan after the recent surge in its currency from historically cheap levels, especially given KKR's sizeable investment footprint in the country. **See below for details, but our punch line is that the JPY carry trade unwind was really about a mis-position of investment expectations (i.e., U.S. rates falling faster and Japan rates moving up more abruptly than some investors were thinking)** than a fundamental breakdown in the country's positively shifting macro story. In fact, the sharp appreciation of the yen in recent weeks is actually a sign that the macro backdrop is strengthening both from a cyclical and structural perspective. In particular, we are encouraged that Japan now has enough growth and inflation in the system to begin to normalize its monetary policy after multiple decades of anemic growth and deflation.

Nonetheless, we fully acknowledge that this transition will take time, and there will be – as we saw earlier this month – bumps along the way to normalization. The BoJ clearly understands that patience will be required, as evidenced by its commentary that "we will not raise rates when markets are unstable." Beyond normalization of its monetary policy, Japan also needs greater productivity and more immigration as it looks to offset a material decline in its working age population.

However, despite these hurdles, we retain our optimistic outlook on Japan. Simply stated, attractive valuations, rule of law, an intense focus on corporate reform and appealing funding costs all still make this country one of the more unique destinations for patient capital.

DETAILS

As a follow-up to our macro update on market volatility earlier in August (read more) we wanted to dig a bit deeper into Japan, a market where as a firm KKR remains extremely active across Private Equity, Real Estate, Infrastructure, Credit, and increasingly Insurance. Our key message is that the JPY carry trade unwind was more related to a mismatch of investor perceptions on the path of U.S. and Japanese interest rates rather than a deterioration in macro fundamentals. Most importantly, as we look forward, we remain constructive on the investing environment in Japan and believe that an economic reawakening supported by real income growth is in progress. Capital expenditures also remain elevated, which is critical to boosting productivity to offset not only the increase in wages but also growing competition from abroad. The recent market gyrations have made valuations even more attractive in some cases. The Japanese government has also prioritized corporate governance reforms and improved performance by listed companies. Finally, attractive funding costs also help make Japan one of the more unique and interesting destinations for patient capital, in our view.

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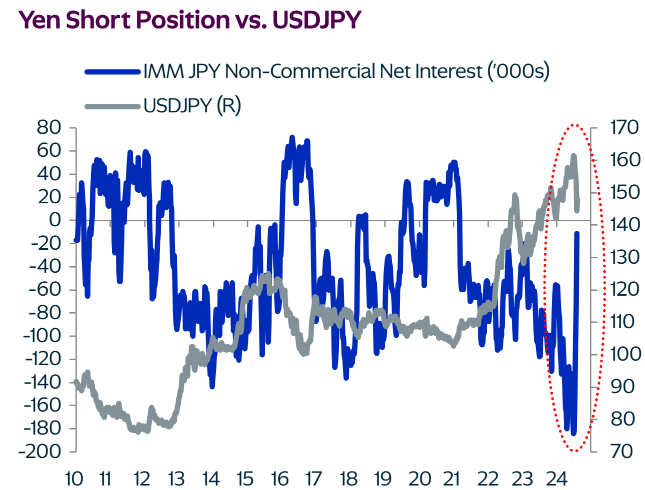
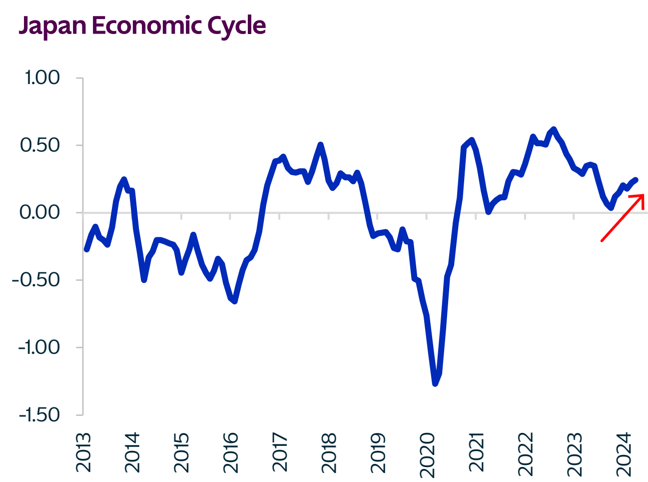
Exhibit 1: Rapid Unwinding of Record-High Yen Shorts Amid Yen Surge on the Disappointing U.S. Jobs Data and BoJ Slightly Hawkish Shift



Note: IMM JPY Non-commercial net interest = CFTC CME Japanese yen non-commercial long contracts/futures only – CFTC CME Japanese yen non-commercial short contracts/futures only. Data as at August 6, 2024. Source: Bloomberg.

Exhibit 2: Japan's Growth Momentum Has Bottomed and Is Likely in an Early Recovery Stage



Note: Our proprietary indicator covers 10 indicators – including manufacturing PMI, retail sales, home prices, exports, unemployment rate – to capture short-term cyclical growth momentum. Data as at June 30, 2024. Source: Haver Analytics, KKR Global Macro & Asset Allocation analysis.

As referenced earlier, we actually find it somewhat ironic that the sharp appreciation of the yen is actually a sign that the macro backdrop is strengthening both from a cyclical and structural perspective. Indeed, following a technical recession from Q3 2023 to Q1 2024, Japan's growth momentum appears to be bottoming out, with our proprietary index indicating that Japan is in early recovery stage. We note that Q2 real GDP growth rebounded to 3.1% q/q saar, surpassing market expectations of 2.1%. On top of this, investment is on the rise, with real private housing investment up by 1.6% q/q and real private capital investment increasing by 0.9% q/q. Moreover, as we look ahead we expect this recovery to continue over the next 4-8 quarters and maintain our bullish call of 0.6% GDP growth for 2024, against the market consensus of 0.1%. Further, Japan has exited deflation (and we do not make this statement lightly after three decades of disinflation/deflation). All told, we expect CPI inflation to remain around 2% from now through 2027 before stabilizing at around 1.5% and we expect nominal GDP to compound at a pace between 2-2.5%.

Monetary policy also remains supportive of the economy as Japan's real rate remains negative and conducive to growth *(Exhibit 7)*. The BoJ's statement that "we will not raise rates when markets are unstable" underscores our view that it is not looking to create sustained capital markets disequilibrium. To review, this statement was in response to the negative market reaction to the July Monetary Policy Meeting, where the tone was slightly more hawkish than expected, leading us to add one more hike to our forecast. Looking ahead, we now believe that the BoJ is on track to bring the policy rate toward the lower band of the neutral rate (1.0-2.5%). To achieve this, we expect to see a hike every six months through 2026, reaching 1.0%.

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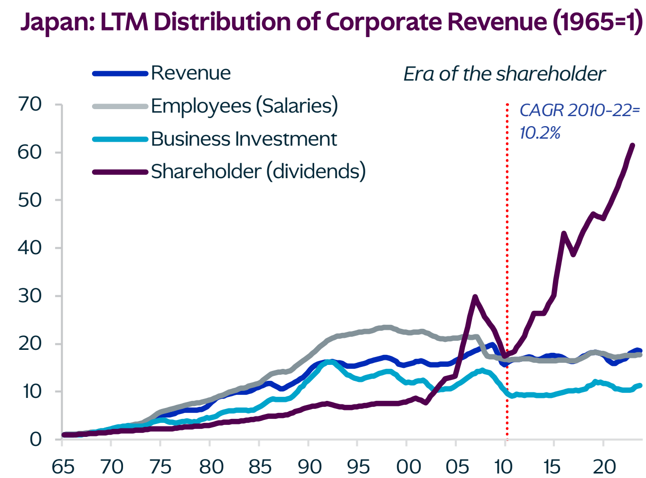
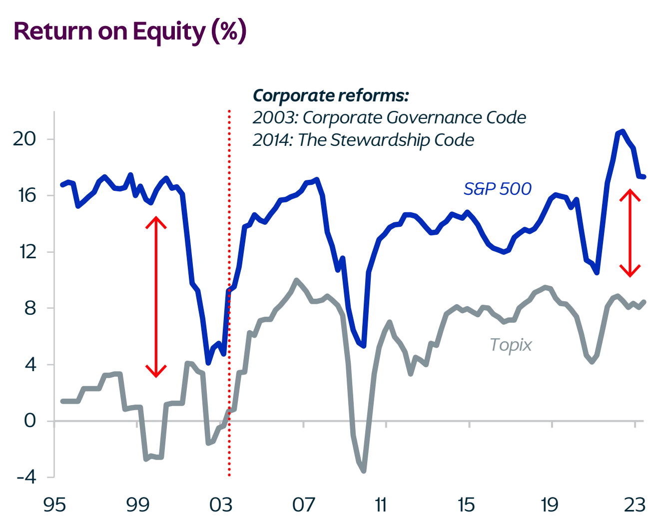
Exhibit 3: Japan's Era of the Shareholder Has Been Unleashed...



Data as at June 30, 2023. Source: Source: Ministry of Finance Japan, Haver Analytics.

Exhibit 4: ...And as a Result, the ROE Gap Between the U.S. and Japan Is Narrowing

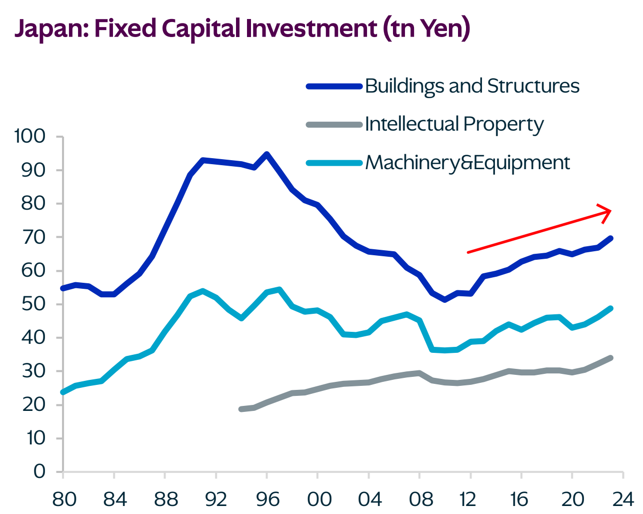


Data as at June 30, 2023. Source: Bloomberg.

Importantly, long-term productivity is increasing but Japan will need these annual increases to combat its demographic challenges. All told, we anticipate labor productivity to gradually increase from the current 0.5-0.7% band to 1% in the next decade, which would put it ahead of most developed market economies except for the United States. The acceleration is significant as the challenge may turn larger after 2027 when the 50-60 age cohort of the population and household formation starts declining. Yet, one does not need to wait until 2027 to see the importance of higher productivity. Already, current wage increases induced by the nationwide labor shortages as the country exits deflation are – to date – largely being offset by productivity gains. The good news is that Japan is experiencing a material acceleration in its automation capex cycle, which we believe will further boost productivity within the industrial segment of its economy.

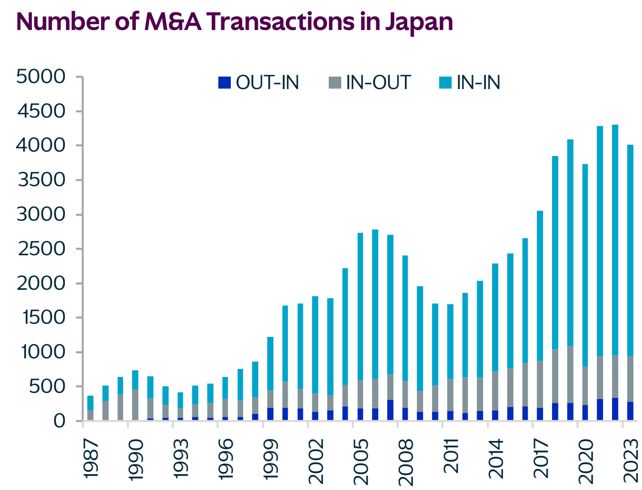
Another positive trend we see is linked to shareholder activism. Specifically, broad corporate governance reforms since 2013 have enhanced the roles of institutional investors and independent board members, leading to greater risk-taking in corporate management and increased M&A activity. Finally, heightened geopolitical tensions are leading multinational corporations to shift parts of their supply chains to friendlier shores such as Japan, reinforcing a virtuous capex and productivity cycle, we believe. This trend towards Japan being viewed as a 'safe haven' in Asia is particularly important, as intra-Asia trade gains further momentum (see #5 Where Do We See Opportunities in Japan).

Exhibit 5: Capex Has Been Improving in Japan Since Corporate Governance Reform Began In 2013



Data as at December 31, 2023. Source: Cabinet Office of Japan, Haver Analytics.

Exhibit 6: M&A Has Accelerated and Resource Allocation Is Getting Better



Note: "In-In" is M&A of Japanese firms by Japanese firms, "In-Out" is M&A of foreign firms by Japanese firms, and "Out-In" is M&A of Japanese firms by foreign firms. Data as at December 31, 2023. Source: RECOF.

How will the political landscape affect the turnaround in Japan? To review, Prime Minister Kishida announced on August 14th that he would not seek a second term as the Liberal Democratic Party leader, effectively ending his tenure as Prime Minister, a position that began in October 2021. Our view is that a change in premiership is unlikely to significantly impact current economic policies. PM Kishida's initiatives, such as returning to nuclear power, broadening the domestic investor base, and moderating fiscal policy, will have lasting effects. Like former PM Suga's championing of decarbonization and digital transformation agendas, PM Kishida pioneered a new economic security agenda, resulting in a remarkable transformation of Japan's advanced semiconductor industry. His tenure also saw Japan finally escape decades of deflation and exit the zero-interest rate policy and yield curve control under his choice of Kazuo Ueda as the BoJ governor. With a more positive economic backdrop, including cooling inflation and with the yen regaining some value after the unwinding of carry trades, we think BoJ monetary policy will remain steady. Against this backdrop, we continue to see significant opportunities for investors.

Where We See Opportunities in Japan

#1: Corporate Reforms	Share buybacks, carve-outs, and M&A activities have steadily increased to improve balance sheet efficiency. This trend offers opportunities for investors to 'buy complexity and sell simplicity.'
#2: Digital Transformation and Automation	Labor shortages and the digital transformation suggest that automation will remain a major theme in Japan. Equipment (e.g., semiconductors and logistics robotics, software, and system integration), will benefit from this trend. It is essential to remain mindful of labor costs in Japan.
#3: Health and Wellness	Japan's aging society creates significant physical and mental healthcare needs, presenting a wealth of opportunity in spaces such as elder and loneliness care, and health AI.
#4: Asset Management	The first generation of Baby Boomers (born 1947-1950) are expected to leave behind JPY 165 trillion in inheritance, largely as bank deposits. This mass of wealth will fall into the hands of a more pro-markets generation that will likely seek to maximize returns across both public and private markets.
#5: Intra-Asia Trade	Asia is becoming more Asia-centric, with increased trade within the region rather than simply with developed markets in the West. Already, the share of Asian trade with regional partners increased massively to 58% in 2021 from 46% in 1990. We believe that more market share gains are likely, particularly when one considers that intra-Europe trade stood at 69% in 2021. All told, we think that intra-Asian trade could hit 65-70% in the next five to seven years.

Of course, there are risks for investors to consider. Normalization of monetary policy could create more than expected volatility if the U.S. ends up easing faster that we currently think (note: we have three cuts in 2024 and six cuts in 2025). That said, our work still shows that, in real terms, a Japanese yen at 140 is still quite 'cheap' across a variety of metrics.

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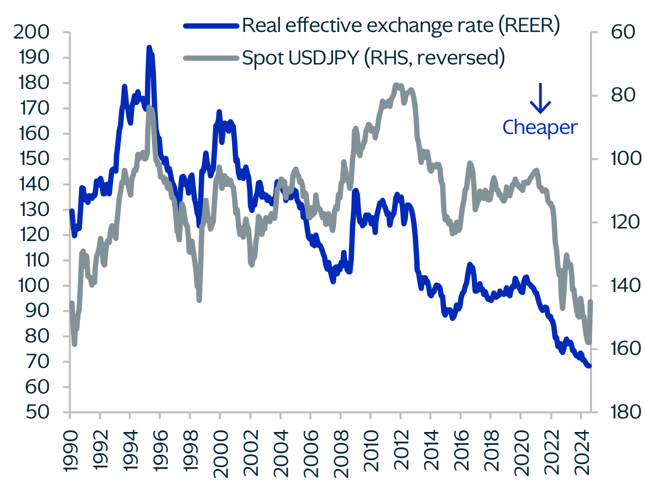
Exhibit 7: The Yen Is Still Very Cheap in Terms of Both Its Spot or Real Effective Exchange Rate

Japan Exchange Rates: Spot and Real Effective Exchange Rates



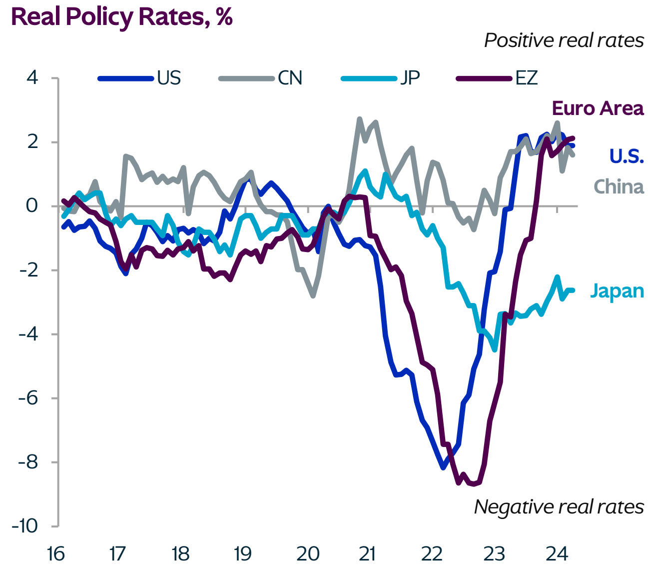
Data as at August 23, 2024. Source: BoJ, BIS, Haver Analytics.

As we mentioned earlier, productivity too is required to offset challenging demographics and lack of competitiveness and will be the backbone of growth going forward. The working-age population is peaking in Japan (with the median age at 50), while the base of older workers they need to support is growing rapidly. Besides the need for increased fertility efforts, we think this challenging demographic landscape will also further incentivize governments and corporations to encourage more domestic savings, including annuities and other tax-deferred savings vehicles. Importantly, the Nippon Individual Savings Account (NISA) reforms have increased the scope for invested savings by making the system permanent, making the tax-free holding period indefinite, and increasing the annual investment and the tax-free holding limits.

CONCLUSION

Despite what we could be some more ongoing near-term volatility associated with the country's normalization policy, we remain constructive on the investing environment in Japan and believe that an economic reawakening is in progress. At its core, we see a positive transition underway in the coming years from the original post-COVID, pent-up, demand-driven recovery to a second phase, fueled by real income growth and further corporate reform. Moreover, capital expenditures should remain elevated, which is critical to boosting productivity to offset not only the increase in wages but also the price increases in food and oil. Finally, as we show below in *Exhibit 8*, despite Japan's normalization process, the cost of capital in real terms remains extremely favorable relative to other parts of the world.

Exhibit 8: While Real Incomes Have Turned Positive in Japan, Funding Costs on a Real Basis Are Still Negative



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

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