KKR

Insights

14.3

Global
Macro Trends
June 2024

Opportunity Knocks

Mid-Year Outlook for 2024

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Opportunity Knocks

Mid-Year Outlook for 2024

Despite intensifying political uncertainty, heightened geopolitical tensions, and volatile commodity prices, we continue to see compelling investment opportunities across the global macro landscape. Accelerating AI demand for electricity, reorientation of global supply chains, improving labor productivity, and retirement security all represent important macro themes behind which to invest. We also remain really encouraged by the technical backdrop, as net issuance of Equities and Credit remains well below trend. However, it is definitely not business as usual in the world of macro and asset allocation, as our *Regime Change* thesis requires a different approach to portfolio management. To build upon this view, we have done more analysis to underscore the value of adding more non-traditional assets to one's portfolio. Indeed, unlike in the past, today's volatility in portfolios is being driven by stock-bond correlation, not by single asset volatility. Importantly, most of today's CIOs have not invested in this type of environment. In terms of areas to lean in, we think that the current vintage will be a strong one for Private Equity, especially opportunities linked to value creation by operational improvement and/or corporate carve-outs. Meanwhile, we continue to pound the table on many parts of Real Assets, including Real Estate Credit, Infrastructure, and Asset-Based Finance. Finally, we see a lot of potential in Opportunistic Credit and Capital Solutions. On the risk side, we believe higher rates – especially if productivity should tail off – are a more challenging scenario than lower rates and slower earnings. We are also keeping an eye on employment trends. Our bottom line: *Opportunity Knocks*, as we still think the current economic cycle has further to run, a backdrop that should accrue to the benefit of long-term investors, especially ones who have dry powder to lean into the inevitable periodic dislocations that are likely to occur during a *Regime Change*.

> A pessimist complains about the noise when opportunity knocks.
>
> — **Oscar Wilde**, Irish poet and playwright

We are often asked, especially heading into the second half of 2024, if we still believe that the glass is half full for global allocators when it comes to deployment opportunities, particularly in an environment of heightened complexity, 'sticky' inflation, and higher for longer interest rates. (See *Glass Half Full Outlook for 2024*). With an uncertain presidential election around the corner in the United States, and many other important elections taking place across the world, there is certainly a lot to consider. On the more cautious side, equity markets are now nicely higher, and credit spreads are now sharply tighter since late December 2023 when we laid out our thesis that investors might regret looking at the glass as half empty. In fact, our KKR proprietary market-implied default model suggests HY spreads are pricing in about a two percent default rate today, compared with about three percent at the beginning of the year and a historical average of 5.7%.

Exhibit 1: Equity Markets Have Withstood Substantial Volatility to Enjoy Glass Half Full Returns and Then Some in the 1H24...

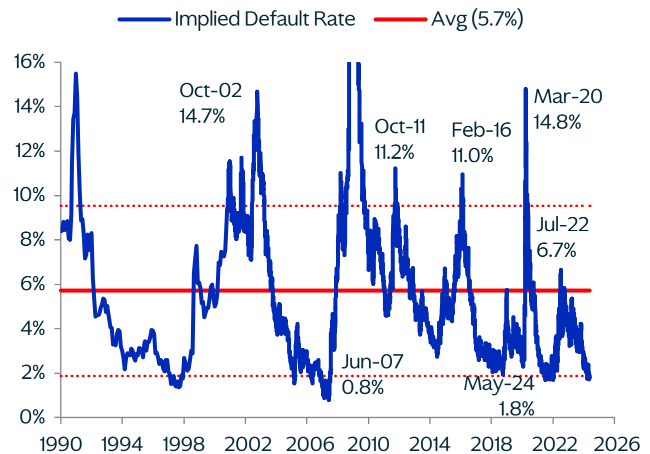
Equity Performance Across Regions, YTD Performance

Data as at June 7, 2024. Source: Bloomberg.

Indeed, unlike in the past, today's volatility in portfolios is being driven by stock-bond correlation, not by single asset volatility.

Exhibit 2: ...While Investors Have Also Gotten More Optimistic About the Outlook for Credit, High Yield in Particular

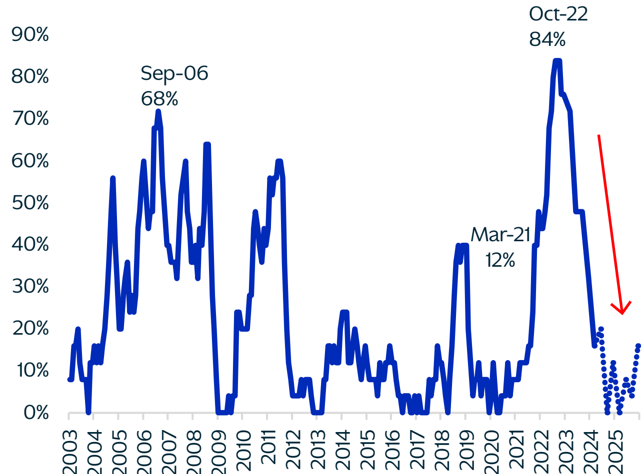
U.S. High Yield Implied Default Rate, %



Data as at May 24, 2024. Source: Bloomberg.

Exhibit 3: Risk Assets Have Responded Favorably to the Idea That There Will Be Fewer Tightenings and More Easings

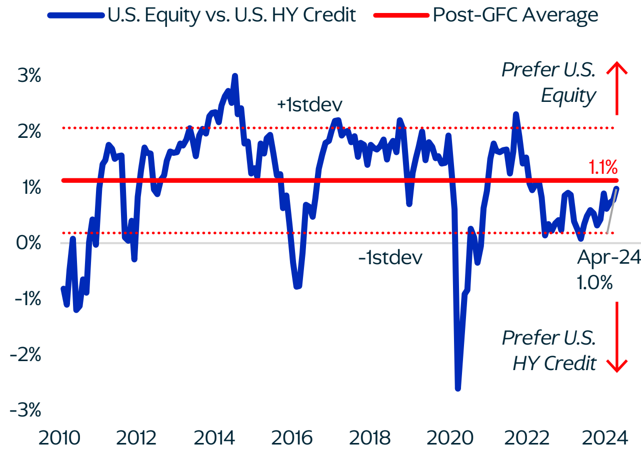
Consensus Forecast: % of Global Central Banks Hiking Rates



Hiking rates is defined as an increase in rates over the past three months. Data for U.S., JP, CN, AU, CA, E2, NZ, NO, SE, GB, JP, CH, IN, ID, KR, PH, TW, TH, VN, BR, CL, ZA, TR, IL, CZ, HU, PL. Data as at May 31, 2024. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 4: Overall, Our Models Still Favor Credit, But Now Only at the Margin

Relative Value: Equities vs. Credit, Internal Rate of Return for Equities vs. HY YTW



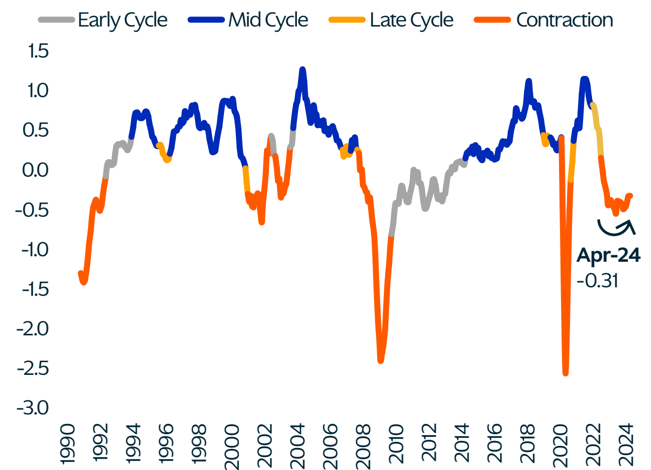
Data as at May 24, 2024. Source: Bloomberg.

However, perhaps more important for long-term investors, there are a lot of political and social crosscurrents that are increasingly bleeding their way into markets. Not surprisingly, the introduction of social media into our political process has created more discord. This type of disruption is like other post-industrial revolutions where technological change ushered in periods of social and political unrest. As our colleague Ken Mehlman explains, just as the invention of the printing press around 1440 introduced years of political, religious, social, and scientific disruption, the combination of the Internet and social media is a 'Gutenberg 2' moment that has produced and portends similar disturbances.

At the same time, complicated issues around immigration and inequality are also driving tense debates across the Western world that increasingly seem to push the left and right further apart. See Section IV, question #3 for a full discussion, but the upcoming U.S. presidential election only increases our conviction that policy from either a Trump or a Biden administration is likely to maintain an inflationary bent (which further heightens discord), given the threat of tariffs and the need for security spending, contributing to an increasing 'normalization' of wider than usual deficits. Finally, great power rivalries around the globe have intensified notably in recent quarters. As such, investors should expect more barriers to trade and capital flows in the coming years under almost all scenarios. Key to our collective thinking is that the intensifying focus on 'homeland economics' is a post-COVID, post-Ukraine global phenomenon that is likely to continue almost regardless of electoral outcomes in most countries.

Exhibit 5: After Two Years of Being in Late Cycle and Contraction, Our Proprietary KKR Cycle Indicator Is About to Move Into Its Early Cycle Phase

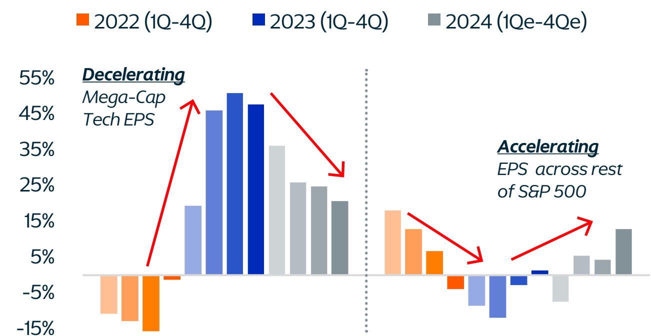
KKR Cycle Indicator (1990-Present, Z-Score)



Data as at April 30, 2024. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 6: We Think Earnings Growth Is Set to Broaden Beyond Mega Cap Technology and Become More Balanced in Coming Quarters, Driven by Positive Operating Leverage and Margin Growth in Other Sectors

S&P 500 EPS Growth Disaggregation



Data as at April 30, 2024. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

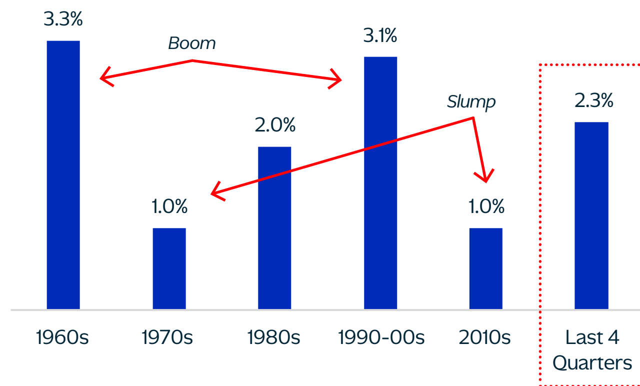
Exhibit 7: Long Periods of Equity Outperformance Have Been Driven by Productivity and/or Central Bank Intervention...

Productivity vs. Equity Markets		Labor Productivity, %QoQ, SAAR	S&P 500 Average Annual Return	Average U.S. Budget Deficit as a % of Nominal GDP	Average Fed Balance Sheet as a % of Nominal GDP
High Productivity Period	1960s	3.3%	8.4%	-1.0%	5.4%
	1990s-2000s	3.1%	8.8%	-0.8%	6.0%
Low Productivity Period	1970s	1.0%	-0.9%	-2.3%	6.4%
	2010s	1.0%	11.8%	-4.8%	20.9%
All Periods	1958-2018	2.1%	7.20%	-2.6%	8.3%
Today	4Q22-1Q24	2.2%	8.5%	-5.7%	29.8%

Note: 1960s and 90s-00s are the 'high' productivity growth (>3%) periods, referring to 1958-1968 and 1995-2005, respectively. 1970s and 2010s are the 'low' productivity growth (<1.0%) periods, referring to 1973-1979 and 2010-2019, respectively. Data as at April 30, 2024. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 8: ...As We Look Forward, Our Thesis Is That Productivity Is Again Set to Reaccelerate, Which Would Be Quite Positive for Capital Markets

U.S. Annual Labor Productivity Growth, %



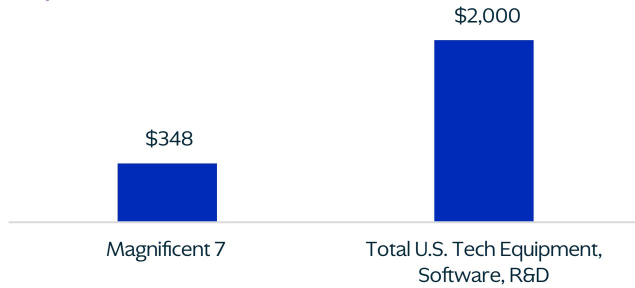
Note: 1960s refers to 1958-68; 1990s-00s refers to 1995-05; 1970s refer to 1973-79; 2010s refer to 2010-19; 1980s refers to 1980-88. Data as at March 31, 2024. Source: Bloomberg, Federal Reserve Bank of San Francisco.

On the positive side of the ledger, growth and earnings – as our models have been suggesting for some time – are all performing better than the consensus expected in a higher nominal GDP growth environment. True, the U.S. consumer is not driving massive demand growth the way he or she was post-COVID, but unemployment has stayed low *(Exhibit 10)*, inventories are in check, and housing activity is stabilizing. Also, we have seen a massive capex cycle being led by the Technology sector *(Exhibit 9)*. Our view is that, similar to the Internet boom in the 1990s (and the corresponding period of solid economic growth leading up to 2000), the AI boom will drive a sustained period of higher capex before it is actually reflected in corporate profitability results. Implicit in what we are saying, though, is that the recent ongoing surge in productivity has actually occurred *before* AI benefits have been realized at scale, further underscoring our view that the corporate sector could enjoy a longer-tailed profitability renaissance. Importantly, though, unlike the dot-com bubble 20+ years ago, the companies financing this spending this cycle have bullet proof balance sheets, lower costs of capital, and a more consolidated market.

As we look ahead, we also want to signal another positive: Corporate earnings growth is beginning to broaden beyond just the Technology sector. One can see this in *Exhibit 6*. We think this increased breadth should create a more balanced tone within the liquid Equity markets. In addition, the technical picture remains quite compelling, with a lack of both *net* equity and corporate debt issuance (*Exhibit 11*), which generally bodes well for returns (*Exhibit 12*), especially in Private Equity.

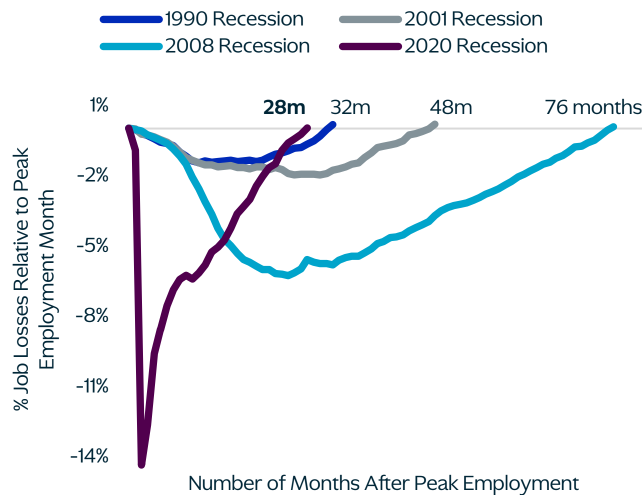
Our view is that, similar to the Internet boom in the 1990s (and the corresponding period of solid economic growth leading up to 2000), the AI boom will drive a sustained period of higher capex before it is actually reflected in corporate profitability results.

Exhibit 9: The Magnificent 7 Reinvests 61% of Their Operating Free Cash Flow Back Into Capex and R&D. They Now Also Account for Almost 20% of Total Capex



Data as at May 20, 2024. Source: Goldman Sachs.

Exhibit 10: We Think the Jobs Environment Is Much More Akin to the 1990s Than Post-GFC



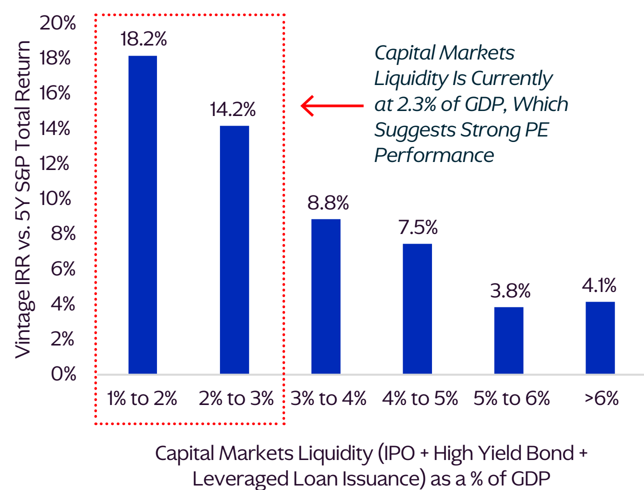
Data as at December 31, 2023. Source: U.S. Bureau of Labor Statistics, Haver Analytics.

At the same time, we think that many investors are still actually underweight their target allocations, including holding too much Cash at a time when most central banks have finished raising rates (*Exhibit 3*). Our proprietary survey work within the Family Office (see Loud and Clear) and Insurance (see No Turning Back) segments supports this view, while money market/cash balances in the individual investor market are also quite high relative to trend.

Exhibit 11: Our Liquidity Indicator Is Still Recovering From Near-Trough Levels

Data as at March 31, 2024. Source: Preqin, Bank of America, Bloomberg , KKR Global Macro & Asset Allocation analysis.

Exhibit 12: Private Equity Tends to Outperform Public Markets in Low Liquidity Environments

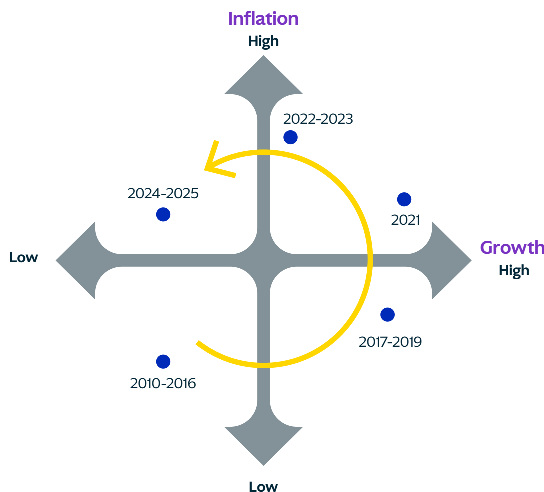


PE returns from Preqin on a 5-year forward returns from 1997 - 2019 basis. Data as at December 31, 2023. Source: Preqin, Bank of America, Bloomberg, KKR Global Macro & Asset Allocation analysis.

Against this unique macroeconomic backdrop, however, we continue to argue that as investors we are experiencing a *Regime Change.* There remain four pillars to our original thesis: ongoing fiscal stimulus, heightened geopolitics, a messy energy transition, and stickier wages (driven largely by a shortage of skilled workers). If we are right, then global allocators and macro investors need to view their portfolios through a different lens. In particular, we think that more diversification across asset classes as well as less dependence on global sovereign bonds is warranted, especially given correlations between stocks and bonds have turned decidedly positive (*Exhibit 14*).

Exhibit 13: While Inflation Should Continue to Cool, We Don't Think It Will Return to Previous Levels. As a Result, We Maintain Our Regime Change Thesis

Low and High Growth and Inflation Regimes



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

So, where do we land as we look ahead to the second half of the year and into 2025 and beyond?

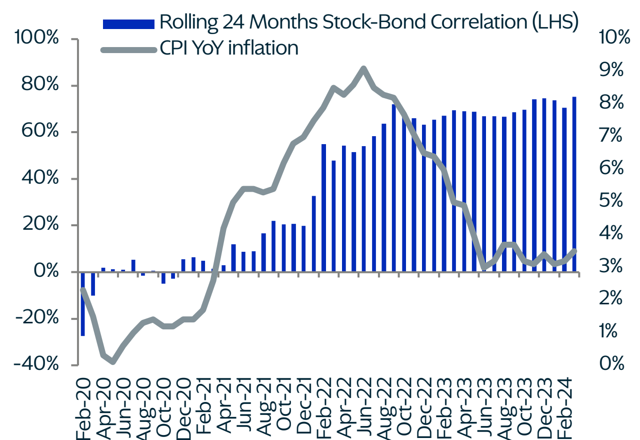
Most importantly, we retain our optimistic viewpoint for the following four reasons:

1. **We think that we have entered a structurally higher level of productivity in the United States, a backdrop that we believe will benefit capital markets globally**. We were not around for the 1960s, but the surge in productivity that followed tech investment in the 1990s is likely an apt parallel, we believe. Importantly, this increase in productivity will at least partially offset some of our concerns about wider deficits in the near-term. As we detail below in Section II, we are also raising our long-term run rate for U.S. GDP to two percent from 1.5%, signaling a structural improvement in growth that we believe warrants investor attention.

2. **We think that central banks, especially the Bank of Japan and the U.S. Federal Reserve, have adopted policies that are actually not that restrictive from a historical perspective**. For one thing, the Fed and other central banks' steady states for balance sheets are still plump relative to history *(Exhibit 15*). If we are right that U.S. real rates peak at two percent in the coming quarters and decline below one percent over time (note: we forecast one Fed cut in 2024 and an additional four in 2025), then this Fed tightening cycle will have been a fairly mild one by historical standards. One can see this in *Exhibit 16,* which shows that, if our forecasts are correct, the real fed funds rate will not spend a very long time in truly restrictive territory this cycle (i.e., at or above the level of potential GDP growth).

Exhibit 14: Despite Inflation Falling on a Cyclical Basis, the 'New' Positive Relationship Between Stocks and Bonds Remains Strong

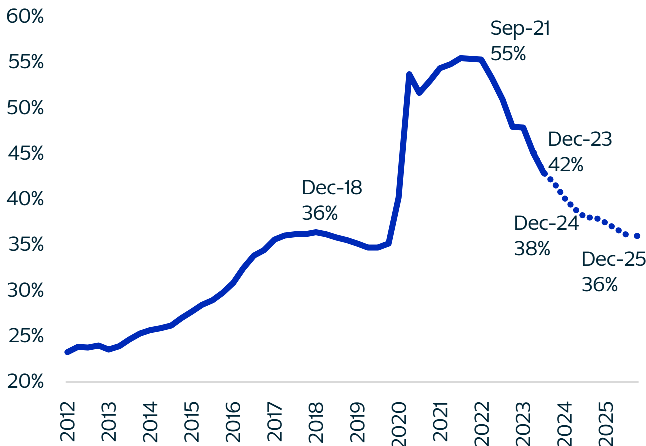
U.S. Stock-Bond Correlation and U.S. CPI, %



Data as at March 31, 2024. Source: Bloomberg, KKR GBR analysis.

Exhibit 15: Despite Record Tightening at the Front End, Central Bank Balance Sheets Will Remain Plump With Assets

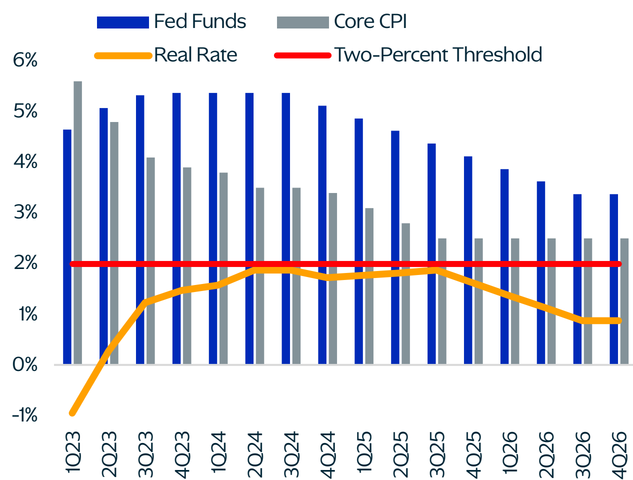
G4 Central Bank Balance Sheets as % of GDP, Dollar-Weighted



G4 = Federal Reserve, the ECB, the Bank of England, and the Bank of Japan. Data as at September 30, 2023. Source: Haver Analytics, national central banks and statistical agencies, KKR Global Macro & Asset Allocation analysis.

Exhibit 16: We Think The Fed Will Bring Real Rates to Two Percent This Cycle, But No Higher

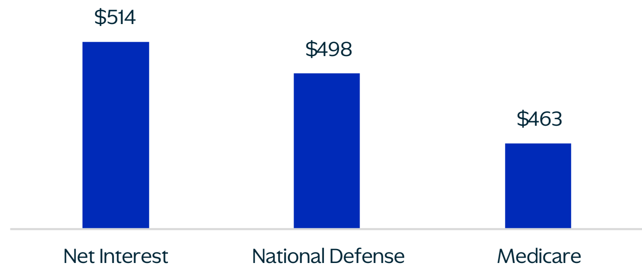
GMAA Base Case: Real Rates



Data as at June 12, 2024. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 17: Annual Spending on the U.S. Debt Service Burden Is Now More Than Spending on National Defense or Medicare, and More Than the U.S. Spends on Veterans, Education, and Transportation Combined

Overall Spending, US$ Billions



Data as at April 30, 2024. Source: CBO.

Traditional Macro Relationships Are No Longer Behaving the Same as in the Past	
1	Japan is experiencing inflation, while China has disinflationary headwinds.
2	U.S. Treasuries and the Japanese yen are no longer the 'risk-off' assets of choice. They are, in fact, driving much of the volatility in the capital markets during periods of uncertainty.
3	European growth is coming from the periphery, not the core, this cycle.
4	The interest rate easing cycle has started in Europe, not in the U.S., for the first time.
5	We have actually raised our long-term forecast for U.S. GDP growth, despite an inverted yield curve and a low savings rate. In the past, these two macro variables were recession signals.
6	It is the government, not the consumer or corporates, that is most leveraged this cycle.

At the same time, we think that many investors are still actually underweight their target allocations, including holding too much Cash at a time when most central banks have finished raising rates.

3. **Third, we think that the employment market holds up better this cycle.** Some of our optimism is actually driven by demographics, especially given the exit that we have seen of aged 55+ workers from the workforce since the onset of COVID. While we do expect immigration in the U.S. to create more slack in some sectors, we think this is a positive development for growth as unemployment from excess supply feels very different from the 'typical' cyclical dynamics of over-hiring and layoffs.

Exhibit 18: The U.S. Has Been Able to Grow Its Workforce Through Demographic Growth; Meanwhile, Europe and Japan Have Offset Aging Populations by Improving Participation Rates. Looking Ahead, We Think That Aging Demographics Will Require a Rethink of Both Workforce Participation and Immigration

Contributions to Workforce Growth, Millions

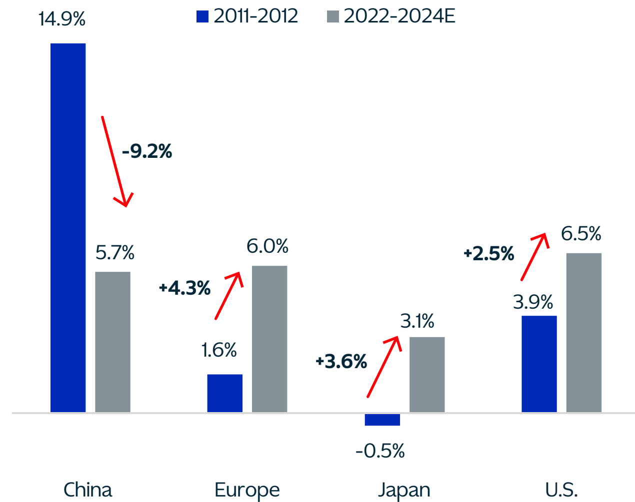
	U.S.	Europe	Japan
1Q2010 Workforce	**153.7**	**159.8**	**65.7**
Demographics	**11.3**	**-3.0**	**-3.4**
Change in Participation	**2.7**	**14.8**	**7.0**
Change in Prime-Age Male Participation	-0.3	0.1	0.0
Change in Prime-Age Female Participation	1.3	3.0	2.7
Change in 55-64 Participation	0.5	9.6	2.0
Change in 65+ Participation	1.2	2.2	2.3
4Q23 Workforce	**167.8**	**171.5**	**69.4**

Europe data based on the 'Euro-Area 19' subset of E.U. members. Latest available data as at December 31, 2023. Source: U.S. Bureau of Labor Statistics, Eurostat, Japan Statistics Bureau.

4. **Finally, consistent with our *Regime Change* thesis, and because we are mostly living in a higher nominal GDP environment,** we retain our conviction that a hard landing is not in the cards. The most cyclical areas of the global economy already dipped in 2022-23 and are now improving from below-trend levels. We are becoming more constructive around the potential for cyclical wage dynamics, as well as structural considerations related to technology and automation, to drive higher and faster nominal GDP growth globally.

Exhibit 19: Besides China, Most Economies Are Experiencing Higher Nominal GDP This Cycle

Annual Nominal GDP Growth, %

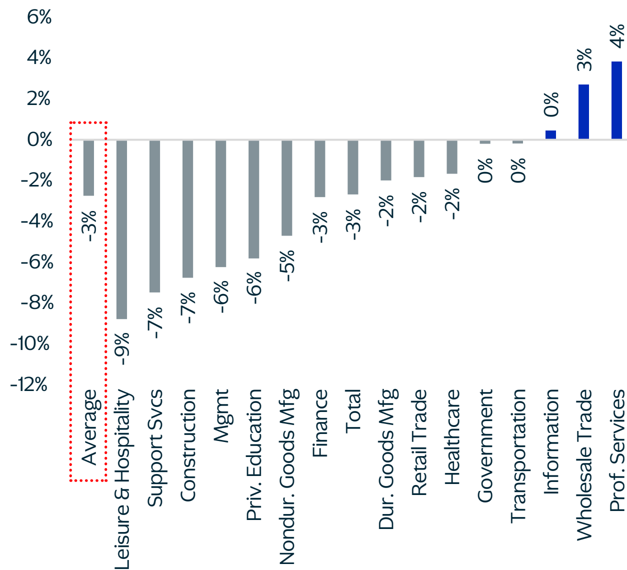


2024 are KKR GMAA estimates. Data as at May 31, 2024. Source: China National Bureau of Statistics, Statistical Office of the European Union, Cabinet Office of Japan, U.S. Bureau of Economic Analysis, KKR Global Macro & Asset Allocation analysis.

Against this unique macroeconomic backdrop, however, we continue to argue that as investors we are experiencing a *Regime Change*. There remain four pillars to our original thesis: ongoing fiscal stimulus, heightened geopolitics, a messy energy transition, and stickier wages (driven largely by a shortage of skilled workers).

Exhibit 20: Pent-Up Demand in Key Pandemic-Affected Services Sectors Continues to Fuel Above-Average Job Growth in the U.S.

Employment vs. Pre-COVID Trend, May-24



Pre-COVID trend based on linear extrapolation of 2014-19. Data as at May 31, 2024. Source: U.S. Bureau of Economic Affairs, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

As our colleague Ken Mehlman explains, just as the invention of the printing press around 1440 introduced years of political, religious, social, and scientific disruption, the combination of the Internet and social media is a 'Gutenberg 2' moment that has produced and portends similar disturbances.

However, while our longer-term thesis remains largely intact, we are constantly refining and evolving our convictions. To this end, we wanted to highlight what's changed since December and why we think adding more ballast to portfolios is warranted, particularly given the optimism being priced by markets during an asynchronous cycle where some sectors are slowing more quickly and inflation remains too sticky. So, as part of the next chapter of our *Regime Change* framework, we note the following:

What Is Changing or Being Amplified Since Our Outlook for 2024?

1

Increasing Importance of Non-Correlated Assets

After two major deep dive surveys across the Family Office and Insurance universes, we have even greater conviction in our thesis around owning more non-correlated assets. Key to our thinking is that, in a world where the efficient frontier for expected returns is now flatter, the importance of diversification increases. As a result, CIOs need more diversifiers in their portfolios so that they do not get whipsawed, especially when short-term performance can be quite volatile. One can see this in *Exhibit 27*. If we are right, then our insight has significant implications for allocators, particularly CIOs who have embraced long-duration bonds and/or VC on the equity side, or that do not believe in linear deployment.

2

Portfolio Volatility Is Increasing Because of the Changing Relationship Between Stocks and Bonds, Not an Increase in Single-Asset Volatility

There is another important influence to consider as well. Specifically, given all the movement around interest rates these days, the changing nature of government bonds in a portfolio, and greater use of concentrated ETFs by market participants (e.g., 40% of the High Yield market is now daily liquidity), the volatility of most benchmarks we track is surging to the upside, which increases the risk that a portfolio allocation change can be made at the wrong time. Some great work by Racim Allouani and Rachel Li suggests that today's heightened portfolio volatility is actually driven more by stock/bond correlation than by a surge in single-asset volatility, which was typically the case pre-COVID. This new reality is a big deal as it adds risk to a typical 60/40 portfolio, and it speaks to our view that we are indeed in a *Regime Change* when it comes to portfolio construction.

3

We Are More Focused On the Positive Path of Productivity, Especially in the U.S.

Given increasing debt loads amidst larger government deficits, we are now extremely focused on the one catalyst that is best equipped to keep stagflation at bay: Productivity. As we detail in *Exhibits 7* and *49*, the best decades of equity performance are usually linked to periods of strong productivity gains. Against today's backdrop of stickier wages, we think that strong productivity will be needed to allow corporate margins to hold. Were productivity to slip, we likely would take a more defensive stance on risk assets, a reality that is new to our macro thinking in 2024.

4

The Mismatch Between Energy Supply and Demand Is More Pronounced

The mismatch between energy demand and energy supply seems even bigger than our previously bullish view. Demand is once again rising on electrification trends for EVs and heat pumps and the explosive growth in energy-intensive users such as data centers, semi fabs, EV battery plants, and steel mills. In the U.S., for example, overall electricity demand is poised to grow 2.4% annually, compared to essentially zero in prior years. We believe as much as one-third of this growth could come from data centers, and that data centers could account for 7-10% percent of total electricity demand in the next few years, compared to two to three percent at the end of 2023. While demand is increasing, our work shows that most developed market economies don't have the infrastructure in place to meet this need. Moreover, a lot of the power demand is not where the power supply is currently located. We view this current set-up as a major opportunity for investors, especially on the Infrastructure side.

5

A Broadening of Earnings Growth Across Sectors and Geographies

As we show in *Exhibit 76*, we have raised our 2024 and 2025 S&P 500 EPS forecasts to $250 and $270, respectively. What is changing in our data is that corporate earnings growth is set to broaden beyond mega-cap

Tech in coming quarters. We think this shift will represent more balance in the equity markets, and as a result, we are raising our 2024 target to 5,700 from 5,400 previously, which is roughly 10% above the 'top-down' consensus estimate of 5,172. Our 2025 target of 6,130 implies about 13% of upside from today's level of around 5,414. Meanwhile, in Europe, we think the economy is bottoming at a time when most investors are underweight the region. Stronger tourism, rebounding sentiment, and an increase in real wages (at last) will lead to a perkier consumer in the coming quarters. As part of this improvement in growth, the services economy is accelerating nicely. Additionally, the end of quantitative easing breathed life back into, and produced strong returns for, the financial services sector. We expect this trend to continue as valuations normalize.

6

More Sustained Deficits Amid Election Volatility Reinforces Our Regime Change Thesis

Regardless of the electoral outcome, the 2024 U.S. election is likely to further strengthen our *Regime Change* thesis. Though actual fiscal policy under Biden or Trump is not likely to loosen much given the expiration of some 2017 tax cuts or the imposition of tariffs, we continue to think that under either administration the deficit will stabilize at historically wide levels. As a result, we think Treasury term premium will stabilize at wider levels, too – which will make it harder for bonds to rally the way they did in past cycles. That said, there are also several policy proposals that could skew inflationary under a second Trump presidency, including writing stimulus checks for households, deporting undocumented immigrants (which would aggravate labor shortages), cutting off Iranian and Venezuelan oil, and potentially pressing for a more dovish Fed.

7

The Labor Supply and Demand Mismatch Could Create Unprecedented Demand for Worker Retraining

We think the U.S. labor force is in the early innings of an inflow of about four million additional potential workers amidst a record surge in immigration. However, our best guess is that limited formal skills training means the overwhelming majority of these workers will be competing to fill a small portion (perhaps about two million) of the 8.1 million open jobs in the U.S. As a result, we think the opportunity set for worker retraining may be as large as it has ever been, in part because there will be a lot of pressure to bring unemployed workers from low-skilled sectors (where we expect more of a labor glut in some cases) into high-skilled jobs left open by COVID-era retirements.

So, while we certainly believe in the opportunity set and our glass half full perspective, we do want to acknowledge that we are entering a volatile period in the second half of 2024 at a time when spreads are already very tight. To be sure, we are not signaling a more sustained bearish tilt the way we did in 2022 (see Walk, Don't Run). Rather – if we could steal a page from our Outlook for 2023: Keep It Simple – now is not a time to get over-extended when it comes to leverage or liquidity. The current environment, we believe, is more akin to the Oscar Wilde quote when he says that, "A pessimist complains about the noise when opportunity knocks." Said differently, if *Opportunity Knocks* in the form of a capital markets draw-down linked to election uncertainty, then you should have your portfolio in position to 'answer the door.' Don't just be the 'pessimist', particularly when many of today's macroeconomic headwinds can be overcome through a combination of thoughtful asset allocation and directed thematic investing.

Six Areas Where We Differ From Consensus

#1: Bumpy, But Faster Growth

Across all regions, we are again more bullish on growth than the consensus. In the U.S., stronger assumptions around both job growth and productivity lead us to raise our 2024 forecast to 2.5%, 10 basis points ahead of the consensus, and our 2025 forecast at 2.0%, 20 basis points above consensus. More importantly, we have raised our long-term forecast for U.S. structural GDP growth to two percent from 1.5% in the past. In Europe, data surprises are no longer lagging the U.S. as economic momentum turns positive. We are increasing our 2024 GDP growth forecast to 0.8% from 0.5% versus a consensus estimate of 0.7%. For 2025, our growth forecast is 1.4%, the same as consensus. We think growth in China is bottoming and likely in the early recovery stage. Our 2024 forecast is at 5.0% versus 4.7% at the beginning of the year and a consensus of 4.9%, while 2025 is at 4.6%, 10 basis points above consensus. In Japan, we forecast 0.6% GDP growth in 2024 and 1.2% in 2025, 20 basis points and 10 basis points above consensus, respectively.

#2: We Are Not as Worried About a Lower U.S. Savings Rate Signaling an Over-Extended Consumer This Cycle

While we do think U.S. consumer spending will slow in coming quarters, we are not seeing the type of imbalances that were observed in the run-up to past recessions. Specifically, although savings rates today are at the lowest levels since the GFC (currently around four percent, versus two to three percent in 2005-2006), we think this simple comparison doesn't account for the increase in the 65+ population over the last two decades (17% today versus around 12% prior to the GFC). Personal savings rates become sharply negative once households retire, meaning aging demographics likely explain some of the savings pullback. In fact, our estimates suggest that the 'neutral' savings rate has actually fallen to around 5.6%, down from 9-10% in the mid-2000s, implying that savings rates today are just 100-200 basis points below 'normal', while the savings rates that prevailed before the GFC were actually 700-800 basis points too low. Therefore, while we do expect some retrenchment, households do not look nearly as overspent as they have in the lead-up to past downturns.

#3: Bigger Regional Differences in Interest Rates. In the U.S., What's the Rush?

In the U.S., we are above consensus on interest rates this year as part of our higher for longer thesis. We see the Fed cutting rates just once this year, to 5.125% (which puts our forecasts about 25 basis points above market forwards) before falling to 4.125% in 2025 (also about 25 basis points above market pricing). For the U.S. 10-year, we stick to our forecast of 4.25% for year-end 2024 and four percent for year-end 2025, which remains a bit more hawkish than consensus of 4.2% for 2024 and 3.9% for 2025. In Europe, we have the bund at 2.6% for end-2024 (above consensus of 2.2%) and 2.8% in end-2025 (also above consensus of 2.2%). We think sustained higher inflation volatility means a return to a longer-term average term premium of approximately 50 basis points, leading to a long-term bund yield target of approximately 3.0%. In China, by comparison, we are actually below consensus for the 10-year for both 2024 and 2025 at 2.2% vs. 2.4%, and 2.0% vs. 2.4%, respectively. Against this backdrop, we think FX volatility will remain elevated and will serve as an important source of information for markets alongside the yield on government bonds.

#4: Better EPS, Driven By Higher Margins

We believe the cycle has further room to run, with margin expansion (as opposed to multiple re-rating) powering the next leg of the recovery. Our 2024 S&P 500 price target of 5,700 remains 10% above the 'top-down' consensus estimate of 5,172. For 2025, our target of 6,130 implies about 13% of upside from today's level of around 5,414. For 2024 and 2025 EPS, our targets are $250 and $270, versus the top-down consensus of $240 and $253, respectively. Our framework linking real GDP growth and unit labor costs to operating margins points to 20-30 basis points of margin expansion this year and next so long as labor productivity stays supportive.

#5: Oil – $80 is the New $60

We expect oil prices to settle in the mid-$70-80s range in 2024 amid slower global demand and better global supply. Longer term, though, we still think '$80 is the new $60.' As such, our longer-term forecasts remain well above futures, which continue to embed prices falling to the mid-$60-70s in 2025 and beyond.

#6: Where Could We Be Wrong?

Our base view is that there is an asymmetric risk for the economy and markets if rates go higher versus lower. We still see six percent short rates as somewhat of a tipping point, given this level limits operating cash flow for most levered entities as well as encourages more deposit flight from traditional financial intermediaries. Also, because policymakers did not remove as much stimulus from the markets this cycle, we continue to caution that the currency markets could be a source of unexpected stress for investors to consider in their portfolios. Finally, an extreme spike in unemployment, which is not our base case (as we think unemployment stays lower this cycle) would likely be unsettling for both our thesis and the markets, we believe.

What does all this mean from a macro and asset allocation standpoint?

In the classic 1975 Steven Spielberg film *Jaws*, Chief Brody, played by Roy Scheider, proclaims – after internalizing the size and power of the shark – "you're gonna need a bigger boat" to Captain Quint, who was played by Robert Shaw. Brody's important epiphany was that traditional shark-catching techniques were no longer effective, and as a result, a different approach was warranted. Like Chief Brody, this is how we view asset and security selection in the current macro landscape: another approach is warranted. This viewpoint, since the onset of COVID, served as the backbone of our now well-established *Regime Change* thesis.

As we look ahead, we still have high conviction in this framework, and if anything, we now think that the longer-term implications of our prior work may be even more profound than we had previously understood. We do not make these comments lightly, and to this end, we think that there are several key action items for portfolio managers and CIOs to consider. They are as follows:

1. **First, we remain of the mindset that a *Regime Change* *(Exhibits 13* and *14)* has occurred that requires a different type of portfolio, including more collateral-based cash flows, more upfront yield, and more linkage to the higher nominal GDP environment in which we are operating *(Exhibit 19)***. Importantly, it also means that safe haven assets like government bonds and traditional currency hedges like JPY won't work as well this cycle. If there is good news, it is that our own internal work is showing that wages, which we view as a proxy for sticky services inflation, are moderating from peak levels, though KKR's portfolio company CEOs still see a higher resting heart rate for wages and inflation this cycle.
2. **Second, given flatter expected returns than in the past, we now think more focus on diversification is warranted**. As we detail in *Exhibit 21*, the five-year forward median return across asset classes we forecast is 80 basis points lower than what we saw over the last five years. That said, we also see more ways to win in this cycle across a wider swath of asset classes. This viewpoint is in direct conflict with what worked before COVID, when concentrating one's assets in long-duration equities (e.g., VC) and fixed income (e.g., long-duration Investment Grade Debt) easily bested the benefits of constructing a more diversified portfolio. If we are right then CIOs, similar to what we learned from our *proprietary insurance survey*, should broaden their exposure and own more non-traditional assets that are less correlated. In addition, allocators will likely need to be more opportunistic to deploy when asset classes, regions and/or sectors periodically fall out of favor.

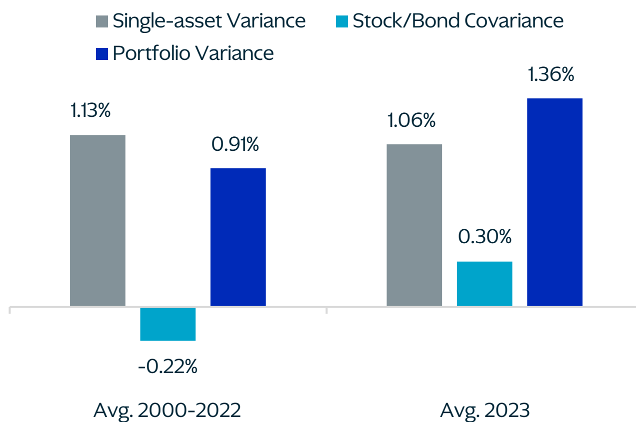
Exhibit 21: Given Flatter Returns, We Think a More Diversified Portfolio Will Perform Better in the Future

Private Market Expected Returns, %

Data as at April 30, 2024. Source: Bloomberg, BofA, Cambridge Associates, Green Street, KKR Global Macro & Asset Allocation analysis.

Exhibit 22: The Recent Heightened Portfolio Volatility Is More Correlation Driven Than Single-Asset Volatility Driven. This Backdrop Means That CIOs Need to Find More Assets That Bring Down Overall Portfolio Variance

60/40 Portfolio Variance Decomposition — Rolling 3-Year



Data as at December 5, 2023. Source: Bloomberg, BofA, Cambridge Associates, Green Street, KKR Global Macro & Asset Allocation analysis.

3. **Third, in our new regime framework, we expect heightened volatility around the fundamental relationship between stocks and bond assets, which have become more correlated. As a result, traditional benchmarks are likely to demonstrate more volatility than in the past**. Somewhat ironically, our colleague Chris Sheldon likens the current state of affairs in the global capital markets to self-inflicted wounds, as investors' desire for greater liquidity increases volatility given so much of the fixed income market is actually now in equity linked, daily liquidity credit vehicles. One can see this in *Exhibit 22*, which shows that the increase in stock/bond covariance is leading to higher overall portfolio variance. Importantly, this outcome is occurring despite single asset variance actually declining. Our bottom line: Allocators should consider a shift towards assets that help overcome this increasing correlation between stocks and bonds. Greater communication with boards and end constituents is also likely becoming more important. Otherwise, there is now heightened risk that boards encourage CIOs and their teams to tamp down on certain single asset class allocations at precisely the wrong time, which ultimately could further dent cumulative performance in a world where the investment community is already starting with lower expected forward returns.

Our bottom line: Allocators should consider a shift towards assets that help overcome this increasing correlation between stocks and bonds. Greater communication with boards and end constituents is also likely becoming more important. Otherwise, there is now heightened risk that boards encourage CIOs and their teams to tamp down on certain single asset class allocations at precisely the wrong time, which ultimately could further dent cumulative performance in a world where the investment community is already starting with lower expected forward returns.

SECTION I

Asset Allocation and Key Themes

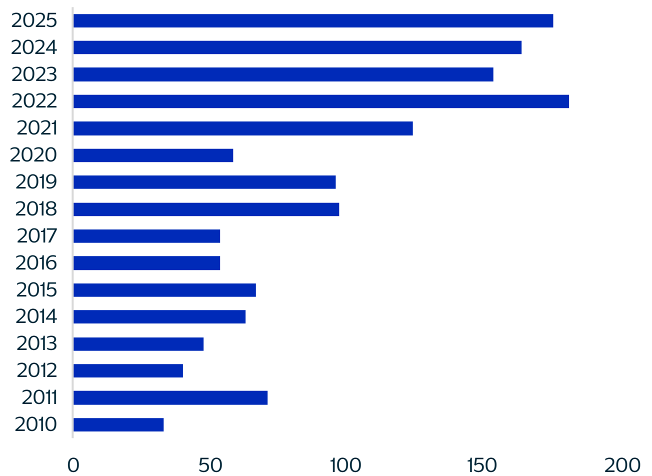
Picks and Pans

Against the current macroeconomic setting, we offer our updated Picks and Pans for investors to consider:

▲ Public Company Buyouts of Themselves (NEW)

We are seeing a growing number of public companies that are essentially taking themselves private through better capital allocation, including aggressive buyback programs. A good example, we believe, is the home building sector. We are also seeing this type of corporate reform behavior in the U.S. home improvement sector as well as in parts of the industrial and energy sectors. In our view, many executives in this area are de-emphasizing the cyclical components of their businesses to create more sustainable companies with greater visibility of earnings and returns. As a result, we think that not only solid buyback activity but also a lower cost of capital could drive valuations materially higher at many of these companies than the consensus now thinks.

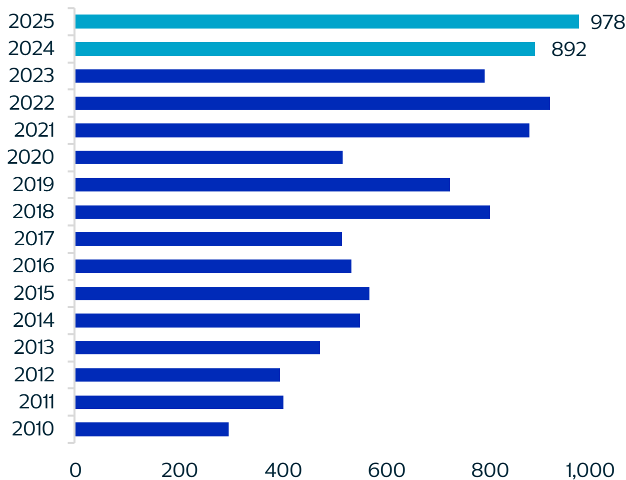
Exhibit 23: Europe Has Historically Done More Dividends and Fewer Buybacks, But That Is Changing



Data as at April 24, 2024. Source: Goldman Sachs.

We are of the view that all-in yields are likely near peak levels, as cooling inflation will give the Fed more conviction on interest rate cuts and easing financial conditions.

Exhibit 24: U.S. Buybacks Have Been Driven by Solid Earnings Growth and Tech Stocks, Contributing Mightily to the Lack of Supply



Data as at March 31, 2024. Source: S&P, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

▲ CLO Liabilities (NEW)

We are of the view that all-in yields are likely near peak levels, as cooling inflation will give the Fed more conviction on interest rate cuts and easing financial conditions. While we still like Loans, our preference is to play this idea through higher-quality CLO tranches, as diversification benefits and credit enhancement matter more in an environment where idiosyncratic risks are elevated (particularly when it comes to refinancing). We also think that CLOs fit into our higher for longer thesis on rates relative to pre-COVID.

▲ Biotechnology (NEW)

We think the recent drawdown in biotech stocks is likely overstated when one compares it to how the rest of the equity market has performed. Just consider that the Nasdaq biotech index is down about 19% from its 2021 peaks, while the S&P 500 has actually *climbed* about 19% over the same period. Nonetheless, we continue to think biotech remains one of the most compelling secular growth stories in the market, backed by aging populations, increased technological investment, and the fact that a lot of weaker startups have struggled to raise capital/IPO in recent years. Our bottom line: We are turning more bullish on the sector, particularly when one accounts for the fact that valuations in price-to-book terms are now hovering near the lowest levels since the GFC.

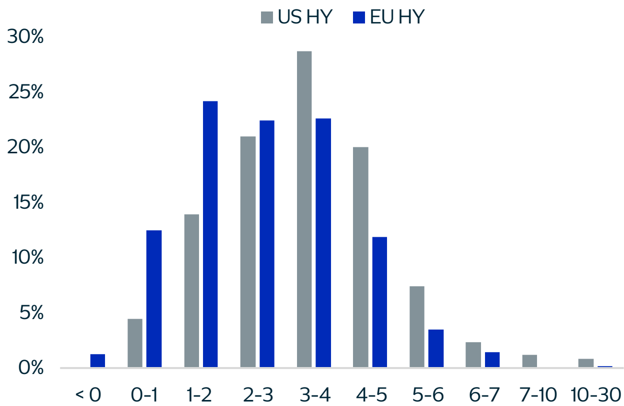
▲ USD EM Corporate Debt (NEW)

While we remain bullish on the growth trajectory for emerging markets, we continue to think that EM Public Equity markets may not be the best way to play this theme, as they are often overweight state-backed enterprises that do not prioritize returning profits to shareholders. By contrast, we like opportunities in the private markets to work alongside local partners to align with key growth themes, as well as opportunities in the public debt markets (particularly as EM default rates are often lower than those for U.S. corporates). At present, we especially like the relative value opportunities in EM Debt to lend to some of the same quasi-governmental enterprises that drag on EM index returns, as these companies carry more protection than typical corporates while offering excess spread relative to their inherent risk.

▲ Short Duration European Credit (NEW)

Not only does European HY screen 'cheap' to U.S. HY on a spread basis, but we believe historical levels suggest there is more opportunity for high quality senior secured assets to tighten relative to the U.S. Importantly, European HY maturities tend to be shorter, and against this backdrop, we expect fully 35-40% of European HY to mature by the end of 2026. Taken together with ECB rate cuts, this reality offers near-term takeout opportunities for bonds that still have convexity. Moreover, in many instances across Europe, we think that there is some compelling convexity that remains, particularly for any issuers that will try to use future rate cuts as an opportunity to address existing short-term debt.

Exhibit 25: Fully 35-40% of Euro HY Is Maturing by the End of 2026. We See This Refinancing Opportunity as Significant



Data as at April 30, 2024. Source: Bloomberg.

▲ Japan (REPEAT)

We continue to remain constructive on the investing environment in Japan and believe that an economic reawakening is in progress. We see a transition underway in the coming years from the post-COVID, pent-up, demand-driven recovery to a second phase, fueled by real income growth. Capital expenditures 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. We take comfort that corporate reforms, especially around listed companies, continue to gain momentum under Prime Minister Kishida. We also still see opportunities in corporate carve-outs and significant value in direct public to privates, as we believe the opportunity for operational value creation is meaningful. That said, we do expect the yen to remain weaker for longer and highly volatile, likely only strengthening once the Fed begins its easing campaign. Against this backdrop, we think sound hedging and portfolio construction is only becoming more important.

▲ 365 Day Lending, Including Fund Financing (REPEAT)

If we are right that the Fed cuts rates more gradually than markets expect, then the carry offered by the front end of the curve is going to be an important driver of performance in 2024. We are particularly interested in term subscription lines as an opportunity to receive above-market compensation for exposure to high-quality counterparties in a space where regional banks have pulled back on new lending. Today, a sub-line with less than a 365-day maturity generally yields SOFR +200-250 basis points, which we think could be attractive as a Cash plus surrogate with low default potential. Importantly, this opportunity screens well from a cyclical risk standpoint, as banks are beginning to move back into this market which could tighten pricing in the next few quarters.

▲ U.S. Leveraged Loans Refinancing Wave (NEW)

Similar to what we are saying about European High Yield, we think the wave of refinancing for leveraged loans will continue, driving better total returns for discounted Leveraged Loans nearing maturity. All told, year-to-date through May, U.S. Leveraged Loan issuance stood at $550 billion, of which fully $198 billion (36%) was driven by refinancing activity. We look for this theme to continue in coming quarters as spreads across risk assets have continued to compress. As our colleague Chris Sheldon's recent credit letter suggests, sponsors and issuers are looking to reprice and refinance existing debt, which will continue to provide tailwinds for the asset class and will likely drive spread compression absent new M&A.

Exhibit 26: We Believe Reinsurance Capital Solutions Can – in Certain Situations – Provide Meaningful Diversification, Reduced Volatility, and Enhanced Performance...

Asset	Model Portfolio (Weighting or Ratio)	Alternative 1	Alternative 2	Alternative 3	Alternative 4
Equities	60%	60%	55%	55%	50%
Bonds	40%	35%	40%	35%	30%
Insurance Assets	0%	5%	5%	10%	20%
Annualized Return	5.4%	6.3%	5.8%	6.6%	7.9%
Volatility	13.2%	12.9%	12.3%	12.0%	10.8%
Return Risk Ratio	0.41x	0.48x	0.47x	0.55x	0.73x
	Difference in Basis Points				
	Model Portfolio (Weighting or Ratio)	**Alternative 1**	**Alternative 2**	**Alternative 3**	**Alternative 4**
Annualized Return	5.4%	+90	+39	+129	+257
Volatility	13.2%	-27	-92	-120	-239
Return Risk Ratio	0.41x	+0.08x	+0.06x	+0.15x	+0.33x

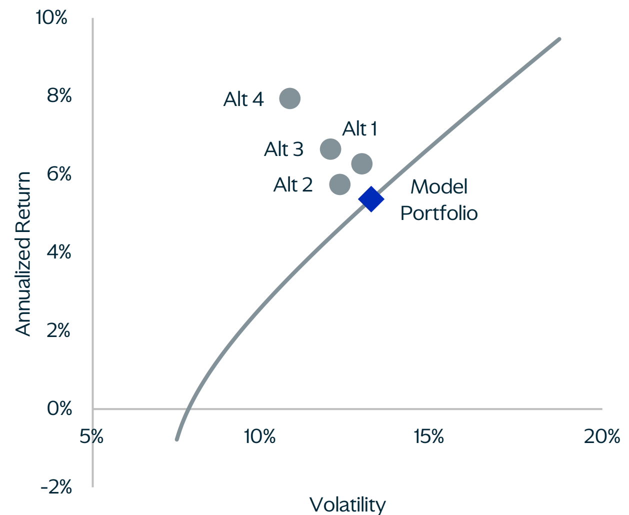
Equities: MSCI ACWI Gross Total Return USD Index; Bonds: Bloomberg Global-Aggregate Total Return Index; Alternative Portfolio: Reinsurance transactions. Data from 1Q18 to 1Q24. Source: KKR GBR analysis.

▲ Reinsurance Capital Solutions (NEW)

A continuing refrain we heard from our recent survey work was the growing desire to own longer duration, compounding-oriented assets with tax-efficient attributes, especially for family offices/high net worth investors. Importantly, we believe participating in reinsurance transactions (or what we call insurance as an asset class) can be an effective complement to yield-oriented asset classes such as Private Credit and/or Asset-Based Finance. At the same time, the high return on capital attributes of this asset class also enable allocators to play 'offense' with their portfolios. The market potential for insurance as an asset class is quite sizeable, as we increasingly see that a growing number of insurers are looking for partners to reinsure block transactions, or actually exit lines of business. Beyond stable returns and solid yield characteristics, the asset class's low correlation to other more traditional fixed income products is quite compelling if our 'bigger boat' thesis is accurate.

Exhibit 27: ...Which Is In Line With Our Diversification Thesis for Portfolio Construction

Various Reinsurance Transaction Portfolios Volatility and Annualized Return vs. a Traditional 60/40



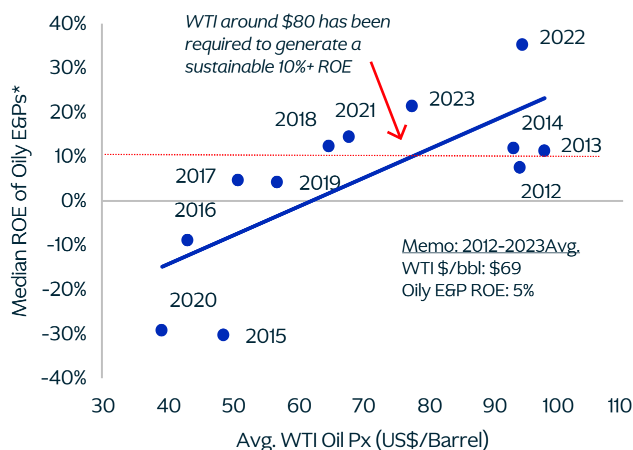
Equities: MSCI ACWI Gross Total Return USD Index; Bonds: Bloomberg Global-Aggregate Total Return Index; Alternative Portfolio: Reinsurance transactions. Data from 1Q18 to 1Q24. Source: KKR GBR analysis.

▲ Out Year Oil Prices (REPEAT)

We expect oil prices to moderate to the mid $70-80 range amid slower global demand and better global supply next year. Longer term, we still think '$80 is the new $60.' Shale is still the key source of longer-term global supply growth, and producers continue to demonstrate a disinclination to grow supply unless prices center at least around $80. This forecast remains well above futures, which continue to embed prices falling to $60-70 in 2025 and beyond.

Exhibit 28: If We Are Correct That Shale Producers Are Now Focused On Generating Attractive FCF and ROEs, We Think Around $80 Is the Long-term Price Level Required to Achieve Those Aspirations

Median ROE of Oily E&Ps vs. Avg. WTI Price



* Median of COP, EOG, PXD, OXY, FANG, APA, PDCE, MGY, MUR, DEN, CIVI, CRC, SM, CDEV, TALO. Data as at December 31, 2023. Source: Bloomberg.

▲ Opportunistic Credit (REPEAT)

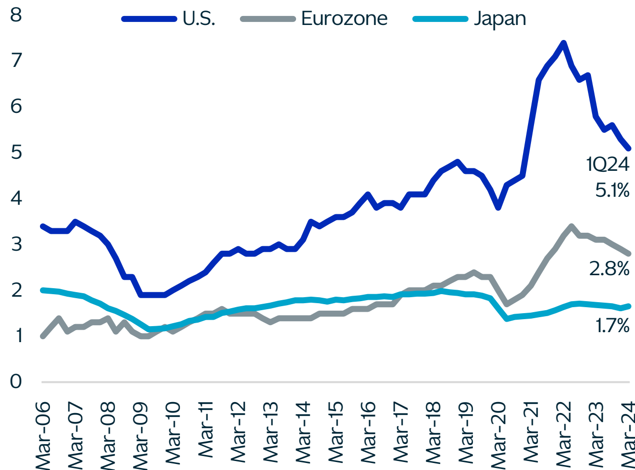
This 'Pick' has multiple threads to it. For starters, we see significant value in opportunistic liquid Credit vehicles that can nimbly 'toggle' allocations across High Yield, Levered Loans, and Structured Credit as well as between sectors and themes, particularly as a repricing of spreads and the risk-free rate create select pockets of relative value.

We also think that wider dispersions within Credit asset classes, often driven by indiscriminate ETF buying and/or selling, are creating substantial opportunities that were not available in the past. At the same time, we are seeing some really attractive relative valuation in the bucket we call Capital Solutions Credit to fund acquisitions and/or major capital expenditures including domestic re-shoring initiatives. In particular, it definitely feels to us like there is an upward 'kink' in the efficient frontier that is providing investors in products like Convertible Bonds and Preferred Securities the ability to enjoy some attractive equity upside participation but also retain some downside protection at limited additional costs. Finally, Asia Credit also remains an area of growing interest from investors, as this more nascent market faces less competition from more traditional players.

▲ Worker Retraining (NEW)

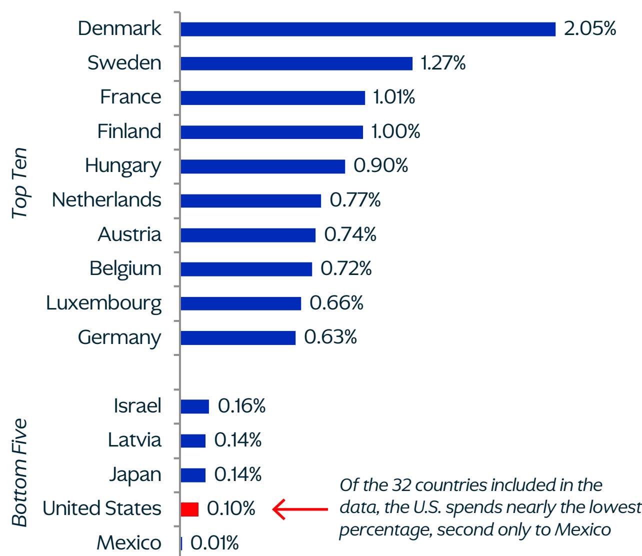
The latest CBO figures imply that total U.S. immigration may be roughly 5.5 million people *higher* over 2023-2027 than previously expected (or more than double what the CBO's previous forecasts for run-rate immigration had assumed). While that should help alleviate labor scarcity, given there are some 8.1 million open jobs in the U.S., the bad news is that the majority of new workers will be qualified for only about two million of these open positions. Thus, we think there is a massive economic opportunity to invest in better worker training that can help move many workers into higher-skill job openings across manufacturing, logistics, nursing, etc., that have been left open as a result of baby boomer retirements or growing needs. Against this backdrop, a rethinking in approach may be warranted. Areas where we see opportunity could include: 1) shifting job requirements from a credentials first model to a skills first model. Importantly, we believe this will optimize ROI in education and training and also lead to more employable people; 2) reliance on certificates to confirm training of people in areas of specific need and employment relevance; 3) a skills first model that allows workers and employers to understand skills adjacency, facilitating the upskilling of existing workers whose jobs have some overlap with or even all of, the skills needed; and 4) expansion of hybrid platform models that provide online credentialing paired with personalized coaching.

Exhibit 29: U.S. Worker Turnover Rates Are Much Higher Than Those in Other Developed Countries



Data as at March 31, 2024. Source: U.S. Bureau of Labor Statistics, Eurostat, Bank of Japan, Haver Analytics.

Exhibit 30: The U.S. Spends Less On Worker Retraining Than 31 Out of 32 OECD Countries Studied



Data as at December 31, 2022. Source: U.S. Department of Commerce.

▲ Multifamily Real Estate (New)

For some time now, we have been advocating an overweight to Real Estate Credit. We now see good value on the equity side, too. Key to our thinking: U.S. rental vacancies are at their lowest levels in about 40 years (except for the pandemic), while run-rate household formation will likely run at a higher rate than rental units can be delivered given the pullback in building starts. Importantly, we think the recent surge in U.S. immigration will only add to these imbalances, as it could potentially double the number of households formed over the next three years. Finally, we think market technicals are becoming more bullish, too, including signs that cap rates have now started to peak (as more transactions are taking place between buyers and sellers) as well as tighter spreads for RE lending (including the CMBS market). So, while we are not yet ready to 'run' when it comes to RE allocations, we think owning some existing multifamily in strategic geographies could be quite fortuitous, particularly in cases where replacement costs are near or above asset values.

▼ Fade Fed Rate Cuts When the Market Gets Euphoric (REPEAT)

If we are right that we are in a higher nominal GDP environment with increased levels of productivity, then the neutral rate for Fed Funds likely stays higher this cycle. As such, we do not share the consensus view of two or so rate cuts this year. Rather, we stick to our view that inflation is on a cooler path but will not return to the Fed's target range of two percent. Therefore, we would use periods of dovish euphoria to hedge out interest rate risks (like the opportunity set that was presented to investors during the banking crisis of 2023).

▼ Low-Cost Consumer Discretionary (REPEAT)

As we have written before, younger and lower-income U.S. consumers have been the most exposed to inflation this cycle, which is weighing on available spending. Moreover, a lot of inflation today is in 'must-have' categories like food, housing, etc., which is taking wallet share from discretionary spending on 'nice-to-have' budget items like restaurants or recreational goods. Finally, we think the composition of low-income demand is likely shifting away from categories like fast-casual dining as a surge in immigration leads to more competition for both employment and low-cost housing. Against this backdrop, although the consumer in aggregate has mostly recovered from the inflation shock of 2022, we remain cautious about the outlook for nonessential spending among this cohort.

▼ FX Risks (NEW)

We think the asynchronous experiences of major world economies around inflation and growth will create more volatility in both interest rates and currencies, particularly in cases where countries face tradeoffs between the long-term effects of higher bond yields on budgets versus the impact of weaker currencies on trade balances. To see this, one can consider the divergent experiences of the U.S. and Japan in recent years: U.S. bonds have become quite cheap, while its currency has strengthened sharply. Japanese bonds remain expensive, which should help government deficits, but its currency is at 30-year lows. There are also crosscurrents from geopolitics, including reserve balances and FX interventions, to consider. Our bottom line: betting on currency returns is likely a poor risk/reward for most investors right now, which is why we prefer FX hedge benefits for USD investors to potential currency upside in most cases.

Key Themes

We also think that leaning into themes that serve as foils to today's uncertain landscape is critical. To this end, we are enthusiastic about the following investment trends:

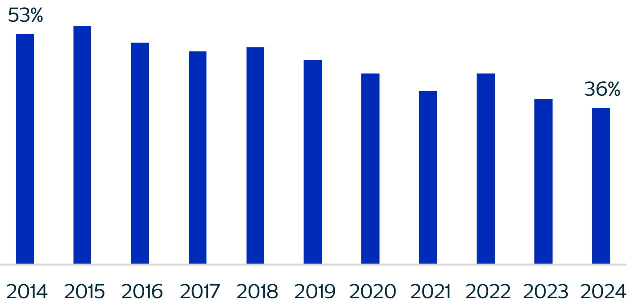
1

Buying Complexity, Selling Simplicity in the Equity Markets

While we still favor simplicity in Credit markets, we are seeing some interesting opportunities around complexity in the Equity markets. In addition to direct public-to-private transactions, we believe that corporate carve-outs are amongst the most attractive ways to find devalued and underappreciated companies in bifurcated markets — markets that too often seem to eschew complexity in favor of simplicity at almost all costs. In particular, we still believe the opportunity set to acquire high-quality carve-outs across PE, Infrastructure, and Energy remains outsized in today's markets. In our view, it would not be unreasonable, for example, to expect corporate carve-outs in large markets like the U.S. and Japan to account for a third or more of total deal volume during the next 12-24 months. Importantly, prices for these types of transactions tend to be much more attractive than regular way private-to-private transactions, and the operational upside has also generally been more significant than regular way Private Equity transactions.

Exhibit 31: The Industrials Sector Is Becoming Much More Fragmented

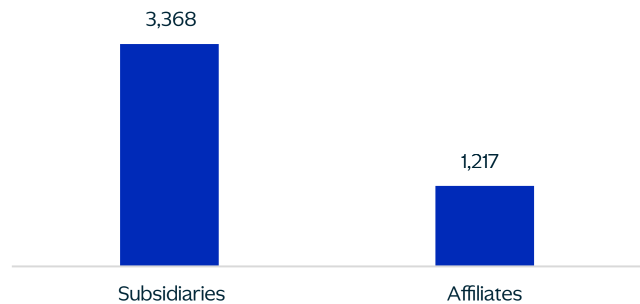
Top 10 Largest Industrials as a % of S&P Industrials by Market Cap



Data as at May 31, 2024. Source: Factset, Melius Research.

Exhibit 32: We Expect Divestments in Japan's Corporate Carve-Out Arena to Continue

Top Five Select Japan Conglomerates Number of Subsidiaries and Affiliates



Subsidiaries refer to subsidiaries with consolidated financial statements. Affiliates refer to unconsolidated subsidiaries. Data as at March 31, 2022. Source: Company disclosures, KKR Global Macro & Asset Allocation analysis.

Just consider that the projected increase in AI electricity demand is roughly equivalent to adding 24 million homes (or 16% of total housing stock) to the grid.

2

Collateral-Based Cash Flows

Our research continues to show that many individual and institutional investors are still underweight Real Assets, especially Infrastructure and Energy, at a time when the need for inflation protection in portfolios remains high. Moreover, if we are right about the AI-electricity demand that we are forecasting, then the opportunity set to own growthier Infrastructure assets, especially around data centers, logistics, etc., is quite compelling, we believe. Just consider that the projected increase in AI electricity demand is roughly equivalent to adding 24 million homes (or 16% of total housing stock) to the grid. Finally, as we show below, the benefits of using Real Assets, especially Infrastructure, Real Estate Credit, Asset-Based Finance, and certain commodity investments, to increase portfolio diversification dovetail nicely with our current macro view about the need to find more diversifiers in one's portfolios. One can see this in *Exhibits 33* and *34*, respectively.

Exhibit 33: We Think More CIOs May Need to Focus on the Diversification Benefits of Non-Traditional Asset Classes, Particularly Infrastructure

Asset Class Correlations, Quarterly, Using Last 12 Months Total Return From 2012-2023

	IG	RMBS	CMBS	Public Equities	Structured Credit	Private Equity	Private Credit	RE Equity	Infra
IG	100%								
RMBS	92%	100%							
CMBS	96%	91%	100%						
Public Equities	50%	28%	44%	100%					
Structured Credit	35%	6%	34%	70%	100%				
Private Equity	29%	12%	28%	84%	49%	100%			
Private Credit	7%	-17%	5%	78%	75%	76%	100%		
RE Equity	-20%	-19%	-17%	33%	12%	52%	55%	100%	
Infra	-3%	-19%	-6%	46%	21%	63%	55%	54%	100%

Data as at September 30, 2023. Source: Cambridge Associates, JP Morgan, Bloomberg, KKR Global Macro & Asset Allocation analysis.

Meanwhile, within Credit, we favor Real Estate Credit and Asset-Based Finance as a play on our *Regime Change* thesis. Even with inflation cooling and the Fed approaching an easing campaign, we still think 'higher for longer' will remain in play. As a result, we see a potential upward re-rating of structured products that are being used to finance Real Assets such as houses, aircraft, renewable power assets, and warehouses. Importantly, these products also have a degree of inflation linkage, given they are backed by hard assets that tend to rise in value with consumer prices, and they often have floating coupons that may benefit lenders during periods of higher rates.

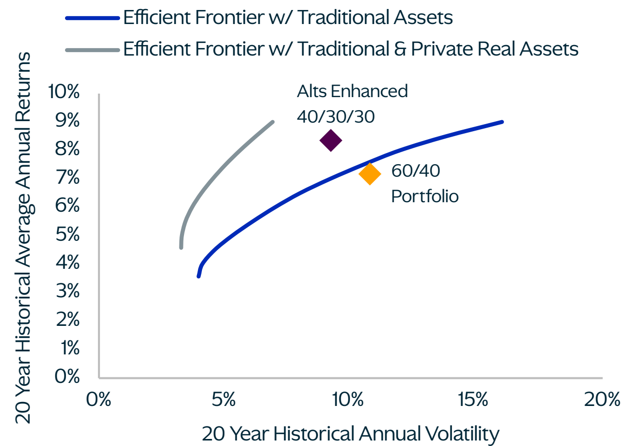
3

Productivity

We continue to believe that corporations will need to focus on automation and productivity to offset skills mismatches and labor shortages in certain instances. In our view, many of the most influential technological trends, including automation and digitalization that were in place before the pandemic have now only accelerated, especially on the industrial side of the economy. We think that the recent uplifts in productivity are not anomalies but instead are closely linked to a resurgence in capital investment that began around 2014. To date, the most advanced efforts have been heavily concentrated in the manufacturing industry, which in the United States accounts for less than 10% of total employment but nearly 90% of all robot installations. However, the playbook is starting to shift, as the aging population makes it harder to fill junior roles in service industries; we believe this trend will only accelerate as automation increases in fields like retail, leisure and hospitality, and healthcare. We are also very bullish on trends in worker retraining. Using data and educational techniques to improve student/employee skills to better match the demand by corporations for labor will be a mega-theme, we believe. No doubt, automation and productivity are emerging as some of the most compelling mega-themes this cycle, in our view, and at times have accounted for about 20-25% of our deal teams' PE activity since the pandemic.

Exhibit 34: Regime Change: We Think That There Is a Need to Shift One's Asset Allocation Mix Towards More Investments Linked to Nominal GDP

20 Year Average Annual Returns and Volatility of Real Assets and 60/40 Portfolios



Efficient frontier calculated using quarterly total returns over the last 20 years ending in March 2023. Traditional asset efficient frontier constructed using the MSCI World Index for Global Equities, the Bloomberg Global Aggregate Treasury Index for Global Government Bonds, the iShares TIPS Bond ETF for TIPS, and the Bloomberg Global Aggregate Corporate Index and Bloomberg Global High Yield Index for Global IG and HY Corporates. Efficient frontier with traditional and Private Real Assets uses all of those indices, plus the MSCI U.S. REIT Index for Global REITS, Commodities proxied using the S&P GSCI Spot Index, Global Private Infrastructure is proxied using the Burgiss Global Infrastructure Index, Private Real Estate proxied using the Burgiss Global Real Estate Index, and the Giliberto Levy Commercial Mortgage Index for Private Real Estate Debt. Data as at March 31, 2023. Source: Bloomberg, Burgiss, Giliberto Levy, KKR Global Macro, Balance Sheet & Risk analysis.

We are also very bullish on trends in worker retraining. Using data and educational techniques to improve student/employee skills to better match the demand by corporations for labor will be a mega-theme, we believe.

Exhibit 35: Overall, Higher Wages Should Lead to Productivity Growth Over Time, Particularly for Skilled Positions

Data as at April 30, 2024. Source: U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, KKR Global Macro & Asset Allocation analysis.

4

Security of Everything

We remain the maximum bullish on this theme. Against a background of rising geopolitical tensions, cyberattacks, and shifting global supply chains, CEOs around the world tell us that they want to know that they have resiliency when it comes to key inputs such as energy, data, transportation, and pharmaceuticals. In particular, we think that regulators and executives in the financial services industry feel strongly that cyber protection spending should accelerate more meaningfully, especially after the 2023 hack of the Treasury market. This theme also ties into rising temperatures around the world. Companies will need to ensure the security of storage, power, and transportation, and with government spending initiatives/tax incentives like the Inflation Reduction Act (IRA) in the U.S., a lot more government support will be targeted at the intersection of climate and supply chains. We also think that the defense industry will continue to benefit mightily from this theme.

5

Intra-Asia

Multiple trips to Asia since the onset of COVID confirmed for us that a meaningful transition is occurring: 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 (versus with the West) has 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.

Key areas on which we are focused include transportation assets, subsea cables, security, data/ data centers, and energy transmission. Importantly, local banks are taking more of the local market share as part of this build-out. Before the Global Financial Crisis, Western financial firms accounted for two-thirds of the region's overseas lending. Today, by comparison, local Asian banks, led by China, Japan, and Singaporean entities, account for more than half.

We also see more countries in the region participating in and robustly benefiting from the Asia global growth engine. Frances Lim believes that India and Southeast Asia in particular stand to benefit from the ongoing changes. In addition to favorable demographics, more multinational companies are expanding their footprints beyond China, which remains an important influence too. This building of resiliency into supply chains has led to opportunities in data centers, logistics, and lower-cost manufacturing in the region.

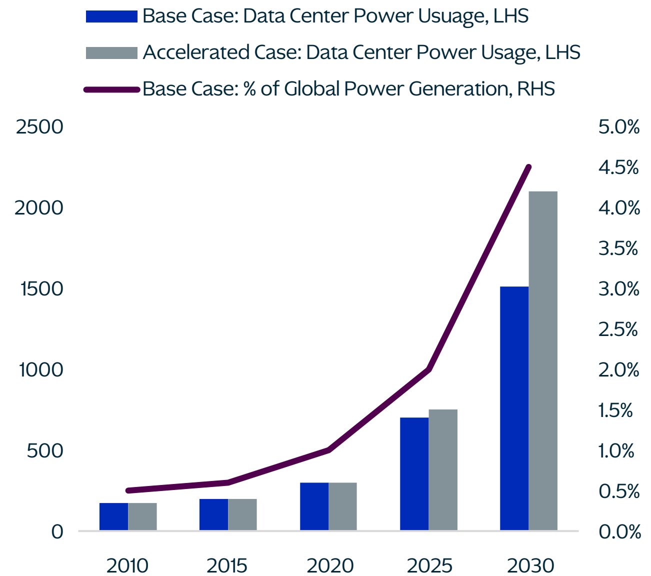
6

Intersection of AI and Energy Supply

In recent months we spent a substantial amount of time with internal and external constituents digging into whether we have the power supply to handle all the bullish demand sentiment we are now seeing. Our conclusion is that the constraint is on the supply side, not on the demand side, and that this mismatch will be one of the biggest investment stories over the next few years across North America, Europe, and Asia. All told, our best estimate is that power demand in the U.S. will increase at a CAGR of 2.0-2.5% over the next five years, compared to zero for the past five years. As this growth accelerates, data centers alone are expected to account for 7-10% of total energy demand by 2029, compared to two to three percent today. If we are right, then billions of dollars will be required across natural gas, renewables, transmission, and other forms of infrastructure. As part of our thesis, we expect energy efficiency, including cooling procedures, to become a significant area of growth. A recent trip to Spain in early June to drill down on this topic not only reinforced our conviction about the growing demand side of the equation, but also the emerging bottleneck in production that will need to be met in Europe through more supply of renewables as well as additional grid upgrades.

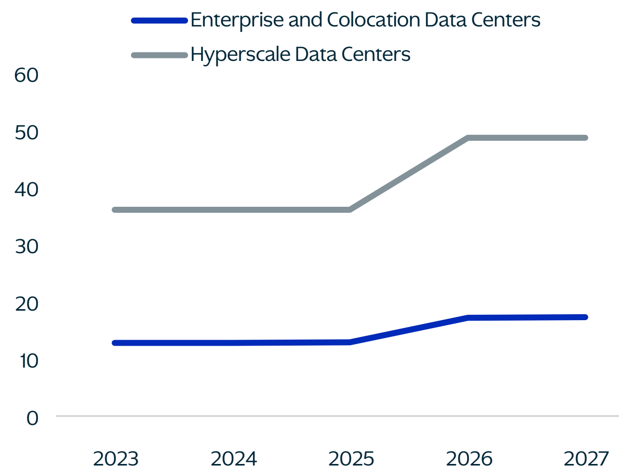
All told, our best estimate is that power demand in the U.S. will increase at a CAGR of 2.0-2.5% over the next five years.

Exhibit 36: By 2030, Data Centers Could Account for 4.5% of Global Energy Power Generation



Data as at March 31, 2024. Source: SemiAnalysis.

Exhibit 37: Hyperscalers, Which Are the Biggest and Fastest Growing Part of the Market, Require More Energy, Racks, and Cooling Systems



Data as at March 31, 2024. Source: JLL.

7

Demographic Challenges to Retirement Security

While we believe productivity is in the early stages of an upcycle, we also remain cautious that productivity growth will not be enough to offset the negative impact of a rapidly aging global labor force. Recall that the dependency ratio, or the ratio of the 65+ population relative to the working-age population, rose from 18% in 1990 to 30% in 2020 and is expected to rise to 37% by the end of the decade. Said differently, the working-age population is peaking in many parts of the world, while the base of older workers they need to support is growing rapidly. Increased fertility efforts will be required. This challenging demographic landscape will also further incentivize governments and corporations to encourage more domestic savings, including annuities and other tax-deferred savings vehicles in the developed markets. In the emerging markets like India, by comparison, we expect the government to introduce new programs that help shift individuals out of gold and real estate into more traditional capital markets savings vehicles.

Exhibit 38: Wealth and Retirement Savings Are Now Greatly Skewed Towards Older Demographics. We Think These Types of Imbalances Will Capture the Interest of Governments Regarding Retirement Security

Household Assets by Age Group, US$ Trillions and % of Total

	Assets, US$ Trillions		As a % of Total Assets	
Age	**2023**	**2001**	**2023**	**2001**
55 and Older	$114	$26	69%	51%
40-54	$37	$19	22%	37%
Under 40	$15	$6	9%	12%

Data as at December 31, 2023. Source: Federal Reserve.

At the same time, existing savings will need to be restructured and/or reorganized, we believe. For starters, just consider that the sizeable wave of retirements experienced in the U.S. and other economies in recent years was linked to financial security that elderly workers enjoyed from rising housing prices, especially post COVID. However, elevated housing prices, combined with structural housing shortages in developed markets, mean that workers will increasingly need to seek alternative vehicles for wealth accumulation going forward. All told, in the U.S. for example, the percentage of total assets owned by the aged 55+ age cohort has grown from 51% in 2001 to 69% in 2023 driven in part by a 4x increase in Real Estate assets during that time. One can see this in *Exhibit 38*.

In our view, homeowners will now need to diversify their holdings to create more balanced retirement plans. At the same time non-homeowners, many of whom have had to dedicate more of their current income to cover rental costs, will need to find ways to create 'catch-up savings', given that they have not benefitted from the home asset price appreciation. In our view, neither task (i.e., diversification of assets by homeowners as well as much needed catch-up savings for non-homeowners) will be that easy to accomplish without utilization of more professional advice and government incentives.

Our final point on retirement security is that we think there will be a blurring between national security and economic security. Simply stated, we expect a greater number of politicians to encourage citizens to keep their savings at home. Indeed, a recent speech by President Macron, for example, identified that Europe is challenged by not having an integrated financial system to ensure that savings are funding innovation and private investment on the continent. Rather, he cited an estimate of €300 billion flowing to U.S. Treasuries, which in his view helped fuel American, rather than European, growth. This vocal viewpoint – frankly – did not come as a total surprise to us, as to some degree, many political leaders want to lower their cost of capital and reduce dependence on foreign flows, especially in countries that run large deficits. As such, we have seen a notable increase in tax-deferred savings accounts that – in addition to the demographic headwinds that countries face – help limit some of the anxiety around running large deficits and/or depending on other countries to fund their growth.

SECTION II

Global / Regional Economic Forecasts

After convening our mid-year GBR IC, we left thinking as a team that global growth was actually sturdier than we had originally forecasted. This 'stronger for longer' viewpoint is consistent with some of the work done by Dave McNellis showing that the risk of a recession was overblown. In fact, most recessions he and the team studied were caused by inventory de-stocking and major slowdowns in housing – neither of which we see in the cards for 2024 *(Exhibit 44)*.

Meanwhile, as we detail below, two recent trips to Europe with Aidan Corcoran made us feel better that the region is showing a cyclical upswing in both corporate profit and GDP growth. Finally, within Asia, it also feels a little better than when we did our last update.

However, given all the uncertainty in the world, we do continue to create scenario analyses in conjunction with our deal teams to help ensure that our underwriting remains both dynamic and resilient.

Meanwhile, as we show in *Exhibit 39*, on the inflation front we have inflation in line with consensus in both the U.S. and Europe for 2024. However, for 2025, we are modestly below the consensus across every region except the United States, which would represent one of the first times since COVID that we are forecasting a more dovish message, albeit we still do not see inflation levels trending towards central bank targets. The one major outlier to consensus remains China, which we still see experiencing very low inflation amidst declining nominal GDP.

After convening our mid-year GBR IC, as a team we left thinking that global growth was actually sturdier than we had originally forecasted.

Exhibit 39: Our Forecasts Reflect the Asynchronous Recovery Happening in the Global Economy

	2024 Real GDP Growth		2024 Inflation		2025 Real GDP Growth		2025 Inflation	
	GMAA New	Bloomberg Consensus	GMAA New	Bloomberg Consensus	GMAA New	Bloomberg Consensus	GMAA New	Bloomberg Consensus
U.S.	**2.5%**	2.4%	3.2%	3.2%	**2.0%**	1.8%	**2.5%**	2.4%
Euro Area	**0.8%**	0.7%	2.4%	2.4%	1.4%	1.4%	**2.1%**	2.1%
China	**5.0%**	4.9%	**0.6%**	0.7%	**4.6%**	4.5%	**1.3%**	1.5%
Japan	**0.6%**	0.4%	**2.3%**	2.4%	**1.2%**	1.1%	**1.7%**	1.8%

Note: KKR GMAA estimates and Bloomberg consensus forecasts. Data as at June 7, 2024. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 40: Our Probability Weighted GDP Forecasts Still Tilt Towards Higher Growth and Stickier Inflation Over Time

	KKR GMAA Real GDP Forecast and Probability, %			KKR GMAA Inflation Forecast and Probability, %		
	Base	Low	High	Base	Low	High
U.S.						
2024	2.5%	1.0%	3.5%	3.2%	2.5%	4.0%
2025	2.0%	0.0%	2.5%	2.5%	2.0%	4.0%
Euro Area						
2024	0.8%	0.3%	1.2%	2.4%	2.0%	3.0%
2025	1.4%	0.3%	2.0%	2.1%	1.2%	3.0%
China						
2024	5.0%	4.6%	5.4%	0.6%	0.2%	1.0%
2025	4.6%	4.0%	5.2%	1.3%	0.8%	1.8%
Japan						
2024	0.6%	0.2%	1.0%	2.3%	1.8%	2.8%
2025	1.2%	0.7%	1.7%	1.7%	1.2%	2.2%

Note: KKR GMAA estimates. In the U.S. and Europe for 2024 and 2025, we assign a probability of 60% for the base case, 20% for the bear case, and 20% for the bull case. In China for 2024 and 2025, we assign a probability of 60% for the base case, 25% for the low case, and 15% for the high case. In Japan for 2024 and 2025, we assign a probability of 60% for the base case, 20% for the low case, and 20% for the high case. Data as at May 31, 2024. Source: KKR Global Macro & Asset Allocation analysis.

U.S. GDP

Forecasts: Our 2024 U.S. GDP moves down slightly to 2.5% from 2.7% previously. As such, we are now 10 basis points above consensus. The biggest driver of our revision is the slowdown we're seeing in discretionary goods spending, particularly among lower income consumers. Meanwhile, an important offset is that TMT investment spending is running even stronger than we'd had penciled in, with AI-related investment a key driver. For 2025, we see growth moderating towards two percent, although the key cyclical drivers of GDP growth (i.e., fixed investment and inventories) should remain supportive. Notably, our forecasts are 20 basis points above the consensus for 2025.

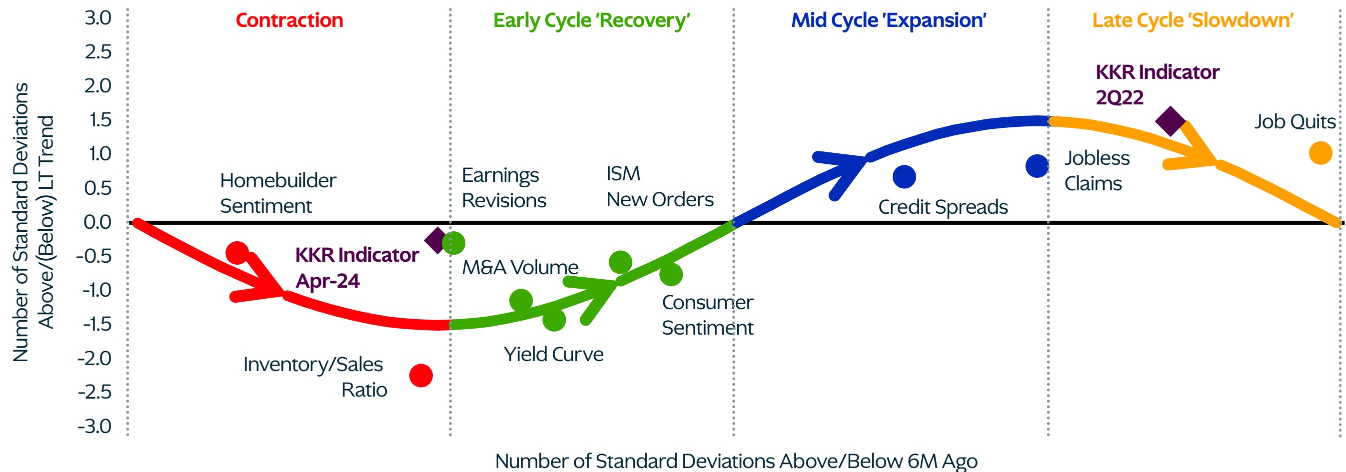
Importantly, for 2026 and beyond, we are raising our forecast for run-rate GDP growth to two percent (in line with consensus) – up from 1.5% previously – reflecting stronger tailwinds from labor force growth and productivity gains. We do not make this statement lightly; however, given the gains we are seeing in productivity as well as some much needed growth in the U.S. workforce, we feel comfortable making this more structural change to our forecast.

Commentary: Upward U.S. GDP revision trends are now finally flattening out for the first time in a year. Our U.S. outlook has been consistently more optimistic than consensus ever since the regional banking crisis broke out last spring. Key underpinnings of our constructive outlook have been 1) the ongoing 'pull' of labor market demand, particularly in pandemic-affected services industries, 2) the continuing drumbeat of long-tailed fiscal support, 3) the health of balance sheets, particularly on the consumer side, and 4) the resilience of the most cyclical areas of the economy, including construction and inventories. Importantly, all of these tailwinds remain in place, though now with a bit less strength on the consumer side, as job trends normalize and revenge spending continues to dissipate, particularly at lower incomes.

Overall, this U.S. expansion remains one defined by rolling sector cycles. In 2022, the key headwind to growth was in residential construction. In 2023, it was an inventory correction related to supply chain reopenings. In 2024, the new wrinkle is a slowing in consumer discretionary spending (something we've been expecting, which is why our forecast revision really reflects the timing rather than the severity of a consumer spending pullback this cycle). Importantly, however, each of these sector cycles has been offset by strength elsewhere. In 2024, we think the offsets are persistently wide government deficits, AI-related investment and less drag from inventory normalization.

Importantly, for 2026 and beyond, we are raising our forecast for run-rate GDP growth to two percent from 1.5% previously.

Exhibit 41: Our Cycle Indicator Is On the Verge of Moving Towards Early Cycle After Being in Late Cycle and Contraction Period for Almost Two Years



The KKR cycle indicator is an equal-weighted average of 10 components spanning the labor market, corporate activity, financial conditions, cyclical activity, and the consumer. Data as at April 30, 2024. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

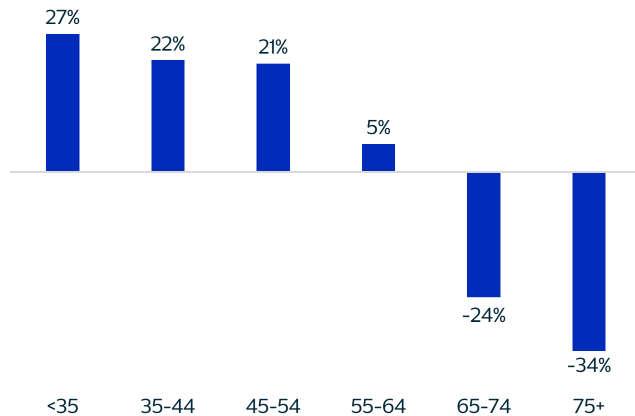
As we show in *Exhibit 41*, our proprietary business cycle indicator is sending a similar message that the U.S. economy will continue to move forward at a decent clip. Indeed, we are encouraged by the fact that the majority of components (six out of 10) are improving on a 6-month rate of change basis. To be sure, we still need to see the breadth of components broaden to 70% to officially enter the 'recovery' phase.

However, we think this condition is likely to occur in coming quarters as M&A volumes recover alongside better capital markets liquidity, earnings breadth broadens out in 2024, and/or homebuilder sentiment stops getting worse as rates stabilize.

Digging into the sizeable consumer segment of the U.S. economy, the setup is certainly less optimistic than it was during the immediate recovery from COVID. In particular, there is no question that savings rates are currently low at around 3.5-4%, which is below the six-plus percent levels that prevailed pre-COVID and close to the pre-GFC lows of about two to three percent. Importantly, though, what is different from the 2005-2006 period is that the U.S. population has gotten much older. Indeed, recall that personal savings rates go negative when consumers retire; given that over 17% of the U.S. population is now at or above 65 (versus around 12% before the GFC) ***we estimate that the 'neutral' savings rate has actually fallen to around 5.6% today, down from 9-10% in the mid-2000s***. When we account for these structural factors, a four percent savings rate today (which is about 100-200 basis points below 'neutral') is a much less downbeat signal for the consumer than a two-to-three percent savings rate was in the run-up to the GFC (which was about 700-800 basis points too low). Our bottom line: while we do expect consumer retrenchment in coming quarters (and think this may feel quite uncomfortable for certain at-risk consumer subsectors) households do not look as overspent as they have during past downturns, particularly if we are right that immigration and labor force growth will provide more of a tailwind for aggregate consumption going forward.

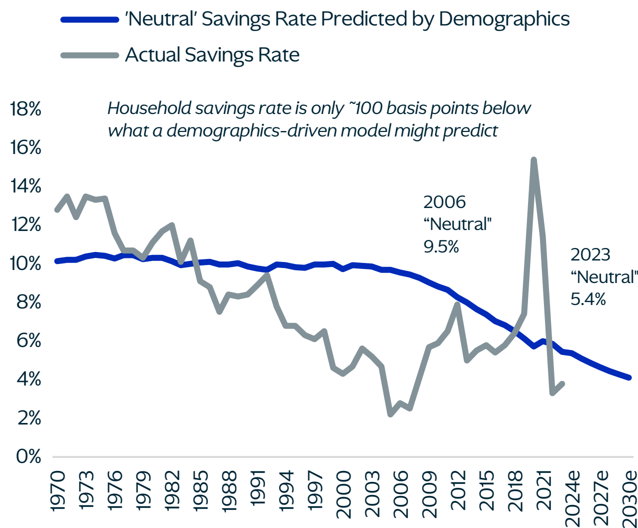
Our proprietary business cycle indicator is sending a similar message that the U.S. economy will continue to move forward at a decent clip.

Exhibit 42: Savings Rates Vary Considerably Over the Consumer Lifecycle, Especially as Citizens Age



Data as at December 31, 2023. Source: U.S. Source: KKR GMAA analysis of findings from https://doi.org/10.17016/FEDS.2019.010r "Lifecycle Patterns of Saving and Wealth Accumulation." Feiveson & Sabelhaus. FRB, 2019.

Exhibit 43: Aging Demographics Are Pushing Down on the 'Neutral' Savings Rate

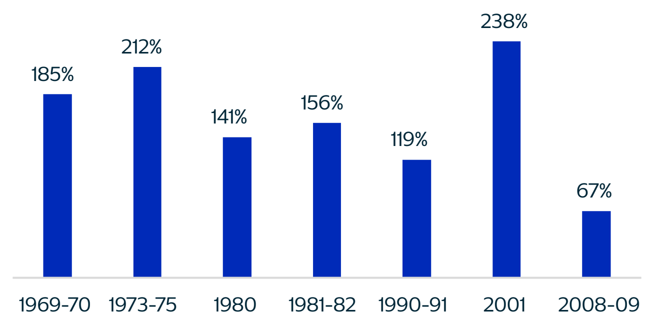


'Neutral' savings rate is the weighted average predicted by the mix of households by age. Source: KKR GMAA analysis of findings from https://doi.org/10.17016/FEDS.2019.010r "Lifecycle Patterns of Saving and Wealth Accumulation." Feiveson & Sabelhaus. FRB, 2019.

At the same time, while we do not expect any new major fiscal programs to be announced in the near term, we remain focused on the fact that CHIPS Act, IRA, and Infrastructure Act outlays are still flowing through the U.S. economy. Economy-wide spending related to the CHIPS Act/IRA will likely continue to run in the $80-$100 billion annualized range until year-end 2024, while Infrastructure bill spending should continue to ramp from an estimated $20 billion in 2023 to $40 billion in 2024 before reaching around $70 billion per year in 2026 and beyond. Moreover, we think the outlook for state and local spending (which actually accounts for more than one-third of total U.S. government spending) is still quite strong, given gains in U.S. home prices and incomes that are still flowing through to local government budgets.

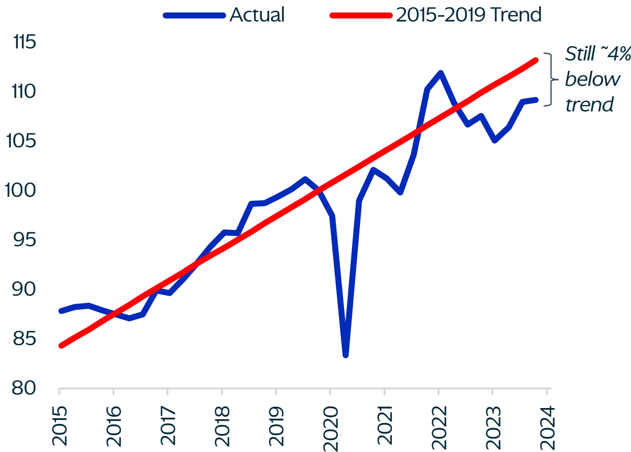
Finally, we continue to think that the most cyclical parts of the economy – inventories and fixed investment – are still in recovery mode from COVID. One can see this in *Exhibit 45*, which shows that total construction/inventory spending has only now achieved its pre-COVID level in real terms and remains well below its pre-pandemic trend. Despite a drag from non-residential investment (which is stabilizing at below-trend levels), our best guess is that real capex spending should continue to accelerate, given elevated levels of cash on corporate balance sheets and high intentions for capex in surveys of U.S. companies amidst a boom in AI-related tech spending.

Exhibit 44: Our Work Shows That Inventory and Construction Capex Contractions Have Driven the Great Bulk of Recessionary Downturns Across Cycles



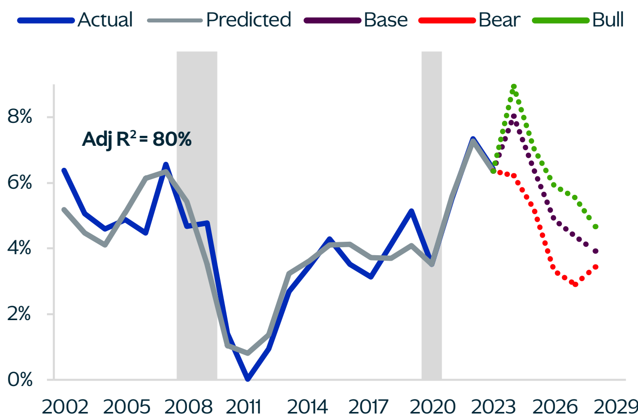
Recession periods examined: 3Q69-2Q70, 4Q73-1Q75, 1Q80-3Q80, 3Q81-1Q82, 3Q90-1Q91, 2Q01-4Q01, 2Q08-2Q09. Data as at November 10, 2023. Source: U.S. Bureau of Economic Analysis, Haver, KKR Global Macro & Asset Allocation analysis.

Exhibit 45: Importantly, Investment in These Categories Is Actually Still Recovering from the Pandemic



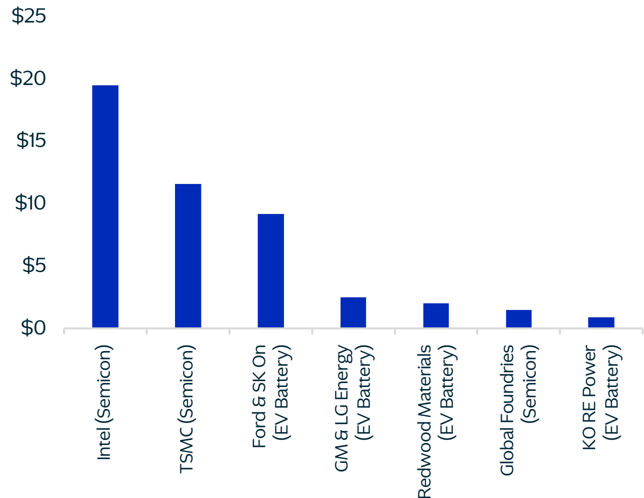
Data as at December 31, 2023. Source: U.S. Bureau of Economic Analysis, KKR Global Macro & Asset Allocation analysis.

Exhibit 46: We Still Forecast State and Local Expenditure (About One-Third of Total Government Spending) to Grow Nicely



Data as at May 9, 2024. Source: U.S. Bureau of Economic Affairs, S&P/Case-Shiller, KKR Global Macro & Asset Allocation analysis.

Exhibit 47: Government Stimulus Is a More Potent Supporter of the Current Capex Cycle Than in the Past, in Some Cases Subsidizing More Than Half of Capital Costs

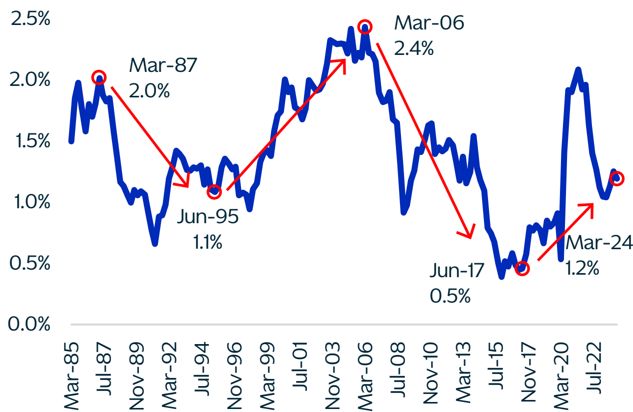


Note: Includes CHIPS Act grants and loans provided by the Department of Energy (e.g., Advanced Technology Vehicles Manufacturing Program). Data as at March 31, 2024. Source: Company Data, Melius Research.

Where our thinking *has* changed most notably is on the outlook for run-rate real GDP growth in the medium term (i.e., in 2026-2027). Specifically, we see more upside for both employment growth and productivity on a go-forward basis, which leads us to raise our longer-term, run-rate GDP forecast to around two percent from 1.5% previously. Let's start with employment. The latest CBO projections suggest that an additional approximately 5.5 million immigrants will have entered the U.S. by the end of 2027 relative to their previous forecast. Our best guess is that about four million of these will join the workforce, with about two million immigrants finding work in sectors that traditionally employ immigrant workers (predominantly low-skilled roles across Construction, Leisure/Hospitality, Manufacturing, and Trade) and an additional half million workers taking higher-skilled jobs. If we're right, then the contribution to NFP growth could be on the order of around 50,000 jobs per month over the next few years. Factoring in typical wages for this employment mix, we estimate the potential impact on GDP growth at around 25 basis points per year over the next few years.

Exhibit 48: Labor Productivity Tends to Move in Long, Secular Cycles

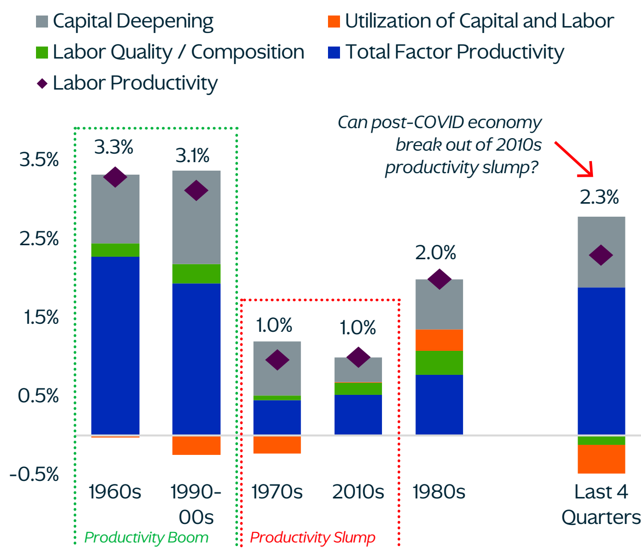
U.S. Real GDP per Nonfarm Employee, 5-Year Rolling CAGR



Data as April 30, 2024. Source: U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, KKR Global Macro & Asset Allocation analysis.

Exhibit 49: We Believe That We Are Now Entering a Stronger Period of Productivity

Decomposition of U.S. Labor Productivity Growth, %

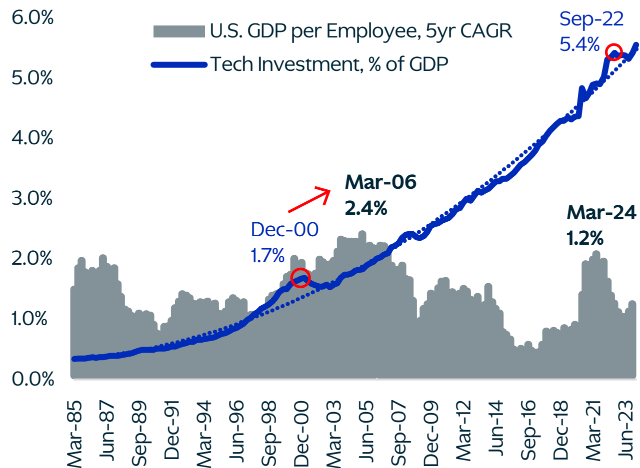


Note: 1960s refers to 1958-68; 1990s-00s refers to 1995-05; 1970s refers to 1973-79; 2010s refers to 2010-19; 1980s refers to 1980-88. Data as March 31, 2024. Source: Bloomberg, Federal Reserve Bank of San Francisco.

The second piece of good news for U.S. GDP is that productivity is on an upcycle after years of decline following the GFC. One can see this in *Exhibit 48* which shows that GDP per worker tends to follow long, secular trends (e.g., productivity rose in the 2000s following Internet investment in the 1990s, fell following the GFC after firms pulled back on new investment, and has been rising again since the late 2010s). Key drivers in our view include labor inflation and better tech investment (*Exhibit 50*), both of which have historically been associated with rising productivity. While we may see a slight drag from the shift in labor market composition towards lower-skilled roles as a consequence of higher immigration, our more positive overall view of productivity leads us to add an additional 25 basis points to our run-rate U.S. growth forecasts.

Exhibit 50: A Mid-90s Surge in Tech Investment Sparked a Multi-Year Acceleration in Productivity. We See a Similar Pattern Taking Shape Today

U.S. GDP per Employee and Tech Investment, 5-Year CAGR and % of GDP



'Tech Investment' here includes business spending on IT Equipment and Software IP. Data as at April 30, 2024. Source: U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, KKR Global Macro & Asset Allocation analysis.

Exhibit 51: U.S. Inflation Data Still Suggests a 'Sticky' Services Component to the Overall Mix

KKR GMAA U.S. CPI Forecast Detail

	4Q23a	1Q24a	2Q24e	3Q24e	4Q24e	Full-Year 2023	Full-Year 2024e	Full-Year 2025e
Headline CPI	**3.2%**	**3.2%**	**3.3%**	**3.1%**	**3.1%**	**4.1%**	**3.2%**	**2.5%**
Energy (7%)	-3.9%	-1.3%	2.9%	0.2%	1.6%	-4.8%	0.8%	2.5%
Food (13%)	3.0%	2.3%	2.2%	2.0%	1.8%	5.8%	2.1%	1.5%
Core CPI (80%)	**4.0%**	**3.8%**	**3.5%**	**3.5%**	**3.4%**	**4.8%**	**3.6%**	**2.7%**
Core Goods (19%)	**0.1%**	**-0.4%**	**-1.5%**	**-1.4%**	**-1.4%**	**0.9%**	**-1.2%**	**0.1%**
Vehicles (6%)	-0.6%	-0.6%	-2.9%	-2.7%	-3.0%	-0.4%	-2.3%	-0.5%
Other Core Goods (12%)	0.5%	-0.4%	-0.8%	-0.9%	-0.7%	1.7%	-0.7%	0.5%
Core Services (61%)	**5.4%**	**5.3%**	**5.3%**	**5.2%**	**5.0%**	**6.3%**	**5.2%**	**3.6%**
Shelter (34%)	6.7%	6.0%	5.6%	5.3%	4.9%	7.5%	5.4%	3.5%
Medical (7%)	-1.1%	1.3%	3.1%	4.6%	5.0%	-0.4%	3.5%	3.5%
Education (2%)	2.5%	2.5%	2.7%	2.8%	3.0%	3.1%	2.8%	2.8%
Other Core Services (18%)	6.0%	6.0%	5.9%	5.7%	5.6%	6.8%	5.8%	4.0%

Data as at May 31, 2024. Source: U.S. Bureau of Labor Statistics, KKR Global Macro & Asset Allocation analysis.

So, our bottom line is that not only is cyclical growth likely to hang on for the near term, but some secular growth drivers could be boosting longer-term GDP growth. Already, productivity growth has increased towards levels more akin to what we saw during the 1960s and 1990s. At the same time, there are now more immigrants coming into the workforce, which should also help growth. Against this backdrop, we think that U.S. GDP growth is in a much better position than it was in the post-GFC years.

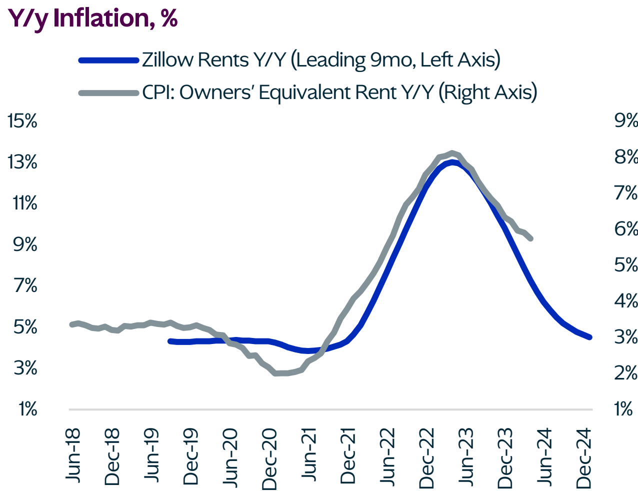
U.S. Inflation

Forecasts: For 2024, we are trimming our CPI forecast to 3.2% from 3.4% previously to reflect slightly more favorable trends in energy inflation, as well as evidence that supercore inflation is trending lower. Our CPI forecast for this year is now in line with consensus. For 2025 and 2026, we maintain our CPI forecast of 2.5% (versus consensus of 2.4% and 2.3%, respectively), as we retain our conviction that inflation is on track to settle at a higher resting heart rate this cycle.

Commentary: We think that month-over-month inflation should be on a cooler path headed into year end (which is why we think the Fed should be able to start cutting rates this year), though we continue to think that this process may play out more slowly than markets or Fed policymakers expect. Specifically, our forecasts have Core inflation only cooling to 3.4% by year-end 2025 (roughly unchanged from today's levels), reflecting the lost ground from faster inflation in 1Q24. One can see our estimates in *Exhibit 51*, which assume that OER inflation slowly moderates while lagged price increases in 'sticky' core categories remain more inflationary.

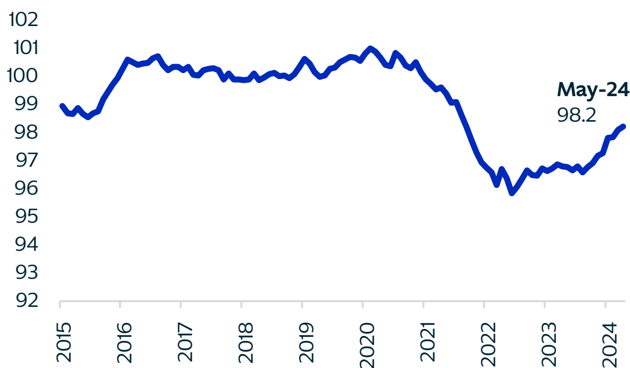
Already, productivity growth has increased towards levels more akin to what we saw during the 1960s and 1990s. At the same time, there are now more immigrants coming into the workforce, which should also help growth.

Exhibit 52: CPI Calculations Are Still 'Catching Down' to More Normalized Real-Time Rents



Data based on a blend of Zillow multifamily and single-family rents. Data as at April 30, 2024. Source: U.S. Bureau of Labor Statistics, Haver Analytics, Zillow, KKR Global Macro & Asset Allocation analysis.

Exhibit 53: Supercore Inflation Is Still Picking Up Lagged Price Increases from Previous Quarters/Years



Data as at May 31, 2024. Source: U.S. Bureau of Labor Statistics.

Longer-term, we remain skeptical that the Fed will be able to bring inflation back to its two percent target on a sustainable basis. Our view has long been that inflation would settle at a 'higher resting heart rate' relative to the post-GFC norm of 2010-2019. Key to our thinking is that a structural shortage of workers and housing, heightened geopolitics, a messy energy transition, and wider fiscal deficits will all keep core inflation higher than what markets were 'used to' in 2010-2019. Importantly, the fundamental drivers of this thesis have not changed despite better data around immigration and productivity (see Section IV, question 2 below for more detail).

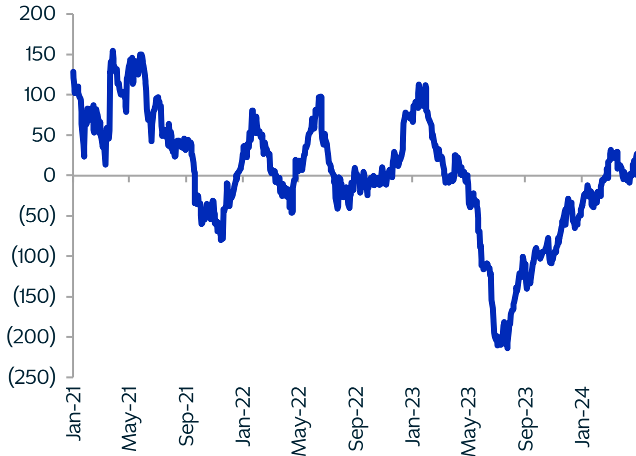
Europe GDP

Forecasts: We are raising our 2024 Euro Area Real GDP growth forecast by 30 basis points to 0.8%, above consensus forecasts of 0.7%, and up from our 0.5% forecast at the start of the year. We expect GDP growth to accelerate to 1.4% in 2025 (in line with consensus).

Commentary: We think falling inflation will support real income growth and consumption into the second half of the year, and as a result, this backdrop keeps us more positive on the fundamentals in the region. The ECB began its rate cutting cycle in June 2024 (before the Fed) with a 25-basis point cut to its deposit rate from 4% to 3.75%. This is the first rate cut in almost five years, following nine months held at four percent. Crucially, it also marks the first time the ECB has cut rates after a tightening cycle without facing any sort of recession or economic crisis, which keeps the backdrop 'glass half full' for European risk assets. True, Europe (like many regions) continues to face political uncertainty — not least in France where the far-right may come to power in upcoming elections — but we believe Europe's institutions, including fiscal oversight and ECB intervention tools, will drive stability in the long run. While the Q1 GDP beat owed much to foreign trade (which will be a less reliable driver going forward), we also note that overall European data surprises are no longer lagging the U.S., as sentiment and activity improve following the prior shocks of the Russian invasion of Ukraine, inflation, and interest rates.

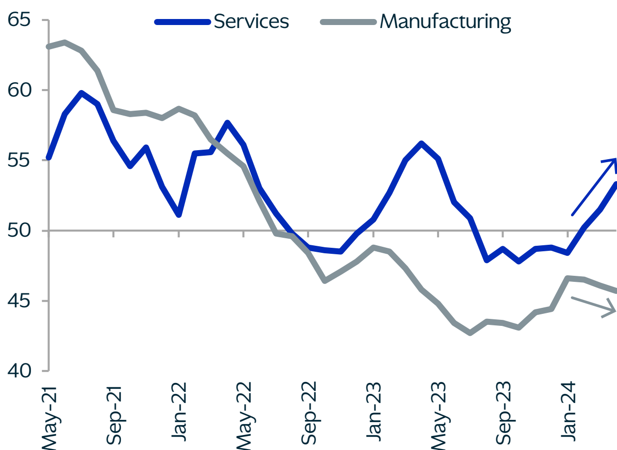
Longer-term, we remain skeptical that the Fed will be able to bring inflation back to its two percent target on a sustainable basis. Our view has long been that inflation would settle at a 'higher resting heart rate' relative to the post-GFC norm of 2010-2019.

Exhibit 54: European Data Surprises Are No Longer Lagging Behind the U.S. as Economic Momentum Turns Positive



Data as at April 30, 2024. Source: Bloomberg.

Exhibit 55: After a Brief Pause, the Services Sector Began to Reaccelerate in 1Q24



Data as at April 30, 2024. Source: S&P Global.

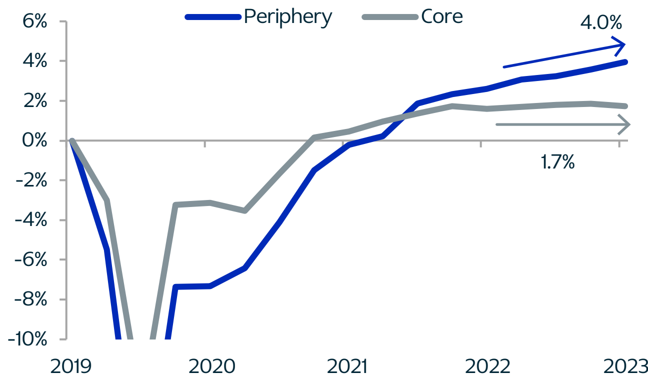
As we detail below, Aidan and his team think that there are several important forces at work to consider. They are as follows:

Point #1: Real household incomes are growing again, providing a supportive environment for consumption into 2H 2024. Wage growth in the Eurozone (as proxied by Indeed wage growth data) has moderated from nearly six percent to around 3.4% today. While wage growth has fallen in nominal terms, inflation has fallen further, causing a return to positive real wage growth. Meanwhile, unemployment have stayed around historic lows. For now, savings rates in the Eurozone have stayed above historical averages as consumers increased their precautionary savings against the uncertain economic environment. However, we see room for this to fall in the quarters ahead, supporting consumption growth and GDP.

Point #2: We believe the recovery will broaden out and that we are past the earnings trough. The improvement in economic activity is not confined to households. Indeed, we are seeing improved sentiment across corporates and investors as well as stabilization in even the most hard-hit sectors of the economy, such as energy-intensive manufacturing. To be sure, we see material structural headwinds to large parts of the European industrial complex, but it has at least stopped being a large negative contributor to GDP growth as it was in the wake of the energy crisis. We believe Q1 24 may prove to be the trough in European listed corporate earnings for this cycle, driven by the normalization of input costs (including energy) and rates.

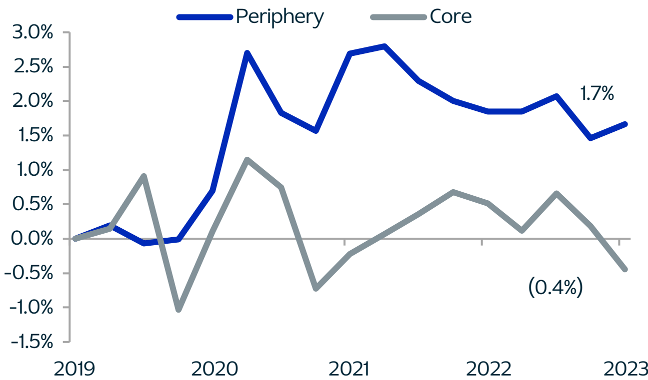
While the Q1 GDP beat owed much to foreign trade (which will be a less reliable driver going forward), we also note that overall European data surprises are no longer lagging the U.S., as sentiment and activity improve following the prior shocks of the Russian invasion of Ukraine, inflation, and interest rates.

Exhibit 56: While Harder Hit In 2020, Growth Has Picked Up Quickly in the Periphery Since 2021



Data as at December 31, 2023. Source: Eurostat.

Exhibit 57: Investment Has Been a Driver of Periphery Exceptionalism, While Stagnating in the Core Economies



Data as at December 31, 2023. Source: Eurostat.

Point #3: The start of the ECB's easing cycle. We continue to forecast that the ECB will cut rates by 75 basis points over 2024, followed by an additional 75 basis points in 2025 to get to a terminal rate of 2.5% by end-2025. True, the market has largely anticipated the cuts and priced them into the forward curve, so the benefit has already started to flow through to GDP. However, the fall in short-end rates will still provide meaningful relief to cyclical parts of the economy in the quarters ahead, including households with floating mortgages, which are more common in Europe than the U.S., and firms active in construction and real estate.

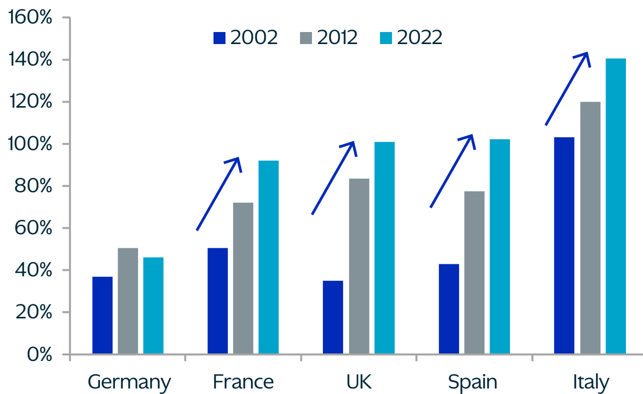
Bottom Line: Economic momentum in the Eurozone is trending in the right direction with broad-based improvements across the economy in recent quarters. Most importantly, improving consumer confidence and an expected moderation in currently high savings rates are set to provide a boost to consumption into the second half of the year.

Exhibit 58: The Fall in Energy and Commodity Prices Has Provided Relief to the Eurozone Deficit With Net Imports of Fuel Falling Over 60%

Data as at March 31, 2024. Source: Eurostat.

The inflation environment in Europe is more benign than in the U.S., with Euro Area headline inflation currently around 70 basis points below U.S. levels.

Exhibit 59: Leverage Is Concentrated in the Government Sector This Cycle



Data as at December 31, 2022. Source: Eurostat.

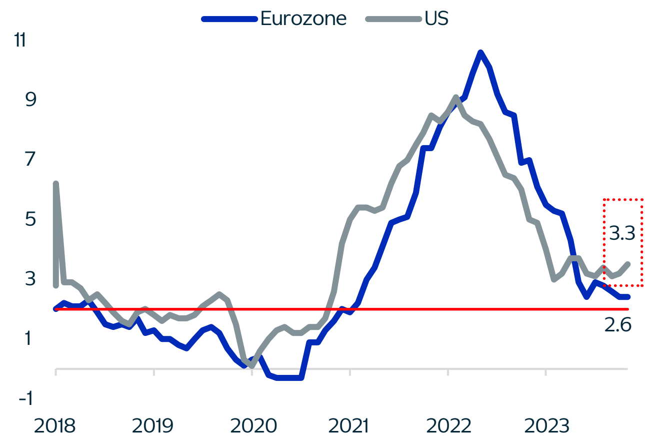
Europe Inflation

Forecasts: We expect headline inflation to average 2.4% in 2024 and fall to 2.1% in 2025 (our 2024 forecast is unchanged since January, while our 2025 forecast is 10 basis points higher). Both forecasts are in line with current consensus.

Commentary: Headline inflation has been falling at a strong pace as the impact of lower energy and food prices and the easing of supply chain issues continue to feed through. The inflation environment in Europe is more benign than in the U.S., with Euro Area headline inflation currently around 70 basis points below U.S. levels. That said, services inflation remains stubborn and was still hovering around 4.1% at the end of May. We believe the surprising strength of labor markets is the key driver, as wage growth, although softening, is still historically strong.

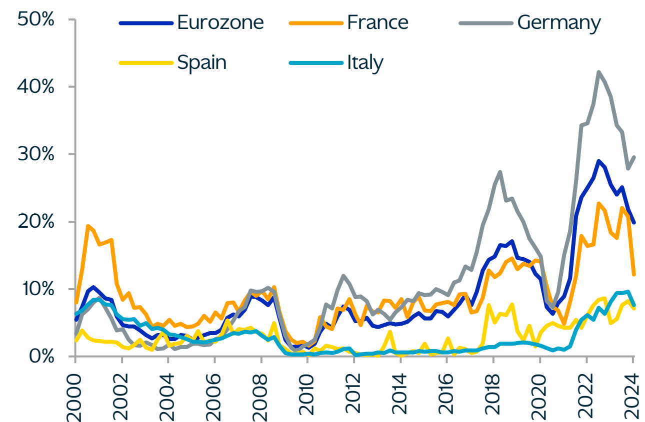
Looking at the bigger picture, the stickiness of services and wage inflation continues to fuel a debate in Europe around the difficulty of covering the 'last mile' of inflation's return to target. Our view on this is simple: European workers have faced meaningful wage cuts in real terms over recent years, contributing to very weak economic growth in the region over a prolonged period. We believe that wage growth has actually been conservative when one takes into account the cost-of-living crisis and its economic impact.

Exhibit 60: Headline Inflation Has Come Down Much Closer to Target in the Eurozone Than in the U.S., Which Gave the ECB Headroom to Cut in June



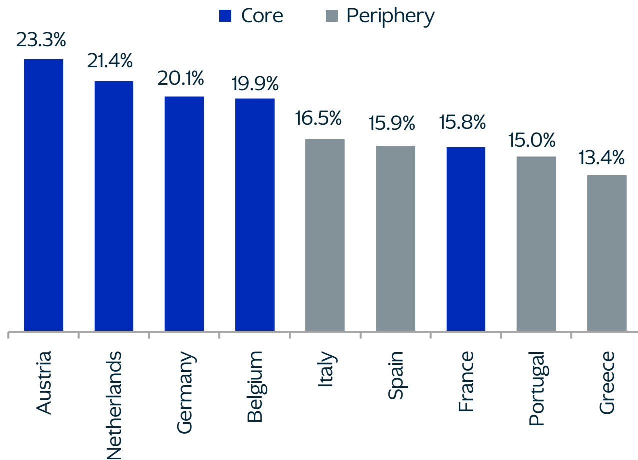
Data as at May 31, 2024. Source: Eurostat, U.S. Bureau of Labor Statistics.

Exhibit 61: Extreme Labor Shortages Have Started to Ease Across Europe



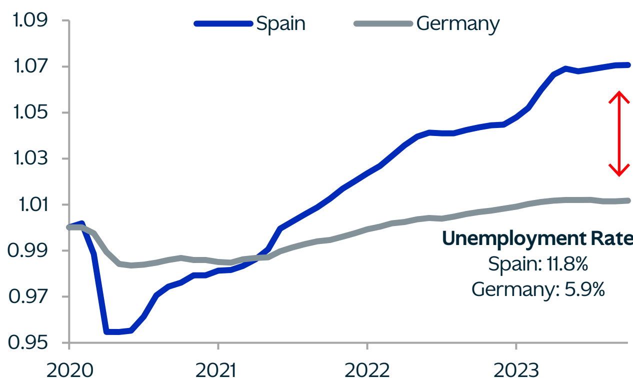
Data as at March 31, 2024. Source: European Commission. .

Exhibit 62: Inflation Has Been Less of a Headwind in Southern Europe/the Periphery



Note: Core economies in the analysis are Austria, Netherlands, Germany, Belgium, and France. Data as at March 31, 2024. Source: Eurostat.

Exhibit 63: Employment Growth in Spain Has Far Outpaced Germany, Admittedly Off a Higher Base of Unemployment



Data as at 2Q23: Source: Deutsche Bundesbank, Eurostat.

China GDP

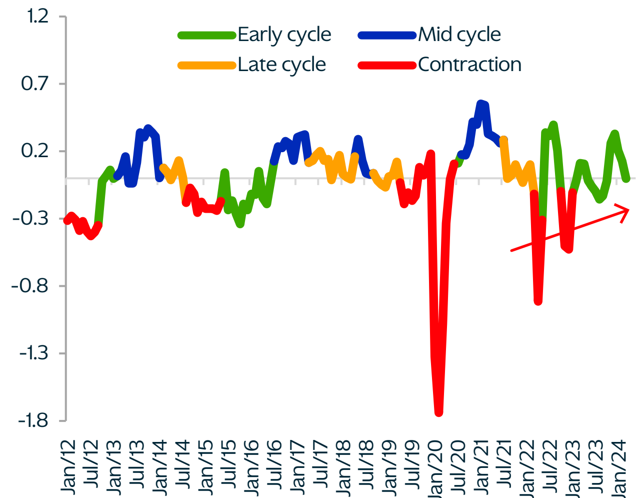
Forecasts: We are raising our 2024 China Real GDP growth forecast by 30 basis points to 5.0% from 4.7% previously. Our new estimate for 2024 compares to a consensus of 4.9%. In 2025, we lift our GDP forecast by 10 basis points to 4.6% versus a current consensus of 4.5%.

Commentary: Our upward revision in growth is primarily driven by what we see as a bottoming in China and near-term growth momentum driven by a moderate recovery in intra-regional trade and service sectors. The government is also speeding up the easing of its housing policy, which could help stabilize market sentiment in the second half of 2024.

As we think about China's growth, there are several factors to consider. They are as follows:

Point #1: On a cyclical basis, the economy in China is getting better, we believe. Similar to what we are seeing in Europe, easy year-over-year comparisons certainly help, but the asynchronous nature of the current global recovery is starting to feel – at last – a little more synchronized. We heard about this improvement during our most recent visit to Beijing where we learned that Chinese exporters were seeing an uptick in orders.

Exhibit 64: China's Cyclical Momentum Appears to Be Bottoming

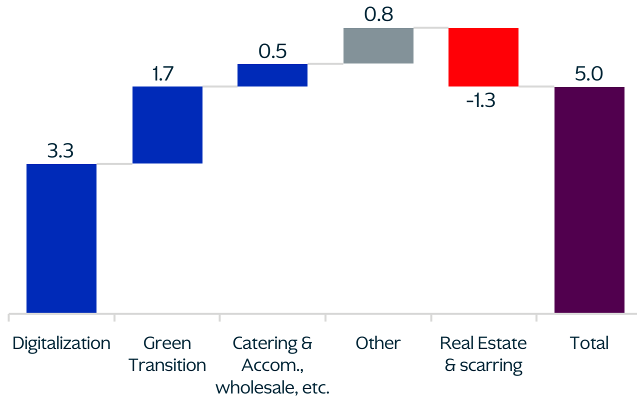


Data as at May 10, 2024. Source: China National Bureau of Statistics, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

On a cyclical basis, the economy in China is getting better, we believe.

Exhibit 65: We Revise Our China 2024 GDP Growth Forecast to 5.0% from 4.7%, as Policy Easing Accelerates

China GDP Breakdown: 2024



Data as at May 10, 2024. Source: China National Bureau of Statistics, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

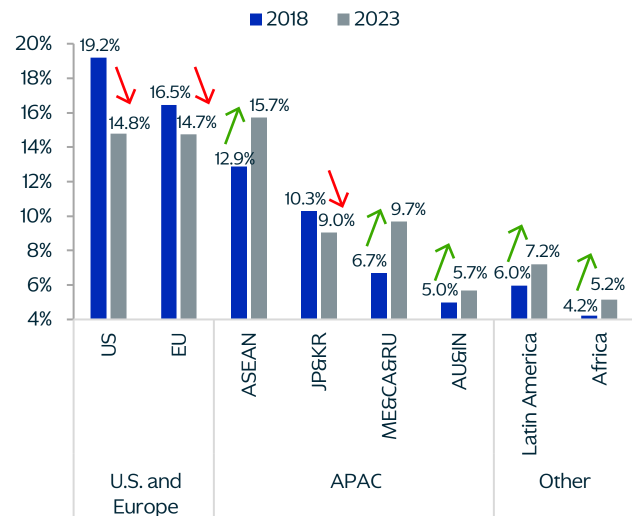
The real structural story on which to focus, however, remains the acceleration in intra-Asia trade. All told, Asia is becoming more Asia-centric as trade within the region rises – in 1990, just 46% of Asian trade took place within Asia, but by 2021, that figure had reached 58%.

As part of this regional shift, China is diversifying away from traditional advanced markets (like the U.S. and EU) towards emerging Asia and other markets. Consider that over the past five years, as a percentage of total exports, China's exports to the U.S. and EU were down by 6.1%. This drop was offset by some notable gains in trade within ASEAN, the Middle East, and Central Asia.

Point #2: The Chinese government is speeding up its efforts to destock housing inventory and stabilize the market. In fact, the PBoC recently lowered the loan-to-value ratio to a record-low level of 15% for first-time home purchasers, removed the floor for mortgage rates, and established an RMB300 billion re-lending facility for affordable housing finance. While these measures in isolation will not solve the problem (as our estimates suggest, the housing correction may only be at a midpoint – see [Thoughts from the Road Asia](#) for more details), they should be able to moderate the painful cycle of negative wealth effects and weaker confidence. Market expectations are that the Chinese government is prioritizing growth in its policy agenda and will provide more stimulus to support the economy.

Exhibit 66: Amid Rising Intra-Regional Trade Activities, China Is Diversifying Its Export Destinations Slightly Away From Traditional to Emerging and Less Developed Markets

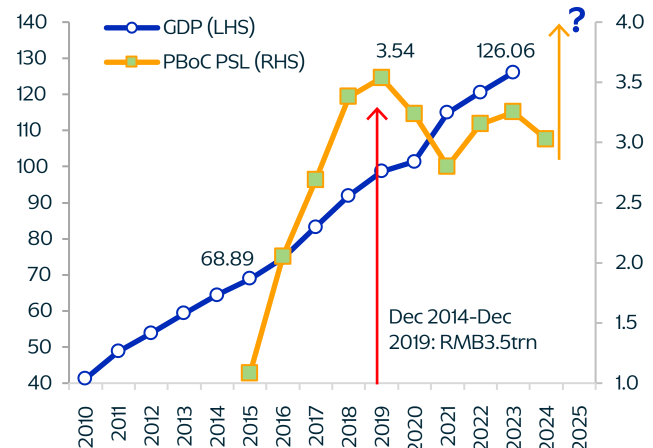
% of China Exports



Note: ME&CA&RU represent the Middle East, Central Asia, and Russia. Data as at December 31, 2023. Source: WIND, KKR Global Macro & Asset Allocation analysis.

Exhibit 67: We Think More Pledged Supplementary Lending Will be Coming in the 2024-2026 Period to Boost Growth in China

China GDP and PBoC Pledged Supplementary Lending, RMB Trillions



Data as at December 31, 2023. Source: WIND, KKR Global Macro & Asset Allocation analysis.

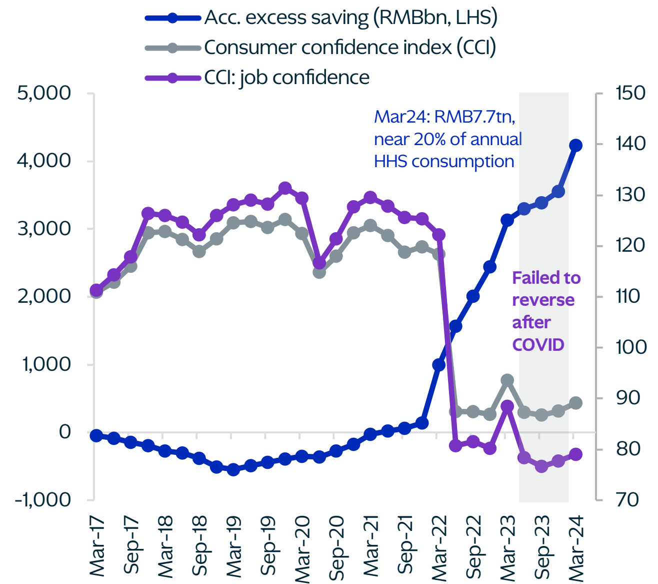
Point # 3: In terms of what is working, the shift towards a greener economy remains robust. Though only 10% of China's GDP, we estimate this segment is growing around 20% year-over-year. There are three areas of focus including 1) the reduction of the carbon footprint for manufacturing; 2) more efficient transportation of goods; and 3) electricity, with renewable energy capacity installation reaching 1.45 billion kilowatts in 2023, accounting for more than 50% of the total installed power generation capacity.

There is also a huge focus on 'upgrading', especially as it relates to China's industrial footprint: higher quality, lower emissions, and better technology are all in play. A rebound in consumption is also an important component of this thesis. However, savings are still going up, a reflection that there is still a real need for an improvement in confidence. As a result of the 'scarring' effects of COVID, a surge in the youth unemployment rate, and the housing crisis, consumer confidence fell and excess savings soared to 20% of annual consumption by 1Q24. That said, while conspicuous consumption is down in China, buying basic goods and services as well as modest lifestyle upgrade activity, especially in the middle to higher income cohort, remains solid. Indeed, this kind of economic momentum is consistent with what we see in our China portfolio companies, the lion's share of which are consumer and services focused.

Bottom Line: Government stimulus is contributing to cyclical growth momentum, and we are hopeful that this support will not be too limited to continue fueling the economic recovery. Downside risks include potential tariffs and other trade barriers for Chinese products from the U.S. and other trading partners.

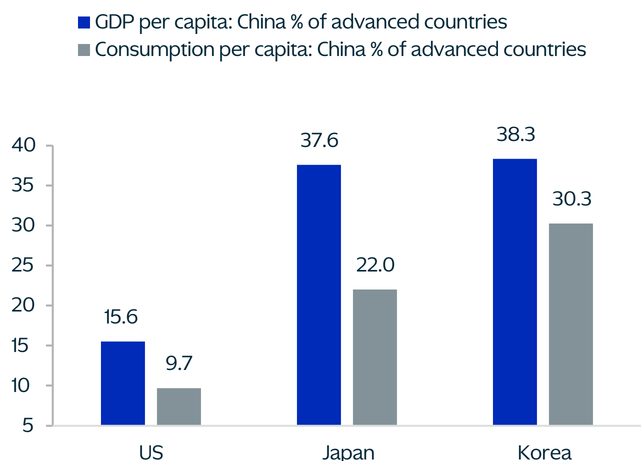
In terms of what is working, the shift towards a greener economy remains robust. Though only 10% of China's GDP, we estimate this segment is growing around 20% year-over-year.

Exhibit 68: Excess Saving Rose Amid Weak Job and Consumption Confidence



Data as at May 10, 2024. Source: China National Bureau of Statistics, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Exhibit 69: Even at the Current Income Level, There Is Huge Potential for Growth in Chinese Consumption



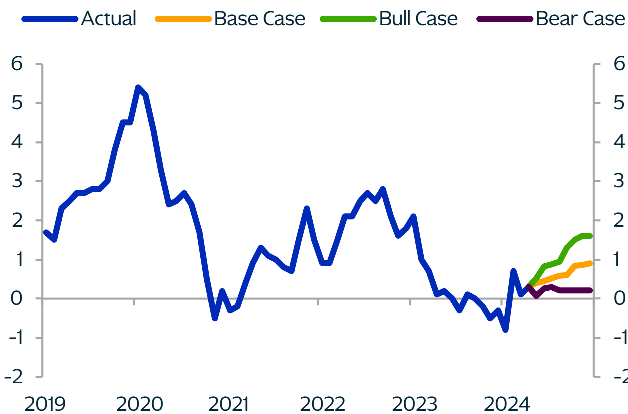
Data as at May 10, 2024. Source: China National Bureau of Statistics, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

China Inflation

Forecasts: Deflationary pressures of late are coming in worse than we expected, and as a result, we are revising down China CPI by 10 basis points to 0.6%, versus consensus of 0.7% for 2024, and down by 30 basis points to 1.3%, versus consensus of 1.5% for 2025.

Commentary: The risk in this era is that China may fall into a deflation trap given the overcapacity problem in housing-related sectors as well as emerging sectors (like EV, chemical materials, solar power, etc.). Automakers are still cutting prices as the sector's capacity utilization ratio has come down to 65%, the second lowest in history (next to the 2020 COVID lockdown). Unfortunately, we think these deflationary pressures could remain for several years.

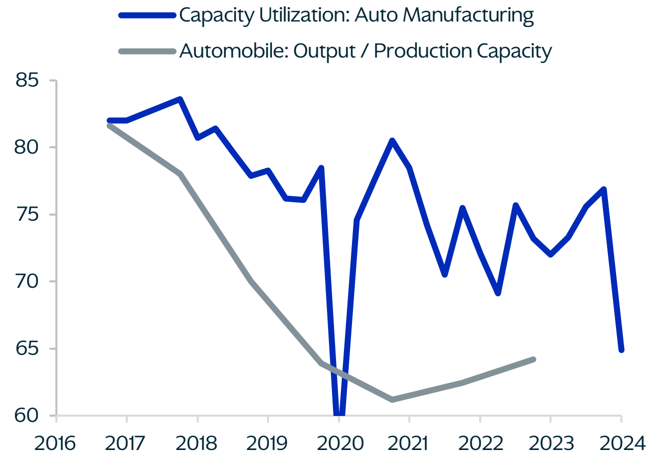
Exhibit 70: Deflationary Pressures Persist in China



Data as at March 31, 2024. Source: China National Bureau of Statistics, China Automobile Dealers Association, WIND, KKR Global Macro & Asset Allocation analysis.

Despite the recent run, many global investors are still underweight Japan after literally three decades of underperformance.

Exhibit 71: China Auto Capacity Utilization Is Trending Down



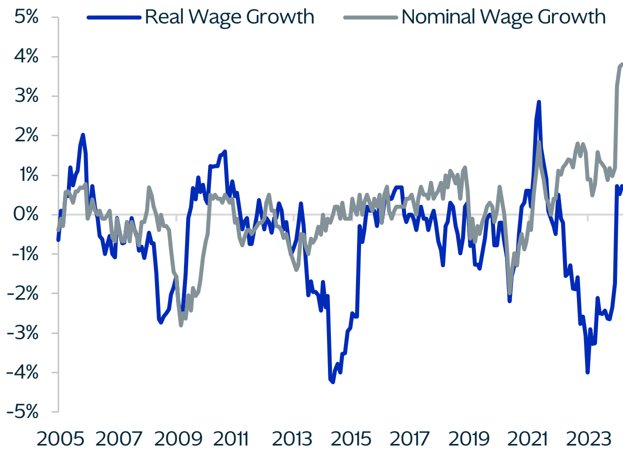
Data as at March 31, 2024. Source: China National Bureau of Statistics, China Automobile Dealers Association, WIND, KKR Global Macro & Asset Allocation analysis.

Japan GDP

Forecasts: Due to weaker than expected Q1 growth, we are revising down our GDP growth forecast for 2024 to 0.6% from 1.0%, but still remain above market consensus of 0.4%. However, we maintain our long-standing view that Japan is exiting deflation and make no change to our above-consensus growth forecast of 1.2% for 2025, compared to a consensus of 1.1%.

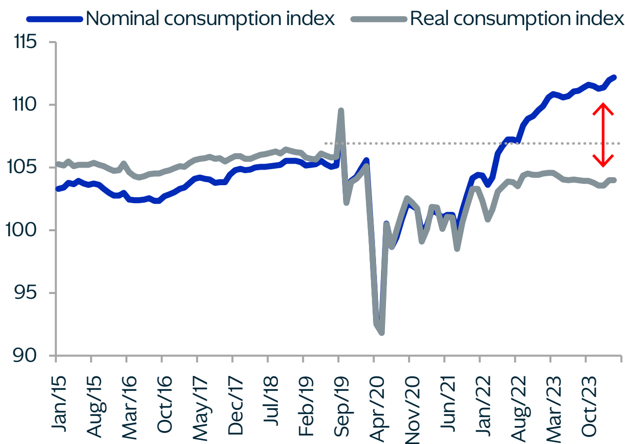
Commentary: Japan 2024 Q1 growth fell to -1.8% q/q SAAR on the larger than expected auto recall, which affected both consumption and corporate capex. However, we think Japan's growth is bottoming and we expect it to recover moderately this year on improving real wage growth, hefty corporate earnings, and still loose financial conditions (e.g., cheap yen). The initial shunto wage result for 2024 is actually quite positive: headline wage growth for the full-time worker is 5.3%, up from 3.6% in 2023. In addition, part-time hourly wages rose 6.5%, following the already strong growth of 5.1% in 2023. Together, these upgrades are the highest wage increases since 1991, which makes us raise our already bullish wage growth call to 3.0%, from 2.7% previously, for 2024.

Exhibit 72: Japan Real Wage Growth Started Rebounding in Early 2024



Data as at March 31, 2024. Source: Japan Cabinet Office, Haver Analytics.

Exhibit 73: Rising Real Income Growth Should Support Real Consumption Recovery



Data as at March 31, 2024. Source: Japan Cabinet Office, Haver Analytics.

We are still of the view that Japan remains a 'must own' country for investors. Japan is exiting deflation for the first time in decades, which means it is one of the few countries in the developed world whose stock market is benefitting from our thesis about a higher resting heart rate for inflation. At the same time, Japan is having a corporate reform renaissance that may ultimately rival what investors saw during the 1980s in the United States. Finally, while monetary policy is definitely changing and the BoJ is striving for policy normalization, we are confident that the long end of the curve will not compromise economic health and/or the positive trajectory of the capital markets and that financial conditions are still supportive of growth. The weak yen makes Japan a very attractive destination in terms of both tourism and investment.

As we think about Japan's growth outlook, we think investors should consider the following key points:

Point #1: The technical backdrop remains quite compelling. Despite the recent run, many global investors are still underweight Japan after literally three decades of underperformance. At the same time, corporations are on track to buy back more than $100 billion of their own stock, which would surpass last year's total. Maybe more importantly, individuals are beginning to recognize that their huge cash deposits may not yield the same real returns in today's more inflationary environment. As a result, they are increasingly thinking of moving their domestic savings into stocks and bonds, a favorable background for Japan's capital markets.

Point #2: The fundamental backdrop is encouraging too. Our bigger picture view is that corporate reform in Japan will lead to a structural uplift in margins, and this improvement will likely occur against a setting of undemanding valuations. Such rapid improvement is a big deal in our view and suggests that there is the potential for even more growth in book value ahead. In particular, we think the next phase of growth will harness the large cash position on balance sheets to invest more aggressively in automation, AI, robotics, and acquisitions.

In terms of where to focus in Japan, we think the key area lies at the intersection of monetary policy, productivity, and labor costs. We do think wage growth will remain persistently higher, as Japan's surplus labor has now been depleted as labor participation rates are already very high, yet the working age population continues to shrink. It will be bumpy, but we think corporate Japan will be able to navigate this transition.

Bottom line: We believe rising real incomes, a weak yen, and stronger external demand should support

Japan's recovery. The downside risk for Japan's economy mainly lies with long-term demographic challenges and competition from China, especially in the auto and other emerging sectors.

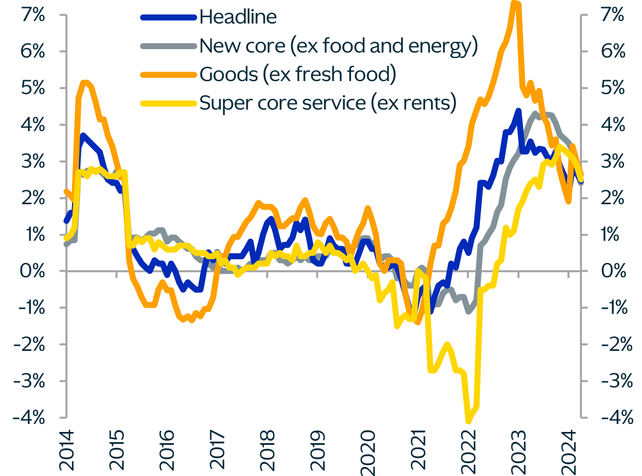
Japan Inflation

Forecasts: We hold our CPI inflation forecasts of 2.3% for 2024 and 1.7% for 2025 unchanged, largely in line with market consensus. We think Goods inflation – especially the 26.3% share of food inflation – will soften. However, supercore services (i.e., Services ex housing), which are more labor intensive, will see more persistent inflation amid labor shortages and rising wage growth. We think, for example, culture and recreation inflation could fluctuate between six and seven percent, and we still see wages moving higher across multiple industries.

Commentary: After exiting decades of deflation, inflation in Japan remains somewhat sticky, though cooling. The tight labor market should keep wage growth strong, and the pass-through of wage growth into inflation is likely to keep inflation at or above the BoJ's target inflation rate of two percent, particularly as Japan has maxed out on its labor participation across males, females, and the elderly. Importantly, when the unemployment rate is two percent or lower, the relationship between the unemployment rate and wage growth rises steeply. Looking ahead, we expect trend or average CPI inflation of about two percent and average wage growth of about three percent.

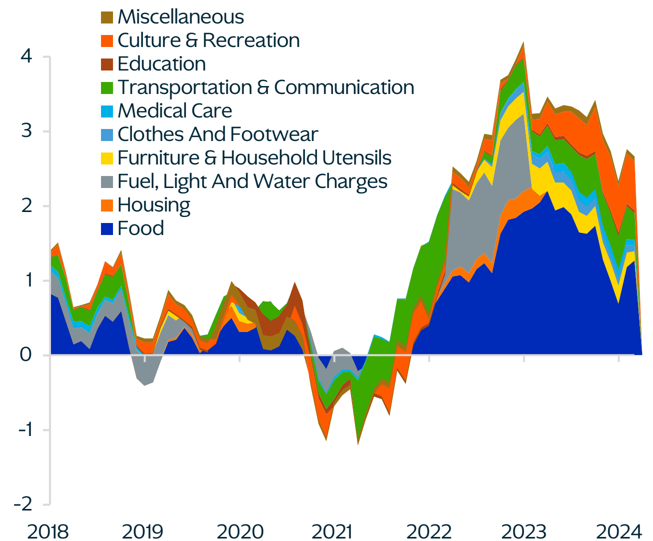
Importantly, when the unemployment rate is two percent or lower, the relationship between the unemployment rate and wage growth rises steeply. Looking ahead, we expect trend or average CPI inflation of about two percent and average wage growth of about three percent.

Exhibit 74: Goods Inflation Slows While Supercore Services Inflation Remains Strong



Data as at April 30, 2024. Source: Japan Cabinet Office, Haver Analytics.

Exhibit 75: Core CPI Inflation Will Be Stickier Due to Still Rising Services Inflation



Data as at March 31, 2024. Source: Japan Cabinet Office, Haver Analytics.

SECTION III

Capital Markets

S&P 500

Our colleague Brian Leung continues to emphasize that 'Opportunity Knocks' when it comes to future potential returns for the S&P 500. Specifically, he still sees the ingredients for a more sustainable economic cycle with margin expansion helping to drive the next leg of the recovery. At the beginning of the year, our expectations were for positive, albeit below average, growth. However, the strength and resilience of the U.S. economy and the removal of a mild, technical recession in the second half of 2024 in our original S&P 500 base case, drive our more upbeat approach. See below for full details, but we are nudging up our 2024 S&P 500 price target to 5,700, up from 5,400 previously, which is roughly 10% above the 'top-down' consensus estimate of 5,172.

For 2025, our target of 6,130 implies about 13% of upside from today's level of around 5,414. For 2024 and 2025 EPS, our targets are $250 and $270, versus the top-down consensus of $240 and $253, respectively.

Overall S&P operatings margins outside of the top 12 Tech/AI stocks are still below pre-COVID levels. Importantly, we see sector contribution broadening, with non-Tech stocks playing catch-up. Further, we think productivity can fuel higher non-inflationary growth.

Our base case (60% probability) calls for a more durable economic cycle, with margin expansion powering the next leg of the recovery. There is no 'hard landing' given the expansionary fiscal stance, continued labor hoarding, record consumer net worth, and a positive inflection in cyclical areas of the economy. We see disinflation ahead, no surprise Fed hikes, and have increasing confidence that corporate earnings accelerate higher this year and next on the back of real GDP upgrades, better productivity growth and positive operating leverage. Under this scenario, the S&P 500 reaches 5,700 by end-2024 (vs. the 'top-down' consensus estimate of 5,172) and more than 6,100 by end-2025, underpinned more by earnings than by incremental multiple expansion.

Exhibit 76: We Think This Cycle Has More Room to Run. Under Our Base Case, S&P 500 Reaches 5,700 by Year-End 2024 and 6,130 by Year-End 2025

S&P 500 Price Target Scenarios

	Base (60% Prob)	Bear (20% Prob)	Bull (20% Prob)	Weighted Average	*Bottom-Up Consensus*	*Top-Down Consensus*
2024 Year-End Target	**5,700**	**4,750**	**6,220**	**5,614**	***n/a***	***5,172***
P/E on 2025 EPS	21.1x	19.8x	21.7x			
2025 Year-End Target	**6,130**	**n/a**	**n/a**	**n/a**	***n/a***	***n/a***
P/E on 2026 EPS	21.4x	n/a	n/a			
2022a EPS	$220	$220	$220	$220	*$220*	*$220*
2023a EPS	$224	$224	$224	$224	*$224*	*$224*
2024e EPS	$250	$231	$265	$249	*$245*	*$240*
2025e EPS	$270	$240	$287	$267	*$280*	*$253*
2026e EPS	$286	$248	$313	$284	*n/a*	*n/a*

Data as at June 12, 2024. Source: Bloomberg, Haver Analytics, Global Macro & Asset Allocation analysis.

On EPS: After bottoming in 2Q23, we expect S&P 500 EPS growth to accelerate higher in 2024 and 2025. Specifically, we are calling for 12% EPS growth in 2024, which implies an above-consensus EPS of $250 per share (vs. the 'top-down' consensus estimate of $240 and the 'bottom-up' estimate of $245). Importantly, EPS growth should broaden out in coming quarters, going from extremely narrow Tech/AI leadership in 4Q23 to a more balanced picture with every sector contributing positively to EPS growth by 4Q24 *(Exhibit 6)*. 1Q24 EPS exceeded estimates by about seven percent and earnings revision trends for both 2Q24 and full year 2024 are rising, corroborating the improving momentum. For 2025, we expect EPS to increase another eight percent

to $270 per share, which is again above the 'top-down' consensus of $253.

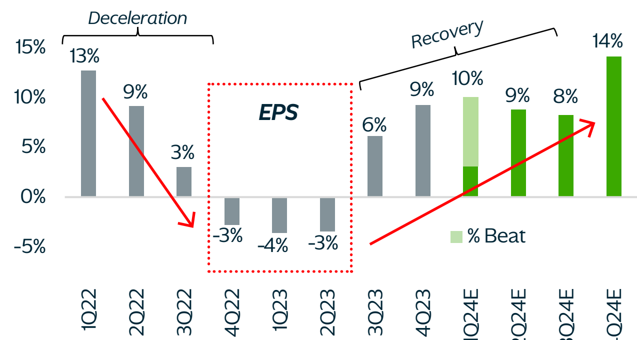
Contrary to conventional wisdom, S&P 500 operating margins are not that extended. On an ex-top 12 Tech/AI-stocks basis current margins of 12.1% are actually below pre-COVID levels of 12.7%. Our framework linking real GDP growth and unit labor costs to operating margins points to steady 20-30 basis points of margin expansion this year and next *(Exhibit 78)* so long as labor productivity stays supportive.

Our *Regime Change* thesis should be conducive to faster technological diffusion and productivity gains. A higher nominal GDP growth economy, coupled with tighter labor markets and more frequent geopolitical supply shocks, likely will incentivize companies to invest and work more efficiently to meet robust aggregate demand. This is markedly different from the post-GFC 'secular stagnation' backdrop, when productivity slumped to multi-decade lows because companies leaned on low rates (e.g., ZIRP) and cheap labor (e.g., China labor arbitrage) to preserve margins and meet tepid demand.

Stronger labor productivity is the 'secret sauce' to extending the business cycle, in our view, as it raises the economy's potential output and paves the way for higher non-inflationary growth. Wages can keep running above pre-COVID levels without degrading corporate margins as productivity keeps unit labor costs contained *(Exhibit 78)*. It is likely too early for AI to show up in official productivity data. But even excluding the potential AI impact, we are encouraged by how U.S. productivity has been running well ahead of the rest of the world since COVID. Our view is that U.S. labor productivity can run closer to its long-term average of around two percent, which would be above the productivity slumps (around one percent on average) during the 2010s and 1970s, but below the productivity booms (about three percent on average) during the 1960s (interstate highways, transistors, penicillin, synthetic polymers, etc.) and mid-1990s (the rise of the Internet) *(Exhibit 79)*.

Exhibit 77: We Expect S&P 500 EPS Growth to Accelerate Higher in 2024, After Bottoming in 2Q23

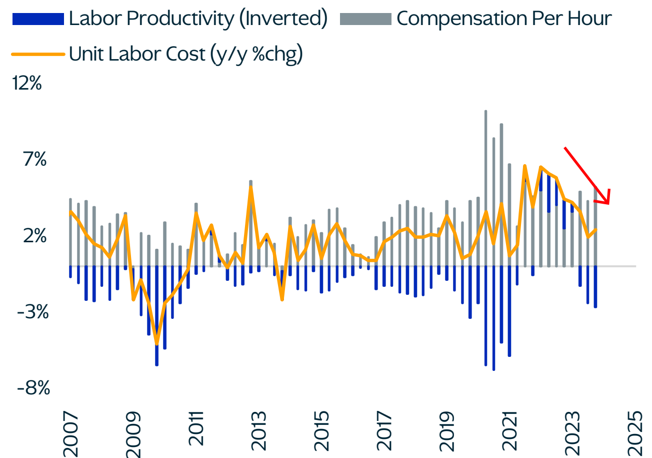
S&P 500 EPS Growth by Quarter, With Consensus Estimates



Data as at April 30, 2024. Source: Bloomberg, Haver Analytics, Global Macro & Asset Allocation analysis.

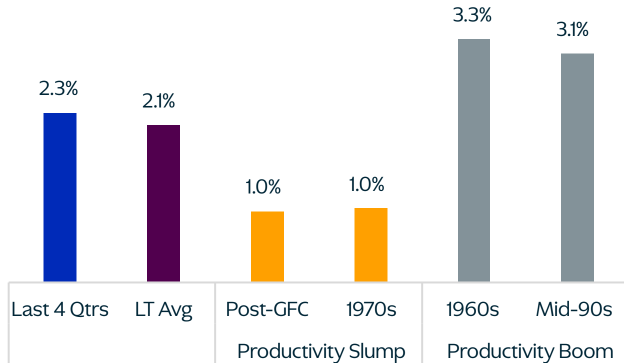
Exhibit 78: Wages Can Keep Running Above Pre-COVID Levels Without Jeopardizing Corporate Margins If Labor Productivity Keeps Unit Labor Costs In Check

U.S. Unit Labor Cost Decomposition, %



Data as at April 30, 2024. Source: EY-Parthenon, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Exhibit 79: Stronger Labor Productivity is the 'Secret Sauce' to Extending the Business Cycle, Allowing for Higher Non-Inflationary Growth



Note: LT average refers to 1948 to 2023. Data as at April 30, 2024. Source: Bloomberg, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

On Valuations: To be sure, headline valuations appear extended at 21.1x, but the current trading multiple is below the 2021 peak of 23x and well below the 1999 tech bubble peak of 25x. In addition, the S&P 500 – excluding the top 12 mega-cap tech/AI stocks – trades at a far more 'normal' 18x, which is not that far off of where it should be trading in today's interest rate environment.

Looking ahead, our 2024-25 outlook assumes multiples stay range-bound at 21-21.5x, which is essentially in line with the market's current forward multiple. We do not want to downplay the potential drag from higher real rates for longer, but our research shows that it is usually a disorderly surge higher in real rates (rate of change as opposed to the level) that hurts equity multiples.

Our Bear Case (20% probability): The lagged impact of tightening finally leads to widespread credit contraction, driving higher layoffs in cyclical sectors (e.g., construction, manufacturing, business services, etc.), higher consumer delinquencies, and another lurch lower in housing. Fed cuts are too little, too late as the U.S. economy falls into a garden-variety recession, driving renewed earnings contraction in the second half of 2024. The S&P 500 ends the year at around 4,750 (-12% downside from current level).

Our Bull Case (20% probability): A productivity boom drives a 'goldilocks' environment of robust real GDP growth, continued disinflation, and benign financial conditions. Lower inflation uncertainty and lower rates volatility further compress the equity risk premium, supporting a melt-up in both mega-cap tech/AI stocks and cyclical/reflationary names. The S&P 500 rallies to new highs of about 6,200 by end-2024 (+15% upside from the current level).

Our Bottom Line: We think this cycle has more room to run. Equities – as measured by the S&P 500 – can grind higher so long as we avoid the 'edge' cases of either renewed rate hikes because inflation is reaccelerating or rapid rate cuts because the economy/labor market is weakening precipitously. Key to our thinking is that the unemployment rate stays lower this cycle. At the same time, we expect capex, driven by the reorganization of supply chains and productivity-driven investment, to stay above trend. If we are right, both employment and productivity serve as long-term differentiators.

Global Interest Rates

Our regional forecasts suggest that short rates in the U.S. and Europe will fall as inflation continues to cool, which should bring some relief to capital markets. However, our forecasts are generally less dovish than the consensus regarding the timing of cuts for U.S. short rates as well as the level of 10-year Europe bond yields. Meanwhile, although we see Japan's rates rising further, we think that the Bank of Japan will opt for a gradual approach to policy normalization, even as rate differentials continue to pressure the yen. Against this asynchronous backdrop, we expect more volatility in both currencies and long-term bond yields, both of which we think offer a lot of useful information right now.

That said, our instinct remains that things are not going back to the way they were. Specifically, more aggressive fiscal spending (particularly in the U.S.), supply-driven inflation from labor, housing, and commodities, and a fracturing geopolitical environment all point to a higher cost of debt across developed markets this cycle. Against that landscape, our long-term bond yield forecasts remain above consensus – and well above the pre-COVID 'norm' – in every market we track.

Exhibit 80: For 2024 and 2025, We Are Considering a Range of Interest Rate Outcomes, Underscoring the Asynchronous Nature of Today's Capital Markets

KKR GMAA 10-Year Interest Rate Forecast and Probability, %

	Base	Low	High
U.S.	**60%**	**20%**	**20%**
2024e	4.25%	3.0%	5.0%
2025e	4.0%	2.5%	5.0%
Euro Area	**60%**	**20%**	**20%**
2024e	2.6%	1.75%	3.25%
2025e	2.8%	1.75%	3.75%
China	**60%**	**20%**	**20%**
2024e	2.2%	1.8%	2.6%
2025e	2.0%	1.6%	2.4%
Japan	**65%**	**15%**	**20%**
2024e	1.25%	0.65%	1.85%
2025e	1.50%	0.90%	2.10%

In the U.S. and Eurozone for 2024 and 2025 we assign a probability of 60% for the base case, 20% for the bear case, and 20% for the bull case. For China: In 2024, we assign a probability of 60% for the base case, 20% for the bear case, and 20% for the bull case. In 2025, we assign a probability of 50% for the base case, 25% for the bear case, and 25% for the bull case. Data as at May 31, 2024. Source: KKR Global Macro & Asset Allocation analysis.

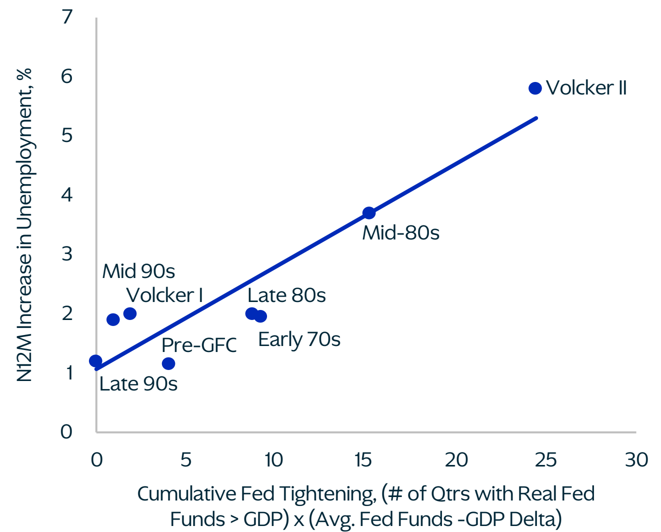
U.S. Interest Rates

Forecasts: We are trimming our fed funds forecast to 5.125% in 2024, down from 5.375% previously (implying one cut this year). For 2025, we still expect four cuts, which puts our year-end forecast at 4.125%. By contrast, the forward curve is about 25 basis points below our forecasts for both years, which we think is too ambitious given how much ground was lost in the Fed's disinflation fight in 1Q24. Longer-term, we continue to see fed funds settling near a 3.125% run-rate 'neutral' level. In terms of bond yields, we stick to our forecast of 4.25% for year-end 2024 and four percent for year-end 2025, which remains a bit more hawkish than consensus of 4.2% for 2024 and 3.9% for 2025.

Commentary: We think that Chair Powell will ultimately want to see more credible and consistent evidence that inflation is cooling before cutting rates, which should emerge by this fall. At the same time, though, from the perspective of the Fed's 'full employment' mandate (i.e., its desire not to overtighten), our base case for a slower decline in core CPI suggests that real rates will not reach the two-percent level until the beginning of 2025 (*Exhibit 81*). Said differently, if we are right that positive U.S. economic momentum means the economy will not slow dramatically heading into the back half of this year (even if we see more signs of normalization), we think the Fed can afford to be patient, meaning there is no need to cut in the very near term. This approach would be broadly consistent with Chair Powell's view that rates are not yet sufficiently restrictive, but will be over time, as well as the Fed's long-stated view that two-percent real rates should define a peak this cycle.

Exhibit 81: The Fed Remains Focused on Keeping Real Rates from Rising Above Two Percent

Real Fed Funds vs. Potential GDP and Unemployment



Data as at December 31, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

By contrast, the forward curve is about 25 basis points below our forecasts for both years, which we think is too ambitious given how much ground was lost in the Fed's disinflation fight in 1Q24.

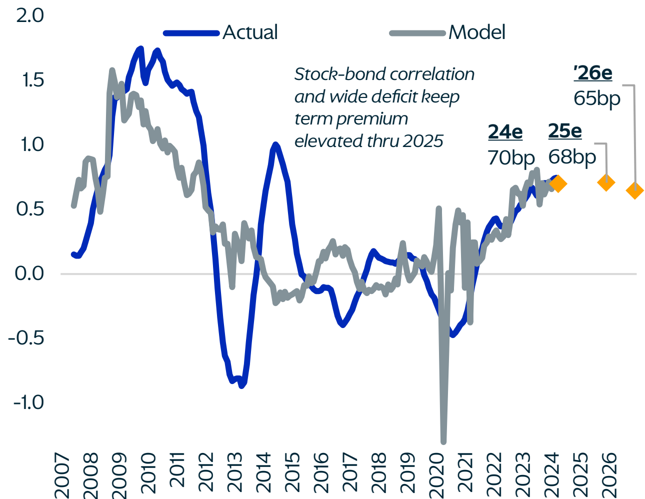
Meanwhile, we also envision a high case where inflation remains 'stuck' in the mid-three percent range on a multiyear basis, and the Fed responds by pushing real rates above two percent (which would equate to two more interest rate hikes), as well as a bear case where growth and inflation fall sharply in response to a financial 'accident' and the Fed is forced to ease 325 basis points over the next year-and-a-half.

Importantly, our base case remains that bond yields are likely to settle in the four percent range over the longer term. Key to our thinking is that the term premium for longer-term U.S. debt – i.e., the extra spread investors demand for holding Treasurys over cash on average – has likely increased on a structural basis. One can see this in *Exhibits 82* and *83*, respectively, which show that a positive stock-bond correlation, a wider deficit, and a lower savings rate have led to structurally higher Treasury yields over time. Given our view for an average short rate in the low-mid three percent range over the next ten years, that term premium should help set a floor for bond yields around four percent, we believe.

If there is good news, it is that: 1) stock-bond correlations are already elevated; 2) deficits are not likely to widen dramatically under the next administration; and 3) savings rates are unlikely to fall further. As a result of all these factors, we do not see bond yields sustaining above the high-four percent range barring a major reset in inflation expectations that we are not currently forecasting. With that said, we expect volatility to remain elevated in this market, given a lack of available market-making capital and the inherent uncertainty as the market's base case toggles between dovish and hawkish rate scenarios.

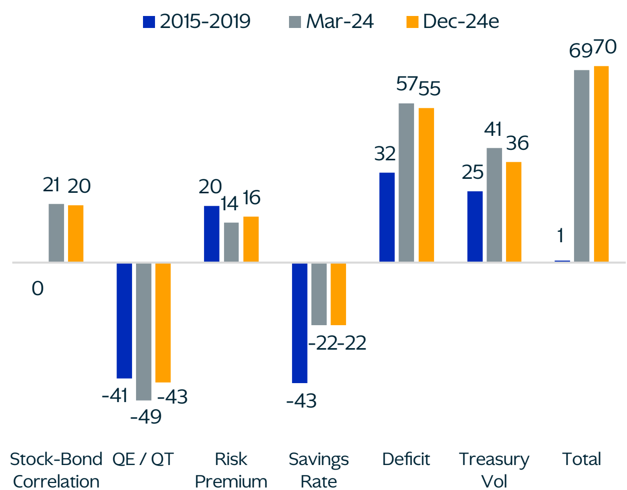
At the same time, from the perspective of the Fed's 'full employment' mandate (i.e., its desire not to overtighten), our base case for a slower decline in core CPI suggests that real rates will not reach the two-percent level until the beginning of 2025.

Exhibit 82: Our Term Premium Model Suggests UST Yields Will Reset Structurally Higher Over Time...



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

Exhibit 83: ...Driven by Negative Stock-Bond Correlation and Persistently Wide Fiscal Deficits



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

Europe Interest Rates

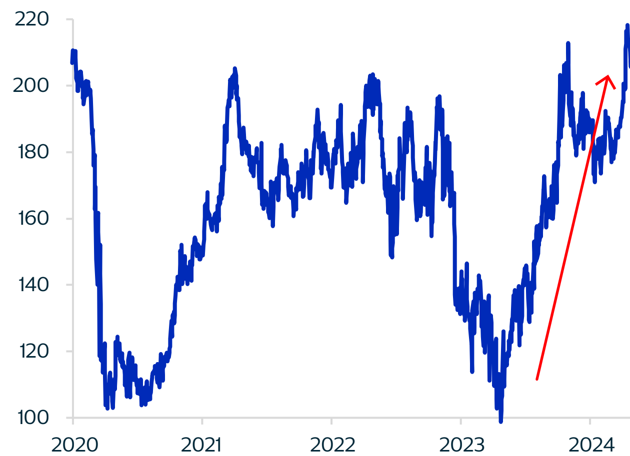
Forecasts: We continue to expect a terminal rate of 2.5% for the ECB, with three cuts in 2024 and three in 2025. While consensus expectations had called for a much earlier start to the cutting cycle at the time of our January forecasts with around seven cuts in 2024, those expectations are now about in line with our own, calling for a 3.3% rate at end-2024 (compared to our 3.25%) and 2.8% at end-2025 (compared to our 2.5%). Further out the curve, we retain a view that is quite differentiated, as we look for the 10-year bund yield to step up from 2.6% at the end of 2024 to 3.0% by 2026. By comparison, consensus expectations are calling for a 2.2% 10-year yield at the end of both 2024 and 2025.

Commentary: We are at a historic turning point in the rates cycle, with the ECB cutting rates from an all-time high deposit rate of 4.0%. While we acknowledge the thick fog of war surrounding the ultimate path of rates, we do take issue with consensus forecasts. Specifically, the consensus call for a return to a negative term premium from the ECB's deposit rate to the 10-year bund at end-2025 (2.6% vs. consensus of 2.2%) embeds an overly pessimistic view of the growth and inflation prospects of the Eurozone. By comparison, our forecasts call for a return to a positive term premium (2.5% vs. consensus of 3.0% by end-2025), with a base rate that is also positive in real terms, given our long-term inflation forecast of two percent. We view the upcoming period as part of an overall normalization of economic growth and inflation after almost two decades of dislocation post the GFC, the EZ debt crisis, COVID, and the Russian invasion of Ukraine.

Further out the curve, we retain a view that is quite differentiated, as we look for the 10-year bund yield to step up from 2.6% at the end of 2024 to 3.0% by 2026.

Exhibit 84: The Delta Between Treasuries and the Bund Has Rapidly Widened Over the Past Year, With Treasuries Now Yielding 200 Basis Points Over the Bund

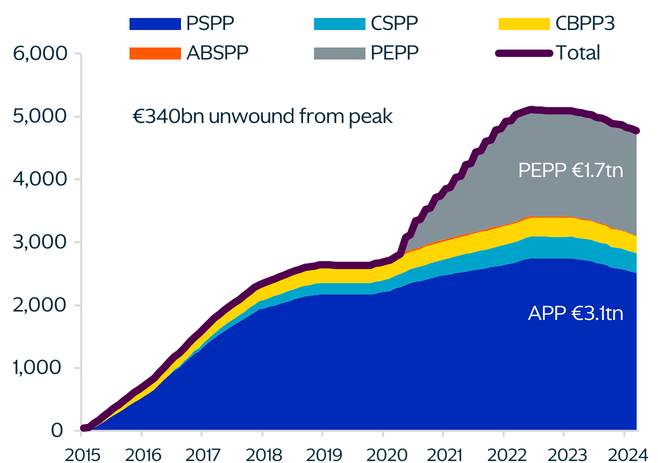
U.S. 10-Year Treasury Bond vs. German 10-Year Bund Spread



Data as at April 30, 2024. Source: Bloomberg.

Exhibit 85: The ECB Is Expected to Increase the Pace of QT, Even as Other Central Banks Have Paused Balance Sheet Reduction

ECB Holdings - Asset Purchase Programes, € Billions



Data as at April 30, 2024. Source: Bloomberg.

Oil

Forecasts: We continue to forecast that '$80 is the new $60' as a midpoint for WTI oil prices in coming years. If we are correct that shale producers are now focused on generating attractive free cash flow and return on equity, we believe that a long-term price level of around $80 is required to achieve those aspirations. This level is above futures pricing of $71 per barrel in 2026 and $68 per barrel in 2027.

That said, we do think prices may center closer to the mid-$70s during parts of calendar year 2025 (i.e., somewhat below average relative to an $80 long-term run-rate). The key driver is our expectation that the global supply/demand balance will – at times – flirt with a modest surplus next year. The combination of ample Americas supply growth (Guyana, Brazil, Canada, etc.) and decelerating global demand (end of COVID recovery boost for jet fuel) would likely leave little room for OPEC+ to boost production. That would keep the core OPEC spare capacity elevated (at more than five million barrels per day), capping the oil price upside absent renewed flare-ups in the Middle East and/or Russia.

We are often asked if a second Trump term would change this dynamic via increasing U.S. production or easing of sanctions on Russia. The problem, from our perspective, is that the levers Trump has available to pull are quite limited. For starters, easing Russian export sanctions would add only modest new supply to the market, as it is already exporting most of what it has available to China and India. Furthermore, the acreage of U.S. federal lands where Trump could ease drilling restrictions is relatively small, and as such, we think the additional capacity would likely not move the needle on supply in the near term. We think, however, that Trump could achieve friendlier relations with the Gulf states than what exists today, but the real potential for this to ease oil prices looks limited. Importantly, fiscal breakevens in the Gulf remain quite high, so we see limited scope vs. today's levels for OPEC to facilitate any structural easing of pricing.

The bottom line, from our perspective, is that we respect the fundamental unpredictability of Donald Trump's policy playbook, as well as the imperative he may feel to push prices lower. That said, we currently do not see any obvious 'magic bullets' to immediately lower oil prices.

Commentary: In terms of why we hold a differentiated view in the out years for oil, we tend to focus on what we call the 'four C's' at KKR. They are as follows:

Exhibit 86: Our 2024 Average WTI Price Forecast of $85 per Barrel Accounts for Tighter Fundamentals and a Heightened Geopolitical Risk Premium. Our 2025 Forecast of $75 per Barrel Is in Anticipation of OPEC+ Partially Unwinding Voluntary Cuts Amidst Moderating Global Demand Growth

	GMAA Base Case vs. Futures			High/Low Scenarios		Memo: Dec-23 Forecasts	
	KKR GMAA	**WTI Futures**	**KKR GMAA vs Futures**	**KKR GMAA**	**KKR GMAA**	*KKR GMAA*	*WTI Futures*
	May'24	**May'24**	**May'24**	**High Case**	**Low Case**	*Dec'23*	*Dec'23*
2021a	**68**	**68**	N/A	68	68	N/A	N/A
2022a	**95**	**95**	N/A	95	95	N/A	N/A
2023a	**78**	**78**	N/A	85	75	N/A	N/A
2024e	**80**	**79**	**1**	125	65	75	73
2025e	**75**	**74**	**1**	95	60	*80*	*68*
2026e	**80**	**71**	**9**	100	70	*80*	*66*
2027e	**80**	**68**	**12**	100	70	*80*	*64*

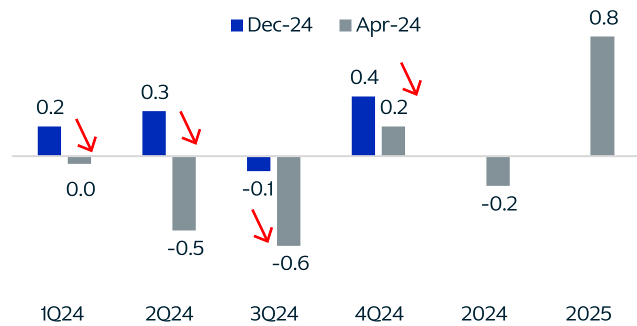
Data as at May 28, 2024. Prior as of December 7, 2023. Forecasts represent full-year average price expectations. Source: Bloomberg, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

- **Shale Consolidation**: The Shale supply elasticity to price has been cut in half in recent years, as producers are maintaining capital discipline and prioritizing shareholder return over volume growth. The wave of consolidation by larger players should also reduce pro-cyclical drilling by smaller privates. The drawdown of drilled but uncompleted wells (DUCs) to decade lows, coupled with aging tier-1 acreage, base declines, and plateauing well productivity, should lead to a slower pace of U.S. supply growth going forward.
- **Production Costs:** The PPI for oil and gas drilling is still roughly 20% above pre-COVID levels. The latest Dallas Fed Survey suggests that the breakeven price for U.S. producers has increased to around $65 per barrel (up from about $50 per barrel on average in 2019-21), which raises the floor for oil prices, in our view.
- **OPEC+ Control of Incremental Supply:** More modest U.S. Shale production leaves OPEC+ in the driver's seat of incremental global supply. Importantly, core OPEC is now prioritizing price stability over market share in our view, underscored by repeated production cuts in recent years to balance global markets. In addition, Saudi Arabia's fiscal breakeven has increased on a structural basis to $90-100 per barrel given the higher pace of spending on Vision 2030 mega-projects, which incentivizes higher oil prices.
- **Durable Consumption**: We think the durability of demand from emerging markets (especially Asia) and petrochemicals can offset declines in gasoline demand from developed markets and China. Overall, we expect non-OECD demand to keep growing through the end of the decade at least.

Bottom line: Our thesis that '$80 is the new $60' as a midpoint for WTI oil prices keeps us constructive on energy-related businesses going forward. As it relates to natural gas, we also remain optimistic about the medium-term demand outlook. New LNG export capacity remains the key source of demand growth, with current FIDs (Final Investment Decision) pointing to exports roughly doubling to greater than 25 billion cubic feet per day by the end of the decade (from 13 billion cubic feet per day in 2023). Power demand should also be a source of upside going forward, which follows 15-20 years of largely stagnant domestic electricity consumption trends. Industry analysts expect AI-related data center power demand to drive an incremental 3-5 billion cubic feet per day of new natural gas demand by 2030, which is a notable boost to help offset erosion from continued renewables penetration.

Exhibit 87: The Global Supply/Demand Balance Has Tightened Consistently Over the Past Few Months

Global Supply Surplus/Deficit, Consensus Estimates, Millions of Barrels per Day



Note: Consensus includes Evercore, MS, JPM, GS, UBS, Citi, RBC and Piper Sandler. Data as at April 16, 2024. Source: Energy Intelligence, KKR Global Macro & Asset Allocation analysis.

We continue to forecast that '$80 is the new $60' as a midpoint for WTI oil prices in coming years. If we are correct that shale producers are now focused on generating attractive free cash flow and return on equity, we believe that a long-term price level of around $80 is required to achieve those aspirations. This level is above futures pricing of $71 per barrel in 2026 and $68 per barrel in 2027.

SECTION IV

Frequently Asked Questions

QUESTION NO. 1

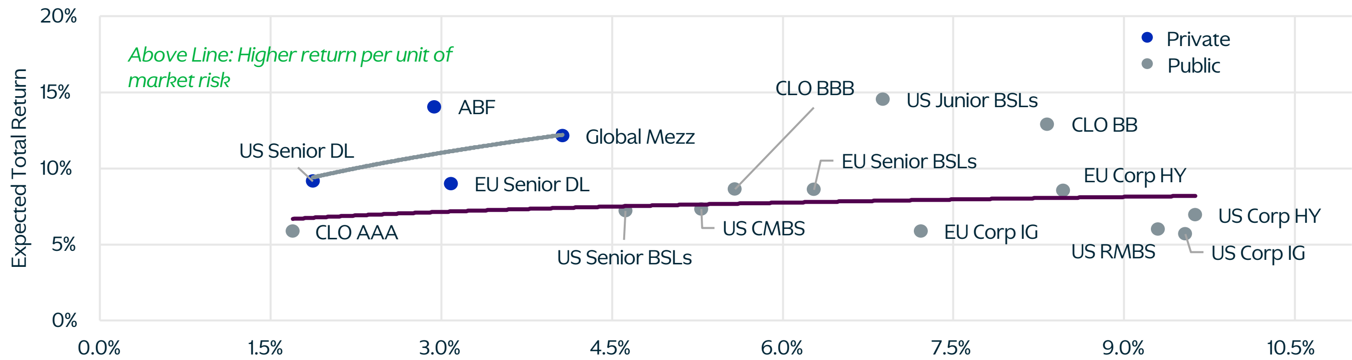
Where do you see relative value in Credit?

While we think that relative value opportunities in Credit have become less outsized versus the beginning of the year, we still see several attractive pockets of opportunity across both Public and Private markets. We note the following:

- Within Liquid Credit, we see value across the capital structure, but we continue to prefer high-grade CLO liabilities as a way to pick up extra spread without taking on significant credit risk. To review: Our research suggests that senior CLO liabilities typically offer about 10-15% credit enhancement (making the chance of a default quite low based on historical behavior), but a total return in the eight to nine percent range. So, while recent spread tightening makes us a bit less excited about this part of the market from a tactical perspective, we still think there is plenty of value in terms of absolute return. Meanwhile, within High Yield we continue to prefer European HY to U.S. HY this cycle. Key to our thinking is that shorter maturities and discounted prices in many instances mean that there is potentially more upside in this market, especially if the refinance wave continues to come earlier than markets are expecting.
- In Direct Lending, by comparison, we are now a little more cautious on a cyclical basis, though we agree with the growing number of CIOs who now view this asset class as a permanent allocation in a diversified Credit portfolio. What are we seeing? Competition has continued to heat up, with average terms for a new unitranche continuing to tighten and the illiquidity premium falling to very low levels versus history. At the same time, average leverage has remained flat. As a result, the premium for many new entrants is now getting quite narrow relative to liquid U.S. public loans in many instances. We are also seeing a greater propensity for corporations to use payment-in-kind (PIK) strategies when cash flow gets tight. The good news, however, is that – for existing portfolios – most of the pressure on margins from inflation and interest coverage now seems to be behind us. Said differently, we are not looking for a huge surge in losses in the Private Credit space, despite what we see as a more competitive positioning in this area of the market.
- Against this backdrop, we increasingly view Asset-Based Finance as a potentially more interesting destination for new capital on a relative value basis versus Direct Lending. Banks, feeling the impact of fleeing deposits, higher accruals, and/or more regulatory scrutiny, are now more willing sellers of assets backed by hard collateral, and we continue to think the 'core'/prime consumer should continue to hold up fairly well this cycle. All told this space is definitely one area where we continue to look for opportunities, particularly in cases where one can partner with existing platforms around underwriting and origination.

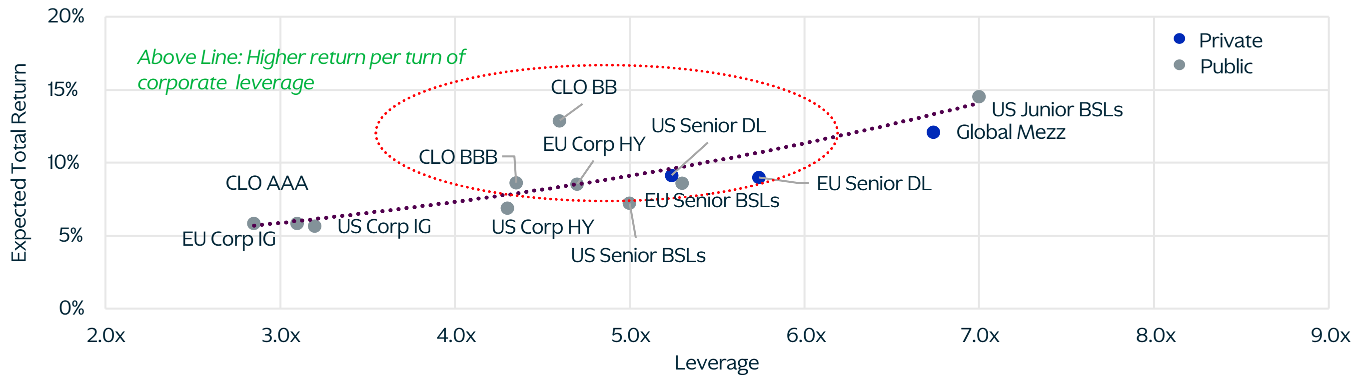
We continue to think the 'core'/prime consumer should continue to hold up fairly well this cycle.

Exhibit 88: We Continue to Favor Asset-Backed Finance, Senior Direct Lending, and Shorter Duration European High Yield



Data as at April 30, 2024. Source: KKR GBR analysis.

Exhibit 89: BB and BBB CLOs, Senior Direct Lending, and European High Yield Screen Well On a Return Over Leverage Basis



Data as at April 30, 2024. Source: KKR GBR analysis.

QUESTION NO. 2

Do you still believe in a higher resting heart rate for inflation?

For a long time, our view has been that inflation would be both higher (on average) and more volatile than what markets got 'used to' in the 2010-2019 period. No doubt, we have maintained our conviction that inflation would cool heading into year-end in the U.S., as a lot of the worst cyclical imbalances in supply chains, labor markets, and lagged 'supercore' price increases are now behind us or are being resolved.

Our view presently is that, while inflation is certainly cooling (and May's CPI was definitely a step in the right direction), it will not return fully to the Fed's two percent target and certainly will not trend below two percent the way it did leading up to COVID. Moreover, our colleagues Dave McNellis and Ezra Max think that both the level and volatility of inflation will likely be higher than in the past, owing to a structural shortage of skilled workers and housing, along with geopolitical tensions and record fiscal stimulus. Importantly, we think that this thesis still holds despite better cyclical inflation in the U.S.

We have also been asking ourselves whether the recent surge in the supply of workers and goods or the transition to an older demographic base could change our thinking

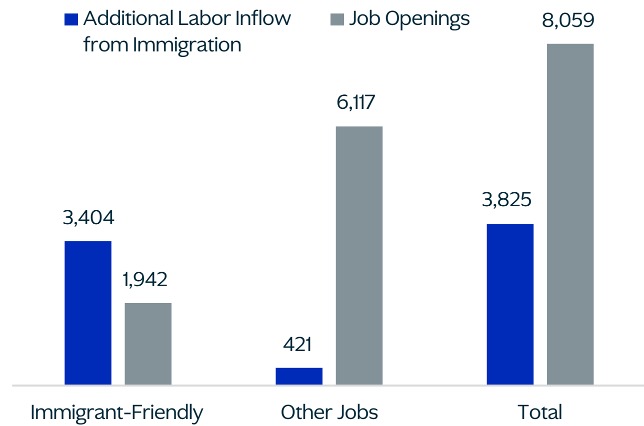
on the longer-term resting heart rate for inflation. For our money, the answer is no. Top of mind for us are the following:

The recent surge in U.S. immigration will not resolve the U.S. worker shortage, we believe. The CBO recently revised its population forecasts to reflect an additional approximately 5.5 million immigrants over 2023-2027. Our estimates suggest that this surge could translate into about four million additional workers over the same period (*Exhibit 90*). No doubt, this improvement in supply should help the Fed's goal of bringing better balance to the labor market. However, the actual impact on labor availability in most industries may be smaller than the headline figures would suggest. ***In fact, accounting for legal status and educational/skills training, we estimate that about 90% of this additional workforce (or roughly 3.5 million workers) will only be eligible for employment in traditional 'immigrant-friendly' roles, which account for only around 25% of open U.S. jobs (or about two million out of 8.1 million total job openings). As a result, immigration will do comparatively little to impact worker availability for the 6.1 million higher-skilled roles that remain open in the U.S. economy.*** While this mismatch opens a massive opportunity around skills retraining, it also means that the shortage of skilled workers following a wave of age- and pandemic-related retirements will not be easily resolved.

Just as important, perhaps, is the fact that U.S. immigration may actually put more pressure on housing inflation. Recall that the total vacancy rate for U.S. rental housing is currently at just 10%, lower than at any point since the 1990s. See *Exhibit 92*, but we estimate that new immigration may translate into an additional 780k rental households being formed over the next three years, roughly doubling the run-rate demand for new housing. If we are correct, then the average number of annual rental deliveries needed to maintain current vacancy rates over the next three years could be on the order of 510k (well above the average of 276k annual rental deliveries since 2015).

Exhibit 90: A Skills Mismatch Means That the Surge in Immigration Will Not Fill Most Job Openings

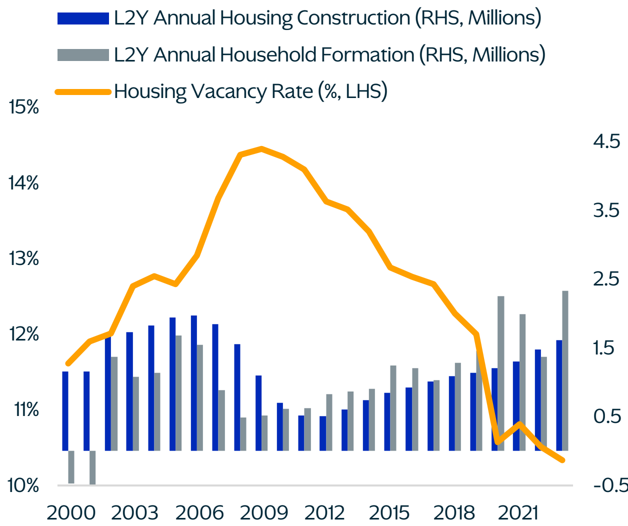
Immigration-Related U.S. Labor Inflows and Job Openings, '000s



Additional labor inflow from immigration reflects impact of additional immigrants over 2023-2027 from the revised CBO forecast. Data based on the share of U.S. jobs that require no formal education and low-or mid-level workforce training, as well as the share of the undocumented population that typically pursues employment outside of Agriculture, Construction, Leisure/Hospitality, Admin/Waste/Temporary Help Services, Manufacturing, Wholesale/Retail, and Transportation. Data as at April 30, 2024. Source: U.S. Bureau of Labor Statistics, Pew, CBO.

We have also been asking ourselves whether the recent surge in the supply of workers and goods or the transition to an older demographic base could change our thinking on the longer-term resting heart rate for inflation. For our money, the answer is no.

Exhibit 91: The U.S. Remains Short of Housing on a Structural Basis, With the All-Housing Vacancy Rate Falling to Forty-Year Lows...



Data as at December 31, 2023. Source: U.S. Census, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Exhibit 92: ...and Immigration Flows May Make This Shortage More Severe

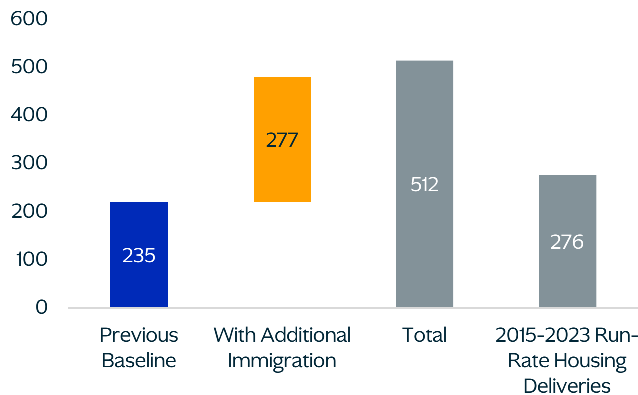


Chart reflects average rental deliveries required to maintain a 6.7% rental vacancy rate (below pre-GFC levels of ~8.4%) based on our baseline and revised forecasts for renter household formation. Revised forecasts assume 5 new immigrants per household and that all 2023 arrival households have already been formed. Data as at April 30, 2024. Source: U.S. Census, CBO.

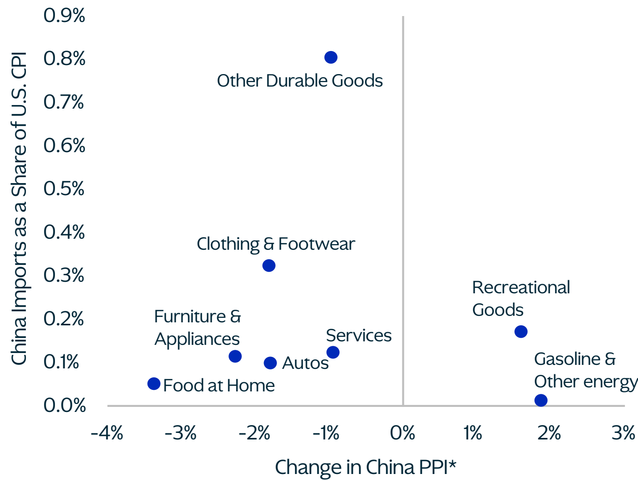
We don't think goods overcapacity in the U.S. or China will solve inflation in the medium term, either. While prices in China remain under pressure, our work suggests that inflation in the most oversupplied goods categories in China will have only limited pass-through to U.S. CPI, even before one accounts for the likelihood of more protectionist trade policies. One can see this in *Exhibit 93*, which shows that – in total – China goods imports in categories where PPI is slowing account for only around 1.5% of U.S. consumption. Looking at the details, we also think that goods categories where China's overcapacity is most pronounced (e.g., EVs, green energy technology) are likely to be targets for U.S. trade restrictions under either a Trump or a Biden administration.

Meanwhile, while a surge in U.S. factory capex should help increase domestic supply capacity over time, history suggests that factory construction actually tends to be *inflationary* (through increased demand for materials, construction labor, and training) before the resulting increase in manufacturing capacity can lower prices. One can see this in *Exhibit 96*, which shows that capex spending is associated with an increase in Goods prices in the near term with a decrease in prices after five years.

We retain our conviction that an aging population is likely more inflationary than deflationary in the U.S., as retirees reduce labor supply while still contributing to overall demand (particularly for services).

Exhibit 93: We Believe That China Deflation Will Have Limited Pass-Through to U.S. CPI...

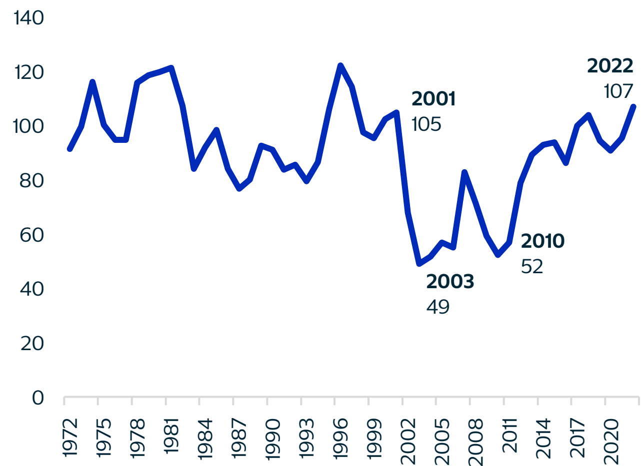
China Deflation vs. Share of U.S. Inflation



*Versus pre-COVID run-rate. Data as at December 31, 2023. Source: U.S. Bureau of Labor Statistics, China PPI data, Goldman Sachs, KKR Global Macro & Asset Allocation analysis.

Exhibit 95: U.S. Factory Capex Has Surged to 25-Year Highs...

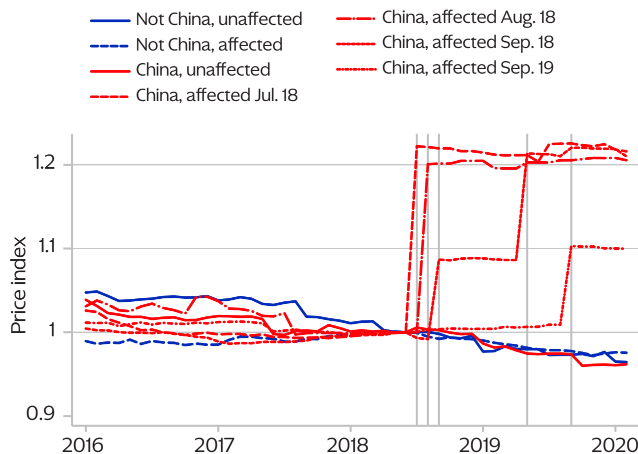
U.S. Real Investment in Factory Buildings, Quantity Index, 2017=100



Data as at December 31, 2022. Source: U.S. Bureau of Economic Analysis.

Exhibit 94: ...and More Restrictive Trade Policy Will Lead to Higher Prices for Some Imports

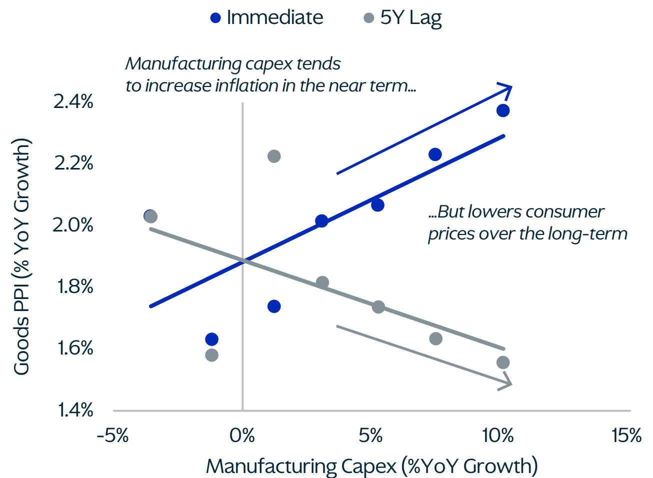
Import Price Indices, Including Tariffs



Source: Cavallo, Alberto, Gita Gopinath, Brent Neiman, and Jenny Tang. 2021. "Tariff Pass-Through at the Border and at the Store: Evidence from US Trade Policy." American Economic Review: Insights, 3 (1): 19-34. Copyright and reproduced with permission of the American Economic Review: Insights.

Exhibit 96: ...But That Will Be Inflationary Before It Becomes Disinflationary

Manufacturing Capex and Inflation, 1976-2023, Bucketed by Decile

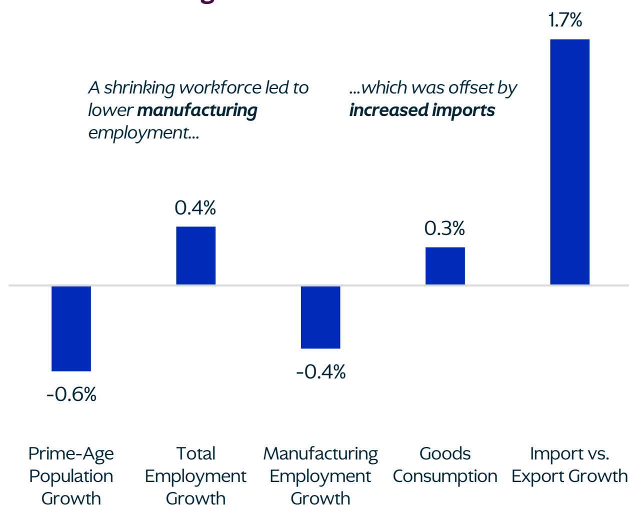


Manufacturing capex is defined as real spending on Industrial Equipment and Manufacturing Facilities. Data trained on 20th-80th %ile to exclude outliers. Data as at December 31, 2023. Source: U.S. Bureau of Economic Analysis, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Finally, we retain our conviction that an aging population is likely more inflationary than deflationary in the U.S., as retirees reduce labor supply while still contributing to overall demand (particularly for services). This outlook is consistent with our prior research on U.S. savings rates, which shows that older households consistently spend more than they earn (see *Exhibit 42*). Interestingly, aging populations were often cited as a *deflationary* macroeconomic force before COVID, in part because the country with the world's oldest population, Japan, was also the market that struggled the most to stimulate its way back to its inflation target following the GFC. No doubt Japan's example is an important one, but a big part of the explanation for its low inflation in our view is that Japan was actively offshoring its manufacturing capacity during this period *(Exhibit 97)*. We think that pursuing offshoring to lower domestic inflation/avoid domestic worker shortages is no longer an option for national governments the way it was during the period of 'benign globalization' that ended in 2016, meaning that the U.S. and other countries will have fewer levers to pull to combat the inflationary impact of older populations going forward.

Exhibit 97: For Years Japan Has Helped Navigate a Shrinking Population by Offshoring Manufacturing. The U.S. Will Not Have This Lever to Pull, in Our View

How Japan Dealt with an Aging Population, % Annualized Change Over 2005-2023



Data as at December 31, 2023. Source: Haver Analytics, government statistical agencies.

Exhibit 98: The Markets Have Continued to Whipsaw Around Fed Rate Cut Expectations

Number of Fed Hikes (Cuts) Priced Over the Next 12 Months

Data as at June 7, 2024. Source: Bloomberg.

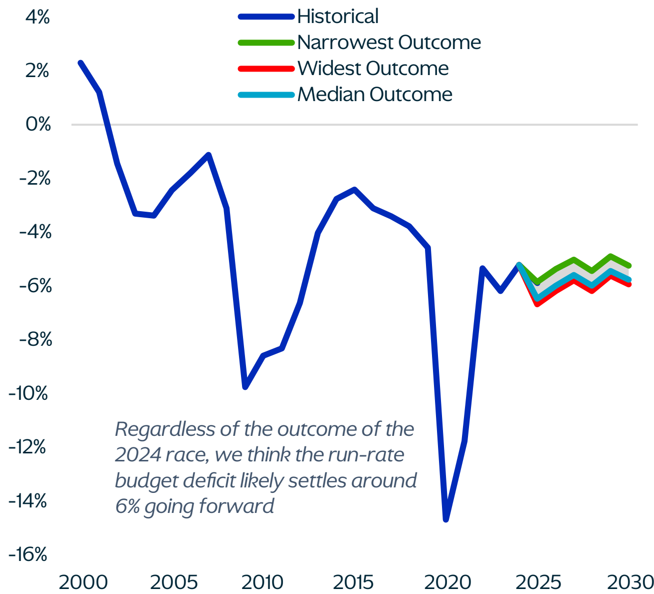
QUESTION NO. 3

How are you thinking about the U.S. election, including impacts on fiscal policy and the Treasury market?

When we published our Outlook for 2024, we shared how our colleague Ken Mehlman had deemed 2024 to be the 'year of elections', including within the U.S., the EU, the U.K., India, Indonesia, and Taiwan. These elections (and linked spending) will occur in a time of heightened geopolitical tensions and rising populism/institutional distrust, with little consensus for the middle ground. Just consider how many touchpoints of voter angst are present. Geopolitical rivalry has increased, causing many governments to prioritize increased defense spending, while redefining from a national perspective what the 'security of everything' means globally.

Exhibit 99: The Good News Is the Deficit May Have Stopped Widening for the Time Being...

U.S. Deficit Under Electoral/Legislative Scenarios: U.S. Budget Deficit as % of NGDP



Data as at March 20, 2024. Source: Veda Research, Congressional Budget Office, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Exhibit 100: ...But We Acknowledge That the U.S. Deficit Is Structurally Larger This Cycle

U.S. Federal Government Deficit vs. Unemployment Rate

Data as at October 31, 2023. Source: Bloomberg.

When I joined KKR in 2011, it was all about fiscal austerity, with Europe being ground zero for budget reductions. Today, by comparison, we see both left- and right-leaning politicians using government programs and fiscal outlays to woo their voter bases. Against that backdrop, we have little doubt that – almost regardless of the election outcome in the U.S. and other countries – fiscal packages will likely remain large, as left and right wing governments embrace a more 'visible hand' for government spending.

If there is good news, however, it is that we do not see government deficits getting much wider in the U.S. in the near term, which should help protect against the threat of 'bond vigilantes' driving a selloff at the long end of the yield curve. Specifically, our work suggests that under either a Trump or a Biden administration, much of any new fiscal package will be devoted to extending expiring TCJA tax provisions. Said differently, it is becoming harder to enact major new spending programs or revenue cuts at a time when the 'math' around wider deficits from the Congressional Budget Office reflects persistently higher interest expense on the incremental dollar of borrowing. The flip side is that there is little momentum around efforts to actually shrink or freeze the deficit, which is why we feel confident that government support will continue to drive growth in the medium term.

Finally, policy uncertainty looks likely to rise under the next administration, whether due to concerns around tariffs under a Republican administration, or corporate tax increases (a tent pole of the Biden agenda) and a GOP Senate confrontation under a Democratic one. It is important to note that both Biden *and* Trump are protectionists. In fact, tariffs have actually been higher on average under the Biden administration than under Trump. We think green energy subsidies will also likely be at risk under a Trump administration. It's also worth considering that even as EVs have become more of a political hot button, adoption rates have slowed, particularly outside dense coastal state locations such as California, New York, and New Jersey. Separately, regardless of administration, we think domestic energy production, critical minerals, and healthcare cost controls will likely remain in focus.

Our bottom line is that it is becoming more important than ever to be aware of the pitfalls associated with binomial policy outcomes. Said differently, now is not the time to depend on either politically-sensitive subsidies or favorable tax treatment to continue to make an investment 'work'. However, there are still outcomes that we think will actually look fairly similar regardless of electoral outcomes, which can help keep the 'Glass Half Full' for investors even amidst elevated political noise: namely, wider deficits will keep more support flowing to the economy; the fact that these deficits are not getting worse for the time being should help protect the long end of the yield curve from selling off much further; and finally, there are still areas of bipartisan consensus including the security of everything, workforce training and development, 'homeland economics', skepticism towards China, and domestic manufacturing where investors have the opportunity to avoid some of the noisier/more contentious parts of the political cycle today, which we see weighing on markets more meaningfully in coming years.

QUESTION NO. 4

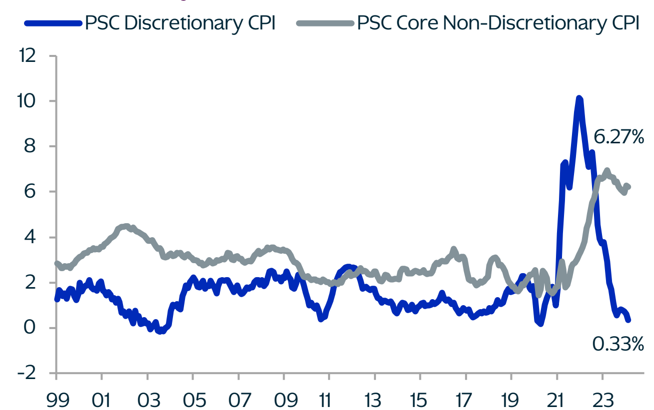
What is the outlook for U.S. consumer spending?

As we have written for some time, we do think U.S. consumer spending is likely to slow after a period of elevated growth following COVID. Indeed, today's savings rates in the United States are currently low compared to history (although, as we describe above, they do not look as out-of-step in age-adjusted terms), as is unemployment, which limits the upside for consumer spending. At the same time, inflation has eaten into savings and increased the cost of essential goods. The finances of U.S. consumers who own their homes and have strong credit scores have proven to be resilient even through this period of high inflation and rising interest rates. Those same economic conditions, however, have posed a serious challenge for younger consumers, renters, and those with lower credit scores. Against this backdrop, we continue to think that discretionary spending by low-income households will remain a key headwind for overall consumption over the next twelve months.

Nonetheless, our view remains that the U.S. consumer – in aggregate – is not going to collapse the way he or she did during the GFC. *In fact, we think that consumer spending will remain in positive territory this cycle, even if the next few quarters represent something of a 'soft patch' for spending.* Key to our thinking: household budgets and balance sheets remain in solid shape for middle- and high-income families; labor supply – rather than demand – remains the limiting factor for hiring; and a surge in immigration should boost demand for basic low-cost essentials.

Exhibit 101: Costs of Essentials Continue to Rise, While Those for Discretionary Items Remain Better Contained

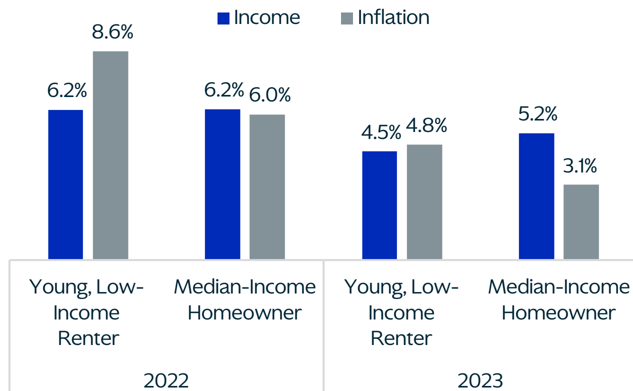
PSC Discretionary and Core Non-Discretionary CPI Models, SA, Y/y%



Data as at April 30, 2024. Source: Piper Sandler.

Nonetheless, our view remains that the U.S. consumer — in aggregate — is not going to collapse the way it did during the GFC. In fact, we think that consumer spending will remain in positive territory this cycle, even if the next few quarters represent something of a 'soft patch' for spending.

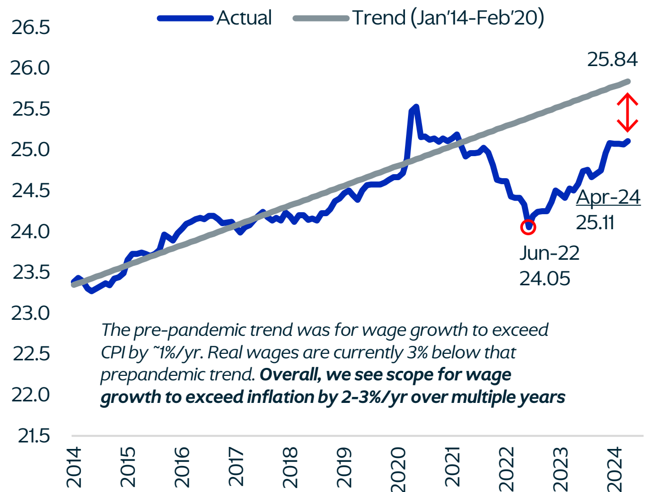
Exhibit 102: The Worst of Inflation May Be Behind Us, But Low-Income Households Continue to Face Negative Real Income Growth



Inflation data excludes the impact of OER, which does not flow through to homeowners' consumption costs. Young, low-income renter data based on under-25 income mix, and spending habits for renters earning ~35k/year. Average-income homeowner data based on median-income (~60k/year) income mix, and average inflation rate assuming flat shelter costs due to fixed-rate mortgages. Other income growth is assumed to match aggregate per PCE data, and 2023 income growth based on PCE data across categories. Data as at December 31, 2023. Source: U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, KKR Global Macro & Asset Allocation analysis.

Let's start with income. As described above and shown in *Exhibit 42*, savings rates actually look reasonable when one accounts for the demographic reality that more Americans are now entering their retirement years. Supporting this reality is the fact that homeowners (who represent about two-thirds of U.S. households, and about 75-80% of U.S. gross household income) have been spared the worst impacts of rental inflation and higher rates, courtesy of low-cost, fixed-rate mortgages refinanced during the pandemic, as well as a lower wallet share dedicated to the must-have essential categories where inflation has been most severe. Importantly, the 'average' homeowner actually enjoyed real income gains in both 2022 and 2023, even in the face of elevated inflation *(Exhibit 103)*. In addition, despite higher interest rates, we actually think that consumer debt service coverage ratios look fairly well-contained coming out of the pandemic, thanks in part to deleveraging *(Exhibits 104* and *105)*.

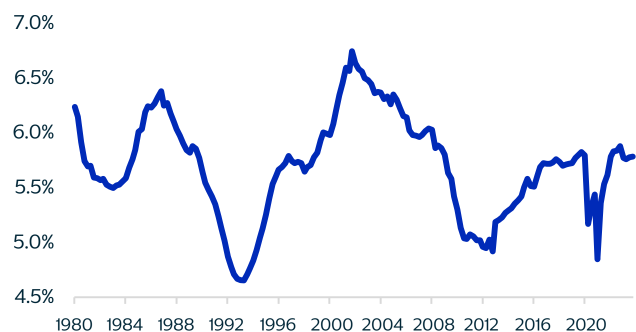
Exhibit 103: We Still Believe That Wages Need to 'Catch-Up,' Given the Recent Surge in Inflation



Data as at April 30, 2024. Source: Bloomberg, U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, Federal Reserve, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

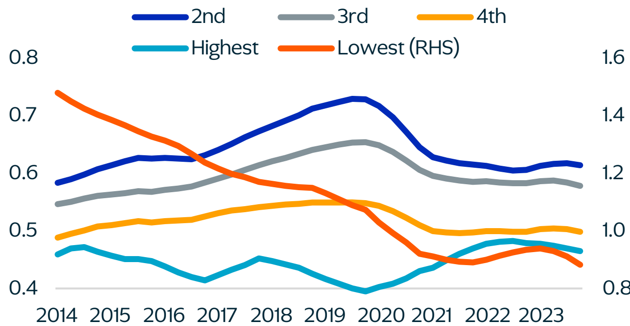
Exhibit 104: Consumer Debt Service Coverage Ratios Have Stabilized at Near Pre-Pandemic Levels...

Consumer Non-Mortgage Debt Service as % of Household Income



Data as at December 31, 2023. Source: Federal Reserve Board, FRED.

Exhibit 105: ...As Consumers Have Held Off On Borrowing

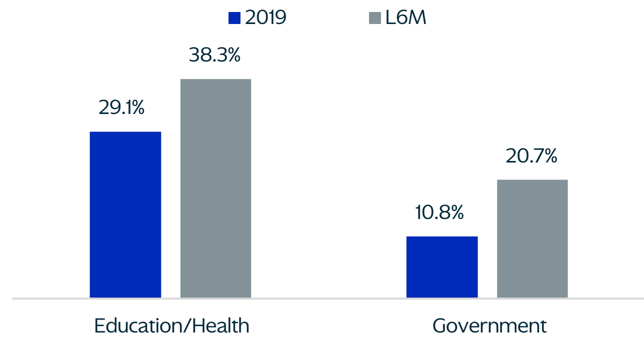


Data as at December 31, 2023. Source: Federal Reserve Board, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Meanwhile, we continue to think that unemployment is not likely to surge this cycle. Indeed, a surprising number of U.S. industries are still catching up to their pre-pandemic trends for employment *(Exhibit 20)*, while lower real wage costs mean that it is still a good time for a lot of employers to continue adding staff. Particularly important from our perspective is that non-cyclical industries (including Healthcare/Education and Government) are driving the recent labor market expansion. Consumer confidence has also been holding up, which we take as an important sign that consumers are not expecting unemployment to surge the way it has in past downturns.

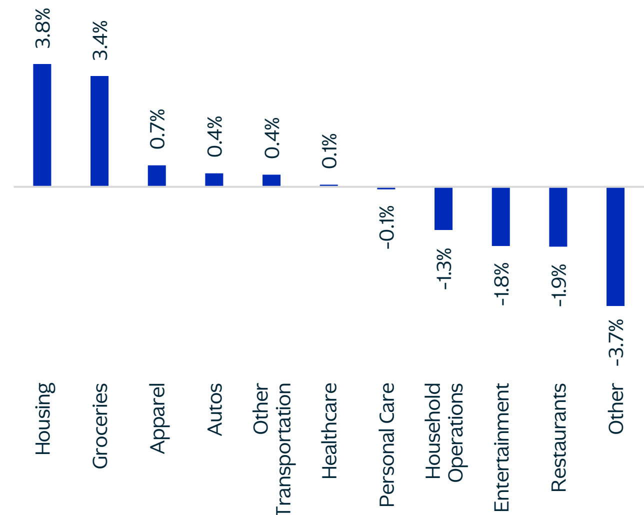
Finally, as noted above, one of the biggest macro 'shocks' of the last few years has been the surge in U.S. immigration. If we are right that four million additional workers will join the workforce as a result, and correct in our adjustments for composition of employment, the impact from income growth alone suggests that these newly formed households could add about 25 basis points per year to aggregate U.S. PCE growth. Importantly, while there is limited data available on spending patterns for these new households, our best guess is that they will drive more demand for low-cost essential goods (e.g., Policylink reports that about 88% of immigrant households own a car, which is not so different from the 92% of native-born households). One way to approximate these trends is to break down spending by educational level, which would similarly suggest that households who do not have formal educational credentials likely spend a similar or greater share of their income on housing, food, and clothing with more of a pullback on 'nice-to-have' categories like dining out and entertainment *(Exhibit 107)*.

Exhibit 106: Non-Cyclical Industries Are Supporting Job Growth



Data as at April 30, 2024. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 107: Data on Educational Attainment Suggest that Newly Arrived Immigrant Households May Still Spend a Lot on Essential Categories Like Autos



Data as at December 31, 2022. Source: Federal Reserve Board, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Pulling all of this together, where do we net out? Our key takeaway is that the core/prime consumer should be able to support aggregate spending in coming years, along with low-income essentials spending on basics,

for example, groceries. Where we see more pressure is on low-cost nice-to-have items which, unfortunately, will fit into fewer Americans' budgets (e.g., McDonald's recently reported its first quarterly earnings miss in two years). Secondly, we think that consumer defaults will likely continue to trickle out in the coming years, although most American households have now made it through the 'worst' of inflation (which is why we do not expect a 'full' default cycle, particularly in cases where credit boxes have remained tight). Third, we continue to believe in our Services over Things thesis, which holds that high-end services spending will continue to support aggregate consumption. Finally, as banks pull away from certain types of consumer lending and shed assets, we think there is a growing need to provide credit to high-quality borrowers with resilient finances.

QUESTION NO. 5

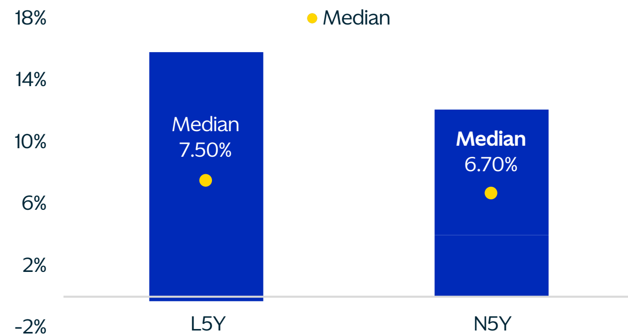
How are you thinking about expected returns and portfolio construction going forward?

We wanted to highlight some of the most salient themes in our latest update of expected returns across asset classes. See below for details, but our biggest takeaway from this update is that there is no longer a 'one-size-fits-all' portfolio that can replace the 60/40 portfolio as a driver of performance. For starters, investors are likely confronting a 'flatter' set of expected returns than they did a few years ago (meaning there is going to be less differentiation between the best- and worst-performing assets in a portfolio, on average). At the same time, 'old' portfolio correlations are breaking down, meaning that asset allocation – not single asset volatility – is having a much bigger impact on overall portfolio volatility.

However, spreads remain quite tight, which is why we favor a more selective approach to investing within Credit.

Exhibit 108: We Think the Efficient Frontier Has Gotten 'Flatter'

Range of Expected Returns Across Asset Classes



Data as at April 30, 2024. Source: KKR Global Macro & Asset Allocation analysis.

In this type of environment, we continue to favor more portfolio diversification, particularly within private markets. As we referred to with our Jaws analogy, we think that asset allocation and portfolio construction could require a different approach this cycle. In particular, we like tilting portfolios to hold more assets linked to nominal GDP growth in this *New Regime*. We also think that, given the spike in stock/bond covariance, CIOs need to spend more time educating their constituents about the potential for an increase in short-term portfolio gyrations. If done correctly, these periodic dislocations should emerge as opportunities to increase deployment, not dial down risk.

Key observations by asset class:

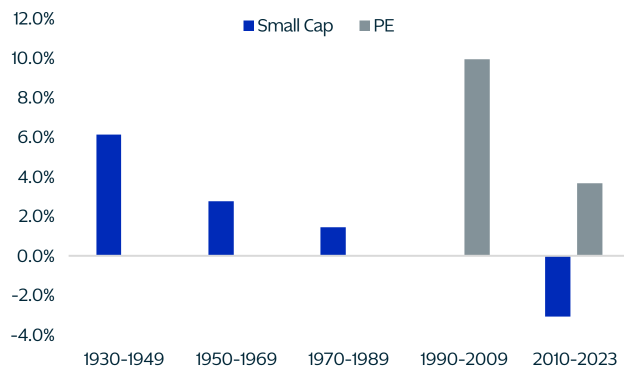
1. **The delta between Credit and Equity returns continues to compress relative to the start of the year.** We still think both High Yield and Levered Loans offer a solid total return from this point in the cycle in absolute terms. However, spreads remain quite tight, which is why we favor a more selective approach to investing within Credit. So, not surprisingly (especially given the increase in our earnings forecasts), as we showed earlier in *Exhibit 4*, our Credit versus Equity model now shows a more balanced approach is warranted, compared to its prior stance of being more positive on Credit.
2. **We actually think Japan and Europe might be more interesting geographies this cycle.** No doubt, local currency returns in these two regions are not much

higher than those in the U.S., but remember that dollar-based investors can earn a very decent income just by hedging out FX risk, which makes these regions much more compelling (particularly Japan). Moreover, we continue to like high current income from European equities, as well as a rising focus on shareholder value in Japan.

3. **Small cap equities may not work like they used to.** While we still expect small cap outperformance in absolute terms, our forecasts are actually fairly downbeat on a risk-adjusted basis. Beneath the surface, we think the quality of small cap indices has degraded over time as the best small-cap companies increasingly stay in private markets amidst a more selective IPO market. One can see this in *Exhibit 109*. Our bigger picture message may be that some of the higher quality companies in this segment are now staying private or are being taken private, a background that makes us – on the margin – more inclined to lean into more private, control positions than just buying into a passive small cap index.

Exhibit 109: Fama and French Famously Argued that Small Cap Stocks Carry a Durable Risk Premium. While That Was Evident in the Data for About 60 Years, The Torch Has Now Passed to Private Markets

Small Cap Annualized Outperformance vs. S&P 500



Data as at December 31, 2024. Outperformance on a total return basis. Source: Cambridge, Ibbotson, Bloomberg.

4. **Manager selection will be even more important, especially across private markets.** We still expect a compelling illiquidity premium in aggregate this cycle, which tends to be the case when public market returns are weaker relative to history. Also, our work shows that dry powder as a percentage of market capitalization has actually not changed much during the last 10 years. At the same time, the average duration of invested capital, according to our colleague Dave McNellis, suggests that seasoned investments as a percentage of total assets under management are at or near record levels, underscoring KKR's view that deal activity is poised to reaccelerate.

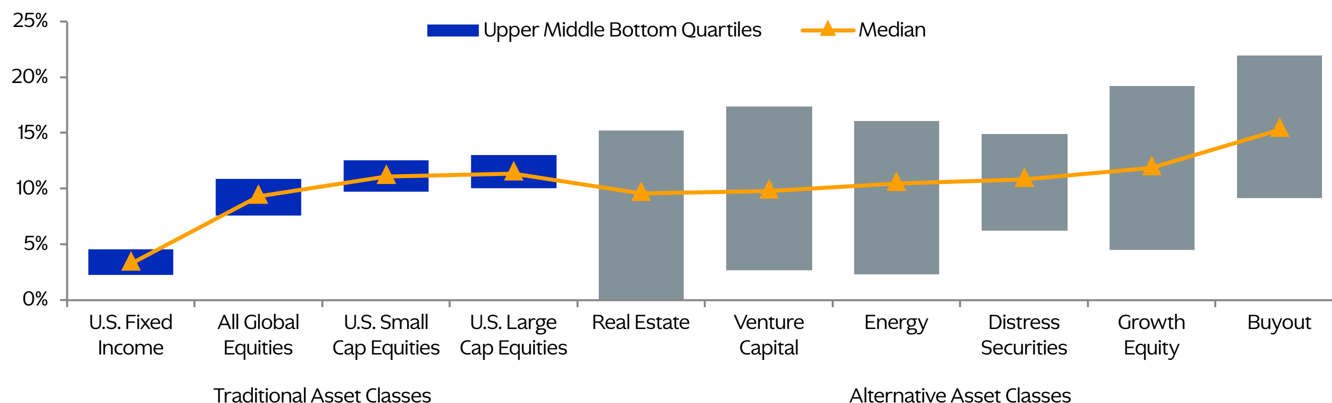
However, we also expect the gap to widen between the best- and worst-performing managers. One can see this in *Exhibit 110*, which shows how much manager selection matters. Not surprisingly, at the high end of the dispersion analysis is where we find Private Equity, which makes sense given the operational and strategic opportunities as well as the ability to time entry and exits. In our view, these gaps between asset classes on the private side, especially Private Equity and Venture Capital, will widen as the industry reviews which firms over-deployed and under-deployed in recent years, especially during the 2021 period.

Our bottom line is that relative value from an absolute-return perspective is becoming less obvious in today's market environment. At the same time, volatility is increasingly a product of portfolio-level asset mix, rather than individual assets. Against this backdrop, we think there is a lot of subtlety between the portfolio that works 'best' for different allocators of capital but think now is the time to drive more focus on both portfolio construction and manager selection (rather than just sticking to what 'worked' over the last two decades).

We also think that, given the spike in stock/bond covariance, CIOs need to spend more time educating their constituents about the potential for an increase in short-term portfolio gyrations.

Exhibit 110: Manager Selection Matters, Particularly in Alternative Asset Classes, as There Is a Wide Dispersion of Performance Between Top Quartile and Bottom Quartile Managers

Performance: Net IRR: Inception to Date, % Vintage Years 2000-2023



Data as at December 31, 2023. Data for alternative investments based on the average Since-Inception-IRR for vintage years 2000-2015 from Cambridge Associates. Data for traditional asset classes based on average CAGR for time periods 2000-3Q17, 2001-3Q17, etc. through 2010-3Q16 from eVestment Alliance database to match the alternative asset class time frame. Source: Cambridge Associates, eVestment.

Exhibit 111: Expected Returns by Asset Class

Asset Class	Dec-23 Forecast, Next 5 Years	New Forecast, Next 5 Years	Comments
Private Equity	11.9%	12.0%	A more upbeat view on public equities helps, along with confidence that operational improvement and value creation trump higher interest rates
Private Real Estate	8.3%	8.8%	Entry cap rates have risen, while NOI outlook has improved. Offsets include more refinancings and repricing as well as higher capex to attract office tenants
S&P 600	8.0%	7.9%	Stronger corporate earnings outlook helps, but adverse selection of best small caps going private reduces outperformance versus S&P 500
Private Infra	8.2%	8.4%	Higher starting valuations offset by better exit valuations as higher illiquidity premium afforded, given structural demand for infra assets
Direct Lending	7.8%	7.3%	Spreads continue to narrow (now ~590), while OID has compressed from 2% to 1%
MSCI Japan	NA	6.8%	The uptick in inflation and renewed focus on profitability leads to a much better earnings growth environment
S&P 500	5.0%	6.6%	We have revised up our exit multiple to reflect a bigger, more powerful Technology sector in the S&P 500. We also now include slightly faster GDP growth (see Economics section) and a little more operating leverage
Loans	7.1%	6.5%	Entry spreads -40bps, but improving fundamentals on refinancing wave
STOXX 600 Europe	NA	6.7%	Region in cyclical upswing: Exiting recession, rates coming down, and a high dividend yield
U.S. HY	6.5%	6.3%	Better loss outlook, but entry spreads -90bps from October
10Yr UST	4.5%	5.3%	No change to the LT target, but the entry point is +40bps from November
Global Agg	4.6%	5.0%	Mirrors change in Treasury returns; partial offsets include worse convexity and lower starting yields
Cash (USD)	3.9%	3.9%	We have pushed out our forecast for Fed cuts by about six months relative to 2023

Data as at April 30, 2024. Source: KKR Global Macro & Asset Allocation analysis.

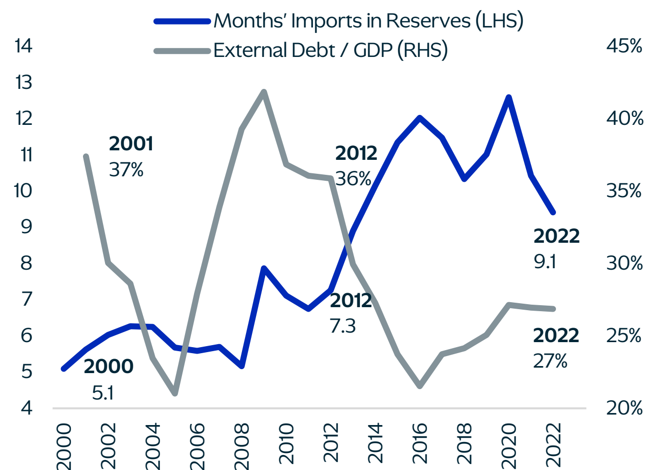
QUESTION NO. 6

Emerging Markets: Do you still favor EM Debt over EM Equities?

When we think about Emerging Markets as an asset class, there is still a continuing overhang from high interest rates in the developed markets, a stronger U.S. dollar, heightened geopolitical tensions, and a sluggish property sector (e.g., China). However, since the Taper Tantrum incident back in 2013, overall emerging market macro fundamentals have been steadily improving. In fact, we think that EMs in aggregate have now held up fairly well through the twin shocks of COVID and higher inflation, which we see as convincing evidence that the more disciplined approach taken by policymakers following the GFC is working *(Exhibit 112)*.

Despite improving macroeconomic fundamentals, however, we remain guarded about the outlook for public equities in EMs. Why? For starters, as one can see in *Exhibit 113*, our model continues to send a cautious signal around both equity market momentum and profitability, both of which have been quite downbeat over much of the past three years. At the same time, valuations are not that cheap *(Exhibit 116)*, and FX remains a highly uncertain driver of dollar-based returns *(Exhibit 115)*. Finally, and perhaps most important, is our structural observation that many EM public-market indices remain overweight financials and state-owned enterprises, both of which continue to deliver underwhelming returns for shareholders.

Exhibit 112: EM Governments Have Taken Down Leverage and Built Reserves Since the GFC



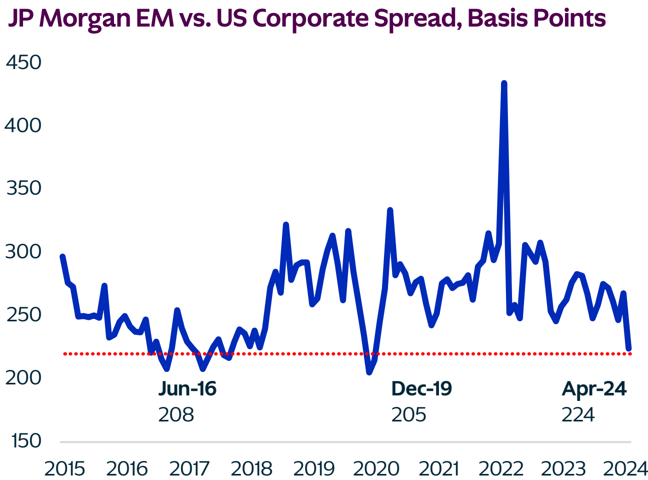
Data as at April 30, 2024. Source: MSCI, Bloomberg.

Exhibit 113: We Remain Cautious on EM Equities as an Asset Class: Momentum Remains Negative Amidst High DM Rates and a Strong USD

"Rule of the Road"	Jan '16	Aug '16	May '17	Sep '17	Jun '18	Dec '18	Dec '19	Sep '20	May '21	Nov '21	May '22	Oct '22	May '23	Nov '23	May '24
Buy When ROE Is Stable or Rising	↔	↔	↗	↗	↗	↗	↔	↔	↔	↔	↔	↘	↘	↘	↘
Valuation: It's Not Different This Time	↗	↗	↗	↔	↔	↔	↔	↗	↗	↗	↗	↗	↔	↔	↔
EM FX Follows EM Equities	↘	↔	↔	↗	↔	↗	↗	↗	↗	↔	↔	↘	↗	↔	↔
Commodities Correlation in EM Is High	↔	↔	↔	↔	↗	↔	↔	↔	↗	↗	↗	↔	↘	↔	↔
Momentum Matters in EM Equities	↘	↗	↔	↗	↔	↘	↔	↔	↔	↘	↘	↘	↔	↘	↘

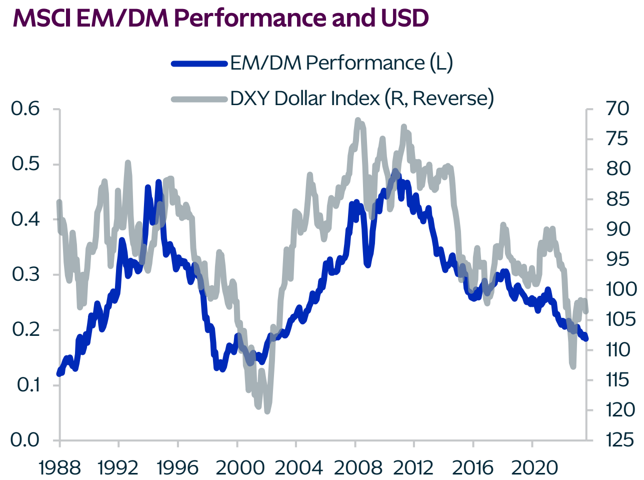
Data as at May 31, 2024. Source: KKR Global Macro & Asset Allocation analysis.

Exhibit 114: Despite Better Fundamentals, EM Credit Spreads Remain Quite Wide



Data as at April 30, 2024. Source: JP Morgan, Bloomberg..

Exhibit 115: In Public Markets, EM Outperformance Is Very Sensitive to FX Volatility...

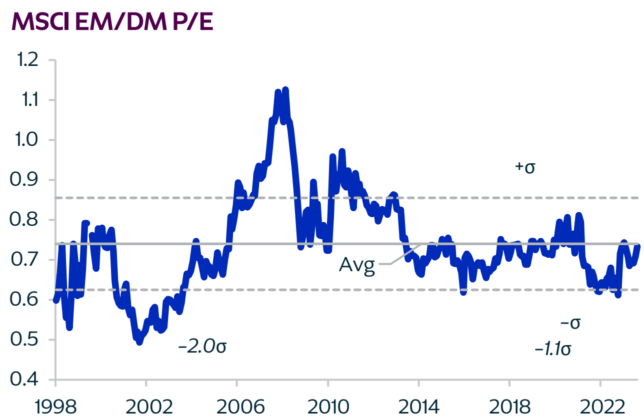


Data as at April 30, 2024. Source: MSCI, Bloomberg.

However, public equity markets are not the only way for investors to engage with emerging markets. Indeed, we have seen more investors focusing on the opportunity to move higher in the capital structure through EM debt, often in the same state-backed enterprises that drag down shareholder returns but carry limited credit risk. We especially like the opportunity to do this by investing in hard-currency issuers, which account for the majority of the EM IG market and in many cases are backed by dollar-based earnings streams (which reduces the potential downside from FX volatility).

Equally compelling, in our view, is the opportunity to tap into stronger nominal growth by partnering with local corporate champions that need external capital to grow faster. Although investing in this space often leaves some residual exposure to FX risk, we think that selectively engaging with EM assets can lead to meaningful outperformance and is 'worth it' in many cases, as it is one of the few ways to gain exposure to the upside in areas where we see important structural tailwinds and elevated nominal growth, including manufacturing and infrastructure in India, China's focus on digitalization and the energy transition, and Mexico's near-shoring efforts (many of which are harder to play through the public markets).

Exhibit 116: ...and Valuations Look Only Average Relative to DM



Data as at April 30, 2024. Source: MSCI, Bloomberg.

Equally compelling, in our view, is the opportunity to tap into stronger nominal growth by partnering with local corporate champions that need external capital to grow faster.

SECTION V

Key Conclusions

As we look around the corner today on what tomorrow might look like, we are inclined to stay the course and maintain a pro-risk posture. No doubt, markets reflect some of the glass half full sentiment that we have been espousing since late last year, and some sectors (e.g., certain areas of U.S. consumer spending) are seeing more pronounced headwinds, both of which speak to the need for 'all-weather' portfolios. However, stronger growth and more favorable central bank policy should help support risk assets as we head into 2025. Consistent with this view, our proprietary cycle indicator, after two years of sitting in Late Cycle and Contraction, is now pushing towards Early Cycle.

Maybe more importantly, though, is that we see productivity in the United States ticking higher, which is a more bullish, structural tailwind than we had previously been anticipating – and one on which we think investors should focus. Indeed, for the first time in years, we have revised up our long-term run rate for U.S. GDP to two percent from 1.5%, a forecast improvement that we do not make lightly. In addition to stronger immigration, the higher productivity we are forecasting will also help mitigate two potential headwinds. First, productivity should allow companies to sustain growth, despite higher wages and input costs. Second, it could act as an important offset to wider deficits, which we continue to forecast under either administration. It also encourages more corporate capex.

In terms of where to allocate, we think that today's market still slightly favors a bit more Credit relative to the benchmark, but we also think that many parts of Equities are attractive. As we mentioned in the Picks and Pans section of this 2024 mid-year update, we like control Private Equity positions, especially corporate carve-outs. On the public side, we see a more balanced set of returns emerging across the United States, Europe, and Japan. China remains tricky, but we do not agree with the notion that China is uninvestable. Meanwhile, we continue to pound the table on many parts of Real Assets, including Real Estate Credit, Infrastructure, and Asset-Based Finance, all of which can help investors build a 'bigger boat' at a time when all-in returns are settling in a more compressed range.

Exhibit 117: The Diversification Benefits of Infrastructure, for Example, Reflect Our View That CIOs Should Migrate Towards More Non-Correlated Assets

Asset Class Correlations, Quarterly, Using L12M Total Returns, 2003-2023

	Global Private Infrastructure	Global Public Equity	Global HY Corporates	Global IG Corporates	Global Treasury	Commodities	Global Inflation-Linked Bonds	U.S. Floating Rate ABS
Global Private Infrastructure	1.00	0.56	0.46	0.35	0.13	0.44	0.16	0.48
Global Public Equity	0.56	1.00	0.84	0.66	0.22	0.53	0.21	0.62
Global HY Corporates	0.46	0.84	1.00	0.77	0.31	0.55	0.38	0.65
Global IG Corporates	0.35	0.66	0.77	1.00	0.79	0.24	0.65	0.27
Global Treasury	0.13	0.22	0.31	0.79	1.00	-0.07	0.65	-0.19
Commodities	0.44	0.53	0.55	0.24	-0.07	1.00	0.16	0.38
Global Inflation-Linked Bonds	0.16	0.21	0.38	0.65	0.65	0.16	1.00	0.02
U.S. Floating Rate ABS	0.48	0.62	0.65	0.27	-0.19	0.38	0.02	1.00

Data as at December 31, 2023. Correlation calculated using 20 years of quarterly returns. Global Private Infrastructure proxied using the Burgiss Global Infrastructure Index; Global Public Equity proxied using the MSCI World Index; Global Government Bonds proxied using the Bloomberg Global Aggregate Treasury Index; Global IG Corporate proxied using the Bloomberg Global Aggregate Corporate Index; and Bloomberg Global High Yield Index for Global HY Corporates; Commodities proxied using the S&P GSCI Spot Index; Global Inflation-Linked Bonds proxied using the iShares TIPS Bond ETF; and Floating Rate ABS proxied using BofA U.S. Floating Rate ABS Index. Source: Bloomberg, ICE, Burgiss, KKR Portfolio Construction.

Overall, though, our message to CIOs is that we have entered the next chapter of our *Regime Change* thesis. Flatter expected returns allow CIOs to use their risk budgets to build more diversification, especially among assets that have low correlation with each other and can provide more balance during periods of volatility. Beyond lower expected returns, what has changed is that the volatility in today's market is being driven by stock-bond correlation, not by single asset volatility. Against this *Regime Change*, we continue to advocate that a new approach to asset allocation is warranted.

In terms of risks, we continue to think that higher rates (especially if productivity tails off), not lower rates amidst slowing earnings, is the greater risk. As such, we still value some floating rate debt in the portfolio as well as more assets linked to nominal GDP than in the past.

Overall, our message is that, despite all the potential headwinds facing our society, our markets, and our economies, now is not the time to be a pessimist, especially when *Opportunity Knocks*. We still see some compelling opportunities, especially for allocators of long-term capital, and as such, we would use any dislocations to increase exposures to longer-term secular themes, including the Security of Everything, Collateral-Based Cash Flows, Productivity, and Intra-Asia Trade.

Maybe more importantly, though, is that we see productivity in the United States ticking higher, which is a more bullish, structural tailwind than we had previously been anticipating – and one on which we think investors should focus.

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