KKR

Thoughts From the Road

ASIA | October 2024

Sometimes you just get lucky. My recent trip across Asia with my colleague Changchun Hua, who is based in Beijing, was one of those times. Singapore was hosting Formula 1 as I landed ahead of our annual investor conference, China rolled out some serious new policy measures the day before I got to Beijing, and I arrived in Tokyo the night before the election. Across these three destinations I spent a significant amount of time with corporate executives, government officials, deal makers, and investors. What did we learn on the ground?

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1. **China's 'Big Bang' on policy changes has been well received**. **This moment is – to steal a line from Mario Draghi — a 'whatever it takes' moment for the country's central bank.** However, central bank liquidity alone will not heal what ails China; the demand side of the economic equation will need to increase to make the current rally *sustainable* into 2025, we believe. Key to our current conservatism is that there are still too many 'excess' homes (our estimates suggest upwards of 30 million), while, as we detail below, the propensity for consumers to spend will likely remain quite low. To this end, we highlight below three actions China can take to transform this market bounce into a sustained bull market, including additional fiscal stimulus, housing support, and market structure reform. Importantly, though, despite all the recently announced initiatives around interest rates, reserve ratio requirements, and refinancings, Changchun is not changing his 2025 GDP forecast of 4.6%, or his inflation forecast of 1.3%. Said differently, the recent stimulus will help lift the economy so it can achieve his base case. Indeed, in hindsight, after my fifth trip to China since the country re-opened, I believe that the risk of a deflationary growth undershoot was probably much more likely than we previously thought.

2. **While the Shigeru Ishiba election victory in late September will be disappointing for some market watchers in Japan, the long-term corporate reform story remains intact, we believe**. Just consider that the unwind of corporate strategic holdings in Japan grew to 3.7 trillion JPY in 2023, a 90% increase, and current trends for 2024 suggest similar strength. Meanwhile, Japan's Private Equity industry is experiencing a major renaissance, and we believe that this activity will help boost corporate productivity and support the public markets. **We think higher productivity will be critical to sustaining higher wages and higher inflation**. **This virtuous cycle will be key in the 2025-2027 period**. Separately, the next leg of the reform journey could focus on how to make the $10 trillion sitting in bank deposits, the majority of which are held by people over the age of 60, more productive, as negative real rates eat into returns. With PM Ishiba now acting more dovish than expected, it also feels like the yen will definitely not surge towards 130 in the near term, which was one of investors' major macro fears after the August shake-up.

3. **Southeast Asia is becoming an exciting destination for capital again**. Return on equity is improving at the corporate level, and we heard lots of good things around consumption upgrades, data/digitalization, and intra-regional trade.

4. While we did not visit India on this trip, we spent a fair amount of time with executives doing business there. **The Indian consumer remains confident, which is leading to lower loan losses**. Productivity continues to be strong, reforms are working, and while this market is expensive, it may be justified as corporate earnings are poised to grow 15% per year for the next four years.

5. **On the more cautious side, we spent time discussing the further splintering of supply chains amidst rising geopolitical tensions.** Recent Israeli military operations in the Middle East targeting Hezbollah via exploding electronic devices such as pagers and walkie-talkies have only heightened the perception that our 'Security of Everything' message has legs.

6. **Overall, though, we think that Asia is poised to enjoy significant capital markets gains in 2025**. The Fed and China are easing at the same time, deficits are in check, and the region is generally under-owned (except for India). Our comparison about historical Fed easing cycles suggests that Asia ex-Japan would typically appreciate 24% if the U.S. economy does not enter a recession. One can see this in *Exhibit 20*. Moreover, with China's recent stimulus news, we think that both cyclical and secular tailwinds are accelerating at a time when holdings of this region in global portfolios are well below average.

Japan's Private Equity industry is experiencing a major renaissance, and we believe that this activity will help boost corporate productivity and support the public markets.

Details

China: A market floor has been established. In China, Changchun, Jerry Guo (who heads up our public policy response in China), and I spent a lot of time digesting the recent slew of policy initiatives laid out by the Chinese government. What was the catalyst for China's 'whatever it takes' moment? From what we could tell, the further dip in economic growth and inflation expectations towards the end of August created a heightened sense of urgency for the 'Authorities.' (Further complicating matters were the high levels of unemployment for university graduates.) So, they moved their late October Politburo meeting up to provide a credible response to these worrying long-term economic trends, thus signaling that 'this time is different.' Our view is that the government plan, a combination of lower rates, reduced capital requirements, and a mechanism akin to a 'repo line' for financial institutions to buy local stocks, is clearly boosting near-term sentiment. It should be, and it is undoubtedly, an important step in the right direction. However, **we still believe more needs to be done on a structural basis. Specifically, we believe a three-pronged attack is likely necessary to drive structural reforms to right the economy**, **including the following:**

1

Implementation of an even more aggressive easing of financial conditions. Despite the good news about a coordinated, broad-based easing in China, we still heard too many examples of deflationary sentiment, including multiple references to the 1930s in the U.S. and Japan's lost decades. As such, we think more directives and action on the fiscal side are also needed (such as local government debt mitigation, more support for consumption, and an enhanced social welfare system for the 200 million migrant workers as part of a larger urbanization initiative). At the moment, it appears the bid-ask on the highly anticipated fiscal stimulus measures is somewhere between 2-5 trillion Chinese yuan. However, we remain hopeful for a larger, more comprehensive package over time to support the lower end of market expectations due to current fiscal constraints. However, we remain hopeful for a larger package to support the economy against significant downward pressures.

2

More far-reaching and robust housing reform initiatives (including the central government doing more with regional governments in a coordinated fashion around affordable housing, taking some of the 30 million 'excess' homes off the market).

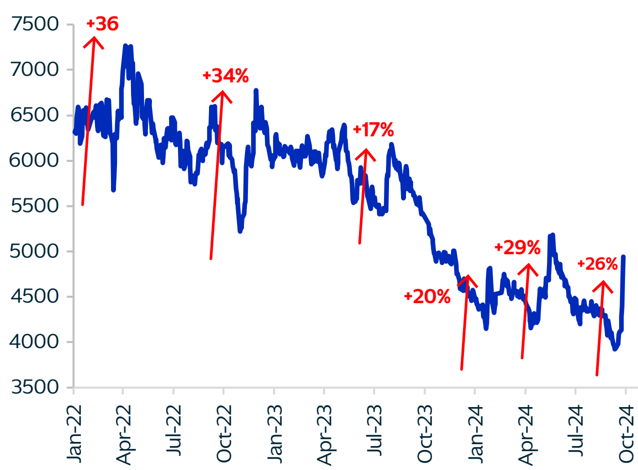
3

Inspiring consumer/corporate confidence by encouraging a greater number of IPOs across sectors, leveling the playing field for foreign and private capital, and providing more tangible incentives to improve returns on capital. During our travels of late, we have consistently heard from global investors that their allocations are not likely to increase in China until there are both better returns as well as material acceleration in capital being returned. This viewpoint is significant, as many global portfolios already have seen their China exposure dip to five to six percent from 10-12% in the past.

Despite our view that China still has a lot more to do to work its way out of its current funk, we do not want to understate the importance of the shifts in China's policies. **The depth and breadth of the recent announcements are different than what we have seen in the past, and we believe the Chinese government acted with force to put in a 'floor' or 'bottom' for the markets, as well as the economy. Maybe more importantly, we think that September 2024 could actually emerge as a turning point in the China capital markets story if some of the aforementioned suggestions are implemented.**

Exhibit 1: Chinese Property Stocks Were Up More Than 20% at the End of September. To Sustain This Bounce, However, More Structural Changes Are Needed

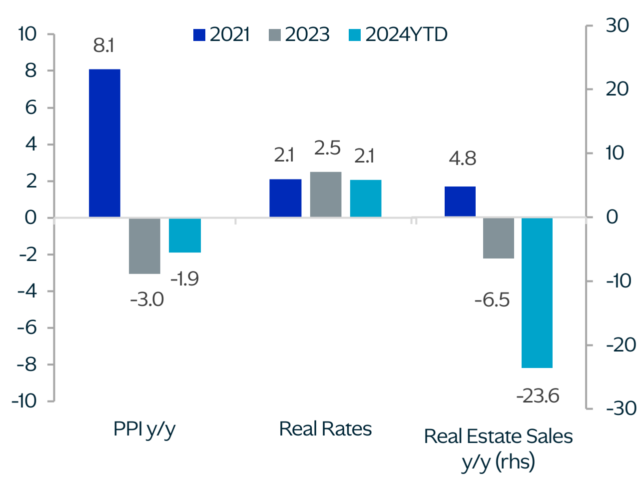
Shanghai Stock Exchange Property Index, SHPROP



Data as at September 27, 2024. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 2: China's Housing Situation Has Gotten Worse in 2024, Leaving the Economy with Significant Deflationary Pressure...

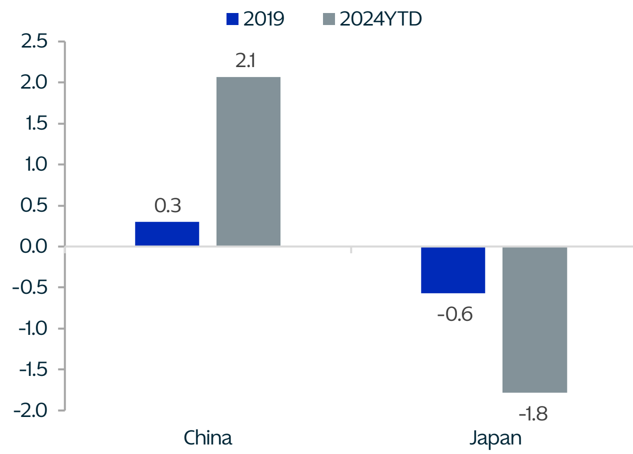
China PPI, Real Rates and Property Sales, %



Data as at August 31, 2024. Source: China National Bureau of Statistics, Wind, KKR Global Macro & Asset Allocation analysis.

Exhibit 3: ...Yet Real Rates in China Remain Elevated at 2.1%, Versus Japan's -1.8%. Given Weakness in PPIs, We Think That Real Rates for Producers in China Could Be Even Higher

Real Rates in China and Japan, %

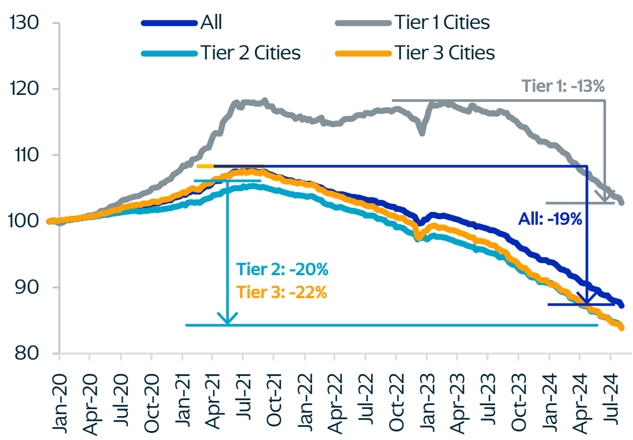


Data as at August 31, 2024. Source: China National Bureau of Statistics, Japan Ministry of Finance, Japan Ministry of Internal Affairs and Communications, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Where are we focused in the coming months? **As we have mentioned before, a structural rebound on the demand side of the GDP equation in China is needed to sustain improvement in growth.** Confidence will be key, as the domestic savings rate has surged to 33% versus 29% pre-COVID. Meanwhile, the unemployment data shows Real Estate, Financial Services, and Education jobs are still under significant pressure. Without question, understanding the 'propensity to spend' is hard to analyze. That said, Changchun and our colleague Allen Liu have done some interesting work to suggest that Chinese consumers are shifting their 'household' asset allocation towards a more conservative mix, which has had a knock-on effect on consumption, we believe. Not surprisingly, some of the slowdown in consumption is linked to the performance of risk assets. Indeed, as *Exhibits 4-9* show, the correction in housing and capital markets has led to a 15% decline in housing and higher risk financial asset values since their 2021 peak. This decrease has prompted a significant shift towards safer assets like cash, deposits, and insurance, which have collectively increased by approximately 27% since 2021.

Exhibit 4: China's Housing Prices Fell Nearly 20% from Their Peak in the Secondary Market, with Lower Tier Cities Falling Much More

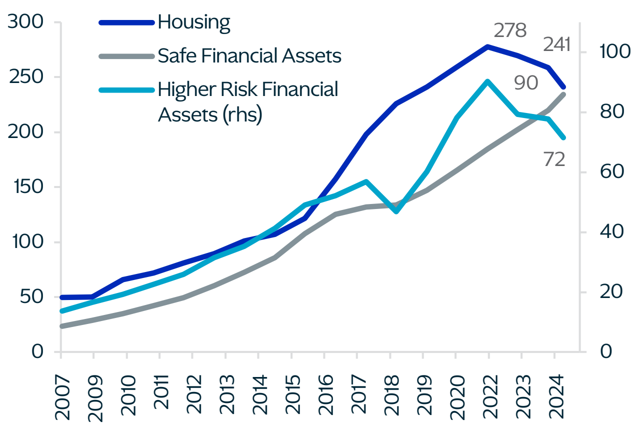
China Secondary Housing Market Ask Prices, Dec 2019=100



Data as at September 20, 2024. Source: Wind, KKR Global Macro & Asset Allocation analysis.

Exhibit 5: As a Result, Household Housing and Higher Risk Financial Asset Values Declined by 14% and 21% from Their Peaks, Respectively

Chinese Household Assets, RMB Trillion

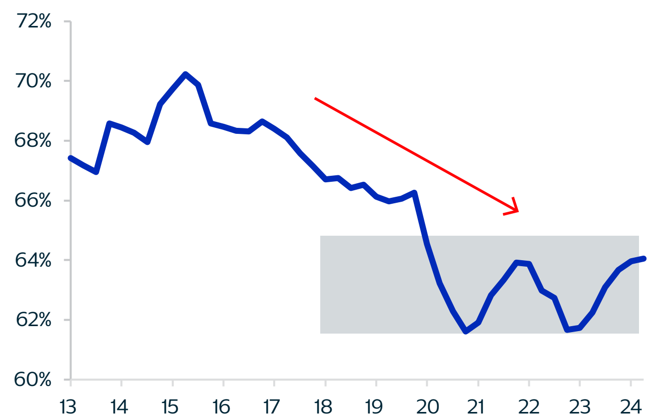


Safe financial assets include cash, deposits, bank wealth management and mutual fund investing in bond and money markets. Higher risk financial assets include listed and unlisted equities, mutual funds investing in equity markets, trusts and other asset management. Data as at June 30, 2024. Source: Chinese Academy of Social Sciences, China National Bureau of Statistics, China Ministry of Housing and Urban-Rural Development, Asset Management Association of China, State Financial Supervision and Administration Bureau, Wind, KKR Global Macro & Asset Allocation analysis.

Against this backdrop, Changchun and Allen then took their analysis one step further to estimate the average propensity to spend post this change in household net worth. As one can see in *Exhibit 6*, it has declined meaningfully. In our view, as we transition towards 2025, this input should probably be the single biggest area of investor focus.

Exhibit 6: China's Recent Stimulus Will Be Key to Generating a Greater Marginal Propensity to Spend...

China's Household Average Consumption Propensity, %

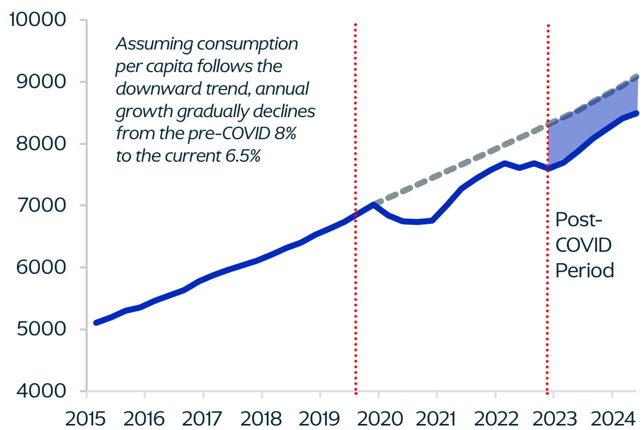


Data as at June 30, 2024. Source: China National Bureau of Statistics, Wind, KKR Global Macro & Asset Allocation analysis.

Understanding the 'propensity to spend' is hard to analyze. That said, Changchun and our colleague Allen Liu have done some interesting work to suggest that Chinese consumers are shifting their 'household' asset allocation towards a more conservative mix, which has had a knock-on effect on consumption, we believe.

Exhibit 7: …As Consumption Remains Below Our Already Much Slower Assumed Post-COVID Trend

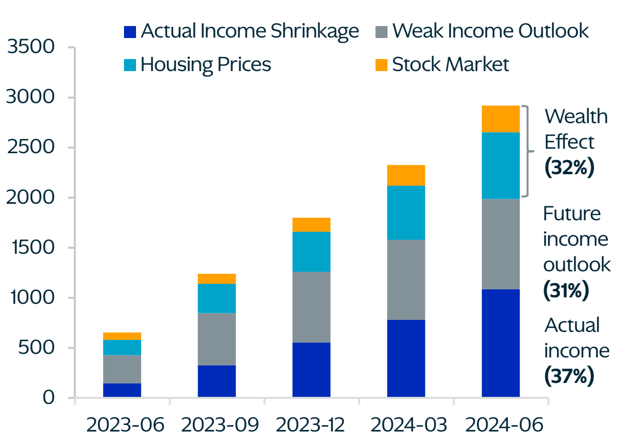
Consumption Expenditure Per Capita, Yuan/Quarter, Four Quarter Moving Average



Data as at June 30, 2024. Source: China National Bureau of Statistics, Wind, KKR Global Macro & Asset Allocation analysis.

Exhibit 8: Weak Consumption Can Be Attributed to Both Wealth Effects and Future Income Outlook…

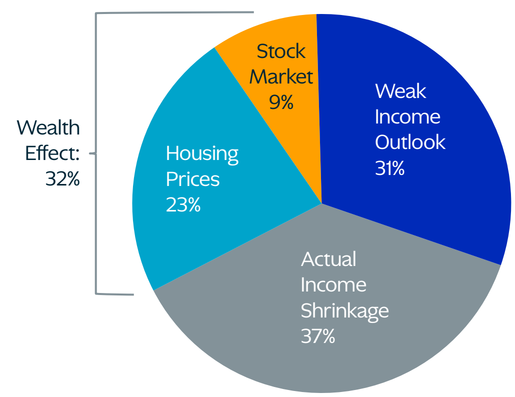
Estimated Cumulative Consumption Per Capita Below Trend By Influencing Factors, RMB



Data as at June 30, 2024. Source: China National Bureau of Statistics, Wind, KKR Global Macro & Asset Allocation analysis.

Exhibit 9: …In Addition to Slower Actual Income Growth

Estimated Contribution to Consumption Slowdown, %



Data as at June 30, 2024. Source: China National Bureau of Statistics, Wind, KKR Global Macro & Asset Allocation analysis.

We also studied other similar situations in history. For instance, Japan's experience post-1992 underscores the challenges China faces in reversing current trends when market confidence has not been restored, especially as it relates to asset mix. Indeed, after the bubble burst, Japan's household assets stagnated for 20-30 years, with a significant drop in the proportion of higher risk financial assets. Our base view is that, while China differs from Japan, policy makers do need to consider our suggested three-pronged attack including frontloading as much of the stimulus as possible. That said, we fully understand the Authorities' reluctance to over-stimulate, given China put the world economy back on track in 2008 via a fiscal surge that later promoted imbalances in the economy. However, today's backdrop is different, we believe, as this downturn is much more specific to China and its economic well-being.

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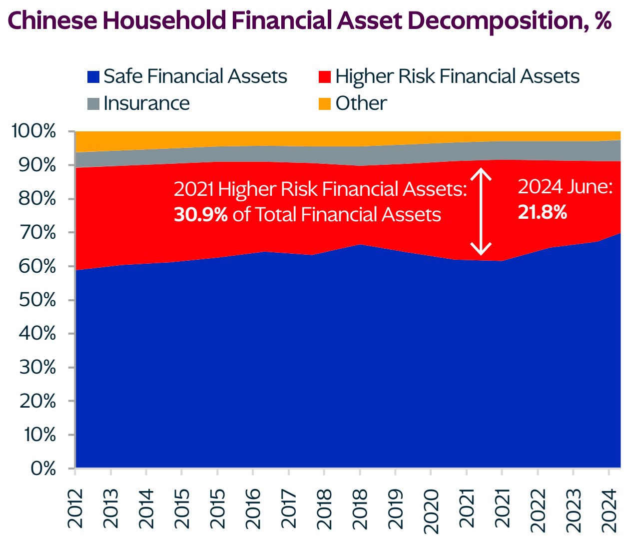
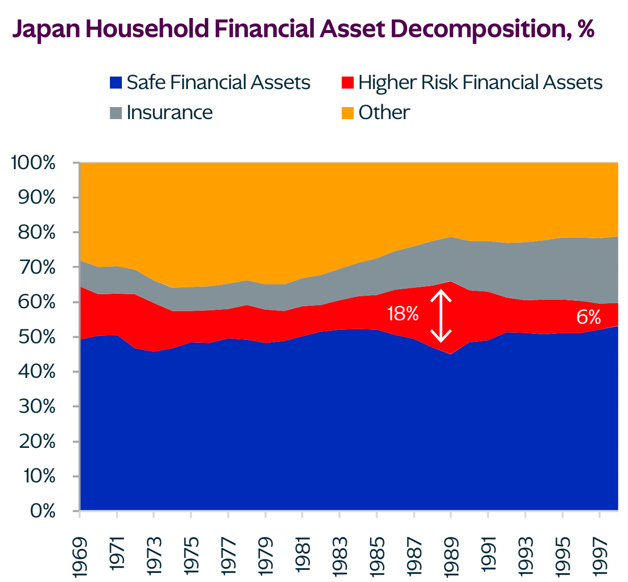
Exhibit 10: Higher Risk Financial Assets as a Percentage of Household Balance Sheets Have Shrunk by One Third in China...



Safe financial assets include cash, deposits, bank wealth management and mutual fund investing in bond and money markets. Higher risk financial assets include listed and unlisted equities, mutual funds investing in equity markets, trusts and other asset management. Data as at June 30, 2024. Source: Chinese Academy of Social Sciences, China National Bureau of Statistics, China Ministry of Housing and Urban-Rural Development, Asset Management Association of China, State Financial Supervision and Administration Bureau, Wind, KKR Global Macro & Asset Allocation analysis.

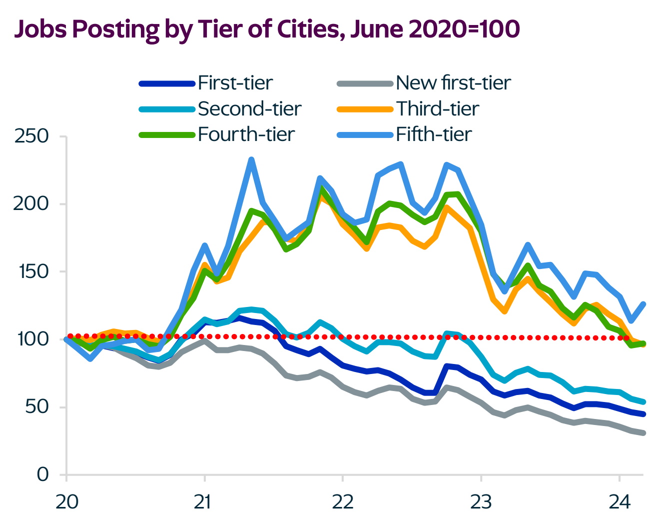
Exhibit 11: ...Compared to Two Thirds in 1990s Japan



Data as at December 31, 2023. Source: Japan Ministry of Internal Affairs and Communications, Japan Ministry of Finance, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

What's our punch line? At its core China is intently focused on achieving the right balance between common prosperity and economic growth. We fully support this goal and think September's announcements represent a necessary step in the right direction. In hindsight, though, this delicate balancing act likely swung too much towards common prosperity in recent quarters. So, if there is good news for investors, it is not that all that ails China will be cured overnight. Rather, **it is that there is now greater acceptance that at least some base level of higher economic growth, including a more robust private sector, is required to deliver common prosperity to the masses**.

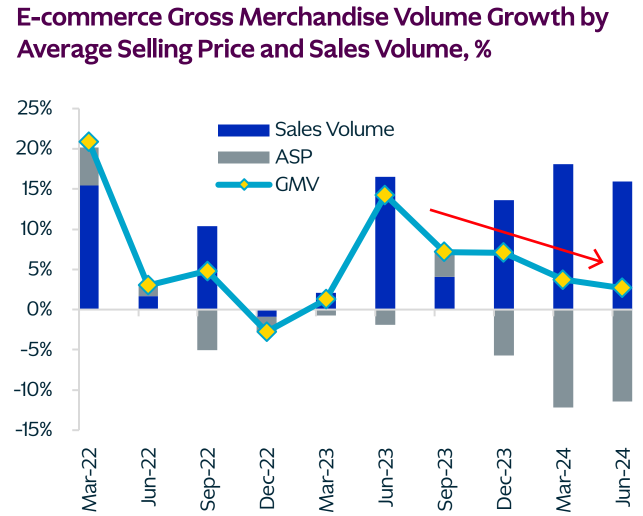
Exhibit 12: Young People Flock to Lower-Tier Cities Amid Employment Challenges for Affordable Living and Job Opportunities



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

There is now greater acceptance that at least some base level of higher economic growth, including a more robust private sector, is required to deliver common prosperity to the masses.

Exhibit 13: Rising Volumes But Falling Average Selling Price



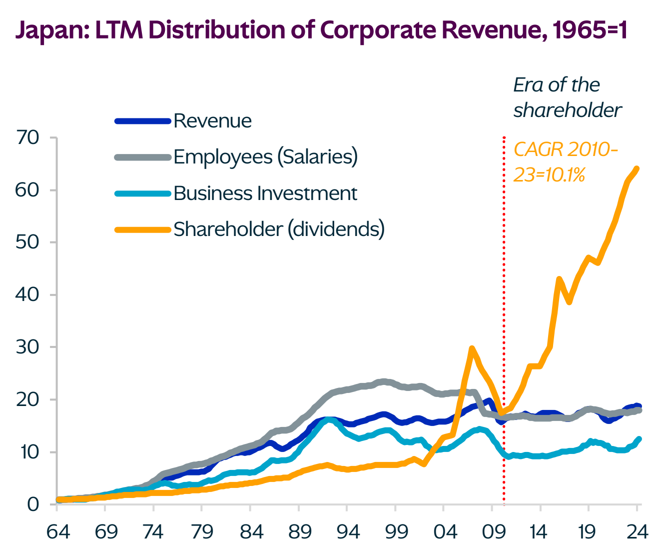
ASP equals average selling price; GMV equals gross merchandise volume. Data as at June 30, 2024. Source: BigOne Lab, KKR Global Macro & Asset Allocation analysis.

Meanwhile, in Japan, the story remains largely the same: a compelling valuation and self-improving corporate reform story. Buybacks are still surging, but the new wrinkle to the corporate reform narrative we heard in Tokyo during this trip was the acceleration in the pace of unwinds related to corporate strategic holdings. As mentioned earlier, this activity is up 90% year-over-year to 3.7 trillion JPY in 2023, an important symbol that corporate complexity is being unwound in favor of shareholder simplicity.

Overall, though, there is likely to still be some ongoing investor consternation that the September 2024 election results could slow or derail the corporate governance reform strategy born under former Prime Minister Shinzo Abe. Though new Prime Minister Shigeru Ishiba's narrative is still being written, some local investors do worry that he could be more hawkish on budget matters, as he previously has stated that he would consider raising taxes on companies and financial income. In the past, PM Ishiba also had bold views on collective defense in Asia and advocated for an Asian version of NATO. As such, we are not surprised by the market's negative reaction upon his victory, which saw both a yen rally and a sell-off in the futures market.

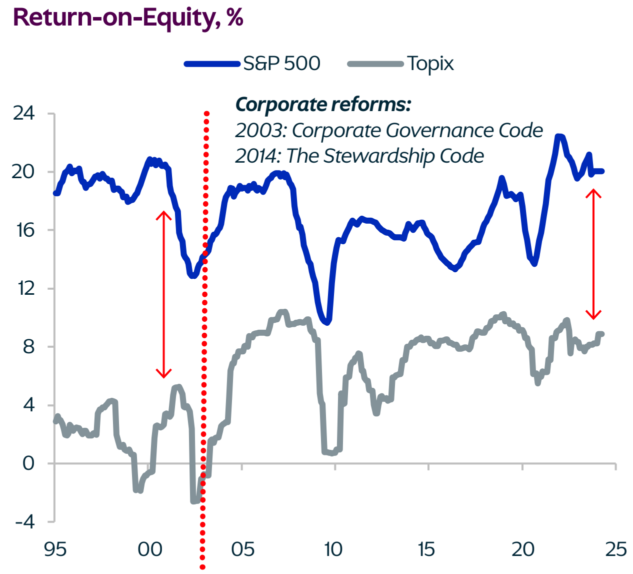
Overall, though, we don't think that the election of the new Prime Minister changes the longer-term narrative (and we are actually of the mindset that he is more investor friendly than the consensus may fully appreciate). Specifically, unlike a country such as India, Japan is a story about return enhancement from a low base, not nominal GDP growth. Importantly, we stick to our call that, after 30 years, Japan is exiting deflation. This reality is leading to a change in mindset and contributing to shifts in consumer and corporate behavior, fueling wage increases and even rents in certain instances. **However, what the country needs, we believe, is an increase in productivity to offset a higher cost of living and a shrinking population.** Corporate restructurings will be needed to boost productivity and growth. More fresh capex investment will be required too. On the currency front, we left Japan feeling better that a significant strengthening in the JPY towards 130 is unlikely. So, while rates are probably heading up 75 basis points over the next 15 months (while U.S. rates are heading lower), macro stability feels like it will remain intact. In addition, we believe most of the macro community has been washed out of their prior JPY short carry trade.

Exhibit 14: Japan's Era of the Shareholder Has Been Unleashed…



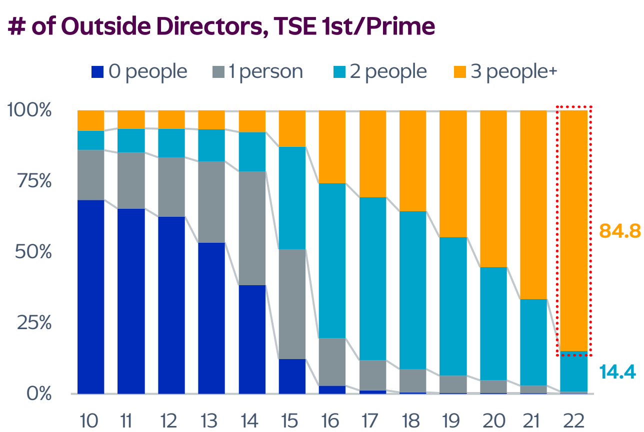
LTM equals Last Twelve Months. Data as at December 31, 2023. Source: Ministry of Finance Japan, KKR Global Macro & Asset Allocation analysis.

Exhibit 15: ...And the ROE Gap Between the U.S. and Japan Is Narrowing



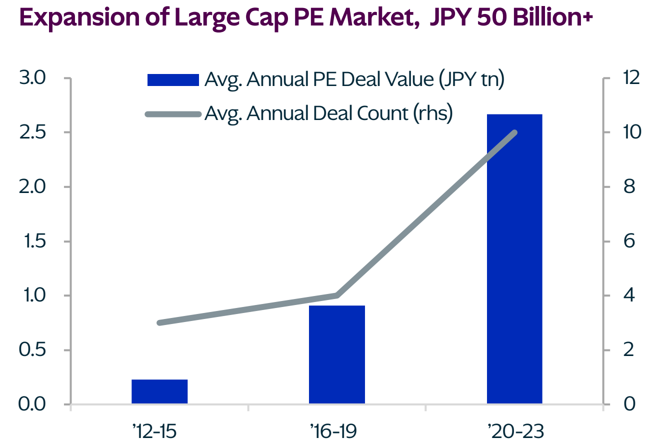
Data as at August 31, 2024. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 16: The Legacy of Abenomics Remains Solid, With an Ongoing Increase in the Number of Outside Directors



Data as at August 31, 2022. Source: Japan Association of Corporate Directors.

Exhibit 17: There Is a Significant Expansion of the Large Cap PE Market in Japan



Data as at December 31, 2023. Source: Bain & Company, AVCJ.

We think global allocators should put Southeast Asia back on their radar. Return on equity in this somewhat amorphous region is increasing again, following more productive growth in Malaysia, Vietnam, Singapore, and Indonesia. A less hawkish Fed will also help on a cyclical basis, but most of the positive sentiment we heard was linked to AI spending (Malaysia), better exports (Vietnam), and consumption upgrades (Indonesia).

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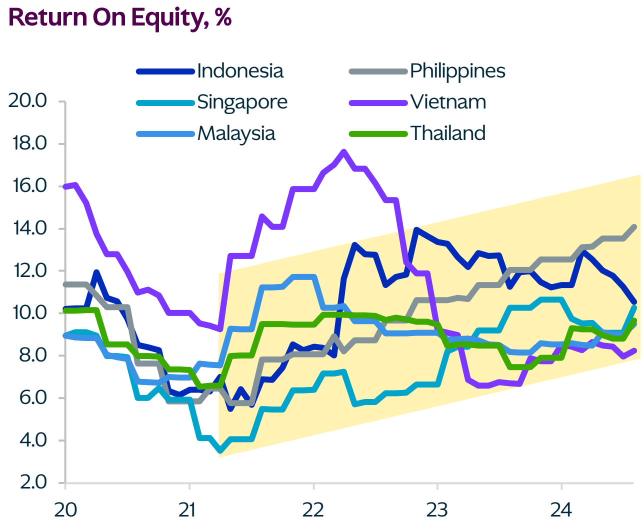
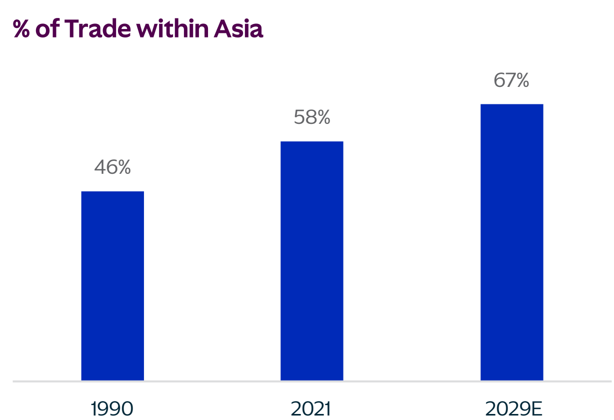
Exhibit 18: Return On Equity in Southeast Asia Is Increasing Again



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

Exhibit 19: In 1990, Just 46% of Asian Trade Took Place Within Asia; by 2021, That Figure Had Reached 58%

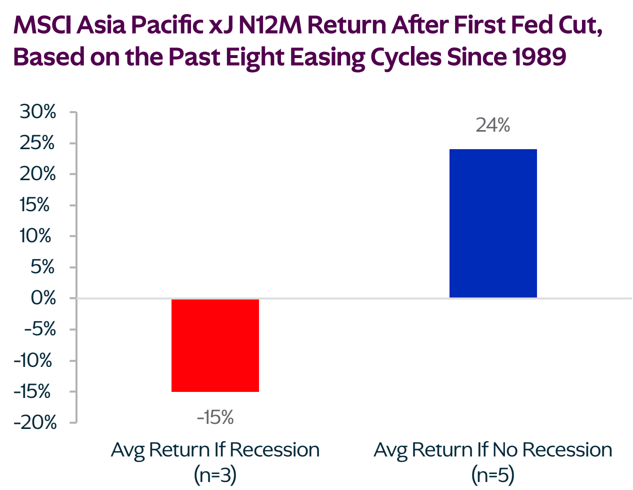


Data as at September 30, 2023. Source: The Economist.

In Singapore, we spent a lot of time discussing the growing trend towards intra-Asia trade. Data usage is growing, trading partnerships are expanding, and infrastructure/logistics are being built to support this major driver of growth. One can see this in *Exhibit 19*. If we are right, then Asia's interconnectivity will soon be on par with the Americas and Europe (which are both already close to 65-70%).

Overall, we expect Asian markets to post very strong gains in the coming quarters as long as the U.S. does not go into recession. See *Exhibit 20* below, but Asia ex-Japan typically appreciates 24% in the 12-months following the start of a Fed easing cycle. No doubt, a recession would reverse that trend, but that is not our base case. A key positive for the region would be that the U.S. dollar becomes less of a headwind. Remember that most of the traditional EM returns have come from currency tailwinds. Also, while we did not visit India on this trip, the macro backdrop in that large economy remains quite favorable, and domestic consumption is strong at a time when fiscal headwinds are low.

Exhibit 20: Returns in Asia Are Poised to Accelerate



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

In Singapore, we spent a lot of time discussing the growing trend towards intra-Asia trade. Data usage is growing, trading partnerships are expanding, and infrastructure/logistics are being built to support this major driver of growth.

What are the risks to consider? Not surprisingly, many of our conversations touched on geopolitics. In particular, we spent a lot of time discussing the further strategic decoupling of the U.S. and Europe relative to China, and what that could mean for our 'Asynchronous Global Recovery' thesis. Through U.S. and European export controls, outbound investment restrictions, and other efforts focused on higher-end technology efforts within China, many of these policies are relatively new and are likely to grow—regardless of the outcome of the U.S. elections. A former President Trump victory would also likely feature even more use of tariffs in politically sensitive areas of the economy such as technology. That said, our trip confirmed that China is already making significant progress on its domestic technology initiatives. For example, local Huawei stores, many of which look a lot like the Apple locations we see in Manhattan, were packed with consumers buying the latest technology, including some cutting-edge smartphones (e.g., the Mate XT, for example, the world's first triple-screen foldable smartphone).

Meanwhile, recent events in Lebanon, where the world saw the literal weaponization of everyday electronic devices—was an illustration of the 'Weaponization of Everything' thesis that our colleague Vance Serchuk has been discussing for several years. Without question, the attack in the Middle East underscored how sophisticated governments can exploit commercial supply chains to deliver devastating geopolitical impacts against adversaries. As a result, this backdrop in turn is likely to accelerate efforts both by China and by its geopolitical rivals in the 'Global West'—including not only the U.S., but also Japan, some EU countries, Australia, the U.K., and Canada—to decouple and harden themselves against each other, especially in areas involving sensitive or dual use technology and to more broadly apply an increasingly stringent national security prism to a widening range of commercial activities.

Against this backdrop, our bigger picture conclusion is that a multi-pronged approach to investing is now required to mitigate potential downside risks. The first prong is enhanced portfolio construction. Specifically, investors must leverage readily available tools to overcome this new reality of heightened geopolitics, including thoughtful underwriting, linear pacing, sector diversification, and more limited use of leverage. Second, from a thematic standpoint, owning 'foils' that are beneficiaries of our 'Security of Everything' thesis is a must. Not surprisingly, cyber, power security, resiliency/back-up facilities, data security, etc., are all themes we continue to invest behind. Finally, increasing the ability to look across countries and capital structures to judge relative value is likely a prerequisite for success in the global macro/geopolitical environment we envision.

Overall, though, we think that Asia is poised to enjoy significant capital markets gains in 2025. The Fed and China are easing at the same time, deficits are in check, and the region is generally under-owned (except for India). Our comparison about historical Fed easing cycles suggests that Asia ex-Japan would typically appreciate 24% if the U.S. economy does not enter a recession.

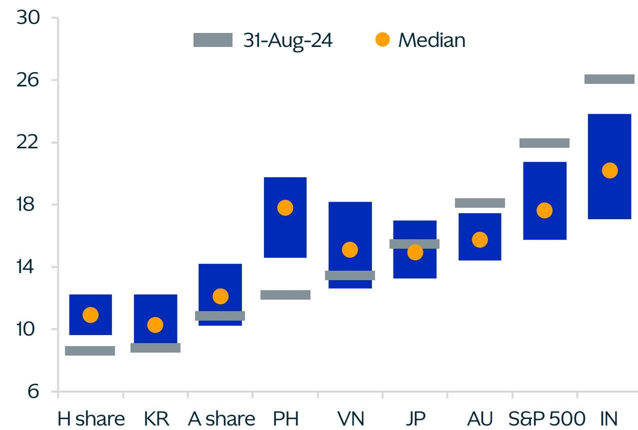
Conclusion: Tailwinds Are Emerging

In conclusion, I left Asia feeling inspired about the investment opportunities. A more dovish U.S. central bank, alongside a Chinese central bank that has acknowledged it will do whatever it takes to bolster growth and address housing conditions, will collectively serve as an important tailwind. Moreover, Asia has emerged as a more sustainable 'self-help' story than in the past, we believe. Japan continues to improve its return on equity, and we think Southeast Asia and Korea too are on similar corporate improvement trajectories (albeit both at a slower pace). Meanwhile, India is definitely the most 'complete' story in the region, but reform-minded PM Modi is also continuing to improve the domestic infrastructure and deficit story in that country as well.

Regarding themes, we remain extremely bullish on consumption upgrades across the region. The driver, we believe, remains urbanization as the total urban population increases to 3.5 billion people in 2050 from 2.2 billion people today in the region. The key variable on which we continue to focus is rising GDP-per-capita, especially in India and Southeast Asia. However, even amidst China's recent slowdown, there is probably not enough acknowledgment that the GDP-per-capita in China actually increased by 2.8x at the same time that the nominal GDP growth rate dropped by 3/4 from 2011 to 2024. Meanwhile, intra-Asia trade is a mega theme that will reshape the competitive landscape of the global economy, including the region, if we are right that this ratio moves to 67% in 2029 from 58% in 2021. One can see this in *Exhibit 19*. Without question, we think that increased connectivity within the region will lead to new opportunities, especially those linked to logistics and consumerism. Finally, the corporate carve-out business remains robust, especially in Japan. The good news is that, as *Exhibit 21* shows, valuations outside India are quite attractive in Asia these days.

Exhibit 21: Outside of India, Valuations in Asia Are Quite Compelling at the Turn of a Global Liquidity Cycle

NTM P/E Ratio vs +/-1σ Range (2013-2024)



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

On the risk side, geopolitics, China's excess housing inventory, and uber-investor bullishness about India all caught my attention. However, these headwinds likely can all be mitigated by linear deployment, buying down multiples through acquisitions, operational improvements, and reduced leverage at entry.

Looking at the big picture, we favor Asia as a destination across portfolios, including Private Equity, Infrastructure, Real Estate, and Credit for both cyclical and secular reasons. Consistent with this view, our commitment to the region continues to scale. All told, we now have $7.2 billion of KKR's balance sheet committed in Asia. As a firm, we like the growth and returns as well as the diversification that the region provides to portfolios. However, as we detailed in this piece, the landscape is changing, and we believe that the ability to comparison shop across countries and across capital structures will be increasingly important, given the growing complexity of the region's role in the global economy.

Regarding themes, we remain extremely bullish on consumption upgrades across the region.

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