KKR

Outlook for 2024

KKR Global Macro Trends | December 2023

Henry H. McVey
Head of Global Macro
& Asset Allocation
henry.mcvey@kkr.com

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Glass Half Full

When we wrote our 2023 Outlook, our lead-in was "Despite all the uncertainty across today's global capital markets, we are poised to enter 2023 with a more constructive tilt, especially on many parts of Credit." **Fast forward 12 months, and as we describe below, we continue to maintain our constructive tilt and suggest that one should view the investing landscape with a 'glass half full' lens**.

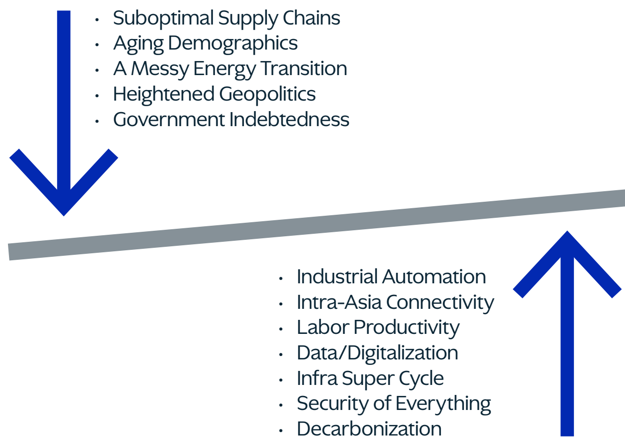
Indeed, we want to reiterate again this year that for those allocators who want to roll up their sleeves and do some digging, there is still a massive amount of dispersion – the lion's share of which has been caused by macroeconomic uncertainty – within and across asset classes/regions that can be harnessed to create substantial value for long-term investors (*Exhibit 11*).

Importantly, though, we still think that too many people are locked into the paradigm that the S&P 500 is trading at lofty headline valuations and the U.S. economy is topping out and headed for a hard landing. As a result, they are sitting idle, as they feel there is little to no value in the market beyond Cash (i.e., despite a strong year in risk assets, there is still a record $5.6 trillion of assets in money market accounts). We just do not see it that way, especially in the core investing businesses that KKR oversees. For starters, outside of the S&P 500's 'Magnificent 7 or 12' (depending on your grouping preference), we think there are some very compelling Equity stories, especially ones that need capital to grow or reposition their businesses. Consistent with this view, the public-to-private and carve-out opportunities that exist today weren't available four to seven years ago, in our view. Meanwhile, Liquid Credit still looks cheap (especially relative to pension and insurance liabilities), and many parts of the Infrastructure sector where we traffic remain in a secular bull market on a global basis. Finally, between ongoing periodic dislocations as well as a growing number of required refinancings, there are a lot of capital solutions opportunities

across Asset-Based Finance and Opportunistic Credit that earn an appealing coupon with some equity upside as well in many instances.

From our perch at KKR, we also believe that the opportunity set to invest behind some of the biggest mega-themes we have seen in years keeps the 'glass half full' for global allocators. Importantly, many of the investment opportunities we are highlighting also serve as compelling investment hedges and/or foils to some of the ails in the global economy these days (*Exhibit 1*). Hence, the famous Winston Churchill quote "A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty" has become our 2024 mantra.

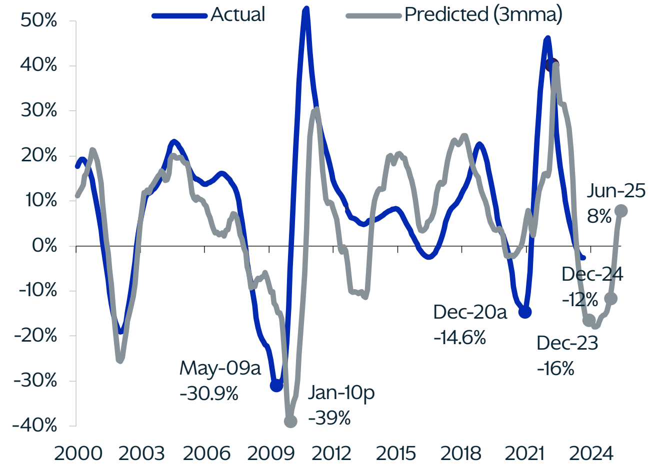
Exhibit 1: While We Fully Acknowledge Some Global Macro Headwinds, Our Travels Continue to Uncover Some Powerful 'Glass Half Full' Themes to Invest Behind



Data as at November 30, 2023. Source: KKR Global Macro and Asset Allocation analysis.

Opportunity set to invest behind some of the biggest mega-themes we have seen in years keeps the 'glass half full' for global allocators.

Exhibit 2: Our Earnings Leading Indicator Has Bottomed and Is Now Suggesting Profits Will Mend

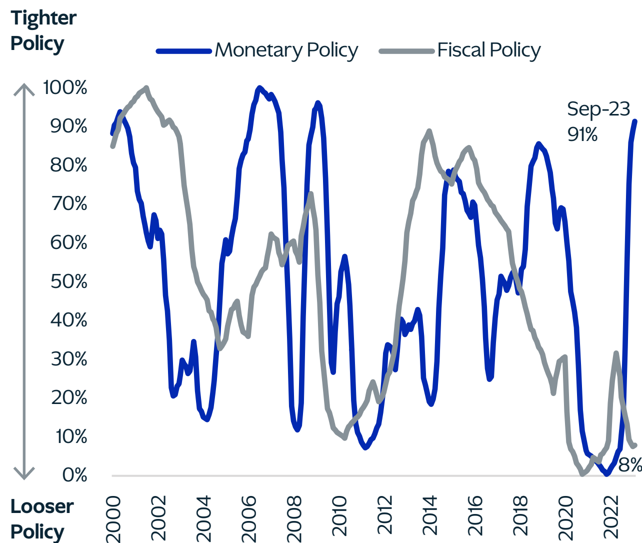


The Earnings Growth Leading Indicator (EGLI) is a statistical synthesis of seven important leading indicators to S&P 500 Earnings per share. Henry McVey and team developed the model in early 2006. Data as at November 30, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

As we reflect on the past 12 months, there is little question that 2023 has been a roller coaster ride, especially given the 'conundrum' we are seeing where a strong fiscal impulse is at odds with extreme monetary tightening (*Exhibit 3*). One macro hedge fund portfolio manager, Scott Bessent, described it as a race car driver who has one foot on the pedal (i.e., fiscal policy) and – at the same time – another foot on the brake (monetary policy). Against these competing influences, we saw the collapse of several prominent banks in the spring, which created fears of a deflationary, deleveraging cycle. However, this macro shock only proved to be a head fake for investors worried about an economic collapse, as the narrative shifted by the fall to one of higher GDP growth and surging long-end rates, despite the lingering effects of Russia's war in Ukraine and rising geopolitical tensions in the Middle East. Finally, heading into year-end, markets have snapped back in the opposite direction, betting on an aggressive series of Fed cuts and driving bond yields sharply lower.

Exhibit 3: Stimulus Conundrum: Today the Fiscal Impulse Is the Gas Pedal, Whereas Monetary Policy Is the Brake

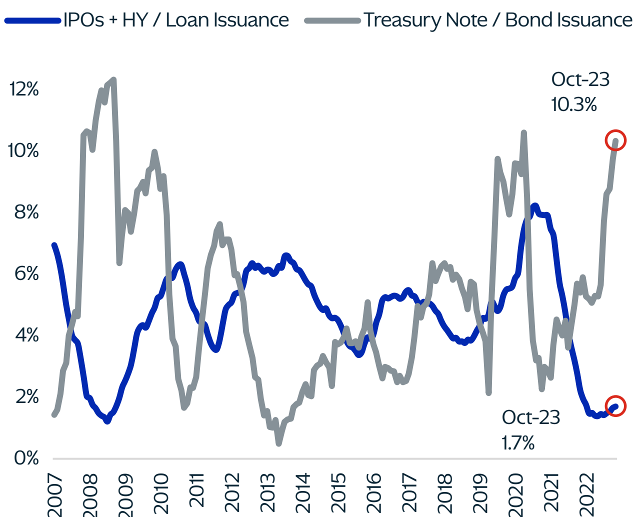
Fiscal and Monetary Policy as %ile of Historical Range



Monetary tightness measures the difference between real fed funds and potential GDP growth. Fiscal tightness measures the difference between the budget deficit and U.S. output gap as a % of GDP. Data as at September 30, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 4: Capital Markets Conundrum: Net Issuance Has Contracted Massively, Except When It Comes to Government Bonds

Capital Markets Liquidity, Trailing Twelve Months, as a % of GDP

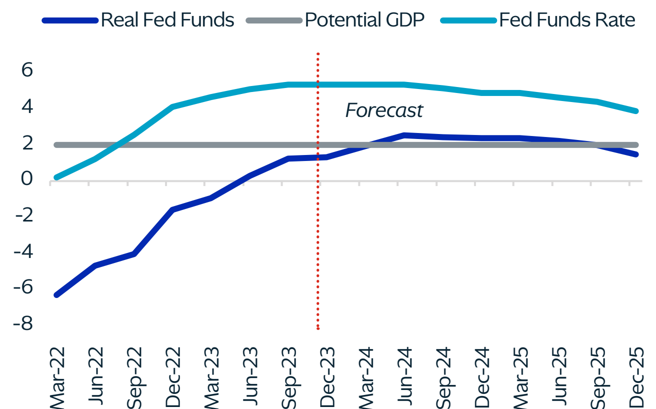


Data as at October 31, 2023. Source: Bloomberg.

During all of these ups and downs, we at KKR continued to subscribe to our Regime Change playbook (see *Regime Change: Enhancing the Traditional Portfolio*). To review, our thesis rests on four pillars – sticky labor costs, heightened geopolitics, a messy energy transition, and overheated fiscal impulses – that suggest there will be a 'higher resting heart rate' for inflation this cycle. This backdrop requires, we believe, a dramatic shift in one's asset allocation towards assets more linked to nominal GDP, not to over-indebted financial assets like government bonds linked to the low inflation, low growth world we are leaving.

Exhibit 5: Real Rates Will Tighten in 2024, Despite Lower Inflation. This Backdrop Is Why the Fed Can Ease (But Not as Much as the Market Now Thinks)

GMAA Projection: Real Rates vs. Potential GDP, %



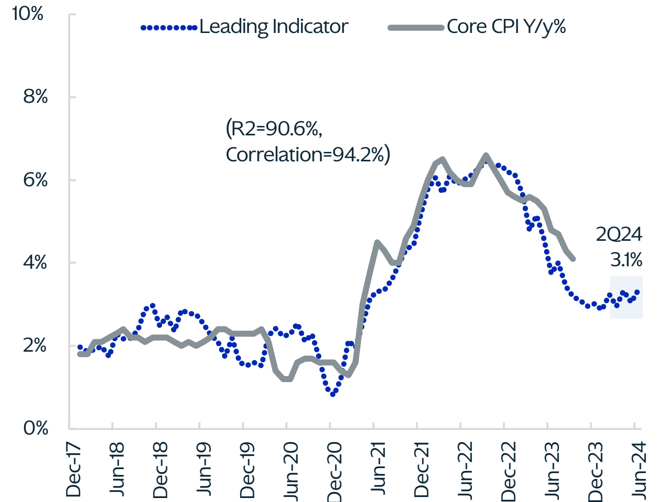
Data as at November 15, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

We think there are some very compelling Equity stories, especially ones that need capital to grow or reposition their businesses.

Exhibit 6: Despite Record Tightening at the Front End, Central Bank Balance Sheets Will Remain Plump With Assets for Quite Some Time

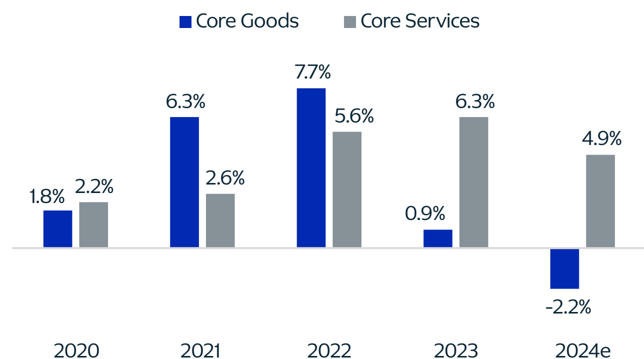
G4 = Federal Reserve, the ECB, the Bank of England and the Bank of Japan. Data as at September 30, 2023. Source: Haver Analytics, national central banks and statistical agencies, KKR Global Macro & Asset Allocation analysis.

Exhibit 7: Our CPI Model Begins to Flatten Out Around Mid-Year 2024



Model calculated on monthly basis to better reflect latest CPI inflation trends. Data as at November 30, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 8: Core Goods Will Be Deflationary in 2024, While Core Services Will Begin to Come Off the Boil



Data as at December 12, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

To date, our Regime Change approach to asset allocation, including being short duration, owning collateral, and being higher up in the capital structure, has served us well. In fact, it has largely been a one-way trade in our favor. **However, buyer beware in 2024: Next year will be different for two reasons. For starters, we are uniformly above consensus on growth (except in Europe) and uniformly below consensus on inflation (except in Japan). Also, rate of change matters, and our models are suggesting lower year-over-year inflation prints for at least the first six months of 2024 (*Exhibit 7*)**. Moreover, we think that in 2024 nominal growth will likely slow (we actually have a mild recession in the second half of the year in our base forecast), and goods inflation could be negative, as we show in *Exhibit 8*. Meanwhile, unemployment will tick up, we believe, and long rates should rally a little further as the Fed finally cuts rates at the short end. **So, our punch line is that, from a tactical perspective, fixed income instruments may continue to benefit from a disinflationary impulse in the first half of 2024, which could be compelling for short-term investors in the U.S.**

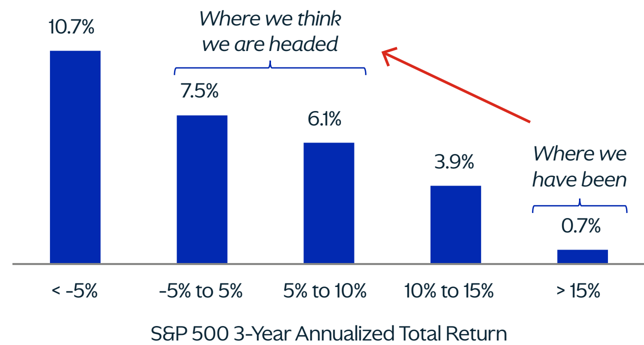
However, we see this positioning in inflation trends as temporary, and we do not want to confuse the cyclical with the secular. For long-term investors, we still believe that there will be a 'higher resting heart rate' for inflation this cycle, compliments of the supply side factors driving our Regime Change thesis, which warrants a different approach to macro and asset allocation, including overweight positions in collateral-based cash flows such as Infrastructure, Energy, Asset-Based Finance, and Real Estate Credit.

Meanwhile, within the equity side of the traditional 60/40, we also think that control-based Private Equity investing can likely play a bigger and more important role in helping to generate higher returns in a world where our overall expected returns have fallen (see Section IV where we address expected returns as well as *Regime Change: The Role of Private Equity in the 'Traditional' Portfolio*). Key to our thinking is that, despite a higher cost of capital, owning control positions with operational improvement opportunities can best the performance of a passive index by a good margin if our macroeconomic forecasts are correct. Indeed, history is on our side; as *Exhibit 9* shows, the value of the illiquidity premium has increased when public markets have reverted towards more modest levels of return. The time to be bearish on Private Equity is not today; rather, it was actually in late 2021 and early 2022, when we believe several growth-oriented PE investors over-deployed their capital relative to trend amidst record low rates (and did not hedge in many instances).

Within the equity side of the traditional 60/40, we also think that control-based Private Equity investing can likely play a bigger and more important role in helping to generate higher returns in a world where our overall expected returns have fallen.

Exhibit 9: The Excess Return of Private Equity Is Greatest When Public Equity Market Volatility Is Highest. We Link These Better Results in Private Equity in Tougher Markets to Operational Improvements and Better Entry Prices

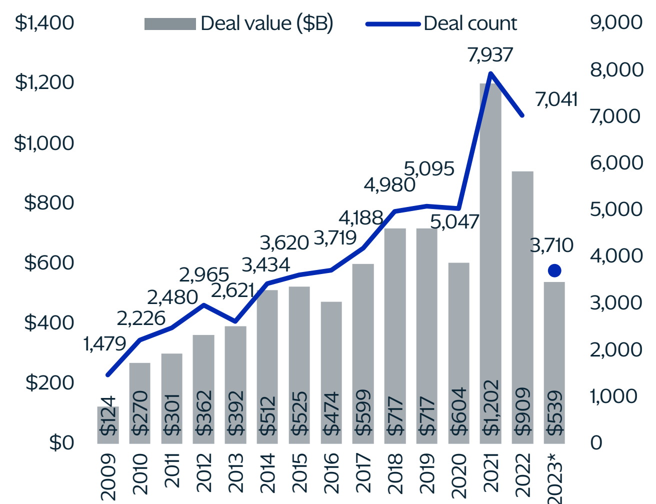
Average 3-Year Annualized Excess Total Return of U.S. Private Equity Relative to S&P 500 Across Public Market Return Regimes



Data as at November 30, 2022. Source: Cambridge Associates, Pitchbook, KKR Global Macro & Asset Allocation analysis.

Exhibit 10: Deployment Pacing in Private Equity Matters a Lot. The Time to Be Cautious Was in the Second Half of 2022, Not 2024, in Our View

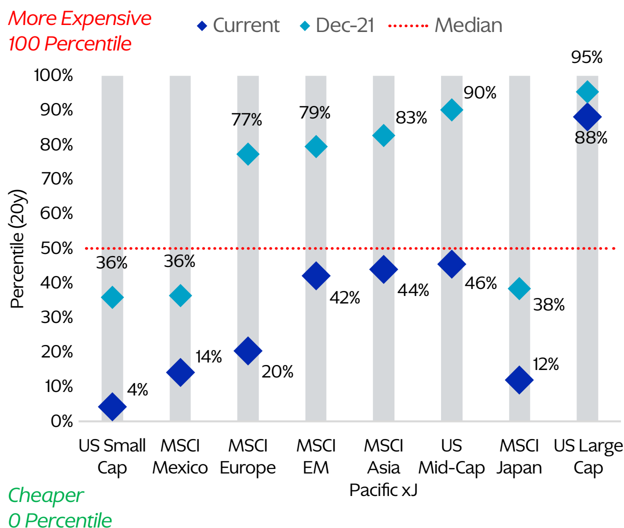
U.S. Buyout Deal Activity, US$ Billions and Deal Count



Note: Private Credit is represented by the Cliffwater Direct Lending Index. High Yield is represented by the ICE BofA U.S. High Yield Index. Senior Bank Loans are represented by the S&P/LSTA Leveraged Loan Index. U.S. Treasuries are represented by the ICE BofAML 10-year U.S. Treasury Index, CLO AAA, CLO BBB, CLO BB refers to the Palmer Square Indices. Data as at November 30, 2023. Source: Bloomberg, Cliffwater, Cambridge Associates.

Finally, we really like flexible capital in the Credit markets. Yields are at attractive levels in absolute terms, the quality of the debt in large liquid markets like High Yield is higher, and periodic dislocations are creating ample opportunities to lean in and out of various Credit products. Moreover, as economic growth slows, dispersions tend to increase within and across asset classes, a backdrop that tends to favor more flexible capital than the past regime where QE 'artificially suppressed' the rate of interest.

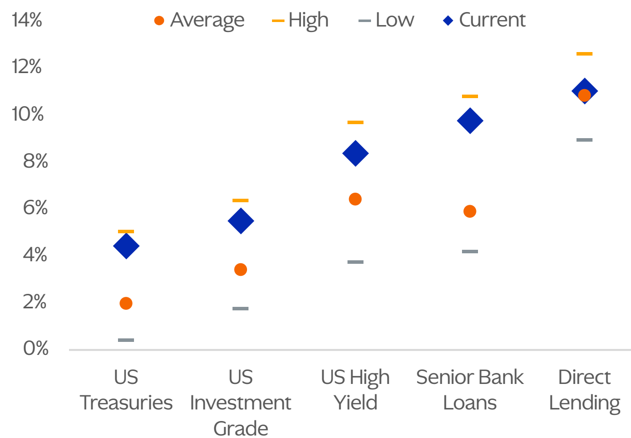
Exhibit 11: Excluding Large Cap Growth, Both Dispersions as Well as Absolute Valuations Remain Compelling Across Many Parts of the Global Equity Markets



Notes: Equity indices refer to NTM P/E. Data as at November 30, 2023. Source: Bloomberg, Haver Analytics, S&P, MSCI, KKR Global Macro & Asset Allocation analysis.

We also keep in mind that, even amid the recent rally in bonds, the stock/bond correlation has remained quite elevated.

Exhibit 12: There Are Multiple Parts of Credit That Appear Attractive Today for Total Return-Oriented Investors



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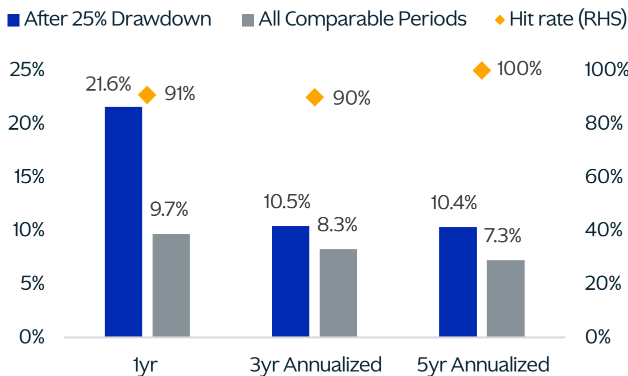
By comparison, we remain long-term cautious on the role of 'risk-free' government bonds in diversified portfolios to serve as reliable shock absorbers. If we are right, then we think that the '40%' segment of the 60/40 portfolio probably contains too much government debt. As a result, we think investors who are following this allocation plan may want to use any cyclical rally from today's levels to lighten up. The reality is that governments, more so than corporations and individuals, are now more heavily indebted. Moreover, there is – compliments of sizeable deficits – still a lot of supply coming to market at a time when the Fed and most of the banks in its network own trillions of dollars of bonds that have unrealized losses. As such, if bond prices do rally more than we expect, then these interested parties become natural sellers, we believe. We also keep in mind that, even amid the recent rally in bonds, the stock/bond correlation has remained quite elevated, validating our thesis that bonds are not portfolio shock absorbers in the regime we envision.

Exhibit 13: We Are Now Only 14 Months Into a Bull Market Recovery Since the Lows in October 2022. We Believe in Staying the Course

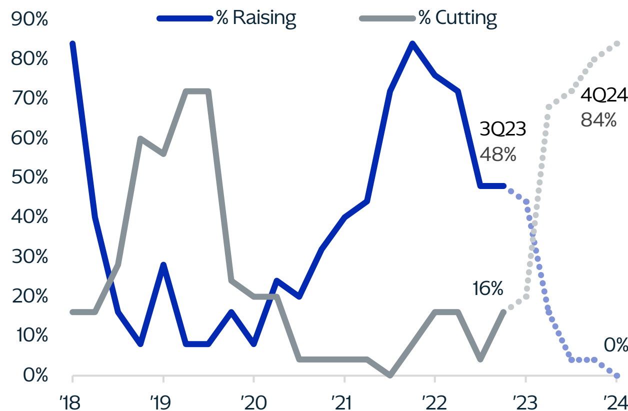
Median S&P 500 Price Return After >25% Drawdown, Based on Drawdowns Since 1940



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

Exhibit 14: Central Bank Tightening Should Be Less of an Issue in 2024

Consensus: % of Central Banks Hiking / Cutting Rates



Hiking / cutting rates defined as an increase in rates over the past three months. Data for US, JP, CN, AU, CA, EZ, NZ, NO, SE, GB, JP, CH, IN, ID, KR, PH, TW, TH, VN, BR, CL, ZA, TR, IL, CZ, HU, PL. Data as at November 4, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Where do we go from here? Our punch line is that, despite all the crosscurrents swirling around us, we are still taking a 'glass half full' approach to our risk tolerance as we think about global macro and asset allocation preferences for 2024. So, although a lot of optimism is now in the price, we remain focused on the following tailwinds:

1

We still think that the bear market in Equities actually ended in October 2022, and while there are plenty of considerations, returns tend to be above average after a 25% decline in the S&P 500. One can see this in *Exhibit 13*. It is more than history being on our side. What continues to be different is that **central bank balance sheets are still near record levels, which allows them to act as important shock absorbers during periods of stress**. As a result, there is still a lot of money in the system, despite money supply growth being negative in many parts of the world. **We think this bullish reality is still largely underappreciated by market participants and helping to support asset prices**. One can see this in *Exhibit 6*, which shows that there is still a much bigger cushion relative to prior cycles.

2

As we detail below, **we think earnings for the cycle already bottomed in 2Q23**, despite our forecast for significantly slower nominal GDP in 2024. See our questions section, but our work shows EPS can increase as nominal GDP cools. Consistent with this view, our KKR Cycle Indicator (*Exhibit 30*) suggests that we will next move from contraction to early cycle recovery (albeit with some bumps along the way), which we view positively.

3

Outside of government bonds, **new issuance supply remains near record lows**. As a result, the **technical bid for parts of Credit and Equities remains compelling**. To be sure, we worry about certain refinancings, but consumers have termed out their debt (especially prime consumers with mortgages) while Private Credit has become a more viable solution for many corporate borrowers. Perhaps most importantly, the lion's share of

the maturity wall for corporate debt has now been pushed out towards 2025-2026 and the bulk of debt maturing in the near-term tends to be higher grade (e.g., the market with the greatest near-term maturity need outside of IG is European HY, which is dominated by senior BB).

4

We also think central banks are closer to the end of the tightening campaign. Consistent with this view, we think that **bond prices have troughed for the near-term**. The disinflationary impulse of 2024 will only help our thesis short term, although we do not think bonds will rally as much as they have in past cycles.

5

Finally, our 'glass half full' approach to investing this cycle also applies to our thematic tilts (and importantly, we think these themes win in a disinflationary *or* a reflationary environment). Despite a lot of consternation and handwringing amongst investors, rising geopolitical and macroeconomic headwinds are actually creating significant opportunities for allocators willing to invest behind the solutions to the challenges that are plaguing the global economy. Though not exhaustive, *Exhibit 1* identifies some of the areas where we are finding significant and compelling opportunities that require billions of dollars of capital investment to overcome new macroeconomic and geopolitical headwinds that were not persistent during the prior decade.

Finally, our 'glass half full' approach to investing this cycle also applies to our thematic tilts (and importantly, we think these themes win in a disinflationary or a reflationary environment). Despite a lot of consternation and handwringing amongst investors, rising geopolitical and macroeconomic headwinds are actually creating significant opportunities for allocators willing to invest behind the solutions to the challenges that are plaguing the global economy.

WHERE WE DIFFER FROM CONSENSUS

Growth	Outside of Europe, we are above consensus for GDP growth in every region in 2024. Key to our thinking is that fiscal spending will remain more resilient and have a bigger multiplier effect than the consensus thinks. We also think that labor hoarding and ongoing fixed investment will lead to a lower unemployment rate this cycle across many developed markets. Finally, in markets like the U.S., traditional recessionary drivers such as capex spending, housing activity, and inventories are still recovering after bottoming this year.
Inflation	Besides Japan, we are below consensus for inflation in 2024. This viewpoint represents an important near-term change in our thinking relative to expectations across Europe, the U.S. and China.
Interest Rates	We remain largely in the higher for longer camp for longer-term rates, given our view on a higher resting rate for inflation this cycle. In the U.S., for example, our 10-year forecast for 2024 is four percent, compared to consensus of 3.75%. Meanwhile, we expect the Fed to cut three times in 2024, compared to four for the consensus. In Europe, we see yields finishing 2024 at 2.6%, and 2025 at 2.8%, compared to a consensus of 2.3% and 2.25%, respectively.
EPS/ Margins	The earnings recession is behind us, as net margins have already declined for five straight quarters. In fact, on an ex-energy basis year-over-year, EPS was already back in growth territory in 2Q23. Confirming this view, our Earnings Growth Lead Indicator has inflected higher after troughing in 2023. That said, we are not as bullish as the consensus. Specifically, we expect six percent year-over-year EPS growth ($235 per share) in 2024 while the bottom-up consensus is much more robust at 11% year-over-year ($246 per share).
Oil	We expect oil prices to settle in the mid-$70-80 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 mid-$60-70 in 2025 and beyond.
USD	We see the dollar as more range-bound in the near term, as we see fewer Fed cuts than the consensus. Thereafter, despite secular headwinds, we expect only a gradual depreciation of the U.S. dollar as growth, inflation, and rates continue to be higher for longer.

Longer-term, however, we do think that this cycle is different; we reflect this conviction in the table below, which highlights eight historical macroeconomic inconsistencies that we believe will prevail going forward:

WHAT'S DIFFERENT THIS CYCLE

1. Asia

Japan is experiencing inflation, while China is flirting with deflation

2. Europe

The periphery of Europe, including once maligned Greece, is outperforming traditional economic stalwarts like Germany

3. Leverage

It is the government, not the consumer, that is over-leveraged this cycle

4. Real Rates

Real rates (Fed Funds - Core CPI) are still rising as inflation moderates

5. Inflation

Demand is cooling in the near term, but supply constraints around housing, labor, supply chains, and commodities mean inflation will settle at a 'higher resting heart rate' this cycle

6. Growth

Nominal GDP will slow materially in 2024, but earnings growth will likely re-accelerate

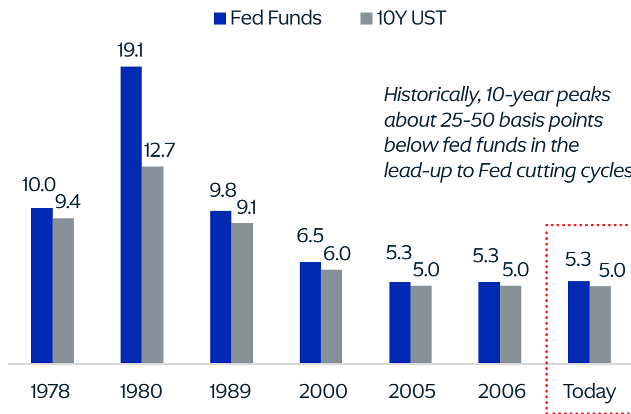
7. Shock Absorbers

Traditional safe-haven assets such as the dollar, yen, and U.S. Treasuries are not rallying consistently during risk-off periods

8. Less Bust

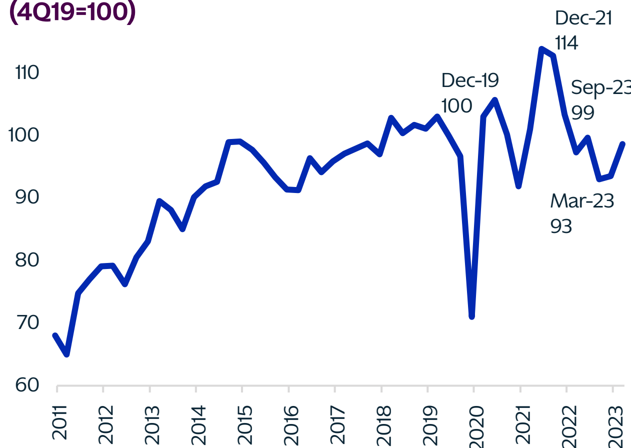
Housing is bottoming and inventories are not overbuilt, which is why there will be 'Less Bust' this economic cycle, Meanwhile, despite record tightening at the front end, central bank balance sheets are helping to contain financial stress

Exhibit 15: Using History as Our Guide, We Still Think U.S. 10-Year Yields Peaked in October



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

Exhibit 16: Recessions Are Typically Caused by Excessive Housing and Inventory Issues. That Backdrop Does Not Look Likely This Cycle



Data as at September 30, 2023. Source: U.S. Bureau of Economic Analysis, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Despite our 'glass half full' thesis for 2024, please don't view our position as cavalier. Having secured my first job on Wall Street back when the banking system was still licking its wounds post the Savings and Loan (S&L) crisis in the 1990s, I want to fully acknowledge the current macroeconomic backdrop is as complex as we have seen in decades. Make no mistake: While we do not ascribe to the hard landing scenario, this environment is not goldilocks the way certain 'soft-landing' bulls are signaling. We think that central banks will counsel patience after seeing financial conditions ease as rapidly as they did in November. At the same time, a lot more of our optimism around growth is now in the price, meaning some of the more compelling bargains we have highlighted over the past few months have now dissipated.

So, stay calm: capital market volatility is the friend of patient, long-term capital. Also, avoid the temptation to stretch. For example, now is not the time to get long the equity of zombie companies, add another turn of leverage to acquisition financing, or go max long on duration because you *can*, in our view. We still advocate for allocators to 'Keep It Simple', a signature phrase from our 2023 Outlook. In terms of what we worry about (i.e., the global 'glass half empty'), we think that refinancing risk, especially for beaten-down Real Estate assets and certain parts of Credit, will reveal that higher rates are having a direct impact on cash flows that could be redistributed back to investors.

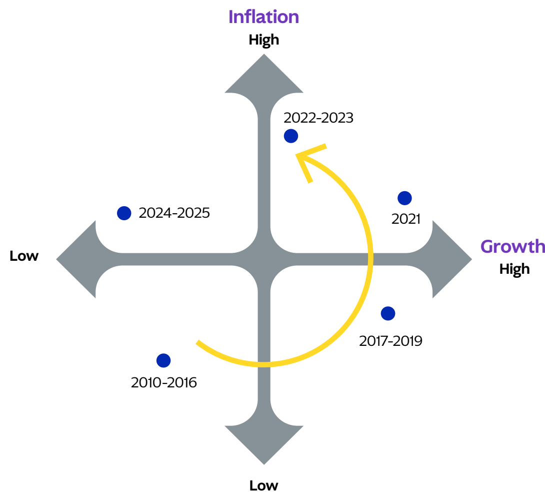
Second, geopolitics remains an increasingly hard-to-predict influence that could derail growth and/or markets. In particular, 2024 is a major election year, which, as history has shown, can lead to political dysfunction and more. Further, we still think labor costs – whether it is through higher wages or business interruption – could dent profitability more than some investors are willing to acknowledge. Simply stated, we need a productivity boom to offset the wage increases we envision. If not, central banks may not be able to ease as abruptly as many investors hope.

Finally, as we detailed earlier regarding what we see as different this cycle, this market is one where we cannot 'just' rely on models. As investors, we must venture out and visit and get 'local' with clients, executives, and counterparts. Case in point: Anyone who primarily relied on the path of the ISM in 2023 – which is usually a good indicator of the direction of the S&P 500 – was being too pessimistic. What such investors missed was the technology mega-trend of Artificial Intelligence, an important driver of growth. They also likely failed to notice

the multiplier effect of fiscal stimulus that was being pumped into the system. So, against this backdrop, our strong view is that history can only serve as a guide. This cycle is not typical, and it requires a more 'hands-on' and creative approach to investing for allocators, especially those who need to make regional tilts and/or find relative value up and down the capital structure.

Exhibit 17: While 2024 Should Be a Lower Inflation Environment, We Believe a Regime Change Has Occurred

Low and High Growth and Inflation Regimes

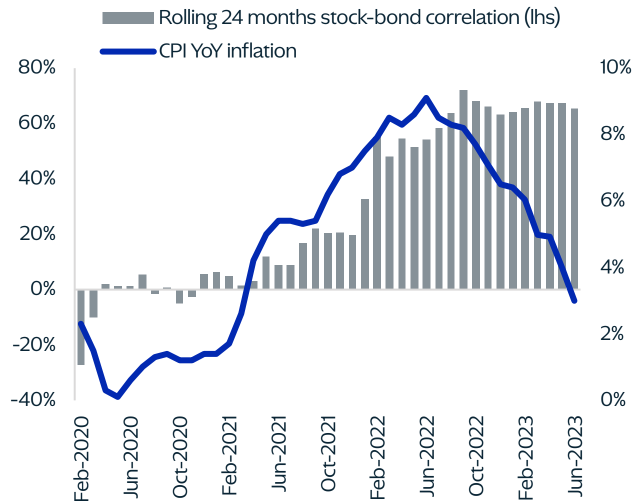


Data as at November 30, 2023. Source: KKR Global Macro & Asset Allocation analysis.

Further, we still think labor costs – whether it is through higher wages or business interruption – could dent profitability more than some investors are willing to acknowledge. Simply stated, we need a productivity boom to offset the wage increases we envision.

Exhibit 18: Despite Inflation Falling on a Cyclical Basis, the 'New' Positive Relationship Between Stocks and Bonds Remains Strong

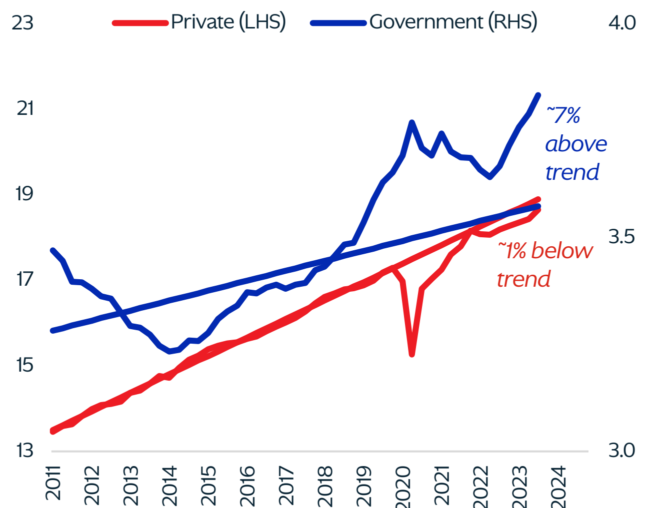
U.S. Stock-Bond Correlation and U.S. CPI, %



Note: Stocks refers to the S&P 500 and Bonds refers to the 10-year Treasury Yield. Data as at September 30, 2023. Source: KKR Global Macro & Asset Allocation analysis.

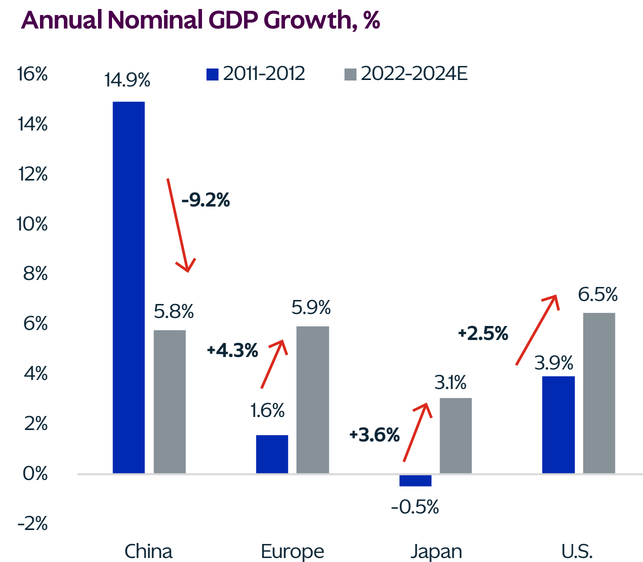
Exhibit 19: The Fiscal Impulse Remains Outsized Relative to Prior Cycles, Providing an Important Buffer to Growth

Real GDP vs. 2011-2019 Trend, US$ Trillions



Data as at November 30, 2023. Source: Bureau of Economic Analysis, KKR Global Macro & Asset Allocation analysis.

Exhibit 20: Besides China, Most Economies Are Experiencing Higher Nominal GDP This Cycle



2023 and 2024 are KKR GMAA estimates. Data as at October 31, 2023. Source: China National Bureau of Statistics, Statistical Office of the European Union, Cabinet Office of Japan, Bureau of Economic Analysis, KKR Global Macro & Asset Allocation analysis.

Anyone who primarily relied on the path of the ISM in 2023 – which is usually a good indicator of the direction of the S&P 500 – was being too pessimistic. What such investors missed was the technology mega-trend of Artificial Intelligence, an important driver of growth. They also likely failed to notice the multiplier effect of fiscal stimulus that was being pumped into the system.

SECTION I

Asset Allocation and Key Themes

Picks and Pans

▲ Japan (REPEAT)

Our multiple trips to Tokyo this year made Frances Lim and me still constructive on the investing environment. The good news is that capital expenditures are accelerating, which is critical to boosting productivity to offset not only the increase in wages but also the price increases in food and oil. We also take comfort that corporate reforms, especially around listed companies, are gaining further momentum under Prime Minister Kishida. We continue to see opportunities in corporate carve-outs. We also see significant value in direct public to privates, as we believe the opportunity for operational value creation is meaningful.

▲ Cyber Security (NEW)

We believe that even more spending will be needed in the area of cyber. The 'bad actors' continue to improve their techniques, with an estimated 72% of firms with annual revenues over five billion attacked in the past 12 months. As a result, we think that both governments and corporations need to respond to this growing challenge. If there was one sector on which to focus, we think that it would be on traditional financial services, including banking, trading, settlement, and wires.

▲ Collateral-Based Cash Flows (REPEAT)

Our research continues to show that many individual and institutional investors are *still* underweight Real Assets, especially Infrastructure and Energy, during a time when the need for inflation protection in portfolios remains high. We are also encouraged that investors are 'expanding' the definition of infrastructure to include more operational improvement stories. We really like having this additional value creation lever in a high and/or rising rate environment.

Meanwhile, within Credit, we favor 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. Structured products as part of this investment strategy often finance certain traditional Infrastructure and Real Estate assets like aircraft, renewable power assets, and warehouses. 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 often have floating coupons that may benefit lenders during periods of higher rates.

▲ 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.

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.

▲ More 'Balanced' Approach to Duration (NEW)

We are not all-in on duration, as we continue to think that long-term borrowing by governments is driving up the risk-free cost of capital. Nonetheless, we do think that there is clear value in investors' ability to lock in cash-like yields at the long end of the curve, as inverted yield curves do not last forever and have historically resolved through bull, not bear steepening. Against that backdrop, we think investors will want to consider trimming their overweight to floating rates as we head into 2024. We actually think a similar logic applies across the risk spectrum, which is why we have been calling for a more balanced approach to High Yield versus Loans, as well.

▲ 365 Days and Less Lending, Including Sub-Lines (NEW)

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 sublines 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.

▲ Energy Infrastructure Related to AI (NEW)

While most investors are focused on the semiconductor angle of the current AI boom, we have been spending more time focusing on the energy demand surge needed to train AI models. The reality is that, in many instances, existing infrastructure is insufficient to meet the demand required. Against this backdrop, we are bullish on critical energy transmission assets, data centers, and cooling technologies.

▲ Opportunistic Credit (REPEAT)

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. The absolute returns of these types of vehicles today are competitive with Public Equities in many instances, yet, there is likely less volatility, and one is higher up in the capital structure. Meanwhile, in Private Credit markets, we are seeing some attractive relative valuation in areas of Asset-Based Finance as well as in Capital Solutions Credit to fund an acquisition and/or a major capital expenditure, including domestic re-shoring initiatives.

▲ Residential Mortgages (NEW)

The technical picture of banks originating fewer mortgages as well as the Fed selling its book of mortgages is leading to indiscriminate selling at times. This is despite, in many instances, an improvement in quality; we think prime consumers will actually hold up fairly well this cycle. We find this backdrop quite compelling and would use any weakness to accumulate positions, especially for investors who have fixed liabilities (pension funds, insurance companies, etc.)

▼ Fade Inverted Yield Curves (NEW)

We think that structural pressures in the treasury market (including a glut of supply and lack of foreign interest in USTs) will keep bonds from rallying as much as they typically have when the Fed starts cutting rates. Our term premium model suggests that 10-year yields currently reflect a lot of structural factors, many of which are unlikely to be resolved in the near term, including wider deficits, lower savings rates, positive stock-bond correlations, etc. Meanwhile, at the short end of the curve, we think that the Fed will have the flexibility to cut several times in 2024 (albeit less than the market thinks), which should help steepen the curve as a whole.

▼ Office Real Estate (REPEAT)

With prevailing Office cap rates around 150 basis points higher than those for multifamily or data centers, we still do not think that Office CRE investors are being appropriately compensated for the uncertain path of operating income at a time when occupancy is still falling and sublet space is still rolling off. By contrast, we think there are some emerging opportunities in less-cyclical sectors like Data Centers, Industrials, and Single-Family Rentals, which offer wider average cap rates than they did in 2021-2022.

▼ Cuspy Credit and Non-Control Positions in Equities (NEW TWIST ON REPEAT)

We are entering an environment where slower nominal growth is relieving pressure on bond yields and helping to encourage more capital markets activity. However, there are likely still too many weak companies with weak capital structures that will need to refinance in the next several quarters. Similar to last year's outlook, our view is to 'Keep It Simple' and not stretch on the quality front in 2024. The incremental yield pick-up in the lowest rated unsecured High Yield, for example, is just not worth it, in our view. Against this backdrop, we think the difference between control and non-control positions will get magnified materially in 2024, as demanding equity multiples require more focus on operational improvement and the ability to retool companies' capital structures, even as borrowing markets thaw.

▼ Non-Core U.S. Consumer (NEW)

See Question #4 below for details, but younger and lower-income U.S. consumers have been the most exposed to inflation this cycle and are increasingly relying on credit cards and loans to make ends meet. By contrast, a lot of 'core' U.S. consumers (including homeowners) are still in decent shape, as fixed-rate mortgages, a manageable overall debt burden, and a solid 'stock' of excess savings help support spending. Against that backdrop, we think a lot of the slowdown in consumer spending and an uptick in consumer distress this cycle will, unfortunately, be concentrated in lower-income households, especially if we are right that the labor market is finally starting to slow.

▼ Unsecured Credit (NEW)

Our data suggest a tiering of consumer obligations with consumers focusing on must-haves, such as paying their mortgages and cell phone bills but skimping on their nice to haves, such as unsecured loans. Importantly, our base case is that there will be lower than normal unemployment this cycle (we are using a 110-basis point increase, compared to 300-400 basis points, on average, in prior cycles). However, even with a more favorable backdrop relative to prior cycles, we believe that some lenders got too aggressive during the post-COVID spending euphoria. As we enter 2024, some of this lax underwriting will come home to roost, especially where there is no direct claim on the collateral.

▼ Regional Banks (REPEAT)

While we think regulators are highly invested in the viability of the regional banking system, we still think that regional banks may be forced to pay up for deposits at a time when they are already facing significant losses on their RE lending books. At the same time, we think regulatory pressures are leading banks to find ways to reduce their risk-weighted assets, leading to a broad array of asset and portfolio changes. While we don't think these forces will be enough to inspire a full scale S&L-style meltdown, we do think that distress in the system will remain elevated while higher borrowing costs 'pinch' net income margins.

▼ Fed Rate Cuts (NEW)

We do not share the view priced in forward markets that the Fed will cut almost six times in 2024. Remember that the Fed wants to hold real rates at or above two percent until inflation returns to target on a sustainable basis. If we're right that inflation only falls to the mid-two percent range next year, then a nominal rate near four percent would be too accommodative in real terms.

Key Themes

In terms of key themes, we note the following:

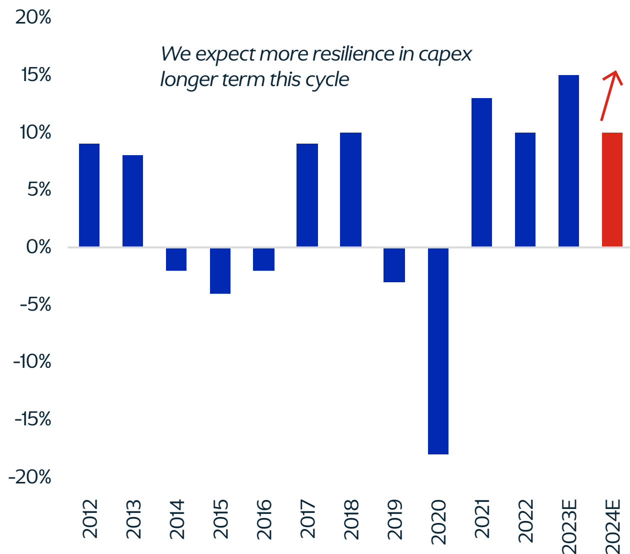
1

Industrial Automation

One of the mega themes that bubbled up during our 2023 travels, especially in Asia this fall, was the emergence of an industrial automation cycle. In Japan, for example, capital expenditures are hitting record highs (*Exhibit 22*), as companies search for new ways to drive productivity. These investments will be critical in a higher nominal GDP world where labor costs and other rising inputs could otherwise pressure margins. We heard a similar story in China and Germany where companies are trying to use technology and automation to deliver more efficiency and productivity in a world where demographics and cross-border connectivity are becoming more challenged. To this end, we favor software plays, as one example, that can help warehouses become more efficient at storing goods and/or using less energy, or industrial automation efforts that retool old manufacturing processes to make them more globally competitive. We also like mission critical, highly engineered, and application-specific products that have high cost of failure, but account for a small percent of total product cost (e.g., flow control. testing/inspection/ certification equipment).

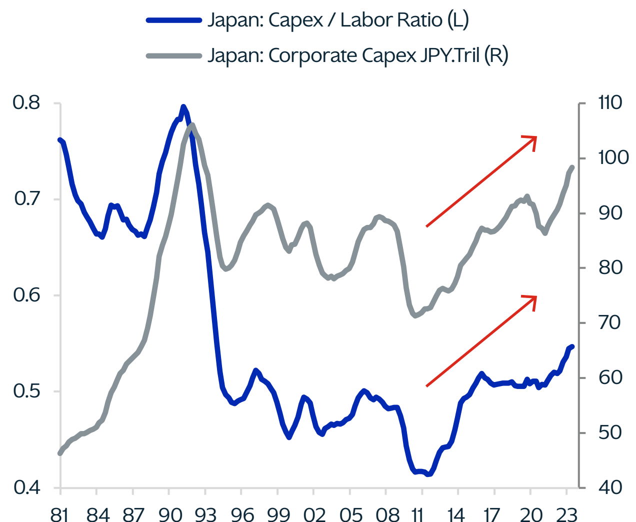
Companies are trying to use technology and automation to deliver more efficiency and productivity in a world where demographics and crossborder connectivity are becoming more challenged.

Exhibit 21: Many Factors From AI and ESG Spend to Reshoring to Past Underinvestment to CHIPS Act/IRA Stimulus Are Contributing to the Uptick in Current Capex Spend



Data as at September 30, 2023. Source: Melius Research.

Exhibit 22: Japan Corporate ROE Has Been Robust, Supporting Higher Corporate Capex, Especially When Labor Shortage Gets Worse



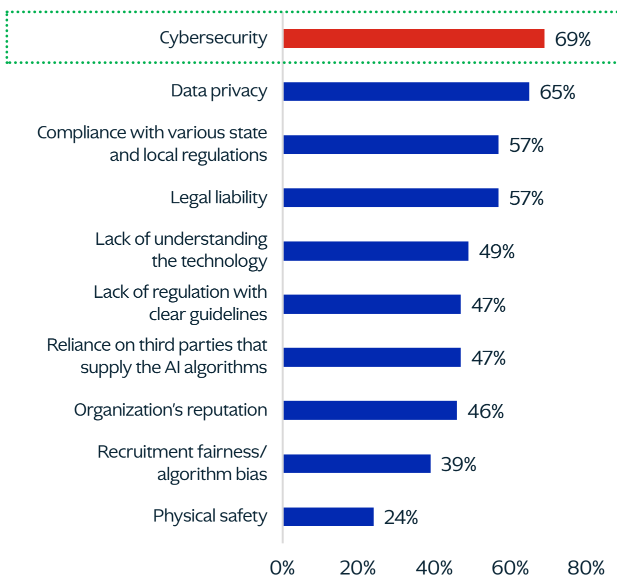
Data as at June 30, 2023. Source: Bloomberg.

2

Security of Everything

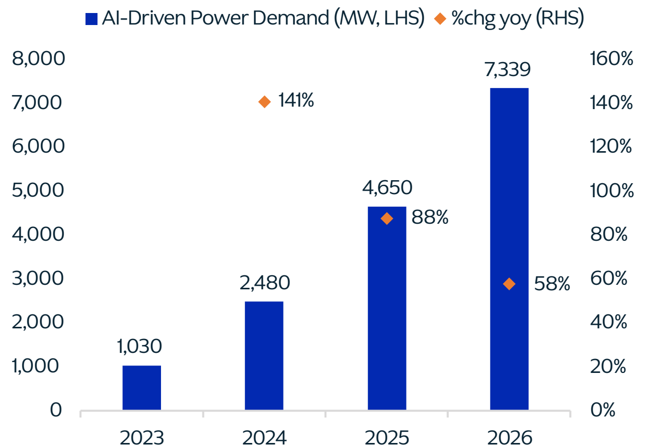
We remain the maximum bullish on this theme. Against a backdrop of rising geopolitical tensions, cyber-attacks, and shifting global supply chains, CEOs around the world tell us that they want to know that they have resiliency when it comes to key inputs such as energy, data, transportation, and pharmaceuticals. 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 recent events in 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 IRA, a lot more government support will be targeted at the intersection of climate and supply chains.

Exhibit 23: Cybersecurity Has Become a Major Risk Surrounding Generative AI Models



n=500. Data as at February 28, 2023. Source: Bank of America, Baker McKenzie, Insider Intelligence.

Exhibit 24: AI Workflows Are More Computational Intensive and Server Racks Use More Energy, Which Will Drive Power Demand



Data as at June 30, 2023. Source: Evercore Research.

3

Intra-Asia Connectivity

Our three visits to Asia in 2023 confirmed for us that this time is different, and a meaningful transition is well under way: Asia is becoming more Asia centric as more trade occurs within the region 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. Key areas on which we are focused include transportation assets, sub-sea 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 (GFC), 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 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.

4

Labor Productivity/Work Force Development

Corporations will need to focus on automation and productivity gains. Periods of labor scarcity have historically been opportunities for greater automation. In terms of key offsets, our team at KKR is particularly focused on technological advancements that can have an impact on productivity. Specifically, many of the important technological trends, including automation and digitalization, that were already in place before the pandemic have now only accelerated. 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. Using history as our guide, we believe that the recent uplifts in productivity 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 have already seen robots cleaning floors at Heathrow and clearing dishes in Japan and think this trend will accelerate as automation increases in fields like retail, leisure and hospitality, and healthcare. No doubt, automation and productivity are emerging mega-themes, in our view, and at times have accounted for about 20-25% of our deal teams' PE activity since the pandemic.

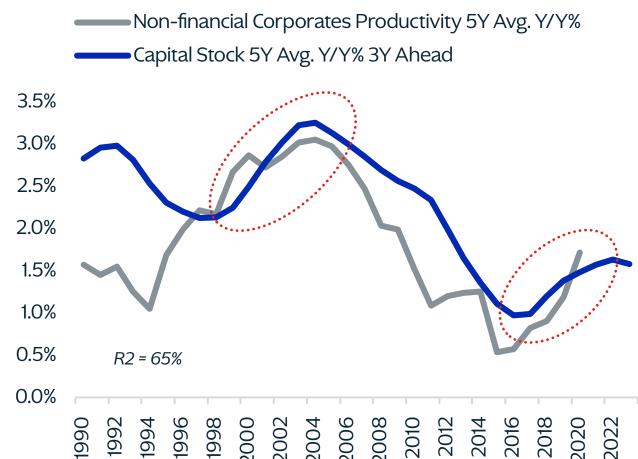
Exhibit 25: Wage Gains Have Historically Led to Periods of Rising Productivity

Wage Inflation vs. Labor Productivity in U.S. Manufacturing, %

Data as at May 31, 2022. Source: BofA Quantitative Research.

Exhibit 26: Capital Investment Leads to Productivity Gains. The Last Major Wave of Capital Investment Occurred in the 1990s and Another Is Currently Underway, We Believe

U.S. Capital Stock vs. Productivity, %



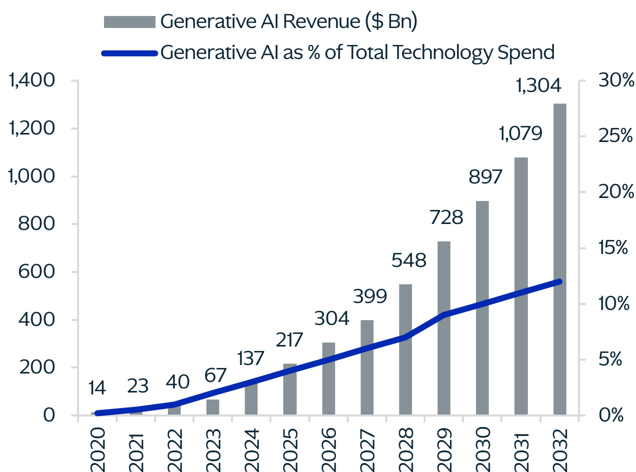
Data as at December 31, 2021. Source: U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, Cornerstone Research, Haver Analytics.

5

Artificial Intelligence

The AI investment opportunity set is massive (some estimates suggest Generative AI revenues may exceed USD one trillion per annum within a decade), but we favor a more nuanced approach to start. Specifically, while direct plays on AI tech development are quite compelling, they are also quite expensive. By contrast, we think a number of non-direct plays on AI, including data center capex, semiconductor manufacturing, power transmission, and distribution will likely also undergo massive investment cycles stemming from the need to develop the underlying infrastructure.

Exhibit 27: Spending on Generative AI Looks Set to Explode in the Coming Years



Data as at June 2, 2023. Source: Bloomberg, International Data Corporation.

Consider that the proliferation of AI work streams also comes at a time when hyperscale operators, which represent roughly half of data center capex, are already dealing with significant backlogs, rising lead times, and higher construction costs. In other words, we believe it will be difficult to quickly scale data center infrastructure to meet the rising demand for computing capacity. All told, some estimates suggest that the servers used in model training and inference could consume an additional 2.5 gigawatts of data center annually by 2024, which represents an increase of 10 – 15% to the current 19-gigawatts TAM (*Exhibit 24*). In addition to higher overall data center demand, we think there will be more focus on power distribution going forward, too: The additional power demand created by AI is related to the fact that AI workstreams are more computationally intensive. It is estimated that the energy density per server rack is ten to thirty times higher for AI servers than for general-purpose cloud computing, meaning each square foot of data center space will require much more power than it did previously. This higher power consumption will further accelerate the transition from air cooling to liquid cooling in data centers, as well, we believe.

However, from a macro perspective, we are less convinced that the productivity-enhancing capabilities of GAI will be enough to offset the impact of demographic headwinds and structural labor shortages on wages. In our view, there are several 'gating factors' that may impede the widespread adoption and implementation of GAI in displacing high-skill service positions including an increasingly complex cybersecurity threat landscape, concerns over data privacy, an uncertain regulatory environment, labor disputes, and shortages of high-end computing capacity. So, while we are believers in the long-term potential of AI, we think that some of the most compelling opportunities in this space may exist outside of mega-cap software companies, and instead have to do with addressing the physical infrastructure bottlenecks and large amount of investment that needs to happen, including building out the 'backbone' of physical infrastructure before GAI can scale.

So, while we are believers in the long-term potential of AI, we think that some of the most compelling opportunities in this space may exist outside of mega-cap software companies.

6

Decarbonization

Decarbonization will remain an important investment theme, but we continue to believe that there are two sides to the Energy Transition 'coin' that an investor must consider. Key to our thinking is that during this transition, there will need to be more investment going back into traditional energy sources such as oil and gas. From our perch, we are also very bullish on the brown-to-green transition across existing corporate and government platforms. These opportunities are the large-scale ones that will allow big sectors of the global economy to become more energy efficient. The last two decades of growth in decarbonization efforts were generally asset-light, driven mainly by advances in software and technology. Those advances, which supported digitalization and services, will still be required to continue fueling growth. However, the climate investing required to really make a difference at scale is likely much more asset-heavy in nature. This reality is largely linked to the requirements for decarbonizing the traditional power generation, property, transportation, and industrial sectors, as well as for upgrading existing global supply chains, buildings, and data centers for sustainability. This reality will be challenging for regulators, many of whom will face a real conundrum between trying to provide the lowest cost to the end consumer in a high inflationary environment balanced against the goals of bolstering the grid for decarbonization and ensuring environmental impact remains low. Clearly these two objectives can be at odds with each other at times, and as a result, regulatory risk remains elevated. Finally, the rise of AI as well as other shifts in new forms of energy will require the footprint of energy distribution to be reworked. This reconfiguration represents a major opportunity for both Infrastructure and parts of Private Equity, we believe.

Decarbonization will remain an important investment theme, but we continue to believe that there are two sides to the Energy Transition 'coin' that an investor must consider. Key to our thinking is that during this transition, there will need to be more investment going back into traditional energy sources such as oil and gas. Maybe more importantly, we are also very bullish on the brown-to-green transition across existing corporate and government platforms. These opportunities are the large-scale ones that will allow big sectors of the global economy to become more energy efficient.

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KKR

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