KKR

Insights

13.3 Global Macro Trends June 2023

Still Keeping It Simple

Executive Summary: Mid-Year Update 2023

Contents

Henry H. McVey
Head of Global Macro
& Asset Allocation,
CIO of KKR Balance Sheet

David McNellis
Frances Lim
Aidan Corcoran
Paula Campbell Roberts
Racim Allouani
Changchun Hua
Kristopher Novell
Brian Leung
Deepali Bhargava
Rebecca Ramsey
Bola Okunade
Patrycja Koszykowska
Thibaud Monmirel
Asim Ali
Ezra Max
Miguel Montoya
Patrick Holt
Allen Liu

This note is an executive summary of our larger report, which also includes global / regional outlooks, insights on the capital markets, and answers to our most asked client questions. Click here for the full report available on KKR.com. We encourage you to reach out to your Relationship Manager for additional information.

Download Full Report

Still Keeping It Simple

Amidst the supply-side-driven regime change that we believe has unfolded across the global macroeconomic landscape, we continue to advocate for 'Keeping It Simple' in today's market. Key to our thinking is that an investor can now earn strong risk-adjusted returns without the need to stretch in terms of either capital structure or counterparty risk. Consistent with this view, we believe investors can create some really attractive vintages in both the private and public markets by doing the little things well, including maintaining linear deployment, ensuring diversification through sound portfolio construction, and hedging currencies and interest rates where appropriate. In terms of what this backdrop means for investing, in our view, now is a really compelling time to be a lender on a global basis. This vintage should not be missed. We also continue to pound the table on the benefits of collateral-based cash flows in portfolios, particularly Infrastructure, Asset-Based Finance, and certain Real Estate projects that are directly linked to positive nominal GDP growth. Finally, within both Private and Public Equities, we remain thematic in our approach and steadfast in our desire to focus on high free cash flow conversion stories, especially corporate carve-outs and public-to-private transactions.

> You have to work hard to get your thinking clean to make it simple. But it's worth it in the end because once you get there, you can move mountains.
>
> **— Steve Jobs, American inventor, designer, and entrepreneur**

No doubt, there is a lot of 'complexity' out there to distract investors.

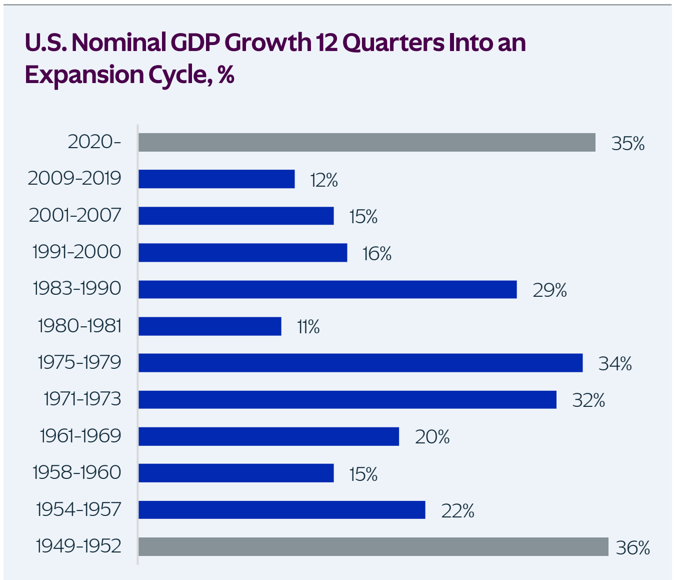
In particular, we have escalating China-U.S./Western tensions, a full-scale invasion of Ukraine by Russia, bank failures, increased political divisiveness, and a surge in AI-related breakthrough technologies. At the same time, central bankers are still trying to unwind what was possibly the greatest coordinated flush of monetary and fiscal spending during COVID that the developed market economies have ever seen.

Yet, despite all this uncertainty, the S&P 500 is up around 14% year-to-date, while the Euro Stoxx 50 and the Japanese Topix have each appreciated about 15% and 20%, respectively. Meanwhile, High Yield bonds have produced a total return of just over five percent year-to-date. Has the market got it wrong? What does this all mean on a go-forward basis? Our take: After multiple trips across Asia, Europe, and the United States to pressure test our macro frameworks in the first half of the year, **we think investors are still too conservatively positioned for the path forward we are seeing for the global economy *(Exhibit 28)***.

Without question, we are all experiencing a complicated, asynchronous global economic recovery following COVID, and we still expect negative EPS growth in 2023. However, similar to what we laid out in our 2023 Outlook note *Keep It Simple*, **we actually remain constructive on risk assets, given stronger nominal GDP growth than in past cycles (*Exhibit 1*). Rarely has there been such an intersection of poor near-term fundamentals, more than offset, we believe, by a compelling technical backdrop (i.e., little new issuance supply, record buybacks) and resounding negative sentiment (S&P 500 shorts are near 30-year highs); at the same time, recent dislocations have created some stand-out investment opportunities that traditional 60/40 investors might be overlooking**. Against this noisy backdrop, Steve Jobs' famous words that "*You have to work hard…to make it simple*" resonate mightily with us. But if you do, the upside is significant as *"you can move mountains"* as an investor, we believe, in this market.

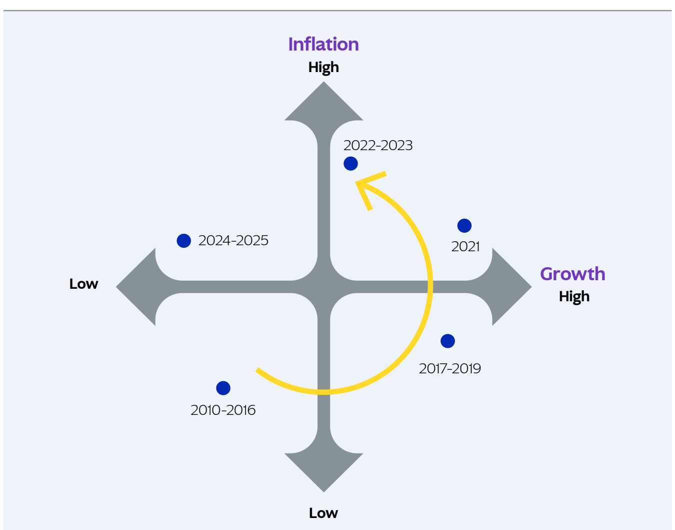
Key Considerations

EXHIBIT 1: It's Actually Been the Fastest Economic Recovery Since the End of World War II



Data as at March 31, 2023. Source: BofA Global Investment Strategy, Haver Analytics.

EXHIBIT 2: While Inflation Has Likely Peaked, We Believe a Regime Change Has Occurred



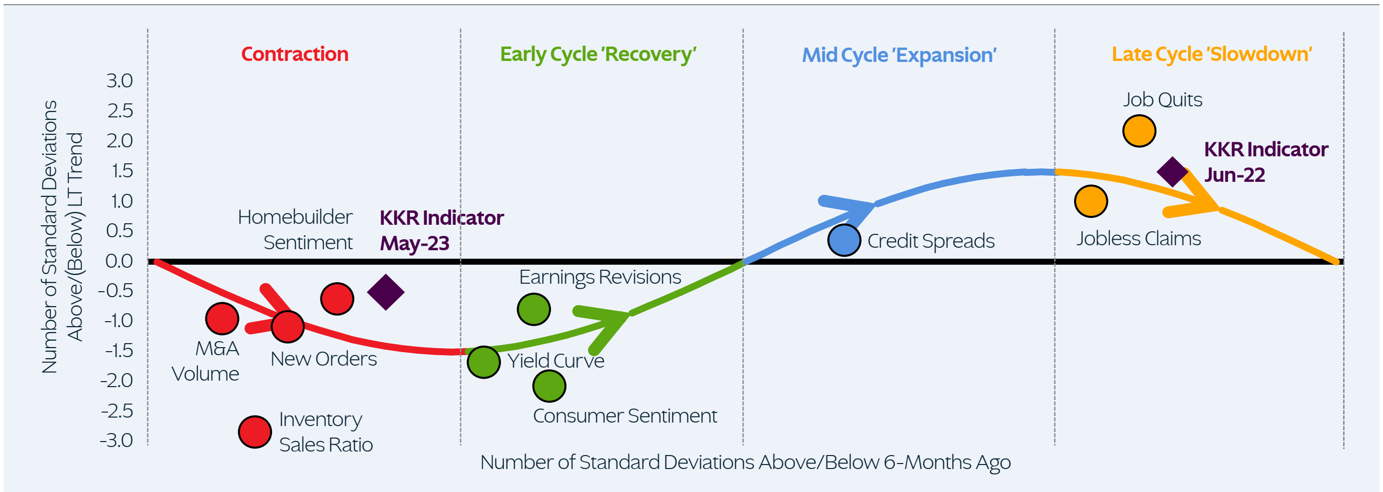
Data as at May 31, 2023. Source: KKR Global Macro & Asset Allocation analysis.

In case there is any question, we want to be on record that we think that the bottom is in for the S&P 500 this cycle, and that it occurred back in October 2022. Similarly, within Credit, our view is that prices are likely to stabilize in the current $85-90 range, and while we expect an increase in defaults, we think the longer-term path is upwards from current levels.

Importantly, we do not think that a CIO can broadly go risk on and/or risk off. Key to our thinking is that the current economic signals are just too varied, which actually makes sense given the supply side shocks we are all experiencing this cycle. Indeed, as we show in *Exhibit 3*, our proprietary four stage model has important inputs actually spread across all different phases of growth (i.e., contraction, early cycle, mid-cycle, and late cycle), and as such, we are experiencing both a rolling recovery and rolling recession at the same time. In the past, by comparison, most of our inputs would concentrate in just one of the phases.

Consistent with this view, we believe investors can create some really attractive vintages in both the private and public markets by doing the little things well, including maintaining linear deployment, ensuring diversification through sound portfolio construction, and hedging currencies and interest rates where appropriate.

EXHIBIT 3: Our Proprietary Framework Suggests That Cyclical Leading Indicators, on Net, Are in a Mild Contractionary Phase in the U.S. Importantly, We Do Not Expect the Same Type of Economic Downside as in Past Cycles, Especially on a Nominal Basis



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

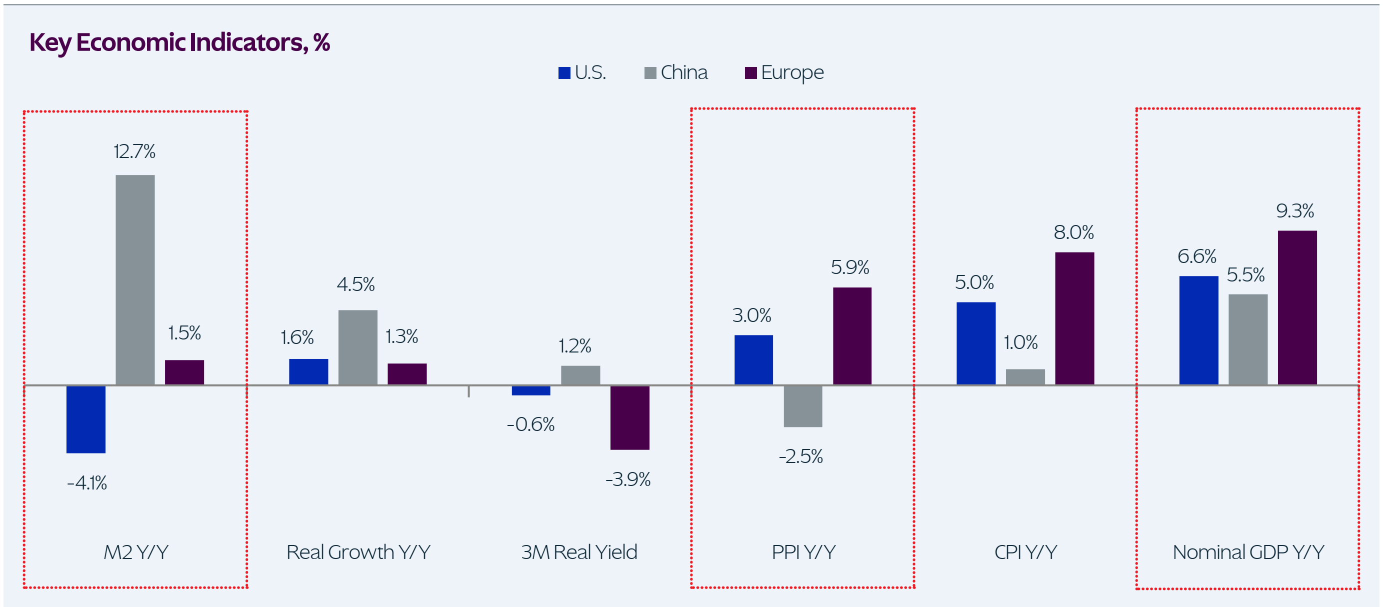
What's Different About This Recovery? Here's What You Need to Know

Constructive/Unusual	Challenges
Strong Technical Backdrop	Stickier Inflation, Especially Services
Low Unemployment Amidst Strong Nominal GDP	Significant Margin Degradation
More Fiscal Spending	Debt Burden Accelerating
Monetary Easing in China Offsetting Tightening in the U.S., Europe, and Japan	Potential for a 2024 Snapback More Limited

Where We Differ From Consensus

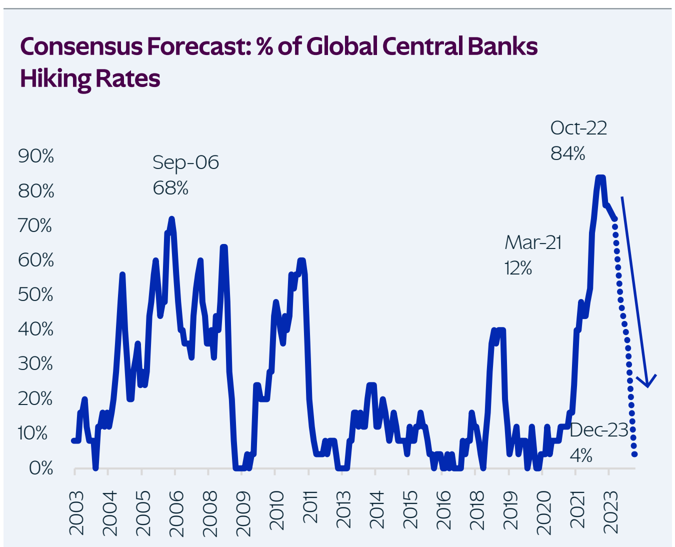
Stronger GDP Growth in 2023, Especially in the U.S.	We are above consensus for growth in the U.S. and China for 2023. Our biggest outlier is the U.S., where we are forecasting Real GDP growth of 1.8% versus consensus of 1.1%. Though we are more conservative on growth in the developed markets in coming years, we think the biggest surprise this cycle may be that growth does not slow as soon or as disastrously in aggregate as the consensus now expects.
We Are Below Consensus for Inflation in Every Region for 2023, But Higher in 2024	We are below consensus on inflation in the U.S. (four percent vs. consensus of 4.1%), Europe (5.3% vs. consensus of 5.5%), and China (1.0% vs. 1.5% for consensus). By comparison, as we head into 2024, we remain above consensus in Europe and the U.S. as a result of higher 'sticky' core inflation and in China as well because of easier year-over-year comparisons.
Regime Change: Inflation Will Remain Higher This Cycle	Although the TIPS curve suggests inflation will be *below* the Fed's two percent target over the next twelve months, we continue to believe in our 'higher resting heart rate' thesis as the crucial disinflationary forces of the last ten years (globalization, lower energy prices, and a labor surplus) have all largely reversed course. Our forecasts suggest that by the end of next year, inflation will have been above the Fed's/ECB's two percent target for 16 out of the last 20 quarters in the U.S. and 14 out of 20 in Europe.
Earnings per Share: Less Bad in 2023, But Less Rebound in 2024	We now expect EPS to decline five percent in 2023 to $210 per share, below consensus of $220 per share. Key to our thinking is that despite positive topline growth, profit margins are starting to contract more meaningfully. Importantly, we believe growth will slow further in 2024 and see a muted rebound of eight percent to $227 per share versus consensus of $245 per share.
Developed Markets Labor Shortage Is Not Going Away	Our work suggests that the U.S. is short of workers on a *structural* basis, as lower participation rates collide with souring demographics and reduced immigration. So, we are not going back to the 'good old days' of labor surplus, even as AI helps to lift some of the burden.
Oil: $80 Is the New $60	Near term cross-currents notwithstanding, we remain constructive on the structural outlook for energy and energy-related investments going forward. We think impressive capital discipline by U.S. producers could support durable long-term pricing that averages closer to $80 per barrel, up from the pre-pandemic range of $50-60 per barrel.
Housing: This Is Not the GFC	While it is likely too soon to be bullish on U.S. housing relative to investor expectations, the big surprise may be that housing doesn't collapse back towards the pre-COVID trend. We think much of the home price appreciation in recent years reflects strong fundamentals such as accelerating household formation and a legacy of underbuilding post-GFC.
Interest Rates: Higher Long-term Yields in the U.S. and Germany	While we see the bund yield rising to 2.75% by the end of 2023 and three percent by the end of 2024, consensus looks for just 2.3% and two percent, respectively. Our thinking is that the impact of ECB balance sheet contraction and the increased need for long-term capital spending linked to the energy transition will drive rates higher at the long-end. In the U.S., we still think that markets are not fully pricing the uncertainty around the pace of fed cuts, which is why we still have 10-year Treasury yields ending the year at four percent.
The Regional Banking Crisis May Be With Us for a Long Time	The Fed has ring-fenced banks' losses on risk-free paper, but one third of small banks' assets are CRE loans. Deposit flight is also still an issue. As such, we think that more regional banks could come under pressure if we are right that the Fed does not cut rates in the near term.

EXHIBIT 4: No Doubt, We Are Experiencing an Asynchronous Recovery



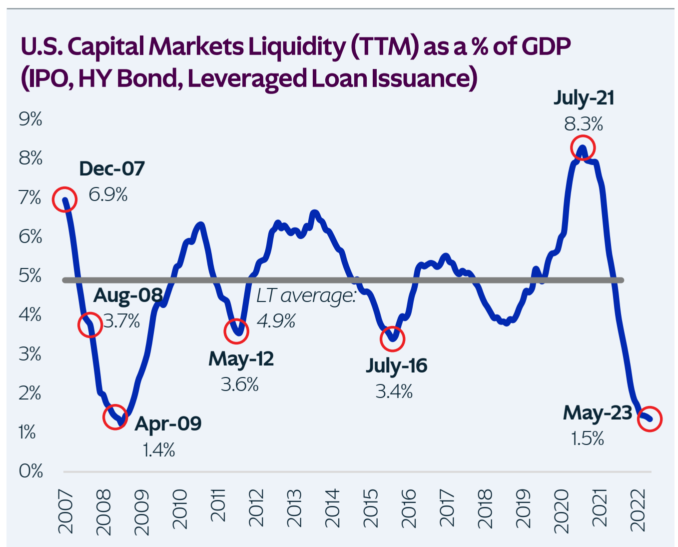
Latest values shown. Real yield calculated as 3M rate - L3M YoY CPI inflation. Data as at May 10, 2023. Source: Bloomberg.

EXHIBIT 5: Good News: Global Central Banks Have Chopped a Lot of Wood, but Both Pace and Level of Rates Still Matter



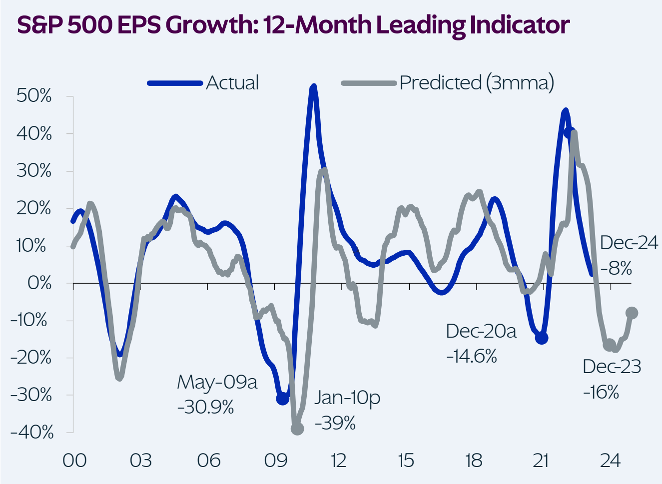
'Hiking' defined as an increase in the policy rate over the last three months. Uses Bloomberg consensus forecast for top 25 global central banks excluding the Federal Reserve. Data as at May 29, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 6: Good News: The Technical Picture Is Still Extremely Compelling, as There Is Literally No Supply of New Issuance



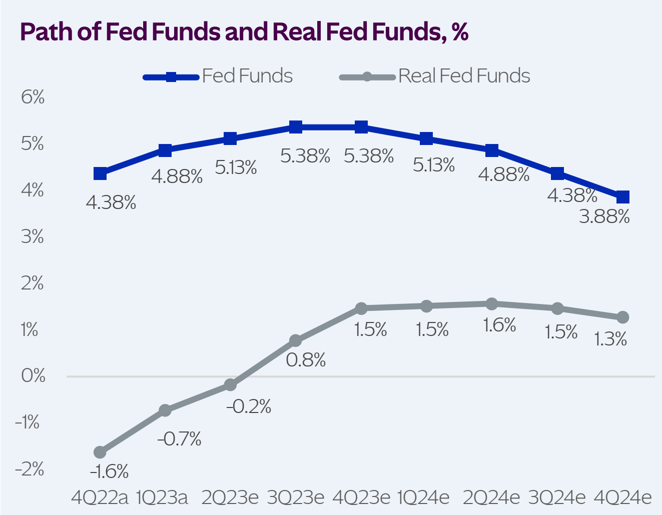
Data as at May 31, 2023. Bloomberg, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 7: Bad News: Our Leading Indicator for S&P 500 EPS Growth Suggests a More Modest Snapback in 2024 Than in Past Cycles



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 May 15, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 8: Bad News: Despite Fed Cuts in 2024, Real Rates Will Be Going Up, Not Down



Real fed funds defined as fed funds - Core CPI. Data as at May 31, 2023. Bloomberg, KKR Global Macro & Asset Allocation analysis.

However, we are not waving the 'all clear' sign, either, as this is not your typical bull market. Indeed, as we show in *Exhibits 7* and *8*, respectively, both lackluster EPS in 2024 and rising real rates likely mean that the traditional risk asset snapback will be more muted this cycle. Accordingly, we are looking for lower expected returns in aggregate this cycle, though there are some notable areas of improvement to consider. One can see this in *Exhibit 11*.

So, our message remains the same: **Keep It Simple**. We believe one does not need to stretch in terms of capital structures or counterparty risks. There will be time for complexity, but now is not that time in the cycle. Indeed, we are likely creating some really attractive vintages by doing the little things well, including maintaining linear deployment, diversifying the portfolio, and not stretching on the return front.

Where to position one's portfolio? Of all the opportunities we see out there in 2023, we believe it remains one of the most interesting times to be a lender that we have seen in recent decades (see *Keep It Simple*, for details of our original thesis, but this call has only gained momentum since the start of the year). Given the ongoing banking crisis, most forms of both Liquid and Private Credit screen well in our forward expected returns analysis. Importantly, the recent turmoil in the U.S. banking system has only reinforced our view that corporations will need to seek alternative forms of lending to fuel growth, make acquisitions, and repay existing loans.

We think too that today Cash is an interesting asset class. It offers high rates of uncorrelated returns, a new reality that, we believe, **should encourage CIOs to think about more of a barbell approach to asset allocation**, including on the one hand, more Cash, and on the other, creating a bigger budget for collateral-based cash flows (e.g., Asset-Based Finance, Real Estate debt, and Infrastructure) as well as Equities with growing dividends.

While we are maintaining our 'Keeping It Simple' mantra, our thinking has continued to evolve. We note the following:

1. **We feel better that we will avoid a major drawdown this year...** Relative to prior cycles, robust government spending, modest debt service burdens, lower unemployment, and some residual excess savings make us feel better that growth is slowing, but not collapsing. As part of this realization, we reduce our negative EPS growth forecast to minus five percent in 2023 from minus 10%. Meanwhile, we increase our U.S. GDP forecast to 1.8% from 1.4% in 2023, which is fully 70 basis points ahead of the consensus.

2. **...But 2024 will likely not see the traditional EPS snapback that one might expect, given higher real yields**. This insight may be the most important one of our mid-year update. Higher real yields – despite lower nominal yields – will prevent the typical 'goldilocks' rally that investors often see when monetary policy changes. Also, the trillions of dollars of unrealized losses and hundreds of billions of

dollars of Office CRE debt now on financial intermediary balance sheets are likely to serve as 'overhangs' to credit creation in the near-term.

3. **Despite slowing headline inflation, our Regime Change thesis remains intact**. There are several factors at play. First, we have more confidence that labor shortage headwinds, particularly in Leisure, Education/Healthcare, and select parts of Professional Services, will lead to structurally faster wage growth across global economies, especially on the services side of the economy. Second, we see geopolitics as a supply driven inflationary impulse, as the 'security of everything' leads to less efficient global supply chains. Third, housing demand largely continues to outstrip housing supply, which means that rental incomes – an important component of inflation – do not tail off as much this cycle. Fourth, the energy transition towards more renewable sources is actually inflationary in nature. Finally, there is more fiscal impulse this cycle than in the past, including global defense spending, the Inflation Reduction Act in the U.S., the Green Act in Europe, etc.

4. **AI: Thorn or rose? We choose rose.** AI has emerged as a wildcard that could both hinder and help our Regime Change thesis and as a result, we are spending a lot of time as a team on this subject. Key to our thinking is that automation gains, including those from AI, could boost productivity and help take some of the sting out of ongoing labor shortages in the developed markets, particularly when it comes to high-skilled services positions. While the semiconductor part of AI story seems to be reflected in the public markets, we are not sure that enough attention has been paid to the other 'picks and shovels' that will be needed to support the AI revolution, including massive investment in grid infrastructure as well as cooling technologies. Just consider that at present training an AI model like ChatGPT for a few months uses about as much electricity as powering 120 homes for a year, along with hundreds of thousands of gallons of water for liquid cooling and more than ten thousand advanced GPUs.

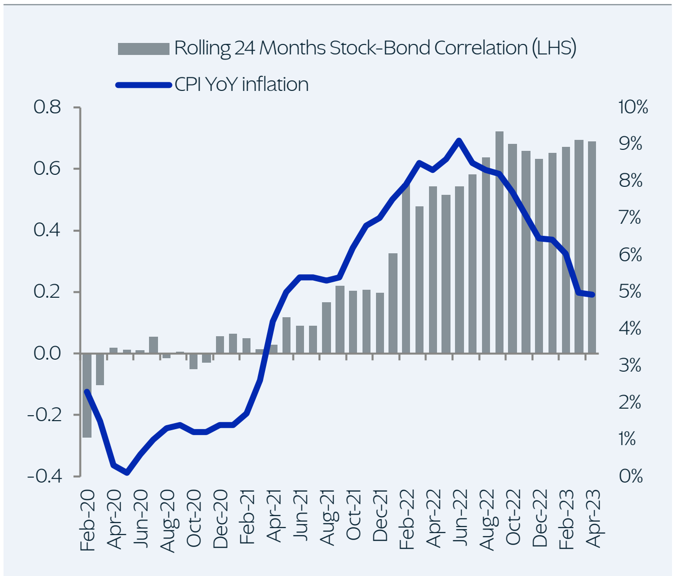
5. **The U.S. consumer will be fine, but the high-end faces new challenges**. On the positive side of the ledger, we only expect unemployment to increase by about 140 basis points on a full-year basis this cycle to five percent, compared to 300-400 basis points during prior cycles, on average. Meanwhile, we 'only' expect home prices – which are the lion's share of most consumers' balance sheets – to fall five percent in both 2023 and 2024 (i.e., values should stabilize around 25% above pre-COVID levels) and we still look for more robust fiscal spending (including tweaks to student loan payment plans, if not outright cancellation). Finally, consumers still have a lot of excess cash. Excess savings skyrocketed during the pandemic and peaked at $2.5 trillion by the fourth quarter of 2021 and are still only approximately 40% spent. However, a lot of the job losses we forecast actually appear to be in more affluent areas of the economy, including financial services and technology. We also have seen net worth fall the fastest this cycle relative to any other cycle, led by financial assets (remember that 90% of all stocks are held by the top 10% of U.S. households), and the excess savings drawdown has been quickest for high-earners. So, similar to the early 1990s, the next few quarters may prove most challenging on a relative basis for wealthier consumers.

6. **Traditional inflation hedges still may continue to disappoint.** See below for details, but investment vehicles such as REITs and TIPS have not worked this cycle. Some of this is related to weaker fundamentals in the REIT sector, as well as the fact that a lot of TIPS holders are DM central banks, who continue to shrink their balance sheets. Our punchline is that there are more compelling ways to play our 'higher resting heart rate' thesis for inflation.

7. **Now is not the time to make a big cap Growth versus Value bet**. While we do not see mega-cap Tech performing well over the long term (given our views on regulation, the law of large numbers, and valuation), these companies' strong cash balances likely mean that they could be perceived as safe havens this cycle. They have also emerged as a back-door play into AI in certain instances. Moreover, given our view that unrealized losses are likely to remain persistent in the financial services system for some time, we think the potential for Value, which is generally overweight traditional lenders and financial intermediaries, could remain pressured.

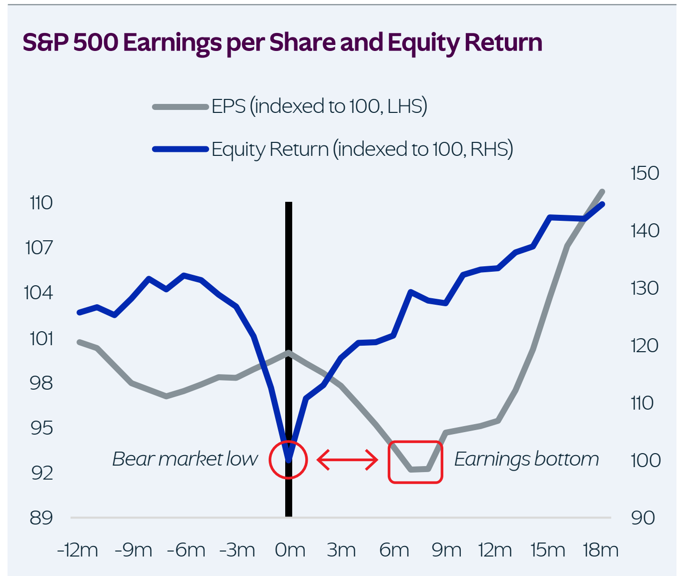
8. **Asset allocation**: **Own more Cash and use risk budgeting elsewhere**. As we detailed above, with Cash earning nearly five percent, the opportunity for CIOs to take a barbell approach to asset allocation with enough dry powder to lean in opportunistically while not denting returns is appealing.

EXHIBIT 9: The Positive Correlation Between Stocks and Bonds Has Continued to Stay Elevated, a Key Feature of Our New Regime Thesis



60-40 Portfolio modeled using S&P 500 and Barclays U.S. Aggregate total returns, assuming weekly rebalancing. Data as at May 31, 2023. Source: Bloomberg, KKR Portfolio Construction analysis.

EXHIBIT 10: Equity Markets Typically Bottom Before Earnings Do. If So, Then We Likely Have Already Bottomed This Cycle



Data as at December 31, 2022. Source: Cambridge Associates, Pitchbook.

EXHIBIT 11: Our Expected Returns Framework Suggests Not Only Lower Aggregate Returns in Many Instances But Also the Need to Think Differently About Asset Allocation

Note: Capital markets assumptions are average across all quartiles annualized total returns. Forecasts represent five-year annualized total return expectations. 'Last five years' through 4Q22 due to limited data availability. For private asset classes (Private Credit, Private Infra, Private Real Estate, and Private Equity), returns are net of Fee/Carry. Note that we have altered our Private Credit methodology to exclude fund-level leverage, which has lowered total return on a go-forward basis. Data as at May 31, 2023. Source: Cambridge Associates, Bloomberg, KKR Global Macro, Balance Sheet and Risk analysis.

So, what are our most important takeaways at mid-year? They are as follows:

1. **Stay the course on deployment and exposure**. It may not feel good to withstand all the volatility, but we remain confident that 2023 and 2024 will be good vintages for investors. Importantly, though, 'Keep It Simple'. We believe investors should focus on earning a solid return without stretching on risk. In high school grading parlance, a 'B' investment today could become an 'A' in tomorrow's market, while a 'C' where one stretches on a risky proposition could become an 'F' over the same time horizon.

2. **Despite cooling inflation in many parts of the economy, we still see enough strands of sticky price headwinds that we think our Regime Change thesis holds**. Said differently, the greater risk to us is that central banks are not able to fulfill the dovish expectations of many investors, given how sticky we think services inflation will prove to be.

3. Given this view, **our work around the path of inflation and its corresponding impact on monetary policy suggests that the upside for traditional risk assets this cycle is more capped than in the past**. Indeed, as *Exhibit 8* shows, despite the Fed easing in 2024, real rates are actually not falling next year. By comparison, we have been living in a world of late where real rates have stayed largely negative in western economies, despite record tightening by most global central banks.

Our bottom line: We believe that this cycle, all investors will likely need to think differently to achieve their financial objectives. Specifically, we are now in a grinder market that – despite the conventional wisdom that easier monetary policy is a straightforward 'risk-on' signal – will likely remain quite challenging for conventional investors. If we are right, then both individual and institutional investors will need a thoughtful top-down approach that includes a greater reliance on different strategic approaches to asset allocation (see our *Regime Change* series developed in partnership with Racim Allouani), including more reliance on upfront cash flow (e.g., dividends, floating rate debt, etc.) as well as flexible capital to buy dislocations, especially with the opportunity to move higher up in the capital structure.

EXHIBIT 12: Based on Historic Returns, the Addition of Private Equity to Portfolios Can Often Help Achieve Better Performance Across a Diversified Portfolio

	Return	Volatility	Sharpe Ratio	Δ vs. 60/40	% Liquid Asset	Cash Yield
All Periods by Portfolio						
60/40	9.3%	12.7%	0.73	-	100%	2.6%
40/30/30	9.6%	9.6%	1.00	+0.26	70%	3.6%
Private Wealth	10.6%	10.6%	1.00	+0.27	70%	3.2%
Institutional	10.9%	9.2%	1.18	+0.45	55%	3.5%
High Inflation by Portfolio						
60/40	1.5%	12.5%	0.12	-	100%	2.6%
40/30/30	4.3%	8.8%	0.49	+0.36	70%	3.7%
Private Wealth	5.3%	9.1%	0.57	+0.45	70%	3.2%
Institutional	6.9%	8.6%	0.80	+0.68	55%	3.5%
Low Inflation by Portfolio						
60/40	11.0%	11.5%	0.96	-	100%	2.6%
40/30/30	10.5%	9.1%	1.16	+0.21	70%	3.6%
Private Wealth	11.5%	10.2%	1.13	+0.18	70%	3.1%
Institutional	11.4%	9.3%	1.23	+0.27	55%	3.5%

Portfolio returns and volatility modeled using annual total returns from 1928 to 2021 for the S&P 500, from 1978 to 2021 for Real Estate, from 2004 to 2021 for Infrastructure, from 1928 to 2021 for Bonds, from 1981 to 2021 for Private Equity, and from 1987 to 2021 for Private Credit. Assumes continuous rebalancing of the portfolios. US equities modeled using the S&P 500 Index. Bonds modeled using a mix of 50% US T-Bonds and 50% Baa Corp. Bond annual returns, computed historically by Aswath Damodaran (NYU Stern). Real Estate modeled using the NCREIF Property Levered Index. Private Infrastructure modeled using the Burgiss Infrastructure Index. Private Equity modeled using the Burgiss North America Buyout Index. Private Credit modeled using the Burgiss Private Credit All Index. Yield calculation using annual data from 2000-2021 for all asset classes with the exception of private real estate (2005-2021), Public Equity using S&P 500 12M gross dividend yield, Private Equity proxied using S&P Small Cap 12M gross dividend yield, Private Infra proxied using S&P Infrastructure 12M gross dividend yield from 2006 onwards and 2000-2006 back filled using S&P Utilities, Public Credit based on Bloomberg Aggregated Credit yield to worst, Private Credit using Cliffwater Direct Lending Index Income Return, Private Real Estate based on NCREIF NPI cap rate, Source: Burgiss, Aswath Damodaran, Bloomberg, NCREIF, KKR Portfolio Construction analysis.

SECTION I

Asset Allocation and Key Themes

Picks and Pans

PICK (OLD) Japan We are still bullish that Japan is breaking out from a deflationary 'funk' (see *Thoughts from the Road: Asia*). The equity market is attractively priced, corporate governance is improving, and the economy is opening up. Within Private Equity, too, we like Japan, especially activity linked to corporate carve-outs.

PICK (OLD) Overweight Collateral-Based Cash Flows We favor cash flows actually linked to nominal GDP, not traditional inflationary hedges such as TIPS. Instead, Asset-Based Finance, Real Estate Credit, and most parts of Infrastructure are near the top of our list. Importantly, they are performing as inflation hedges in a cycle when most traditional hedges are not.

PICK (NEW) Overweight Cash With yields topping five percent in the U.S. and rising in other large markets like Europe, we think Cash can play a vital role in asset allocation as a low correlation yielding asset. In fact, we believe that Cash may be one of the most attractive relative value plays in the market today. Because Cash reduces risk, an overweight to Cash should also allow CIOs to transfer their risk budgets to other higher risk asset classes when and if they want to lean in, especially investments linked to nominal GDP.

PICK (NEW) Higher Quality Liquid Credit Given the move in risk-free rates, investors can get a very decent return lending to high-quality companies right now, including through CLO liabilities and some parts of High Yield. Our view is that CLO liabilities offer attractive volatility adjusted returns across AAA-BB ratings, with more junior tranches (BBB/BB) also offering relatively attractive leverage-adjusted returns and wider spreads versus history. Meanwhile, although HY spreads are not yet 'cheap', the risk free rate has adjusted massively this cycle, so we are in a very different environment than 2008. Against this backdrop, we do not expect a particularly severe default cycle. Also, better quality in the capital structure is helping to reduce the tail risk of surging losses for HY debt, particularly for higher-quality tranches. For instance, we note that 27% of the BB market is now senior secured, up from around *zero* percent at the onset of the GFC.

PICK (NEW) Flexible Capital to Prefered Securities, Convertible Preferred Securities, etc. Without question, not every company is going to be able to refinance itself through debt, especially now with short rates at above five percent. As a result, we are increasingly seeing more levered corporates beginning to issue debt-like instruments with equity upside to fund growth, protect their ratings, and/or maintain adequate cash balances. So, the opportunity set to 'plug' these holes seems extremely attractive to us these days, and we would lean in aggressively.

PICK (NEW) Middle-Income Consumer In mid-2022, we wrote that the outlook for high-end consumer spending was especially strong, given lower exposure to inflation and stronger balance sheets. Today, by comparison, we have a different call, as wealthy households have been drawing down savings; at the same time, high-paying roles have started to lay off workers. By contrast, middle-income consumers' assessment of their finances has – on the margin – been improving in recent months, and we have more confidence that home values – a key support to middle-income household spending – will avoid a painful reset. As such, we think that leaning into the middle-income consumer segment on a relative basis right now likely makes good sense.

PICK (NEW) More Non-Correlated Assets We think non-correlated assets should be added at the expense of traditional long/short hedge funds. One area of opportunity of late is where today's higher rates can help a manager take closed blocks of life insurance, reset the portfolio, and earn returns often well above the guaranteed liability. Separately, we favor absolute return managers, especially those who are leveraging technology to improve their selection and portfolio construction processes.

PAN (OLD) **Short the USD** There are several factors underpinning our thesis. First, the dollar appears to be trading at a premium on a long-term basis. Second, we see other major economies like Europe and Japan going further on a relative basis when it comes to tightening this cycle. Finally, our travels lead us to believe that, since the Russia-Ukraine war, more global corporates and allocators want more optionality with what they view as the reserve currency.

PAN (OLD) **Underweight Regional Banks** As we discussed in our *2023 Outlook* note, a lot of smaller banks are burdened with losses from both duration and commercial real estate credit (see our frequently asked question section for further details). While the current environment is not the same as the GFC, we expect a multi-year process as banks deal with challenges to both the asset and liability side of their balance sheets. We also believe that many will struggle to raise equity without material dilution in shareholder value.

PAN (NEW) **European Cyclicals** Although we are overall quite bullish on Europe, we believe that cyclical sectors may continue to come under pressure. Specifically, a stronger euro, decarbonization and de-globalization trends, could lead to many stalwarts, such as German exporters, being more at risk, particularly as prices still look rich relative to fundamentals. To this end, we would pair European cyclicals as a hedge against one's overall portfolio heading into 2H23.

PAN (NEW) **Turkey** We maintain a cautious stance as Turkey's economy continues to be uneven including higher than expected inflation, linked to unusual government policies. The lack of new investment as well as unorthodox monetary policy, we think, will hinder the country's ability to reach its full potential.

PAN (NEW) **Businesses with Lots of Staff Turnover** As we wrote in our labor note *Eye of the Tiger*, in a structurally tight labor market worker tenure matters more than ever, particularly when it comes to realizing the benefits of worker upskilling and retraining. In the U.S., worker turnover rates are 2-3x higher than in other developed countries, which we think points to room for improvement in aligning employees' incentives with management.

In terms of key risks on which to focus, we see three (and see Section IV below for more details). First, we think that the trillions of dollars that have been accumulated in unrealized losses will act as an important 'hangover' to credit creation for multiple quarters. Moreover, if the Fed needs to do more tightening, this crisis could extend from the banking to the life insurance industry. To date, lapses on annuities have remained tame (which was not the case in 1994). Second, we could be wrong about cyclical inflation coming down in 2024. Our work shows that six percent short-rates, which is about 75 basis points higher than our base case, represent somewhat of a tipping point for all the leverage that is in the system. Third, our recent trip to China reinforced our view that it is different this time when it comes to U.S.-China relations. Coupled with the ongoing conflict in Ukraine, the potential for an external shock that adversely affects both the global economy and capital markets is as high as we can remember during our thirty-two years on Wall Street. It is also important to recognize that political division and dysfunction in the U.S. and other democracies also remain elevated.

Looking at the big picture, we remain convinced about our Regime Change thesis and what it means for investing and asset allocation. No doubt, China stands as a disinflationary outlier in the near term, and U.S. headline inflation is cooling. Europe too will be helped by declining energy costs. However, we think this cycle is different. Key to our thinking is that the Western world is seeing a sustained supply shock, driven by labor shortages, heightened geopolitics, and a messy energy transition, all of which will contribute to a higher 'resting heart rate' for inflation over time relative to the prior cycle, we believe.

Against this backdrop, our message remains largely consistent: 'Keep it Simple'. Now is the time to own more assets linked to nominal GDP, invest higher up in the capital structure where appropriate, and diversify one's holdings across geographies and capital structures at a measured pace. Also, portfolio construction will matter more than ever, including fulfilling linear deployment targets as well as finding new shock absorbers to replace traditional government bonds (given stock-bond correlations have changed). In Credit, focus more on the rebound in fundamentals versus looking for distressed opportunities. Finally, we think the opportunity set to marry the macro with the micro has never been richer. In our view, it is that marriage that will lead to superior results in a world where we are forecasting a decline in overall expected returns across several major asset classes *(Exhibit 11)*.

Key Themes

In terms of key themes, we note the following:

1

Buy Simplicity, Not Complexity, at this Point in the Cycle.

We have often favored complexity over simplicity to avoid overpaying when markets get expensive. This current period, however, is not one of those times. When it comes to Credit, we believe investors should buy high quality Liquid and Private Credit as well as mortgages where the company or collateral is cash flowing. For cross-over funds, we particularly like preferred or convertible security offerings that 'plug' a financing hole, especially where there is an incentive to get called away within a few years and/or pay down the debt. Within Equities, small and mid-cap stocks are cheap by almost all metrics, and on a currency adjusted basis, REITs in the UK and many sectors in Japan (banks and certain multinationals in particular) appear quite cheap, we believe. By comparison, now is not the time to try to call the bottom on unprofitable Tech or lend to a zombie company to capture an additional 100-200 basis points of yield.

2

Real Assets: We Still Favor Collateral-Based Cash Flows and Continue to Pound the Table on this Theme.

Our proprietary survey work suggests that because too many investors are still underweight Real Assets in their portfolios, there remains a high degree of latent demand for this asset class across family offices, endowments and foundations, and insurance companies. Moreover, the fundamentals are compelling, especially on the Energy, Asset-Based Finance, Real Estate Credit, and Infrastructure sides of the business. Also, as we detail below, we think that Real Assets, and Energy in particular, remain a good hedge if we are right about the dollar weakening further.

3

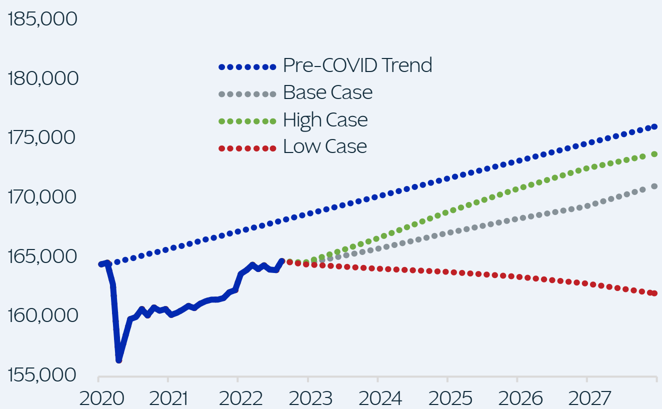
Ongoing Labor Shortages – Combined With More Accessible AI – Will Only Accelerate the Trend Towards Automation/Digitalization.

With labor costs set to increase further amidst sluggish demographics, a dearth of trained workers for key sectors, and a lower participation rate and less immigration, we think that corporations will focus increasingly on technology-driven productivity gains. Without question, we are still in an era of innovation and think that the pace of disruption will only accelerate, particularly as it relates to technological change across multiple industries faced with increasing labor costs. So, if history is any guide, worker scarcity will inspire another era of automation discoveries, including a greater focus on worker retraining (*Exhibit 16*). AI will certainly play its part too, we believe. Recent work from the investment bank Goldman Sachs suggests that two-thirds of current jobs will likely benefit from or be impacted by AI. As such, we think wider adoption of these technologies could usher in an era of increased productivity and economic growth, particularly as periods of innovation are typically followed by the creation of new jobs (which helps offset technology-driven job losses). In the near-term, however, our highest conviction idea is linked to expanding the 'backbone' of the grid and cooling infrastructure that will be required to make AI the success many CEOs and investors believe it can be.

We Will Need More Focus on Worker Retraining, Too. Note that more than half of U.S. firms, three-quarters of EU firms, and nearly *90%* of Japanese firms report a shortage of skilled workers. While AI can help mitigate this shortage, we doubt it will be able to fully resolve it, especially as higher entry-level wages attract young people towards the workforce and away from formal education. One can see this phenomenon in *Exhibit 15*, which suggests that competition for junior workers today could ultimately disrupt the pipeline of skilled workers in the future. Against this backdrop, we think that there will be more opportunities for both workers and employers to lean into worker retraining as formal degrees become scarcer and the population ages further. If we are right, then skills training will become even more of a priority as the U.S. and Europe both seek to reshore key industries where manufacturing will be needed. In our view, the opportunity set around worker retraining is particularly large in the U.S., which has historically lagged badly when it comes to public investment in worker education. In fact, the U.S. government invests less in worker training and transitioning than almost every other OECD country for which data are available (ranking 31st out of 32nd, just ahead of Mexico).

EXHIBIT 13: We See a Structural Labor Shortage Unfolding Across Developed Markets, Including the United States

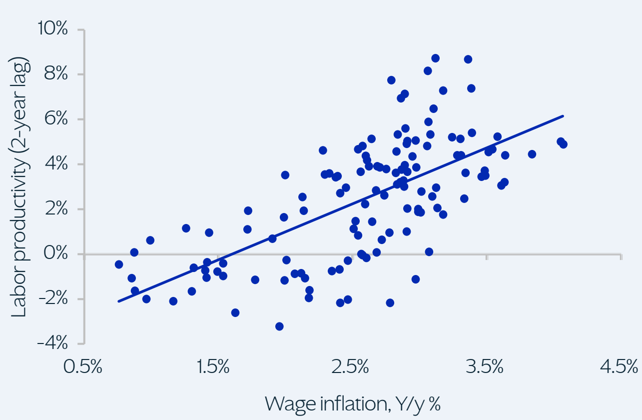
Pre-COVID Trend and KKR GMAA Forecast of U.S. Labor Force Size, 000s



Data as at December 31, 2022. Source: Congressional Budget Office, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 14: Worker Shortages Have Consistently Created New Opportunities Around Automation

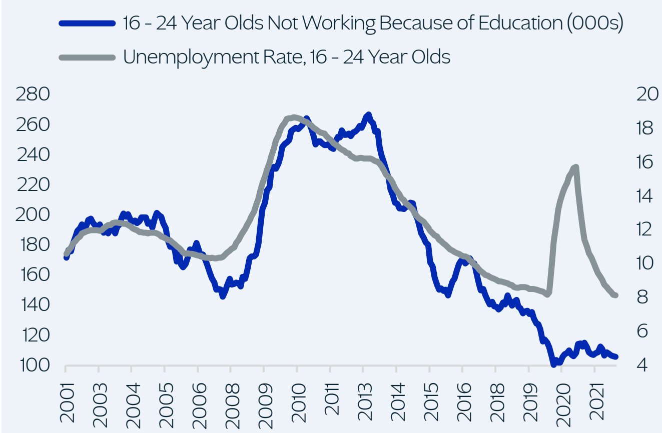
Wage Inflation vs. Labor Productivity in U.S. Manufacturing



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

EXHIBIT 15: We Think Higher Entry-Level Wages Will Attract Young People Towards the Workforce and Away from Formal Education

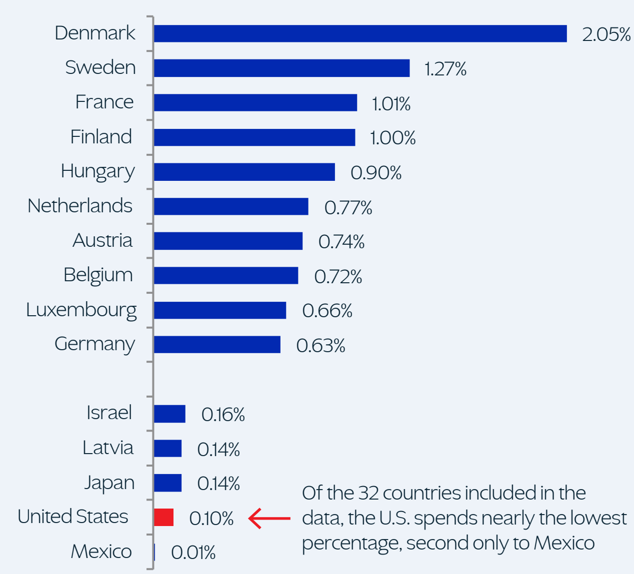
U.S. Labor Market Tightness and College Enrollment



Data as at October 31, 2022. Source: U.S. Bureau of Labor Statistics.

EXHIBIT 16: The U.S. Has Historically Underinvested in Worker Upskilling

Public Expenditures on Assistance and Retraining for Unemployed Workers in Top Developed Economies as a % of GDP



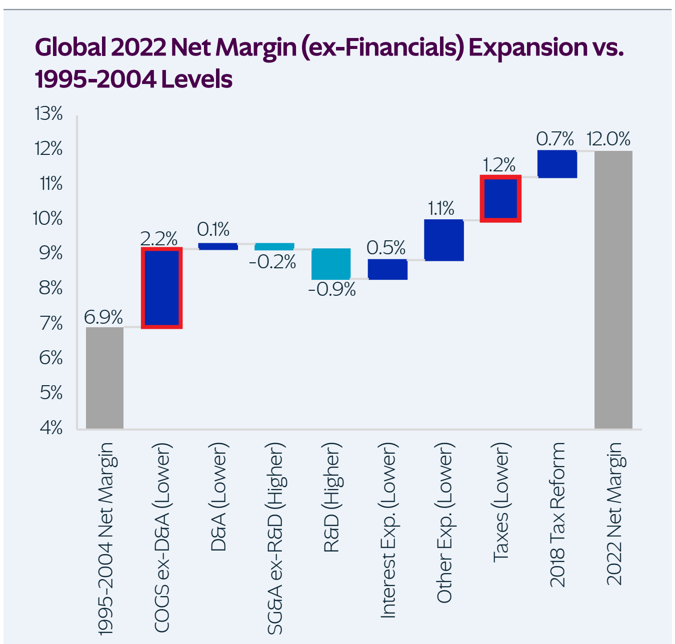
Data as at December 31, 2022. Source: U.S. Department of Commerce.

4

Resiliency: The Security of Everything.

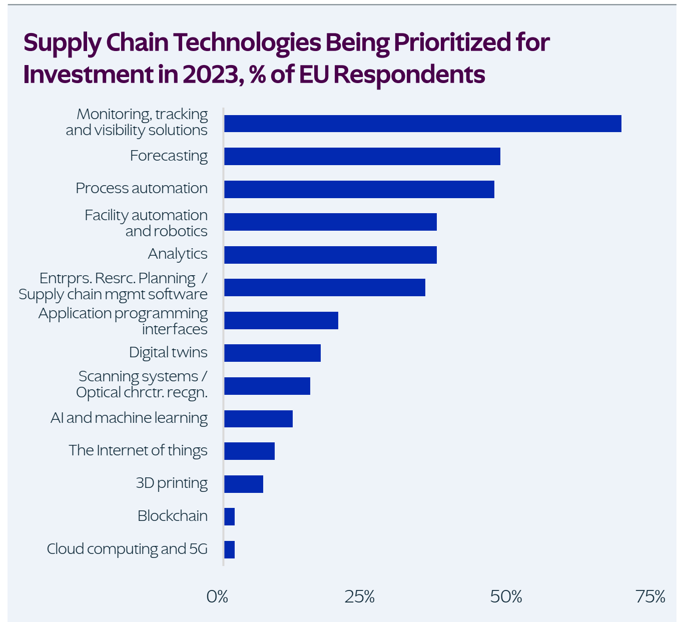
Recent travels across Asia, Europe, and the U.S. confirmed that, as my colleague Vance Serchuk often reminds me, we have shifted from a period of benign globalization to one of great power competition. This shift is a big deal, and it means that countries, corporations, and even individuals will need to build out more redundancy across not only energy but also data, food, pharma, technology, water, and transportation. These sectors and their supply chains will be subject to greater geopolitical oversight, in terms of both industrial policy intended to build national providers of these services, and also scrutiny of foreign investment and resiliency of supply chains. Also, almost all aspects of defense spending are poised to surge. All told, our 'security of everything' concept represents hundreds of billions of dollars in opex and capex that may help to inspire more growth across major economies than typically occurs during an economic slowdown.

EXHIBIT 17: Factors Related to Globalization Have Driven Net Margin Expansion Since 1995. We Do Not Expect This Trend to Continue



Data as at December 31, 2022. Source: BofA U.S. Equity & Quant Strategy, FactSet.

EXHIBIT 18: Investing Behind Enablers of Supply Chain Visibility and Automation Are the Most Immediate Priorities for European Businesses



Survey conducted between December 12, 2022 and January 9, 2023 (101 Respondents). Source: JLL, *The State of the European Supply Chains 2023*.

5

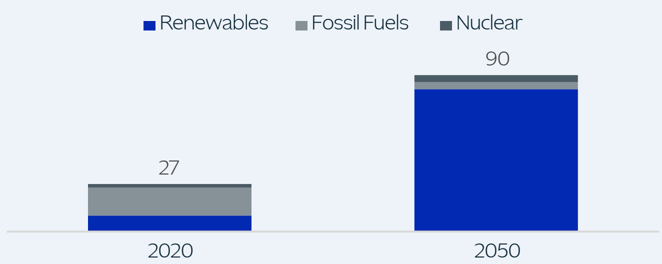
The Energy Transition Remains a Mega-Theme.

We've been pounding the table for quite some time that the energy transition as a theme is probably as massive as the Internet opportunity was around the turn of the century. Just consider that a recent analysis from *Financial Times* found green power generation capacity globally may need to increase by roughly 800% by 2050 to meet current climate goals (*Exhibit 19*). This undertaking will need to span multiple decades and trillions of dollars in capex, including significant investment in all areas of power generation, transmission, and distribution. Along the way, we think that there will be both winners and losers, with the same variety of outcomes and bifurcation in results as we saw during the early days of Internet adoption – think Pets.com bankruptcy versus Amazon's success. However, the generosity of the recent Inflation Reduction Act (IRA) should lead to more winners than losers in the United States, we believe.

Interestingly, though, *while the Internet was a deflationary global force, the energy transition is an inflationary one*. Most commodities required to support growth in onshore wind, offshore wind, batteries, etc., need a lot of energy to mine and process. Moreover, many are sourced from unstable areas of the globe. Around 65% of the total global refining of such commodities, including lithium (72%), cobalt (71%), and manganese (99%) is now done in China at a time when U.S.-China tensions are running hot. Finally, the energy transition will need to address energy security and affordability, as well as sustainability, which will impact its direction and speed.

EXHIBIT 19: Green Power Generation Capacity Globally May Need to Increase Roughly 800% by 2050

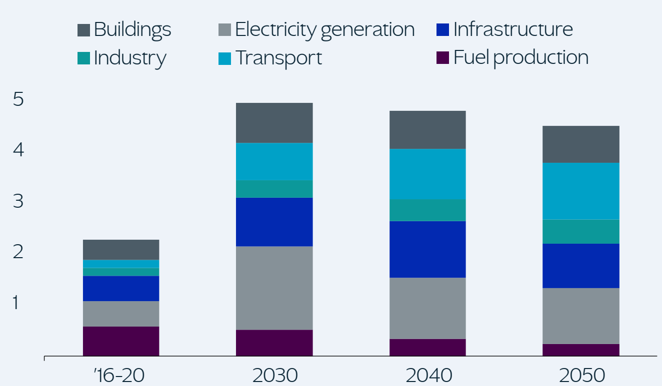
Gross Electricity Generation Under 1.5C Target Scenario (PWh)



Data as at June 11, 2023. Source: IEA, Financial Times.

EXHIBIT 20: Total Annual Capital Investment in a Net Zero Global Emissions Scenario for Energy Rises From 2.5% of Global GDP to About 4.5% by 2030

Annual Average Capital Investment in Net Zero Emissions, US$ Trillions (2019)



2030-2050 are estimates. Data as at April 2021. Source: Goldman Sachs Global Investment Research, IHS Global Insight.

We also want to underscore that digitalization, including AI, is putting more pressure on the energy transition, particularly grid and energy distribution. Our research shows that AI servers consume 10-30x more energy than traditional cloud storage, and as a result, gaining access to the right power sources will be even more important for growth. All told, by 2030 data centers alone will consume eight percent of total global energy with about 50% of that for cooling – and AI has introduced considerable upside risk to these estimates.

6

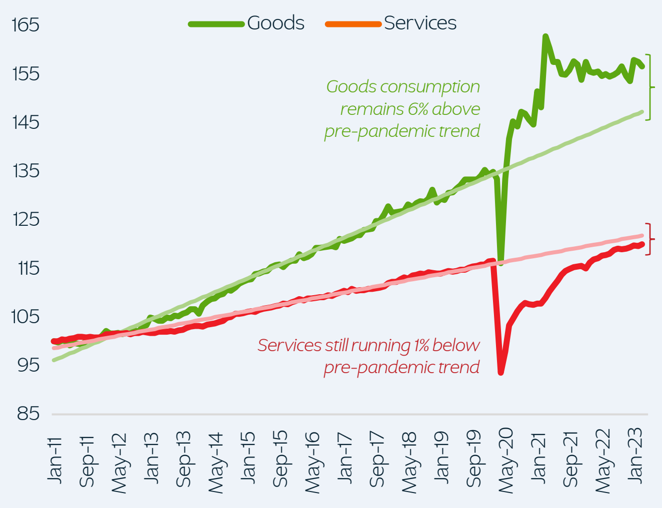
Normalization: Revenge of Services.

For the better part of two years now, we have been suggesting that U.S. consumption would eventually normalize, with services gaining wallet share at the expense of goods. That call has largely been the right one, particularly over the last year, and we think it will continue to play out through the remainder of 2023. Given that U.S. real goods buying is still running six percent *above* trend (down from a peak of 17% in 2021), while services is running one percent *below* trend (up from nine percent below in 2021), we continue to support flipping exposures towards services, which we now think could run ahead of trend for several years. However, this is not just a U.S. call. In Asia, for example, the economy has only just opened up, and as a result, services activity is still well below pre-COVID levels, while in Europe we are seeing a bifurcation between the more industrialized 'core' economies and the service-providing periphery. As such, if the U.S. is a precursor to what other economies will experience, sectors such as tourism, health and beauty services, and entertainment still have a long way to go internationally, we believe.

This shift is a big deal, and it means that countries, corporations, and even individuals will need to build out more redundancy across not only energy but also data, food, pharma, technology, water, and transportation.

EXHIBIT 21: The Pandemic Catalyzed a Shift Into Goods Over Services...

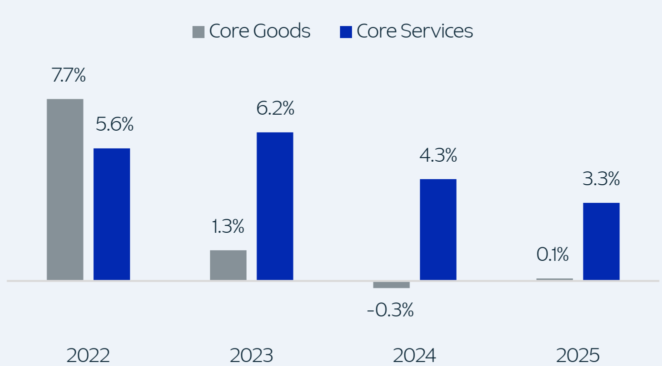
U.S. Real Spending on Goods and Services Relative to Pre-Pandemic Trend



Data as at March 31, 2023. Source: U.S. Bureau of Economic Analysis, Haver Analytics.

EXHIBIT 22: ...Which Is Now Reversing

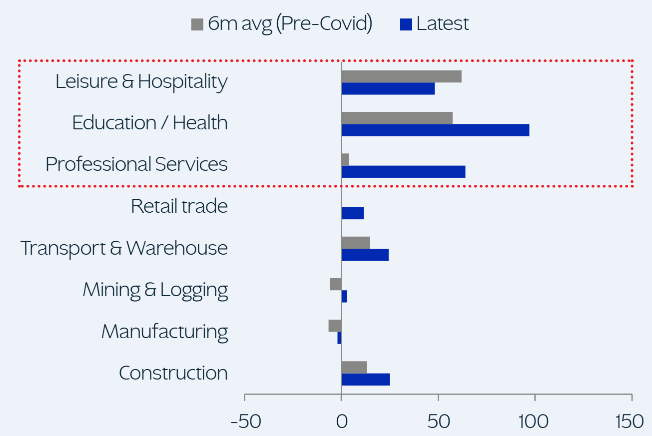
Full Year Actual and Forecast U.S. Inflation, %



2023-2025 are KKR Global Macro & Asset Allocation forecasts. Data as at April 30, 2023. Source: U.S. Bureau of Economic Analysis, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 23: U.S. Job Gains Are Shifting to Services

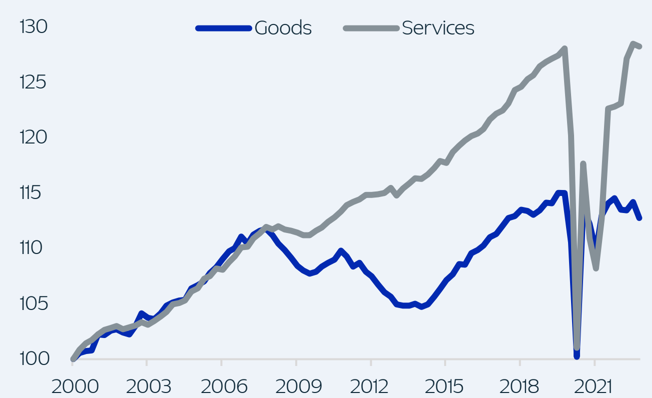
Payroll Growth: Major Services and Goods Sectors (Change '000)



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

EXHIBIT 24: We Still See Significant Upside for Consumer Spending on Experiences in Europe

Euro Area Consumer Spending by Component, 1Q2000 = 100



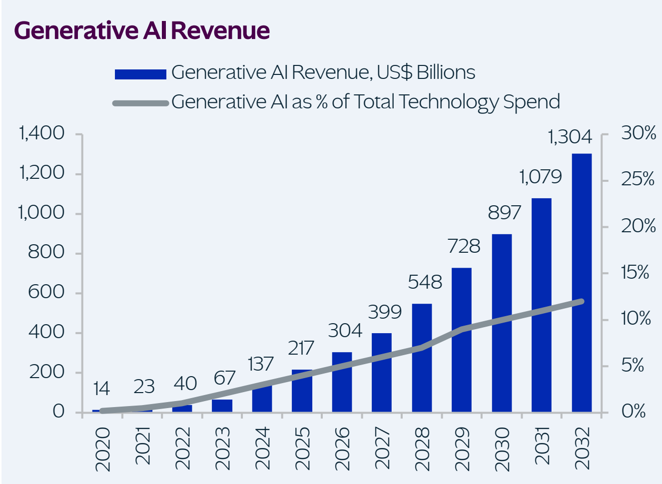
Data as at December 31, 2022. Source: Eurostat.

7

The Emergence of Generative AI

We are seeing a complex but compelling picture for value creation in Generative AI. To be certain, there is a massive opportunity for the tech businesses that bring AI models to market. Indeed, estimates suggest that Generative AI revenues will exceed U.S. dollar one trillion per annum within a decade *(Exhibit 25)*, creating a large new market for the tech industry to address. However, as we mentioned above, there could also be substantial opportunities for other, non-direct plays on AI, including supportive infrastructure such as cooling, access to power (particularly on the transmission/distribution side), and resiliency of supply (including advanced semiconductors and GPUs).

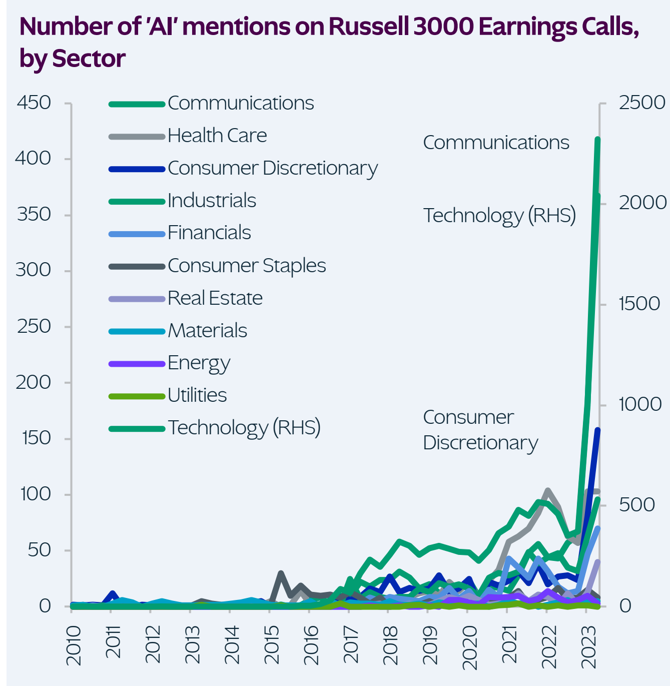
EXHIBIT 25: Spending on Generative AI Looks Set to Explode in the Coming Years



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

Importantly, in seeking to integrate Generative AI, management teams must be open to the possibility that the opportunity could be on the cost or revenue side, or both.

EXHIBIT 26: AI Is a Major Focus for Management Teams Across Sectors

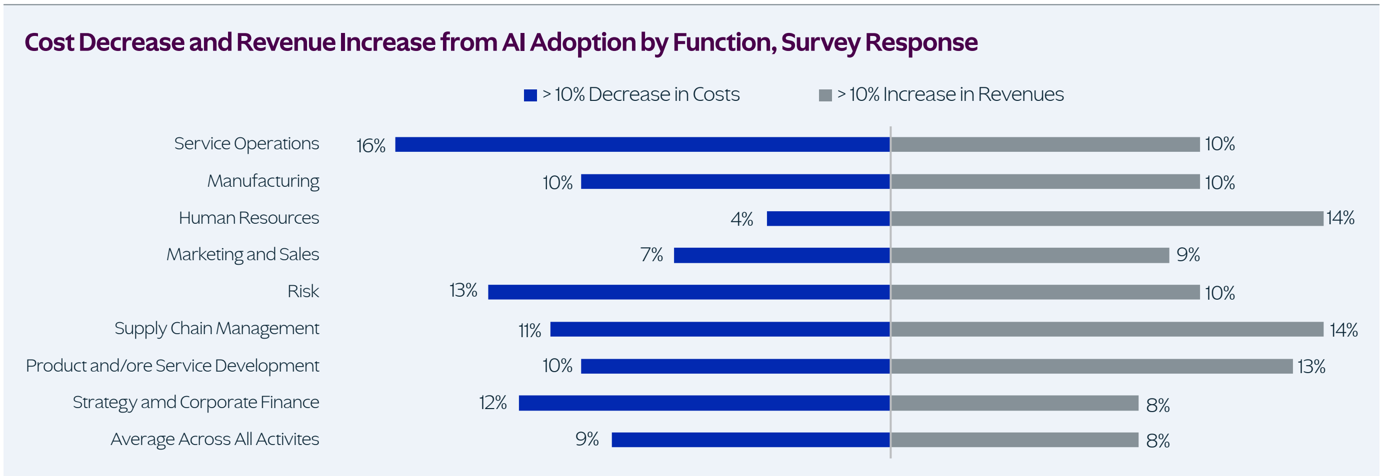


Data as at June 2, 2023. Source: Bloomberg.

Maybe more important, unlike the technology value creation plays that markets have already quickly moved to price in (e.g., think NVDA), the creation of value in non-tech sectors is just getting started, we believe. Importantly, in seeking to integrate Generative AI, management teams must be open to the possibility that the opportunity could be on the cost or revenue side, or both. As shown in *Exhibit 27*, most businesses that have incorporated AI in their business models are seeing both material cost reductions as well as revenue increases.

To date, we have already seen the emergence of AI assistants for software developers, offering the promise of significant reductions in the time taken to develop new code. However, as we look ahead, we believe workers in most knowledge-driven professions could benefit from having a similar 'co-pilot' observing how they work, synthesizing information, and providing suggestions. For example, workers in scientific fields, such as medicine, face a daily deluge of new scientific publications, which AI could easily interpret and summarize. An AI co-pilot could further assist in medical diagnosis, since it will have the full breadth of historical case data at its fingertips, and would not suffer from the same human cognitive biases. Even in Human Resources, an area traditionally viewed as a cost center, smart companies are finding notable revenue opportunities via AI-supported performance and talent management.

EXHIBIT 27: Companies Must Focus on Both Cost and Revenue Opportunities from AI to Realize its Full Potential



Data as at June 2, 2023. Source: McKinsey & Company State of AI 2022 Survey, Artificial Intelligence Index Report 2023, Stanford Institute for Human-Centered Artificial Intelligence.

Our bottom line is that, while we remain in the infancy of Generative AI adoption, there could be 'picks and shovels' infrastructure plays as well as non-technology opportunities that the market may be underappreciating. If we are right, then the recent outperformance of a few large capitalization technology stocks should reinforce our message that investors may already be missing the true breadth of the value creation opportunity within this new mega theme.

Key to our thinking is that automation gains, including those from AI, could boost productivity and help take some of the sting out of ongoing labor shortages in the developed markets, particularly when it comes to high-skilled services positions.

Important Information

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

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

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

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

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

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

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

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

KKR

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