KKR

KKR GLOBAL MACRO TRENDS

June 2023 Midyear Update

Frequently Asked Questions

01

Where do we see value across asset classes?

Given that KKR now oversees more than $500 billion across almost all asset classes, versus just $60 billion in 2011 when we started the firm's macro and asset allocation effort, the firm's ability to evaluate relative value has likely improved mightily, we believe. See below for details, but our punch line is that we are in a different era for asset allocation, in which one does not have to stretch for risk in order to earn a decent return, and where there *are* actually some attractive alternatives out there to mega-cap S&P 500 names.

- **Do not miss this current vintage: This is an opportune time to be a lender.** We continue to favor Credit over Equities on a relative basis for larger pools of liquidity. Our risk premium framework – which compares the market implied cost of equity to the yield on U.S. High Yield credit – shows that the current excess return offered by Public Equities is fully one standard deviation below the post-GFC average (*Exhibit 2*). Moreover, only 10% of S&P 500 companies currently offer a dividend yield that is higher than their own corporate bond yield, which is one of the lowest levels in 13 years and well below the post-GFC average of about 30% (*Exhibit 3*). We see a similar dynamic in Europe where the percentage has fallen to 12-year lows.

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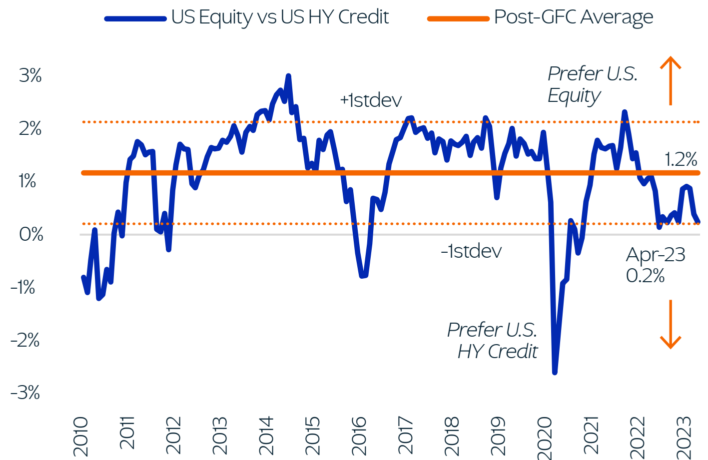
This note is an executive summary of our larger report, which also includes key investing themes and asset allocation, global / regional outlooks, insights on the capital markets, and answers to several more of our most asked client questions. The full report available on KKR.com. We encourage you to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

Click here to download our full Insights report

- **Within Credit, however, selectivity is key.** See *Question #2* below for more details, but we continue to think that defaults will rise over the next few years as EBITDA margins begin to contract. As a result, we are very focused on opportunities to move higher in the capital structure *or* to be selective on high-quality credits. If we are right, then we see more bifurcated outcomes for both liquid High Yield and Private Credit in coming years, meaning that manager selection will become even more important.
- **We reaffirm our call for stronger small-cap performance.** U.S. small-cap stocks are trading at the biggest discount to large-cap stocks in over 20 years. In fact, the valuation gap today is so sizeable that we think small-cap stocks could outperform large-cap stocks by around two to three percent per annum over the next several years (*Exhibits 4* and *5*), even when we account for the fact that SMID-cap earnings have further to fall. So, while we do recognize that AI means the era of large-cap tech ownership may not be over just yet (i.e., we are not calling for a massive overweight to Value), we are focused on the large number of solid, cash-flowing SMID-cap companies currently trading at depressed valuations.
- **Foreign stocks are starting to look more interesting.** We continue to see better value in Japanese, European, and even Mexican stocks, all of which are trading at relatively undemanding valuations and stand to benefit if we are right about a structurally weaker U.S. dollar. In fact, both Japan and Europe have broken out to 52-week highs (in USD terms) while still trading at just 13-13.5x NTM P/E (i.e., a 25-30% discount to the S&P 500); even more extreme is the Mexican stock market, which has broken out to eight-year highs but still sports a <13x NTM P/E.

EXHIBIT 2: The Current Excess Return Offered by Equities is Roughly One Standard Deviation Below the Post-GFC Average, Which Suggests HY Credit Offers Better Relative Value Than Equities

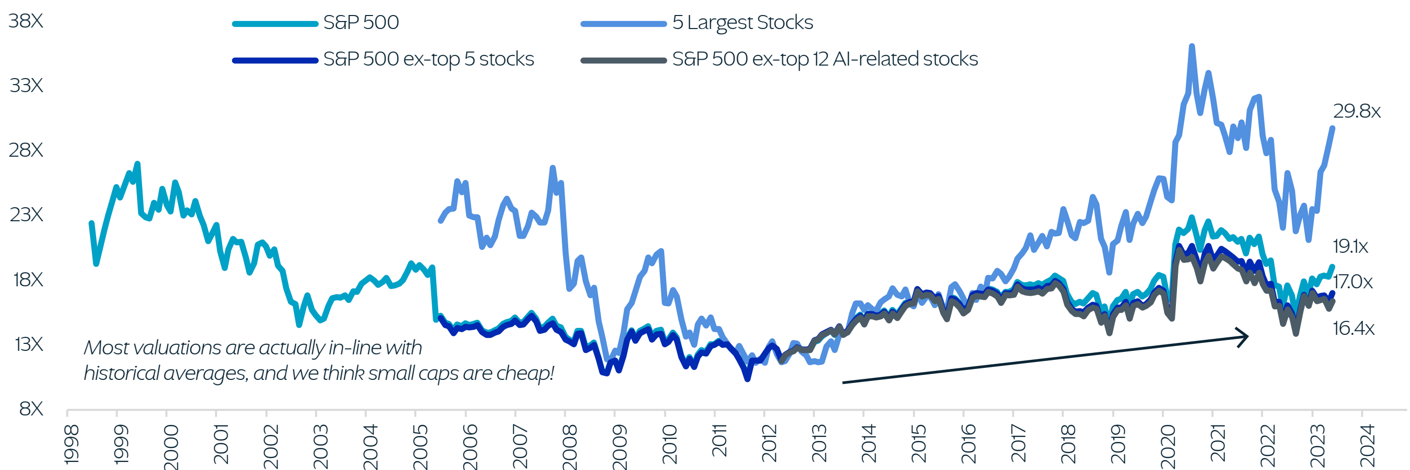
Relative Value: Equities vs. Credit, Internal Rate of Return* for Equities vs. HY YTW



* Internal rate of return is the discount rate at which the present value of all future dividends is equal to the current market level. We use a two-stage dividend discount model. Source: Bloomberg, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 1: While Mega-cap Tech and AI-Related Stocks Look Expensive, There Is Still Value in Other Parts of the S&P 500

S&P 500 NTM P/E



Note: top 5 stocks include Apple, Microsoft, Amazon, Nvidia and Google; AI-related stocks include Apple, Microsoft, Amazon, Nvidia, Google, Meta, Tesla, Broadcom, AMD, Salesforce, Netflix and Oracle. Data as at June 22, 2023. Source: Bloomberg, S&P, KKR Global Macro & Asset Allocation.

EXHIBIT 3: The Percentage of U.S. Companies Offering a Dividend Yield in Excess of Their Own Credit Yield Is Close to 13-year Lows

% of Companies with Dividend Yield Greater Than Corporate Bond Yield

Data as at April 30, 2023. Source: Datastream, FactSet, STOXX, Goldman Sachs Global Investment Research.

EXHIBIT 4: Similar to the Aftermath of the Dot-Com Bubble, We Now Think Small-Cap Could Meaningfully Outperform Large-Cap

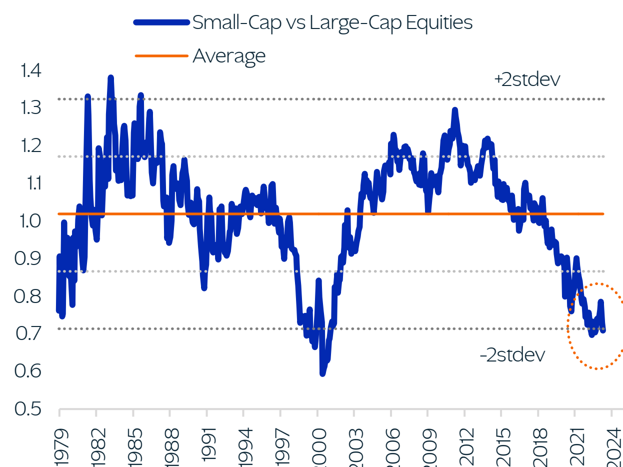
Next Five Years Total Return, Y/y %

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

- **Real Assets look attractive in an era of higher inflation.** We think that many investors' balance sheets are *still* underweight Real Assets at a time when inflation remains the number one macro concern in the developed world. So, we continue to pound the table on almost all aspects of Infrastructure, Asset-Based Finance, and Real Estate Credit. In terms of where our view is changing at the margins, we are becoming more bullish on non-Office CRE equity, given that entry cap rates are much higher than they were in 2021, while our long-term 10-year UST forecast (which feeds into exit cap rates) is lower. As short- and long-term interest rates have risen and as borrowing costs have increased, commercial property values have repriced considerably. These new reset values should create compelling investment opportunities as many property types still benefit from resilient long-term demand trends (such as logistics); high barriers to entry exist due to credit tightening for construction lending (both proceeds and cost); and we think many incumbent owners will need to deleverage capital structures as liabilities mature. We also think there is a lot to do in Infrastructure right now, especially in cases where assets offer exposure to our big themes (including Energy Transition, Digitalization, and the Security of Everything).

EXHIBIT 5: Small-Cap Stocks Remain Historically Cheap vs. Large-Cap Stocks, Trading at 20-Year Lows (-30% Below Long-Term Average)

Relative Forward P/E: U.S. Small vs. Large-Cap



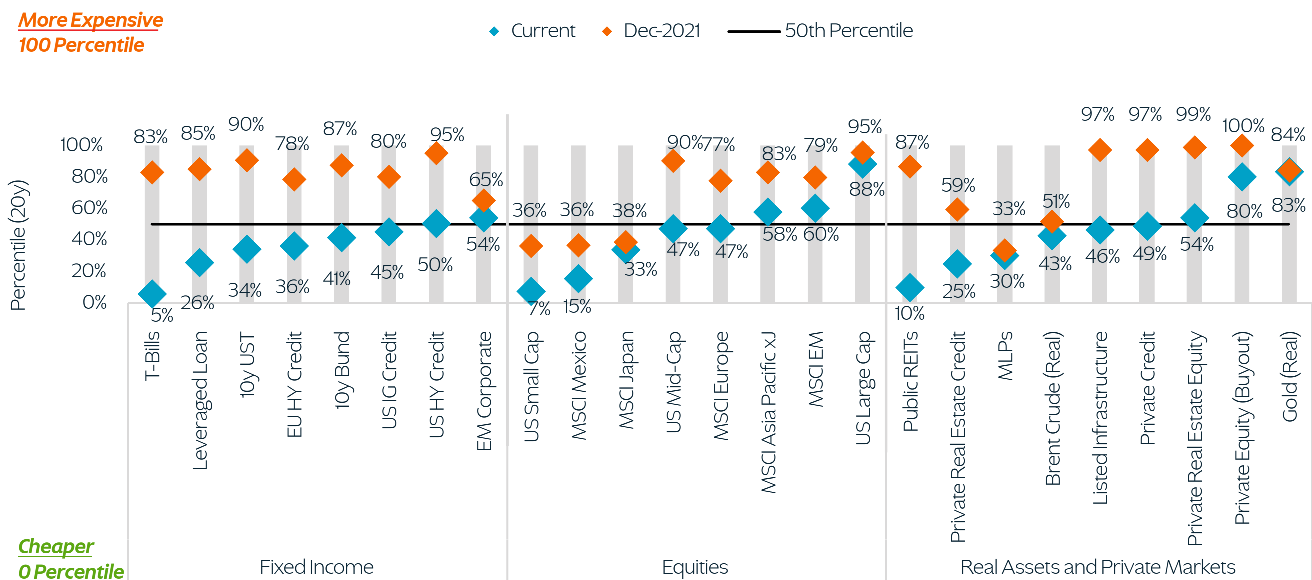
Note: Valuation analysis excludes outliers and non-earners. Data as at April 30, 2023. Source: BofAML Global Research, FactSet.

So, what's our bottom line? We have now entered a new regime of higher nominal growth and *structurally* higher interest rates, which we believe suggests that investors cannot go back to what 'worked' over the last ten years. Instead, we think that a more holistic approach to asset allocation is required, with a greater emphasis on up-front yield, 'Simplicity Over Complexity', and diversification across asset classes. Finally, we are likely in an environment of lower aggregate returns, meaning that more investors will need to find ways to harness the illiquidity premium to drive portfolio performance.

We think that many investors' balance sheets are *still* underweight Real Assets at a time when inflation remains the number one macro concern in the developed world. So, we continue to pound the table on almost all aspects of Infrastructure, Asset-Based Finance, and Real Estate Credit.

EXHIBIT 6: Small-Cap, International Equities, Public REITs and Private Real Estate Credit Look Attractively Valued; Large-Cap Equities Still Look Less Compelling by Comparison Relative to History

Cross-Asset Valuation Percentiles (Relative to 20-Year Average)



Notes: Equity indices refer to NTM P/E; UST, bunds, Cash refer to nominal yield; Infra and MLPs refer to forward dividend yield; Credit and Mortgage indices refer to spreads; Private Equity refers to median EBITDA multiples; public REITs and private real estate refer to nominal cap rate; Brent and Gold refer to real prices. Percentiles from 2003-date where available; Leveraged Loans, Infra and MLP from 2007-date; Private Real Estate Credit as at 1Q23; Private Credit as at 4Q22; Private Equity as at 4Q22. Public data as at April 30, 2023. Source: Bloomberg, Haver Analytics, ICE-BofAML Bond Indices, Green Street, Giliberto-Levy, Burgiss, S&P, MSCI, KKR Global Macro & Asset Allocation analysis.

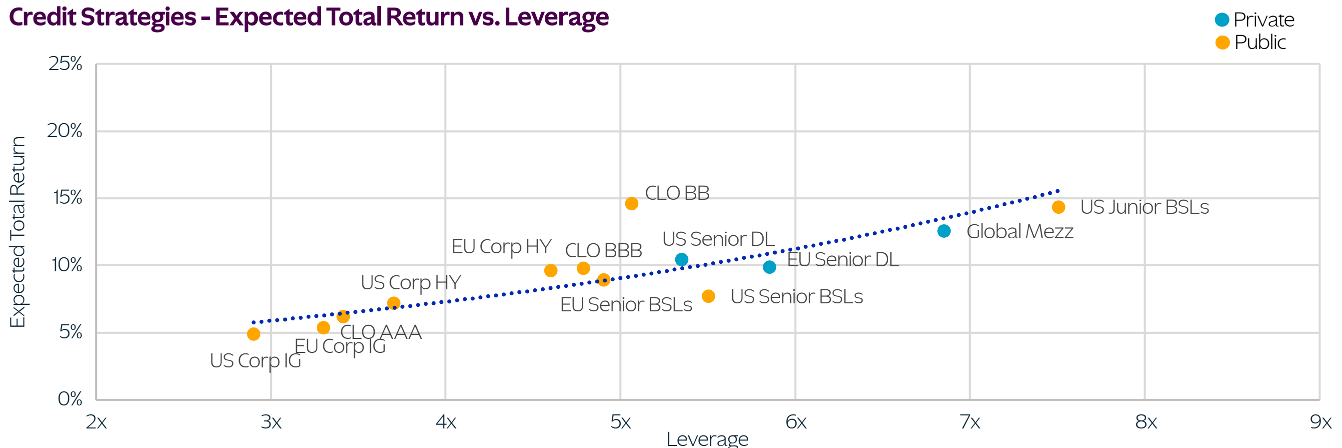
02

Given how bullish you are on lending in this market, how should investors think about the 'Credit' sleeve of their portfolio?

Within Credit, we continue to advocate for 'Keeping it Simple' by moving up in the capital structure and not stretching on leverage, particularly at a time when EBITDA margins are starting to normalize. That said, given the different convexities of various credit asset classes right now, we think that a multi-asset class Credit solution, including both private and liquid securities, could make a lot of sense for large pools of capital. As such, we see something to 'like' across several areas of private and public markets:

- **We think high-quality CLO liabilities offer excellent risk/reward across AAA-BB tranches.** Given how much financial conditions tightening has occurred through higher SOFR (the overnight financing rate), rather than via higher spreads, one can earn a very decent return without taking a lot of credit risk. As such, we favor higher quality liabilities in the floating-rate portion of one's liquid portfolio, especially if we are right that fed funds will remain higher on a structural basis this cycle. In particular, more junior tranches like BB offer a very decent leverage-adjusted return right now, as one can see in *Exhibit 7*.
- **Within fixed-rate debt, parts of High Yield look appealing, too.** Although HY spreads are still fairly tight, we would assign a small probability to a world in which HY spreads blow out *and* risk-free rates remain very high. As such, all-in yields at today's levels offer a decent entry point for long-term investors, particularly given how much of the 'discount' in HY is coming from price versus coupon right now (i.e., HY is currently trading at 85-90 cents on the dollar). Moreover, although we remain cautious about the outlook for margins, HY credit fundamentals are much better than they have been in past cycles. Just consider that the average issuer now has a rating of BB or higher, versus B or lower in 2006-2007, and that about a quarter of the BB market is now senior secured, up from *zero* percent pre-GFC.
- **We also like Real Estate Credit as a way to gain exposure to elevated nominal GDP growth.** Ongoing volatility, as well as bank funding pressures, have caused a pullback in large sources of real estate debt financing, including bank lending and the CMBS market. To be sure, part of this pullback reflects more challenging fundamentals, particularly around Office. Nonetheless, we continue to think that RE lending *overall* will hold up much better than it did in the GFC thanks to lower LTVs, less pro-forma underwriting, and the fact that asset values have already reset in many sectors, providing more of an equity 'cushion' before bondholders take losses. As such, we think that CRE lending may be one of the most compelling ways to add Real Estate exposure in scale at this point in the cycle *(Exhibit 8)*.

EXHIBIT 7: Our Tactical Model Suggests Private Credit Offers Higher Expected Return per Unit of Leverage



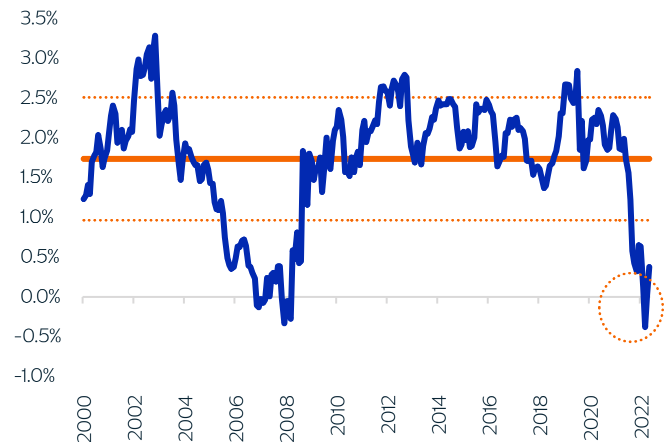
Data as at April 30, 2023. Source: KKR Portfolio Construction analysis based on proprietary and sell side research (BofA, JP Morgan, LCD, S&P Global Ratings, Moody's).

- **Senior Direct Lending remains very compelling.** Unlevered gross returns are now in the 10-12% range thanks to a higher reference rate and a more substantial original issue discount (OID). And on a go-forward basis, we actually think that the opportunity set in this space will remain appealing for some time, given the reality that a lot of good companies will need to refinance their debt at a time when the leveraged loan market is essentially shut. However, we do acknowledge that the asset class has become more 'crowded,' which is why we think investors need to focus on partnering with experienced managers in order to see the full benefit of adding private credit to their portfolios.

Pulling it all together, we think that the current backdrop has created a compelling opportunity for investors to move up the capital structure and lend to high-quality companies at attractive all-in yields and with more protective covenants. By contrast, this is still not the time to simply buy the market when it comes to riskier loans, and there is the possibility of a 'double whammy' from higher defaults and lower reference rates if the U.S. encounters a more severe downturn this cycle.

That said, given the different convexities of various credit asset classes right now, we think that a multi-asset class Credit solution, including both private and liquid securities, could make a lot of sense for large pools of capital.

EXHIBIT 8: The Difference Between Real Estate Equity Cap Rates and Core Mortgage Yields Is Well Below Average, Meaning Now Is a Great Time to Be a Lender in Real Estate



Data as at March 31, 2023. Source: Giliberto-Levy, Green Street, KKR Global Macro & Asset Allocation analysis.

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