

# INSIGHTS

GLOBAL MACRO TRENDS

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## Same As It Ever Was?



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# Same As It Ever Was?

**Whereas Reaganomics and Thatcherism** were terms for economic policies that defined the 1980s, we similarly believe that we have now entered a new period. The acceptance of big government with a more 'visible hand' in tackling thorny challenges such as inequality, data security, cross border investing, monopolistic pricing, and climate change, is becoming mainstream. In particular, we have entered a new era for policy, one that relies on more government support/intervention/regulation on the fiscal side as well as more reflationary strategies on the monetary side. This part of the future macroeconomic landscape we envision is not 'transitory', we believe. So, against this backdrop, we think that pricing power and collateral-based cash flows become truly distinguishing features. There is also the unique cross-current of disinflationary technological change occurring at the same time that there has been a dearth of capital expenditures in old economy sectors required to fund a massive transition towards new energy sources. And all this is occurring at a time of rising geopolitical tensions. Not surprisingly, our asset allocation suggestions for the future are distinctly different from what worked during the past decade.

**Time isn't holding up, time isn't after us,  
Same as it ever was, same as it ever was...**

—David Byrne, Scottish-American Singer, Songwriter

**I was recently reviewing my Outlook calendar**, and it inadvertently flipped back to the week of February 10th, 2020. If memory serves, one night that week my wife Laura and I sat in a crowded New York City theater and saw David Byrne’s American Utopia, our last pre-COVID Broadway show, which included a rousing rendition of one of my favorite songs, Once in a Lifetime. As I think back on that experience now, several lyrics in the song — although originally released nearly 30 years ago — were eerily on point for the environment we soon would all experience.

For starters and with true compassion for all of the lives that have been so adversely affected in so many ways, all of us at KKR hope that this pandemic is truly a ‘once in a lifetime’ event. Yet, even after all the incredible scientific breakthroughs that have taken place, the virus continues mutating in its quest for survival. Moreover, we are all still struggling with understanding the true health, economic and social impacts of the disease, particularly on marginalized communities and those without sufficient social safety nets. So, we still don’t yet know, even as the ‘days go by’, exactly what tomorrow will look like. Will it be the ‘same as it ever was’? We don’t think so.

From KKR’s perspective, we are actually cautiously optimistic about the future, though we are also of the mindset that many aspects of pre-pandemic everyday life may never quite go back to normal. Beyond some notable changes to our day-to-day protocols at home, at the office, and at school that we must all embrace, follow-on aftershocks from the pandemic must also be integrated into

our approach as allocators of capital on behalf of the retirees, teachers, first responders, and other investors we serve.

With these considerations in mind, we enter the second half of 2021 increasingly confident that the portfolio that drives excess returns in the next decade will likely look a lot different than the one that garnered outsized returns during the 2009-2019 period. Key to our thinking is that we have entered a new era for policy, one that relies on more government support/intervention/regulation on the fiscal side as well as more reflationary strategies on the monetary side. Indeed, whereas Reaganomics and Thatcherism were terms for economic policies that defined the 1980s, we similarly believe that we have now entered a new period where acceptance of the ‘visible hand’ of big government in tackling thorny challenges such as inequality, data security, cross border investing, monopolistic pricing, and climate change, is becoming mainstream. If we are right, then we could enter more periods where nominal GDP growth increases faster than nominal profits.

How Our Thinking Has Evolved	Action Item
Inflation, including owner’s equivalent rent, rising faster than anticipated	Boosting our U.S. CPI forecast for 2021 to 4.5% from 3.5% and 2022 to 2.75% from 2.5%
European Real GDP growth to outpace the U.S. in 2022	We now look for Europe to grow 4.4% in 2022, 40 basis points above our U.S. forecast
Equities remain an asset class of choice	Raising our S&P 500 price and EPS targets for both 2021 and 2022
The long-end of the curve will rise more slowly than originally anticipated	Lowering our U.S. 10-Year forecast in 2022 by 25 basis points to 2.0% from 2.25%
Select commodities: Higher for longer	Still favor longer-dated oil and commodities linked to global energy transition build-out

Meanwhile, unlike the most recent economic recovery, the Western Hemisphere — not the Eastern one — is leading the charge to resuscitate growth via larger debts and deficits. By comparison, it was China that spent aggressively using a variety of fiscal and monetary measures funded by large increases in its overall debt load to steady global growth in the aftermath of the Global Financial Crisis (GFC).

Importantly, though, *we think that our structural reflationary call is going to be tested over the next few months, as the rate of change on economic growth and money supply growth both moderate.* The rapid spread of the Delta variant too could pose significant challenges in the near-term. If we are right, then PMIs too will likely come down from near record levels. Goods inflation also could fall somewhat precipitously, albeit from record

levels, according to our estimates.

However, do not be fooled by this perceived growth slowdown. It is a rate of change transition, not a growth bust, as spending shifts more from the public sector to the private sector. Nominal GDP should remain higher this cycle, as we have strong conviction that something structural on the reflation front has changed. Simply stated, the macroeconomic outlook is not the same as it ever was. We do not make this statement lightly, but we are convinced that there are six structural inputs that will make this recovery much different than those experienced during the last four decades — and certainly wildly different from the one that defined the brittle, long-tailed recovery that started in 2009/2010. See below for full details (Section II in particular), but they are as follows:

### **Six Structural Inputs to Recovery Which Will Be Unlike the Last Four Decades:**

- 1 There is a more accommodative approach to monetary policy, including Average Inflation Targeting (AIT) in the United States
- 2 Austerity is out; sustained global fiscal stimulus is in, with more of it going directly to consumers
- 3 We see more input cost pressures in already fragile supply chains, particularly as the PPI rises above the CPI; labor shortages too are part of this emerging conundrum
- 4 Lower real rates mean easier financial conditions for longer
- 5 The current global energy transition towards a cleaner environment is actually inflationary
- 6 There is now a record amount of savings to be spent earlier in the cycle

If we are right in our assessment, then chief investment officers will need a dramatically different top down framework to deploy capital effectively. In particular, we strongly believe that a theme-based approach is warranted to navigate what is becoming an ever more complex global economy. To this end, our team has strong conviction that capital should be aggressively marshalled behind the following top-down investment considerations:

**1 Buy Price Makers, Avoid Price Takers**  
This is a mega theme for this cycle, as we believe that we have now entered a world where input costs, including wages and select commodity prices, are increasing at a faster pace than consumer prices — a trend that we think will last longer than the consensus anticipates. This part of the future macroeconomic landscape we envision is not ‘transitory’, we believe. So, against this backdrop, we think that companies with pricing power, or what we term price makers, will be re-rated upward at the same time that price takers will be de-rated. Not surprisingly, this macro backdrop will create more volatility, as margin estimates are too optimistic and rate of change on economic growth slows. Just keep in mind that the consensus now suggests that fully 80% of the companies in the S&P 500 will deliver improving margins (*Exhibit 37*).

**2 The Yearn for Yield Continues: Own More Collateral-Based Assets**  
We have entered a unique period where global central bankers, particularly in the United States, are doing everything in their power to stoke some inflation to accelerate growth in nominal GDP by holding nominal interest rates at record low levels. Part of this approach by central bankers is focused on their commitment to generate sufficient growth to benefit historically marginalized populations, including attempting to close the employment and growth gaps between white and Hispanic and black Americans. It is also an attempt to lower debt levels relative to GDP by encouraging faster nominal growth of the economy. Unfortunately, this policy is coming at the expense of savers. As such, the importance of an above average cash flow generated by collateral-based assets, against a backdrop of heavy central bank intervention, could improve trading multiples for

these investments. Longer-term, though, we think it will actually be the value of the sound collateral that backs the cash flows that further enhances performance, particularly if the investment has strong pricing power characteristics. Our bottom line: As we look ahead, we have high conviction that — driven by a structural yearn for yield — we are still in the early innings of a structural upward re-rating in collateral-based assets that can generate a competitive upfront yield without too much leverage.

**3 Continue to Invest Behind the Rise of the Global Millennial**  
We think that we are at an inflection point for the global millennial. Starting in the U.S., we are seeing millennials, or individuals born from 1980-1994, beginning to embrace homeownership as well as spend more on their families’ needs. Already, U.S. millennials are spending at least \$1.2 trillion per year, and we think that there could be upside to this number in a post-pandemic environment. Moreover, at nearly 70 million individuals (and with faster growth than most other cohorts), this change in their spending habits is an important part of the U.S. growth story. Europe too has compelling millennial trends, but the most powerful part of the global millennial story is actually emanating from Asia. All told, there are now 822 million Asian millennials, 12 times more than in the U.S. In most Asian countries, millennials are also the cohort just now entering middle income status in such key markets as China, India, and Indonesia, which suggests that there will be important shifts in buyer behavior patterns over the next 5-15 years. Importantly, we now look for these individuals to reshape many traditional consumer markets, particularly as it relates to financial services, healthcare, and technology.

## 4 Environmental Considerations, Particularly Amidst Concerns About Supply Chain Resiliency, Represent a Major Opportunity

In a world of low rates and intensifying socioeconomic divisions, we expect governments to spend aggressively to sustain economic growth as well as to push for higher minimum wages. We also think that there will be less partisan discord over the cost of replacing crumbling and outdated infrastructure, given the post-COVID focus on preparedness. Already, the U.S. has increased its budget deficit by more than three trillion dollars; yet, its annual interest expense has actually dropped. We believe that the current administration finds this backdrop empowering to spend as much as it can. Not surprisingly, as part of the trend towards higher fiscal outlays, we think that almost all aspects of ESG are winners, including water cleanliness, and energy transition (solar, wind, battery, and other renewables). We also think resiliency of energy transportation (e.g., pipelines, power grids, supply chains, etc.) could create a capex super-cycle, the magnitude of which many investors are likely still

underestimating. Cyberattacks, data security, and climate change will only accelerate this growing investment need, we believe.

## 5 Buy Complexity/Sell Simplicity

In past years, we have argued that corporate carve-outs are amongst the most attractive ways to find devalued and underappreciated companies in bifurcated markets — markets that seem to eschew complexity in favor of simplicity at almost all costs. Importantly, we still believe the opportunity set to acquire high quality carve-outs across PE, Infrastructure, and Energy remains outsized. In jeweler's parlance, we are using this 2021 mid-year outlook to shift the focus beyond just undervalued 'diamonds in the rough' to include the occasional 'hidden gem' trading at a fraction of its intrinsic value. In particular, although consumers crave 'things' these days, we still believe that there is an opportunity to own 'experiences', particularly companies that were hit hard by the pandemic and may need capital to de-lever and/or reinvest in their businesses.

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Importantly, at KKR, our thematic work drives our thinking around deployment, monetization, and asset allocation. To this end, we wanted to flag our latest Picks and Pans that reflect our views as to where we believe portfolio managers and asset allocators should be leaning in and out. They are as follows:

### PICK

**We are overweight almost all investments linked to collateral-based cash flows.** This viewpoint is consistent with our focus on owning pricing power stories during an era of rising inflation. As such, **we suggest overweight positions in Infrastructure, Real Estate, and Asset-Based Finance.** Consistent with this view, within Private Equity we also like premium consumer products, industrial distributors, home improvement, and specialized staffing companies.

### PICK

**Remain overweight Global Equities. In terms of Global Equities, we are overweight Europe, Japan, small- to mid-cap stocks in the U.S., and select Emerging Markets.** We are taking a double barrel

approach to style selection, suggesting allocators construct portfolios with both Value and Growth at this point in the cycle.

### PICK

**Lean into the flexibility of Opportunistic Credit. Within Liquid Credit, we favor Bank Loans to High Yield; overall, though, we favor Opportunistic Credit,** which gives us the ability to toggle across multiple asset classes as opportunities arise. We also like CLO equity, based on our desire to term out fixed liabilities that are paired against floating rate assets.

### PICK

**Select Commodities.** See below for details, but **we still favor oil at several spots on the forward**

curve (e.g., 2024); we also like commodities linked to our energy transition thesis, including copper, lithium, and aluminum. We are bullish too on the picks and shovels associated with the global energy transition, and as such, services linked into this business movement make sense also.

#### PICK

**Capital solutions. Providing unique capital solutions, including convertible preferred shares or PIK/Equity structures, to private companies in the innovation sectors makes a lot of sense to us.** Many, though not all, of these early stage companies are already cash generative, and an investor can move up in the capital structure at a time of lofty valuations and potentially still participate in some upside sharing if valuations hold and earnings come through. Media, Biotech, Gaming, and Blockchain all potentially make sense to us. We also like that many traditional banks appear less interested in extending capital to these segments of the market.

#### PAN

**Price takers. The current environment most likely is going to lead to multiple and earnings de-ratings for companies that have high leverage levels and the inability to pass through costs, including labor.** For example, we think that consumer product companies with unhedged input costs will likely suffer. A similar story could play out for companies with large lower-wage workforces and limited pricing power, such as retailers and certain healthcare services. We are also wary of companies that could have trouble passing on higher input costs to a small and powerful base of buyers (e.g., government services or auto parts arenas).

#### PAN

**Short duration bonds. Higher inflation trends make the front-end of the curve particularly unattractive.** As one can see in *Exhibit 1*, current two-year real rates are as negative as they have been in over 40 years. However, this phenomenon is not just restricted to the U.S. (*Exhibit 72*). So, whether the prices of these

securities decline or not, they represent little value in a world where central banks are trying to increase the permanent 'resting rate' of inflation.

#### PAN

**Popular stocks with rich valuations..** In line with what we laid out in our December Outlook for 2021, **we still see many of the most popular growth stocks not doing as well.** Initial indicators support this thesis, as one can see in *Exhibit 2*. The law of large numbers, increased regulatory scrutiny (anti-trust, data, etc.), and higher multiples in certain instances are all acting as headwinds. Importantly, this call extends across the capitalization curve and across regions, including China.

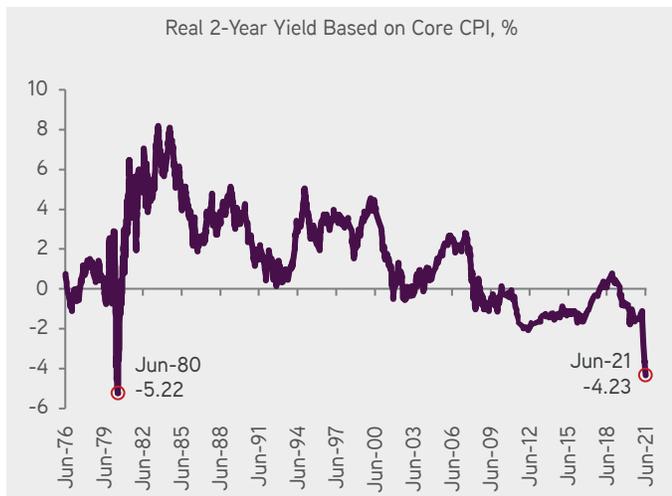
#### PAN

**Select EM currencies. Headwinds such as low vaccination rates, investor sentiment, twin deficits, elections and rising inflation could make certain EM currencies particularly vulnerable if global tightening starts ahead of schedule.** For example, we maintain a preference for short COP positions. Colombia's significant external vulnerabilities make its local assets one of the weakest links in EM, highly susceptible to higher U.S. yields or to a stronger DXY. Moreover, Colombia's monetary policy stance remains too accommodative versus the average EM, which continues to imply significant downside risks for COP.

**We are overweight almost all investments linked to collateral-based cash flows. This viewpoint is consistent with our focus on owning pricing power stories during an era of rising inflation.**

### Exhibit 1

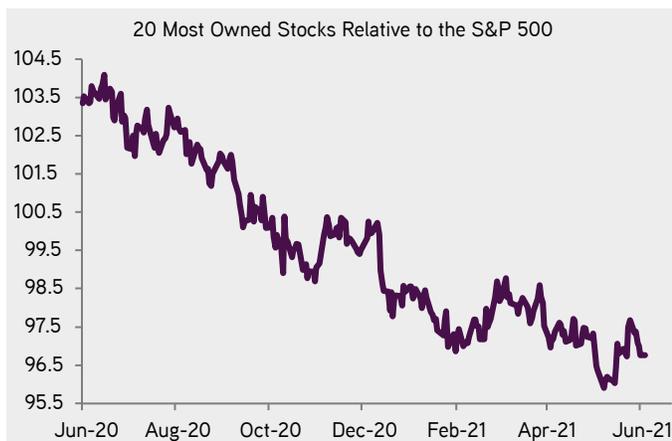
**We Had to Go Back Through 40 Years of Data to Find Real Yields on Two-Year Notes at Such Extreme Levels. Our Response: Own More Cash Flowing Assets With Pricing Power and Collateral Support**



Data as at June 30 2021. Source: Bureau of Labor Statistics, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

### Exhibit 2

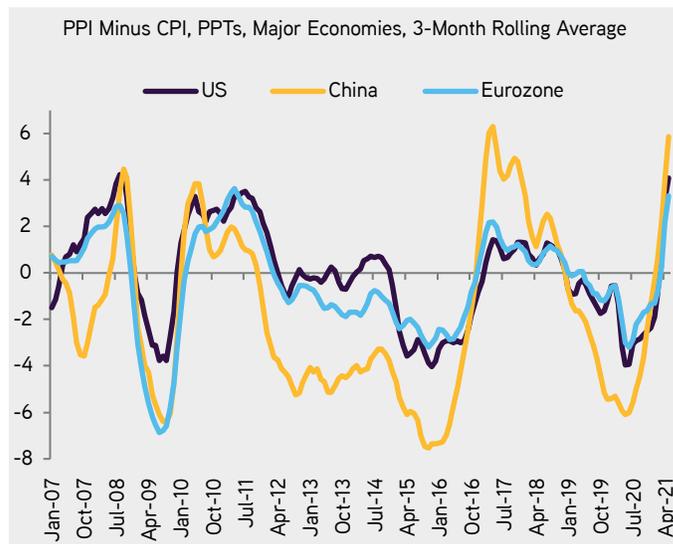
**Popular Stocks That Face the Risk of Heavy Ownership and Full Valuations May Actually Not Be the Best Performing Stocks in the Next Leg of the Cycle**



Data as at June 28, 2021. Source: Cornerstone Macro.

### Exhibit 3

**Pricing Power, Not Value or Growth, Is the Call to Arms at This Point in the Cycle**



Data as at May 31, 2021. Source: Bloomberg.

In terms of risks that could challenge our thesis, we see several key concerns on which to focus. In the near-term, we expect a peaking in the rate of growth to cause some investors to shift back towards more defensive assets. We cannot argue against this type of ‘knee-jerk’ reaction to the collapse in the rate of change, especially when two of the key variables we watch — money supply growth and earnings momentum — are showing definite signs of fatigue. One can see this in *Exhibits 4 and 5*, respectively.

**The current environment most likely is going to lead to multiple and earnings de-ratings for companies that have high leverage levels and the inability to pass through costs, including labor.**

## Exhibit 4

### Money Supply Growth Is Starting to Fall, As Rate of Change Slows in the Recovery

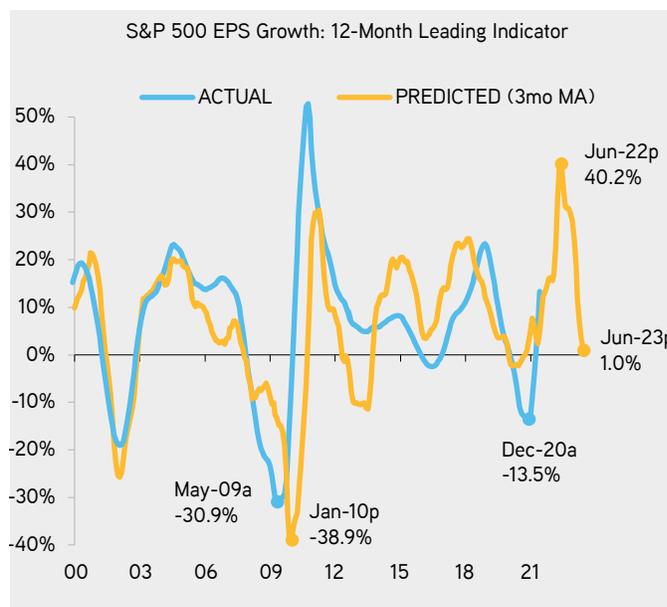


Data as at June 14, 2021. Source: Cornerstone Macro.

However, for longer-term investors with a true eye on value creation, we think that the reflation story remains the right one on which to focus for this cycle. In fact, our greatest worry is that policy is actually too loose, particularly at a time when many economies are re-opening with vigor.

## Exhibit 5

### Higher Input Costs Are Now Affecting Our Forecasted Growth Rate for Overall Earnings. Hence, We Champion Price Makers



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. a = Actual; p = model predicted. Data as at June 30, 2021. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg.

However, for longer-term investors with a true eye on value creation, we think that the reflation story remains the right one on which to focus for this cycle. In fact, our greatest worry is that policy is actually too loose, particularly at a time when many economies are re-opening with vigor. Consistent with this view, we feel strongly that the Federal Reserve needs to reduce its bond buying more quickly than it is currently forecasting to the market. The good news is that the Fed's July FOMC minutes revealed that "Various participants mentioned that they expected the conditions for beginning to reduce the pace of asset purchases to be met somewhat earlier than they had anticipated at previous meetings."

In terms of other risks we are monitoring, we also think that cyber threats are rising across the corporate and infrastructure sectors. All told, we estimate that cyber is already costing

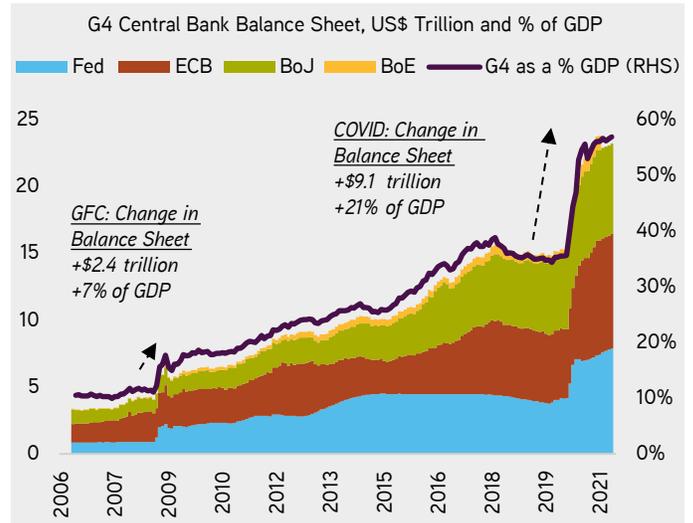
more than one percent of global GDP per annum. Finally, geopolitical tensions between the U.S. and China will remain frosty under the Biden administration, we believe, as China is an issue upon which Republicans and Democrats alike can find common ground.

Looking at the big picture, we still think that we are in a favorable environment for risk assets during the next few years. Liquidity remains ample, consumers are in good shape, and the rate of return on 'safe' investments like government bonds has shrunk to negative levels on a real basis. This pro-risk view is reflected in both our asset allocation tilts as well as our forecasts, including another upgrade to our S&P 500 EPS and target.

However, we believe that the next leg of this cycle will be filled with more uncertainty and volatility along the way. Central bank buying of securities, particularly mortgages in the United States, will slow shortly, and we now look for other central banks to start raising rates in 2022 to prevent overheating. Also, as we detail below, multiple expansion will give way to multiple compression. Meanwhile, input cost headwinds, including labor, are likely to lead to some substantial earnings misses. While government fiscal programs will remain supportive, there will be more debate about continuing the unprecedented levels of spending currently occurring. Finally, geopolitical and regulatory issues will likely intensify (e.g., the scrutiny around data regarding DiDi Global is likely not a one-off). So, our bottom line for long-term investors is that **we favor a more diversified portfolio this cycle that skews positively towards reflation being more permanent than the global 'Authorities' are suggesting as well as one that can lean in opportunistically during periodic bouts of dislocation.**

### Exhibit 6

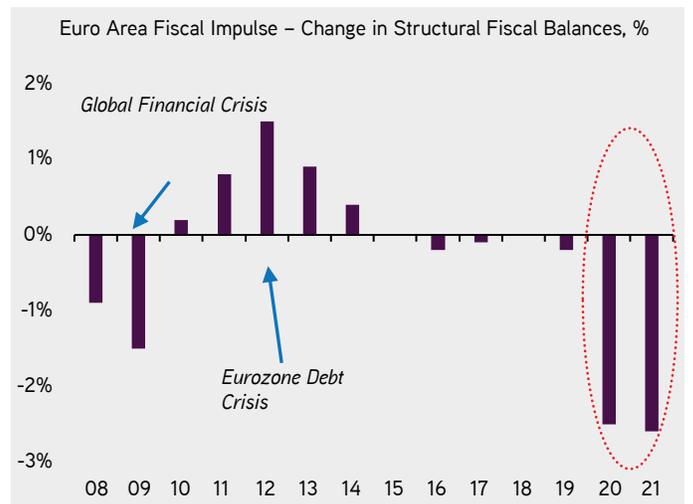
#### Even Though Rate of Change Is Slowing, There Is Still a Huge Amount of Stimulus in the System



Data as at May 31, 2021. Source: Bloomberg.

### Exhibit 7

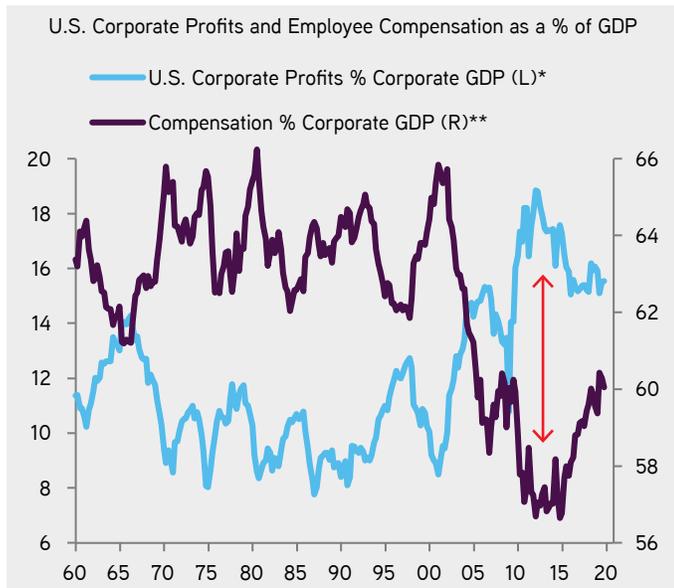
#### This Cycle Is About Accommodation, Not Austerity



Note: Based on EC Spring Forecast. Data as at June 28, 2021. Source: European Commission.

### Exhibit 8

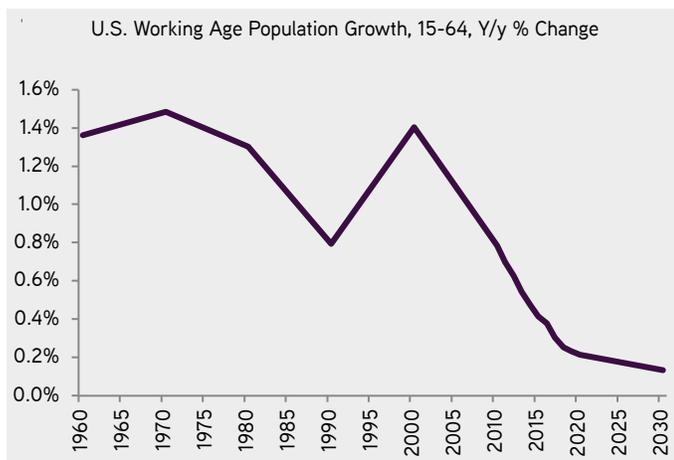
#### We Now See Labor Costs Putting Downward Pressure on Corporate Profit Margins...



Data as at December 31, 2020. Source: BEA, BLS, Haver Analytics.

### Exhibit 9

#### ...Particularly As Growth of the Working Age Population Has Slowed Dramatically Since the 1960s



Data as at June 18, 2019. Source: United Nations, Haver Analytics.

## SECTION I: UPDATING OUR MACRO ASSUMPTIONS

### Global GDP

At the beginning of 2021, we laid out four specific reasons why we were anticipating stronger global nominal GDP growth than the consensus, including: 1) more sustained government spending for major initiatives such as infrastructure and climate change; 2) a stronger than expected rebound in consumer spending once vaccines became widely available as consumers at the high end benefitted from increased rates of savings and those at the low end benefitted from generous government transfers; 3) our view that the Federal Reserve, with its Average Inflation Targeting, and its global peers, would keep financial conditions easier than expected; and 4) a stronger than expected capital expenditure cycle, driven primarily by 'resiliency' upgrades and the global energy transition towards cleaner emissions.

As we peer around the corner today on tomorrow at KKR, we still feel the same way. Specifically, both our quantitative models and our fundamental research, including tapping into KKR's vast CEO network, suggest strong growth continues. As such, it should not be a surprise that we maintain above consensus growth forecasts in many of the regions of the world where we operate. One can see this in *Exhibit 10*.

**We also think that labor will be an important point of differentiation to watch during the recovery, as the U.S. is showing record tightness in its labor force. A major issue, which we again saw in the latest employment report, is that the participation rate remains stubbornly low this cycle.**

## Exhibit 10

### For 2021, Our Forecasts Have Moderated in Tone Based On the Strength of the Snapback

	2021 Real GDP Growth		2021 Inflation		2022 Real GDP Growth		2022 Inflation	
	GMAA Target	Bloomberg Consensus	GMAA Target	Bloomberg Consensus	GMAA Target	Bloomberg Consensus	GMAA Target	Bloomberg Consensus
U.S.	6.5%	6.6%	4.5%	3.7%	4.0%	4.1%	2.75%	2.7%
Euro Area	4.6%	4.5%	1.8%	1.9%	4.4%	4.3%	1.3%	1.4%
China	8.7%	8.5%	1.4%	1.5%	5.4%	5.6%	2.4%	2.3%
Mexico	6.1%	5.7%	4.8%	4.8%	3.0%	2.8%	4.0%	3.6%

Data as at July 13, 2021. Source: KKR Global Macro & Asset Allocation analysis.

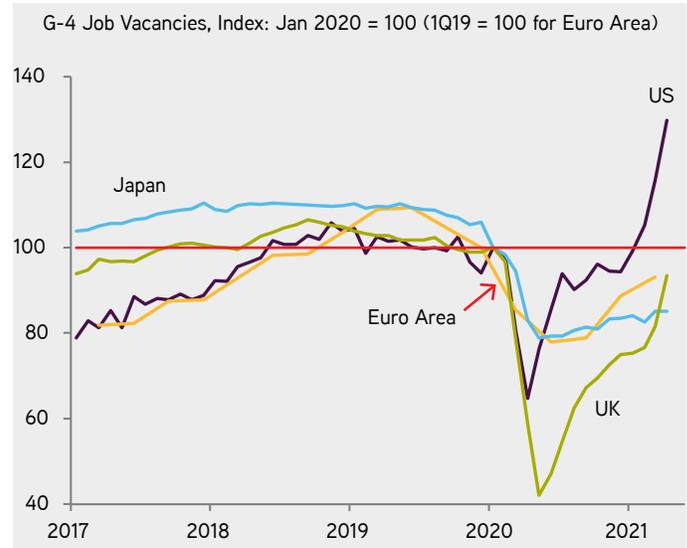
We also see some notable differentiation in how countries are positioning for growth in a post-COVID world. China seems content to not let the fiscal impulse become too outsized this cycle, which is quite different from its leading role using both fiscal and monetary policy to steady global growth post the GFC. Meanwhile, we think the European fiscal impulse is actually just getting ramped up, and remain convinced that the Biden administration will be able to push through some form of an infrastructure plan. Between 1) physical infrastructure initiatives that enjoy some bipartisan support and 2) social infrastructure initiatives that would pass only on a partisan basis under reconciliation, we expect roughly \$2-3 trillion of new spending over 10 years, with \$3.5 trillion being the upper limit based on Senate Democrats' latest proposed budget. We also expect Congress to offset the new spending only partially, likely to the tune of perhaps \$1-1.5 trillion of new revenue via higher taxes and technical offsets (e.g., assuming spending partially pays for itself via higher growth).

This spending will likely focus on traditional infrastructure (roads, transit, rail), energy infrastructure, including electric car and truck charging stations, and funding for schools, housing, broadband, hospitals and water infrastructure. Much of this spending could also advance Biden's climate change agenda, including shoring up roads, bridges and tunnels impacted by rising sea levels, and Diversity, Equity,

and Inclusion (DEI) priorities like removal of artificial barriers such as bridges and overpasses that divide or isolate Black and other minority communities.

## Exhibit 11

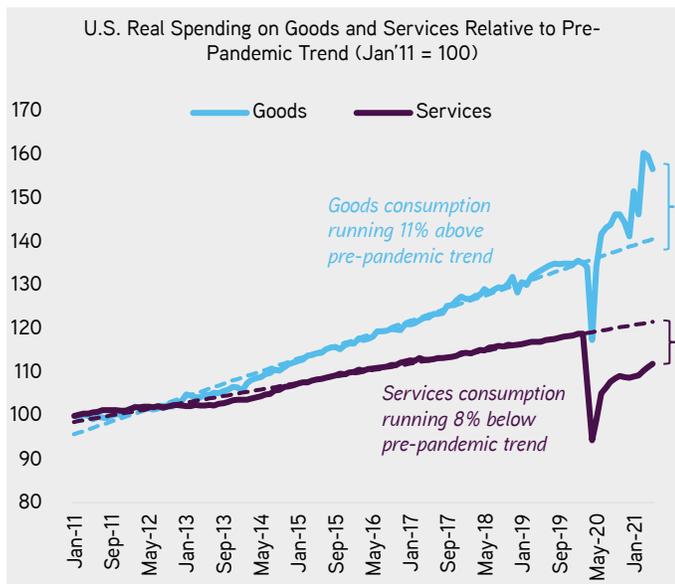
### Demand for Labor in the U.S. Is Outstripping Supply...



Data as at May 31, 2021. Source: JPMorgan, governmental agencies.

## Exhibit 12

### ...Particularly If Services Rebounds More Quickly Than the Consensus Expects



Data as at July 13, 2021. Source: BEA, BLS, Federal Reserve, Haver Analytics.

We also think that labor will be an important point of differentiation to watch during the recovery. As we show in *Exhibit 11*, the U.S. is showing record tightness in its labor force. A major issue, which we again saw in the latest employment report, is that the participation rate remains stubbornly low this cycle. Specifically, it is now at 61.6%, compared to pre-pandemic levels of 63% and significantly higher levels during past recoveries. On the other hand, successful furlough programs in areas like the Eurozone — and to some degree Japan — have kept employment trends more steady.

Overall, we see stronger growth in nominal terms than in past years. We also see a higher resting rate for inflation. In the U.S., for example, inflation should settle in around 2–2.5%, compared to 1.5–2% during the prior cycle. That said, there will be more spikes than in the past. We also expect supply chain issues to remain problematic, which likely means more volatility than in the past. Said differently, the great moderation that defined the shift away from goods

towards more stable services in the past few decades is likely to experience some challenges, including tighter labor and less resilient supply chains. We view this backdrop as particularly favorable for allocators who can gain sizeable exposure to collateral-based cash flows with pricing power as well as opportunistic vehicles that can lean into periodic dislocations.

### United States

As indicated in *Exhibit 10*, my colleague Dave McNellis is forecasting strong growth well into 2022. Given the rebound in services that we are all expecting, our constructive view is now mostly a consensus view, as the consensus has largely caught up with our more bullish GDP outlook. What the market might be missing, though, is the growing impediments that our models now show as potential headwinds to easy financial conditions, a strong consumer, and heightened savings. Specifically, although our U.S. GDP indicator anticipates growth remaining above trend through 2022, high energy prices and moderating housing activity are beginning to weigh on growth by early 2022. One can see the impact of higher fuel prices, sluggish labor force growth, and tougher comparisons in the housing market, i.e., rate of change, in *Exhibit 13*. It's also worth noting that Dave sees much more potential GDP upside from trade and inventory normalizations than from consumer spending at this point in the cycle.

**Said differently, the great moderation that defined the shift away from goods towards more stable services in the past few decades is likely to experience some challenges, including tighter labor and less resilient supply chains.**

Key U.S. Macro Assumptions	
FOMC	Bulk of tapering executed over 2022; first Fed hike not until mid-2023
Corporate tax rates	Increases to about 25% from 21%
GILTI (tax on foreign subsidiaries)	Rises to 18.75% from 10.5%
Total new fiscal spending	\$2–3 trillion over 10 years (\$3.5 trillion the upper limit) split evenly between Infra-structure- and social-related initiatives
Oil price outlook	WTI crude trades in low-\$70s range over balance of 2021, high-\$60s in 2022
U.S. consumer savings rate	U.S. savings rate gradually reverts to pre-pandemic 7-7.5% range
Credit spreads	Credit spreads hold flat around current levels
Housing	Home price appreciation slows to 3–4% annual rate

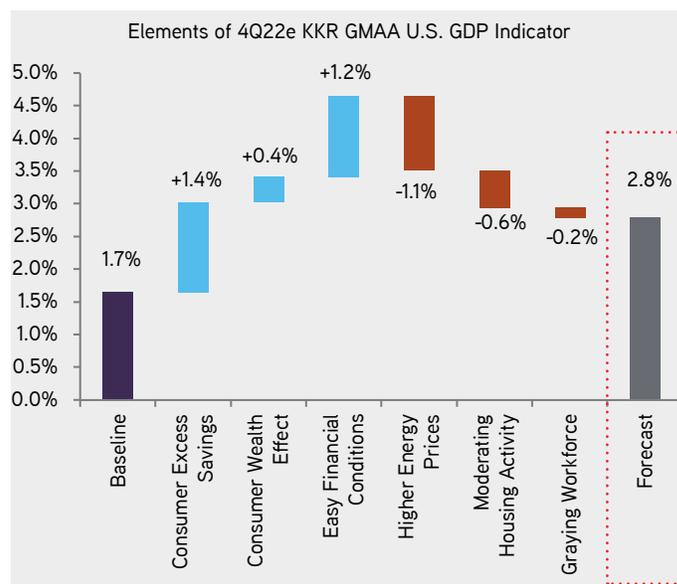
Importantly, what really differentiates Dave’s view from the consensus, however, is that he is forecasting much higher inflation in 2021 and into early 2022. What’s been driving this increase thus far is white-hot ‘scarcity’-driven inflation across roughly one third of the U.S. economy that includes most goods categories, and a few dislocated services categories such as airlines and hotels. Used vehicle prices have continued to move up in an unprecedented fashion while food CPI is now trending higher too (+0.8% Y/y in June, a 10% annualized rate). Looking ahead, Dave believes many of these trends will eventually cool and that the inflation spotlight will start shifting to core services inflation (rents, healthcare, education), and away from ‘scarcity-driven’ goods inflation. Core services inflation represents more than half of the U.S. economy and has remained surprisingly tame across most key categories thus far in 2021. One can see this in *Exhibit 14*. The core services inflation will be more

**What’s been driving this increase thus far is white-hot ‘scarcity’- driven inflation across roughly one third of the U.S. economy that includes most goods categories, and a few dislocated services categories such as airlines and hotels.**

persistent — buoyed by strong wage growth. This development is a big deal, as these three components account for fully 54% of total CPI. If there is good news, it is that moderating goods prices (vehicles in particular) should help keep headline inflation from spiraling out of control, particularly as base effects unfold over the next few months.

### Exhibit 13

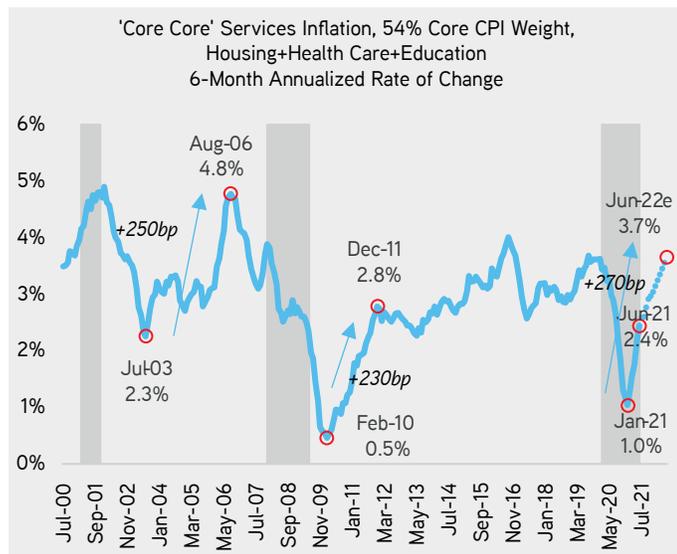
#### Heading Into 2022, High Energy Prices and Moderating Housing Activity Begin to Offset Savings, Wealth Effects and Easy Financial Conditions



Data as at June 28, 2021. Source: KKR Global Macro & Asset Allocation analysis.

### Exhibit 14

#### Core Services Inflation, Which Accounts for More Than 50% of Core CPI, Has Only Just Begun Creeping Higher



Data as at July 13, 2021. Source: Bureau of Labor Statistics, Manheim, University of Michigan, Haver, Bloomberg, KKR Global Macro & Asset Allocation analysis.

### Euro Area

Aidan Corcoran continues to maintain his above consensus Euro Area 2021 Real GDP growth forecast of 4.6% versus consensus of 4.5%. We expect real GDP growth in 2021 to be broadly base effect driven as the reopening of the economy brings back consumer spending opportunities,

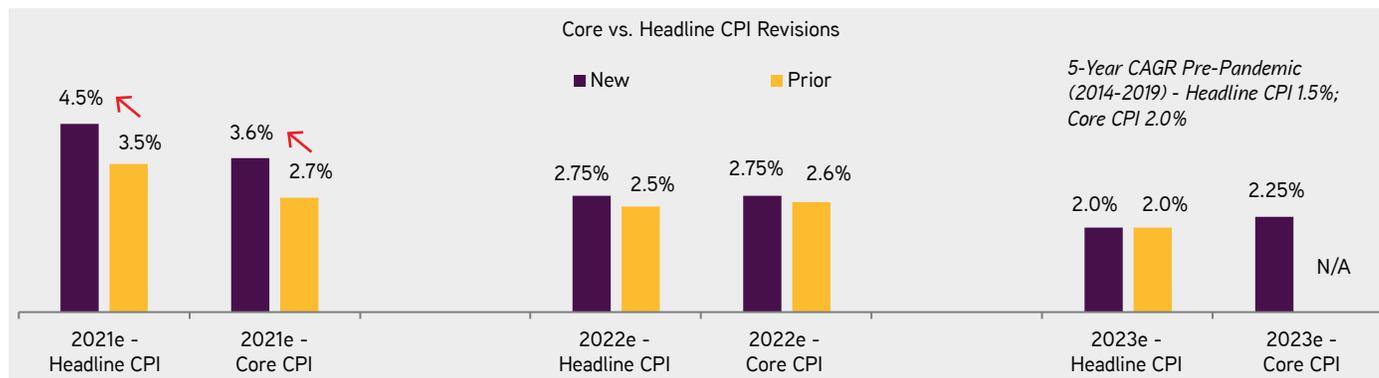
particularly in contact intensive industries. Unlike in previous crises, this time EU fiscal support is plentiful, including about 750 billion of loans and grants which are being made available to countries in proportion to their need. Struggling peripheral countries are therefore the main beneficiaries. In fact, we estimate that Italy, Spain, Greece, and Portugal will account for the majority of funds disbursed.

Importantly, these are not just loans. This time, the EU is making available almost 400 billion euros in the form of grants, which do not need to be repaid. In our view, this approach is a truly an encouraging development. Further, as the ECB just indicated in its recent statement that it welcomes an inflation overshoot of two percent in the near-term, we strongly believe that the European Central Bank is likely to maintain a highly accommodative stance well into the recovery in order to continue supporting the flow of credit to households and firms.

We are establishing a 2022 estimate of 4.4% versus a consensus of 4.3%. Our 2022 forecast reflects our expectation for a stronger than expected economic recovery as restrictions continue to be eased on the back of Europe's vaccination progress, which is gaining momentum. Overall, we expect Europe's reopening timetable to remain broadly on track as containment measures continue to be unwound at a faster pace in 2H21. Two key factors underpin our GDP forecasts: a positive uplift from COVID base effects and continued monetary policy support from the ECB.

### Exhibit 15

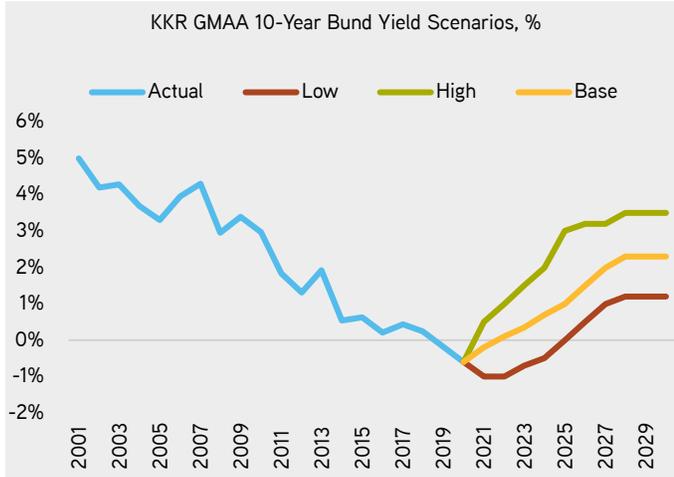
#### Pulling All the Pieces Together, We See a Higher Resting Rate for Inflation This Cycle Compared to the 1.5% Average of the Last One



Data as at July 13, 2021. Source: Bureau of Labor Statistics, KKR Global Macro & Asset Allocation analysis.

### Exhibit 16

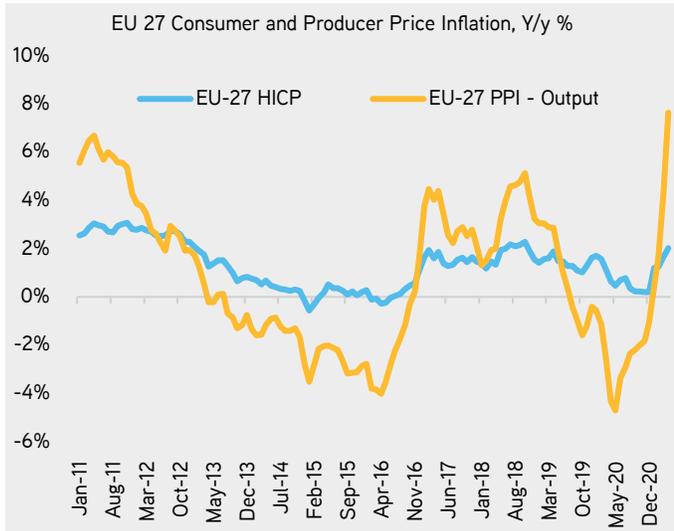
#### We Look for a Gradual Return to Normal From German Bund Yields



Data as at June 28, 2021. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

### Exhibit 17

#### Against Europe's Low Inflation Backdrop, Companies Are Severely Challenged to Pass Costs Through

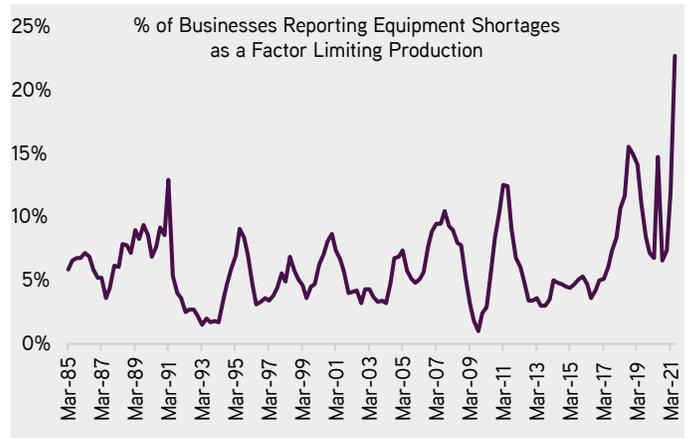


Data as at June 14, 2021. Source: ONS, Eurostat, Bureau of Labor Statistics.

As far as key risks, Aidan identifies two that might restrain growth: a worsening virus situation and continued supply bottlenecks. While the Delta and Lambda strains of the virus pose some risk to Europe, current evidence suggests that existing vaccines are effective against both strains. That said, the emergence of new variants will raise concerns around vaccine efficacy, potentially interrupting the economic recovery, including travel and leisure. We also face potential downside risks linked to current supply chain disruptions, particularly in relation to semiconductors. Should the current supply shortage run well beyond 2021 in Europe, this headwind could dent what we otherwise believe will be a really strong year of growth.

### Exhibit 18

#### Across Industries, 22.8% of Eurozone Businesses Are Reporting Equipment Shortages As a Key Factor Limiting Production...

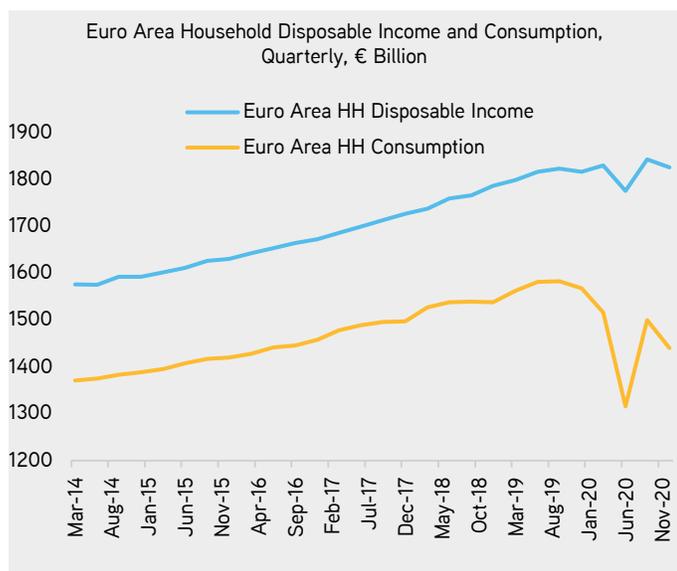


Data as at May 31, 2021. Source: European Commission.

The European recovery is gathering pace, and we maintain a positive outlook. In fact, we are now forecasting that Europe grows 40 basis points faster than the United States in 2022.

## Exhibit 19

### ...And So We See Scope for the Gap Between Household Consumption and Disposable Income to Narrow



Data as at December 31, 2020. Source: Eurostat.

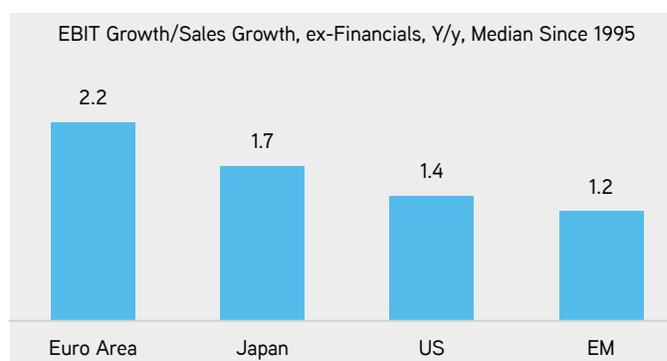
Meanwhile, for inflation, we look for Euro Area HICP (i.e., inflation) to average 1.8% in 2021 versus our prior estimate of 90 basis points. This upward revision is due to rising commodity and transport prices, COVID base effects (including reversal of COVID related tax cuts), price increases in sectors that are reopening (including package holiday) and supply bottlenecks. However, we view this rise in inflation as transitory, as we forecast inflation falling back to 1.3% in 2022 as the base effects roll off, one-off price pressures dissipate, and underlying disinflationary factors reassert themselves. That said, there are risks that supply bottlenecks may become more severe or linger longer than anticipated, so there are still upside risks to our inflation forecasts. As mentioned earlier, we think that the ECB will now be more formally tolerant of cyclical inflation increasing above two percent, as it looks to stimulate nominal GDP.

Bottom line: The European recovery is gathering pace and we maintain a positive outlook. In fact, we are now forecasting that Europe grows 40 basis points faster than the United States in 2022. Consistent with this forecast, we

advocate for selectively leaning into cyclical as we enter into a faster nominal growth regime, particularly given the operating leverage embedded in the European economy/markets during periods of deflation. In particular, we see upside in the consumer discretionary sector given the existence of significant pent-up demand.

## Exhibit 20

### Europe Has the Most Operating Leverage in a Stronger Nominal GDP Environment



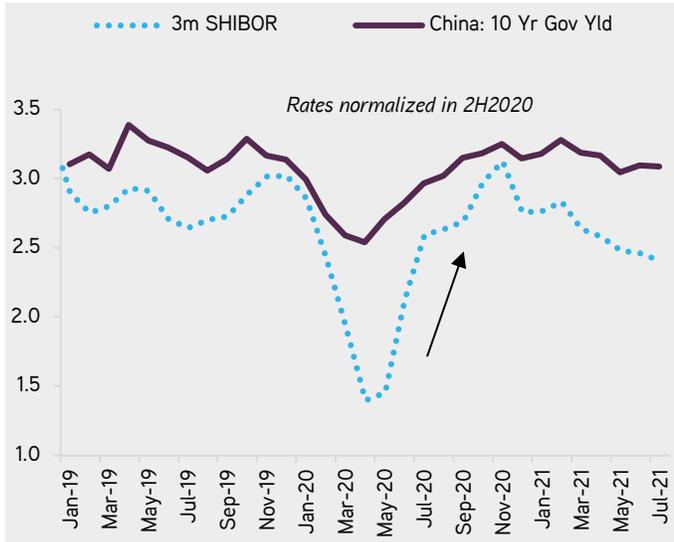
Data as at March 31, 2021. Source: Haver Analytics, Bloomberg, KKR Global Macro & Asset Allocation estimates.

### China

While we expect above-consensus China real GDP growth of 8.7% for 2021 versus a consensus estimate of 8.5%, we do not see runaway growth. Notably, a large portion of the growth we are forecasting this year is due to the base effect of a weak first quarter 2020. China was the first country into the pandemic and the first country to recover as manufacturing, construction and exports had normalized by mid-2020. China rates also normalized in the second half of 2020, while U.S. rates remained floored throughout most of 2020. We now see a decoupling of growth, with China growth already decelerating on a quarter-over-quarter basis, from a high of 10.1% in 2Q2020, to just 0.4% in 1Q2021.

### Exhibit 21

#### China Began Normalizing Policy in 2H2020...



Data as at July 15, 2021. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

### Exhibit 22

#### ...Which Informs Our View That Growth Will Be More Controlled This Recovery Cycle



Data as at June 30, 2021. Source: China National Bureau of Statistics, KKR Global Macro & Asset Allocation analysis.

**Surprisingly, slower growth is not translating into lower inflation.** In fact, China's consumer price inflation has been mostly out-of-synch with the U.S. since 2019. This is due to the differences in CPI composition — China has a large weight in food (27%), while the U.S. has a large weight in shelter (32%) — and differing levels of volatility (food prices tend to be extremely volatile). In 2018/2019, African swine flu infected China's hog supply and over 40% of hogs were culled, sending pork prices up two fold. However, over the past two years, the supply of hogs has been fully replenished, causing pork prices to normalize. This has helped to offset the sharp rise in hard commodity prices. Despite this slower growth environment, we do expect China's CPI to rise over the next few quarters, but still remain below the PBoC ceiling of three percent due to the offsetting impact of food price deflation, providing policy makers some room to maneuver if growth slows too rapidly. We have already seen the PBoC lower the reserve required ratio (RRR) in July by 50 basis points as a targeted measure to ease margin pressure (rising input prices) from supply chain issues and to counter the temporary liquidity impact from the expiration of the medium-term lending facility (MLF).

### Exhibit 23

#### China's CPI Should Remain Below the Three Percent Cap



Data as at June 30, 2021. Source: US Bureau of Labor Statistics, China National Bureau of Statistics, Haver, KKR Global Macro & Asset Allocation analysis.

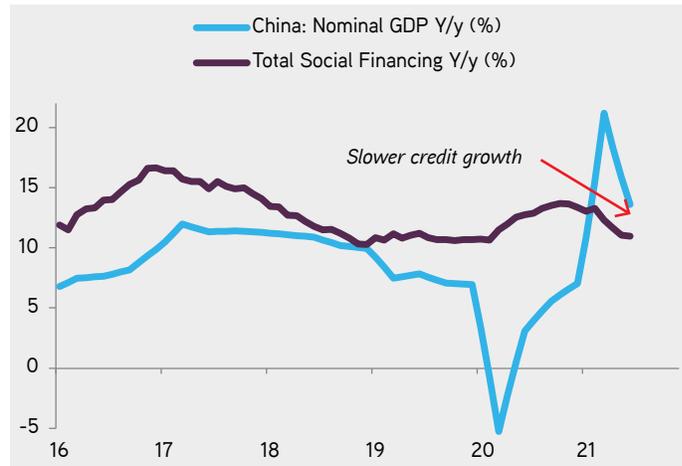
**We think the combination of relatively strong growth and low inflation in China has allowed Authorities to swing the policy pendulum back towards reforms and away from growth at any cost.** While there has been some easing in credit conditions from the recent RRR cut, we do not think it will be broad based, but instead will facilitate improvement in the quality of growth, rather than achieving growth at any cost. In particular, we think the Ministry of Finance will use this window to address the persistent moral hazard problem within local government financing vehicles; and while overall credit risk will be manageable, it will be elevated in certain sectors like Real Estate.

All in all, we expect a modest deceleration in growth to 5.4% for 2022, compared to a market consensus of 5.6%. Longer term, we expect growth to continue its gradual decent towards an average of 5.3% for 2021–25, 4.4% in 2026–30, and 3.5% in 2031–35. Inflation should remain largely within the 2.0–2.5% range prior to 2030. Even though growth and inflation will be lower, China will still be able to achieve its target of doubling GDP-per-capita over the next 15 years, as weaker demographics can be offset by improved capital efficiency and total factor productivity. This can be attained through industrial automation, digitalization, and intelligentization, which involves applying big data, artificial intelligence, cloud computing, Internet of Things and other smart technologies to the manufacturing sector.

**We think the combination of relatively strong growth and low inflation in China has allowed Authorities to swing the policy pendulum back towards reforms and away from growth at any cost.**

### Exhibit 24

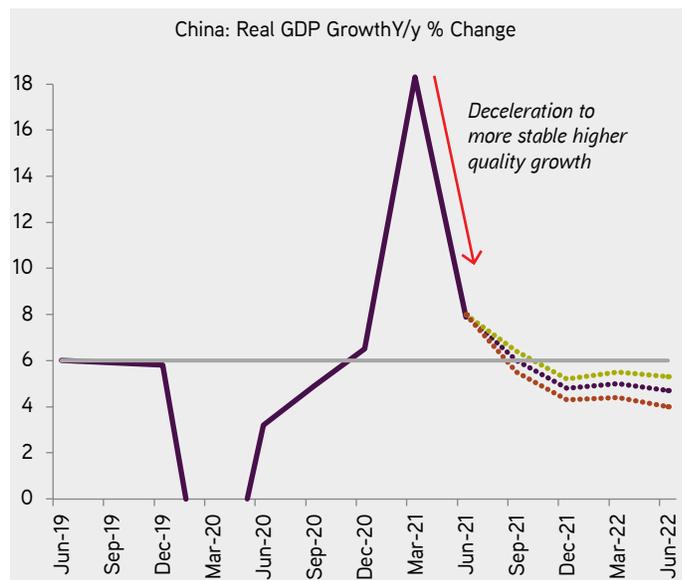
#### Financial Stability and Deleveraging Back in Play



Data as at June 30, 2021. Source: China National Bureau of Statistics, People's Bank of China, Haver, KKR Global Macro & Asset Allocation analysis.

### Exhibit 25

#### Unlike the Last Cycle, We Think That China Is Likely to Have a More Stable Recovery



Data as at July 15, 2021. Source: Bloomberg, KKR Global Macro & Asset Allocation estimates.

## Mexico

My colleague Brian Leung is forecasting above-consensus GDP growth of 6.1% in 2021, up from 4.9% previously and a Wall Street mean estimate of 5.1%. Mexico is benefitting from the strong U.S. recovery, which is boosting both exports and domestic consumption via record-high remittances and tourism flows. Meanwhile, within Mexico we note that midterm results — with President Obrador’s (AMLO) governing coalition losing the qualified majority — also take the tail risk of radical constitutional reforms largely off the table, an incremental positive for the investing backdrop, we believe.

However, Mexico’s medium-term growth prospects remain challenged. Fiscal austerity, coupled with years of underinvestment and continued business uncertainty under AMLO, means longer-term potential GDP growth is likely below the pre-pandemic estimate of around two percent. Worsening inflation dynamics have also prompted an earlier central bank hiking cycle, well before the economy has fully recovered from the pandemic. Consistent with this macro view of Mexico, we continue to favor opportunities leveraged primarily to external demand, exports, and reshoring versus domestic demand plays that rely on fixed investment and/or a sustained boost to consumption.

**Consistent with this macro view of Mexico, we continue to favor opportunities leveraged primarily to external demand, exports, and reshoring versus domestic demand plays that rely on fixed investment and/or a sustained boost to consumption.**

## Exhibit 26

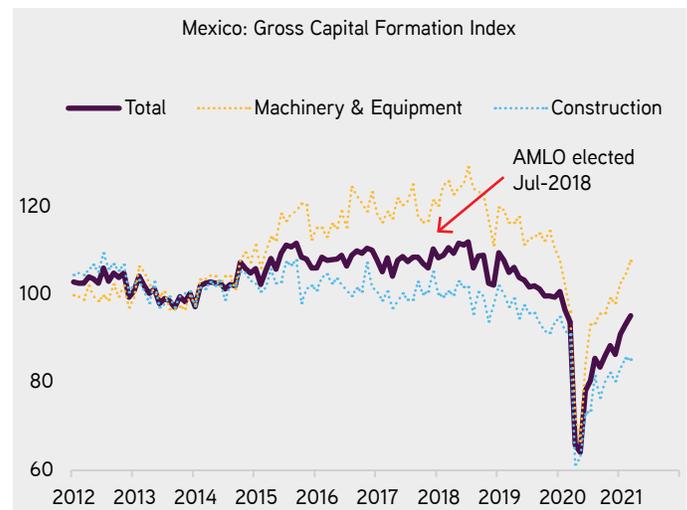
**We Revise Up Our 2021 Mexico Real GDP Growth to 6.1% (vs. 4.9% Previously) and Introduce a Three Percent Growth Estimate for 2022**



Data as at June 30, 2021. Source: Banco de Mexico, INEGI, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

## Exhibit 27

**While Investment Should Partially Recover From Last Year’s Losses, It Is Unlikely to Buck the Multi-Year Downtrend**



Data as at June 30, 2021. Source: Banco de Mexico, INEGI, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

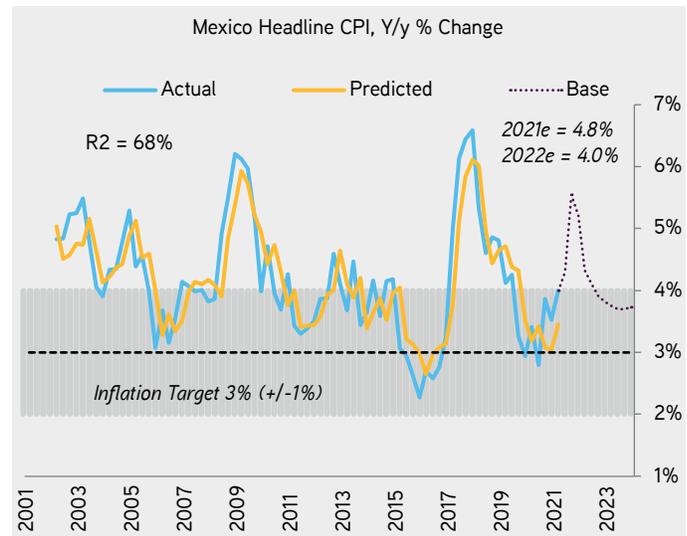
On the inflation side, Brian expects headline CPI to average 4.8% this year, essentially in-line with consensus. For 2022, he forecasts inflation in Mexico at 4.0%, compared to a consensus forecast of 3.6%. Interestingly, despite a large negative output gap, inflation prints have consistently surprised on the upside this year (and we believe this trend will continue into 2022). Our work suggests that rising inflation expectations, coupled with negative supply shocks such as higher minimum wage, higher effective tax rates and energy shortages, will be to blame.

However, the central bank has not sat idle during these adverse inflation developments. In fact, in order to re-anchor longer-term inflation expectations, last month Banxico surprised investors with a pre-emptive 25 basis point rate hike, lifting the policy rate to 4.25% from 4.00%. Going forward, we expect a relatively brief hiking cycle (with the policy rate reaching 5.00% by year-end) given the abundant slack in the economy and dovish tilt in board composition. Overall, we believe a hawkish central bank, coupled with modest current account surplus and less support for AMLO in Congress, should keep the peso resilient over the next six to 12 months.

**Mexico's medium-term growth prospects remain challenged. Fiscal austerity, coupled with years of underinvestment and continued business uncertainty under AMLO, means longer-term potential GDP growth is likely below the pre-pandemic estimate of around two percent. Worsening inflation dynamics have also prompted an earlier central bank hiking cycle, well before the economy has fully recovered from the pandemic.**

### Exhibit 28

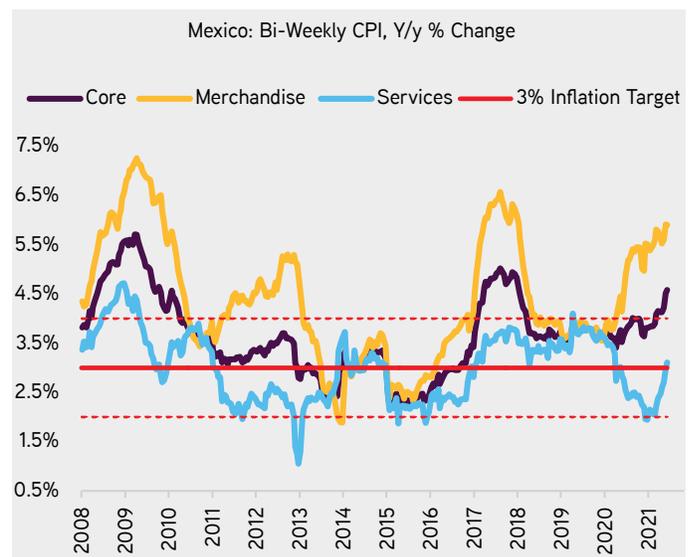
**We Revise Up Our CPI Estimate to 4.8% This Year vs. 3.7% Previously, and We Expect Inflation to Average Four Percent Next Year**



Data as at June 30, 2021. Source: Banco de Mexico, INEGI, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

### Exhibit 29

**Core Inflation Continues to Climb as Higher Merchandise Inflation Is Joined by Recovery in Services Inflation As the Economy Reopens**



Data as at June 30, 2021. Source: Banco de Mexico, INEGI, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

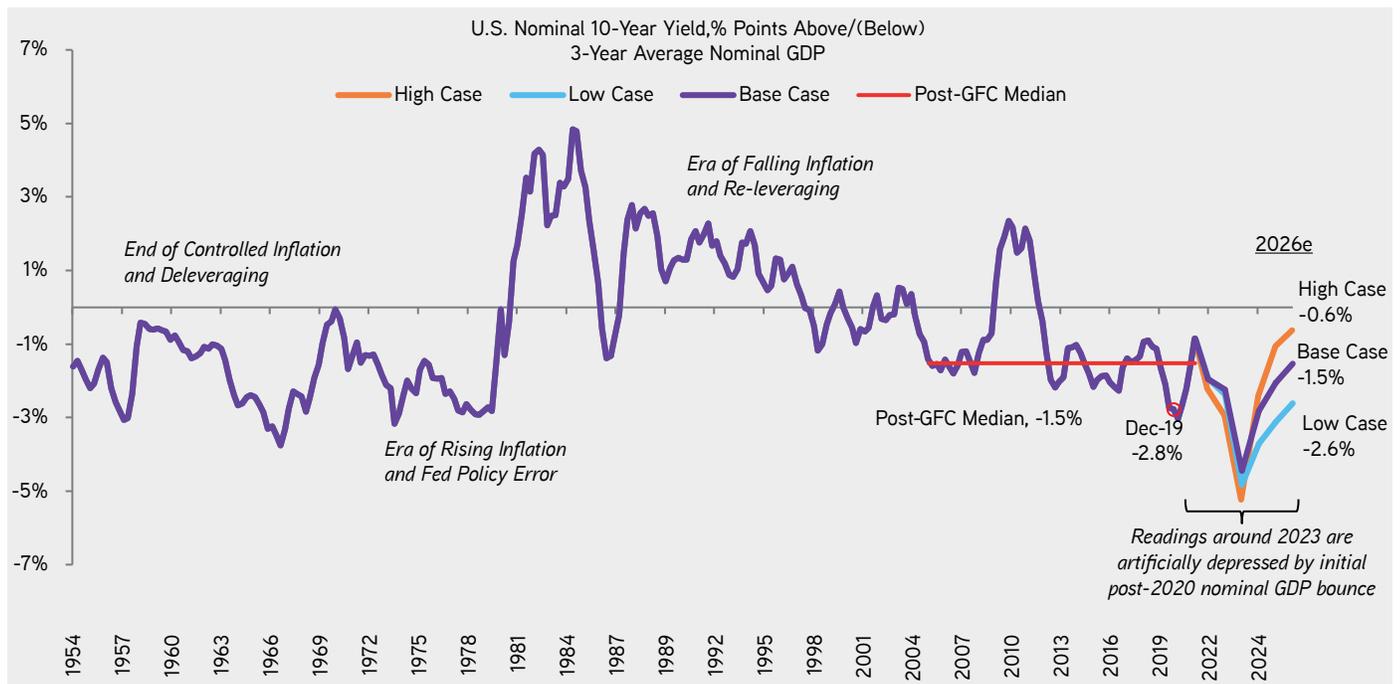
## Interest Rates

Earlier this year, we spent a considerable amount of time with our deal teams pressure testing our traditional interest rate framework. One can see this in *Exhibit 30*, which shows our base, bull, and bear case scenarios for the relationship between U.S. nominal interest rates and U.S. nominal GDP. We also looked at some technical factors, including supply and demand, which supported our view that U.S. 10-Year yields are not on the verge of unraveling. All the models we reviewed suggested higher rates, but they did not foreshadow a surge in either near-term or long-term rates the way some bond bears were growing. Softening demographic growth trends, technological efficiencies, and higher savings

by wealthy consumers with less propensity to spend all remain significant structural factors that suggest a lower resting spot for interest rates. In fact, despite all the stimulus in the system right now, we are actually lowering our 2022 10-year forecast to 2.00% from 2.25%. We are now largely below consensus on 10-year yields, expecting that the market will take a 'show me' attitude towards Fed hikes once inflation starts slowing from peak levels. Also, as we mentioned earlier in this report, we do expect rate of change in the global economy to slow in the near-term, which we think could also keep longer-term interest rates in check until the Fed reconfirms strong growth by actually increasing short-term interest rates.

### Exhibit 30

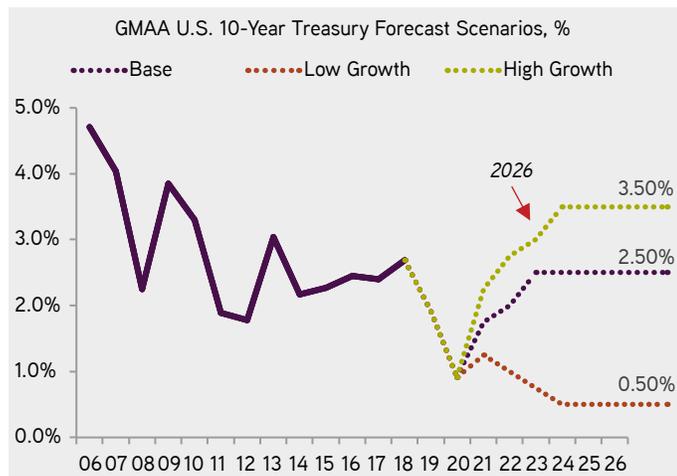
**We Continue to Use Scenario Planning to Attack a Complex Outlook for Interest Rates. The Good News Is That We Are Not Making Any Material Changes to Our Prior Forecasts**



e = KKR GMAA estimates. Data as at April 18, 2021. Source: Bureau of Economic Analysis, Federal Reserve, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

### Exhibit 31

#### Our Scenario Analysis Continues to Lead to Wider Tails, Underscoring the Uncertainty of Recent Policy Initiatives



e = KKR GMAA estimates. Data as at June 30, 2021. Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Bloomberg, KKR Global Macro & Asset Allocation analysis.

### Exhibit 32

#### We Think the Fed Moves Short Rates in 2023. Meanwhile, Our Base View Is That the Long-End of the Curve Gradually Increases

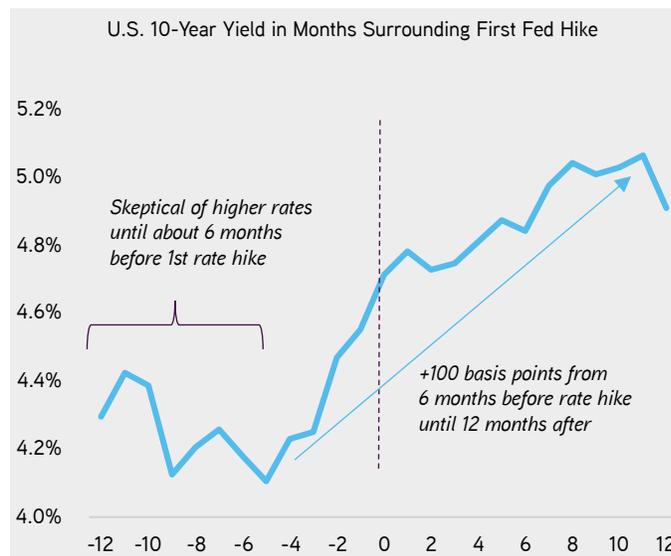
	Base Case	
	Fed Funds	U.S. 10-Year Yield
2020	0.09%	0.91%
2021e	0.13%	1.75%
2022e	0.13%	2.00%
2023e	0.63%	2.50%
2024e	1.38%	2.50%
2025e	2.13%	2.50%
2026e	2.13%	2.50%
<b>Average 2020-2026</b>	<b>0.94%</b>	<b>2.09%</b>

Data as at June 28, 2021. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

That said, we do see rates moving higher. As we show in *Exhibit 33*, it usually takes investors a little time to actually gain confidence the Fed is going to raise rates. However, once they do, the long-end begins to back up. Specifically, our work shows that 10-year rates increase about six months, on average, before the Fed increases rates. According to Dave McNellis, the Fed will likely start increasing short rates in mid to late 2023. Hence, given this timeline, we made the decision to trim our 2022 10-Year forecast by 25 basis points.

### Exhibit 33

#### The Market Tends to Remain Skeptical of Fed Tightening Until About Six Months Before the First Hike



Average of 10-Year yields in months surrounding first Fed hikes in February 1994, June 1999, June 2004, and December 2015. Data as at June 28, 2021. Source: Bloomberg.

**We do see rates moving higher. It usually takes investors a little time to actually gain confidence the Fed is going to raise rates. However, once they do, the long-end begins to back up.**

## Exhibit 34

### U.S. Yields, Which Are Now 150 Basis Points Above German Bund Yields, Rarely Reach the 250 Basis Point Threshold



Data as at June 28, 2021. Source: Bloomberg.

### Capital Markets: Outlook for Equities and Credit

We are using this mid-year update to raise our S&P 500 2021 price target to 4,450, up from 4,320 previously, on the back of higher 2021 EPS of \$200 per share versus \$185 per share previously and a current consensus of \$191 per share. Key to the upgrade is our Earnings Growth Leading Indicator (EGLI) signaling 40% year-over-year near-term earnings growth, as macro inputs such as housing, new orders and credit spreads all suggest strong growth ahead. Importantly, we expect cyclical sectors (Industrials, Financials, Energy, Materials, and Consumer Discretionary) to drive almost two-thirds of the EPS growth this year and next year. One can see this in *Exhibit 36*. This bias towards more cyclical sectors is a marked departure from 2012–19, a period when the three ‘secular growth’ sectors — Technology, Communications and Healthcare — accounted for fully 64% of the earnings growth.

We are also taking up our 2022 EPS estimate to \$219 per share, up from \$204 per share previously and above consensus at \$214 per share. Our estimate already incorporates a 4.8% headwind from higher corporate tax rate (to 25% from 21%) and higher GILTI tax (to 18.75% from 11%). We reiterate our 2022 forecast for the S&P 500 of approximately 4,650, which assumes a forward P/E of 20.2x (about 2.5x below current level), as we expect strong earnings growth, rather than multiple expansion, to drive the next leg of the equity rally. However, despite all this rapid growth we are forecasting, we do want to caution that, if we look at the leading indicator, it points to a major growth slowdown in 2023. To be sure, the model is not always correct, but we do think that margin degradation could have a potentially bigger impact on corporate profits, particularly for price takers, by the time we exit 2022. This reality could come as a quite a surprise to the market, we believe, as the sell-side community is currently forecasting that 80% of companies in the S&P 500 have improving margins in 2022.

## Exhibit 35

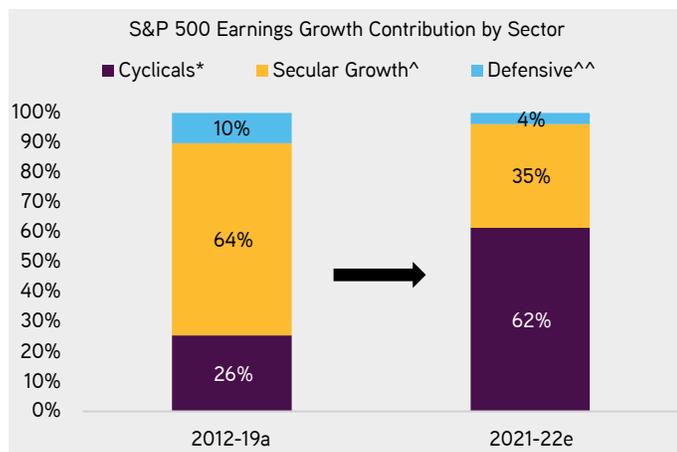
### Our Earnings Growth Leading Indicator Suggests a Peak in 2022 Followed by a Rapid Deceleration Through the First Half of 2023

	May'22e (Peak) Con- tribution	Jun'23e Contribution	Delta
Real Home Price Appreciation	12.6%	6.6%	-6.0%
ISM PMI	7.4%	-1.2%	-8.6%
Oil Prices	6.1%	-10.1%	-16.2%
Credit Spreads	5.9%	0.0%	-5.9%
Baseline Growth	5.3%	5.3%	0.0%
Consumer Confidence	1.4%	0.0%	-1.4%
Trade-Weighted USD	1.2%	0.3%	-0.8%
G7 ex US Monetary Policy	0.4%	0.0%	-0.4%
<b>Total</b>	<b>40.2%</b>	<b>1.0%</b>	<b>-39.2%</b>

Data as at June 30, 2021. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

### Exhibit 36

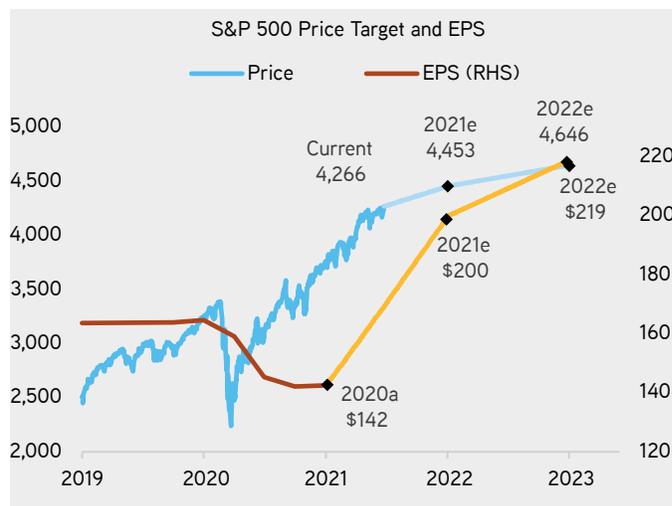
Cyclicals Are Expected to Drive Almost Two Thirds of 2021–22 EPS Growth, a Reversal From 2012–19 Period When Secular Growth Sectors Reignited Supremacy



\* Cyclicals include industrials, energy, materials, financials and discretionary; ^ Secular growth includes technology, communications and healthcare; ^^ Defensive includes staples, utilities and REITs. Data as at June 30, 2021. Source: S&P 500, KKR Global Macro & Asset Allocation analysis.

### Exhibit 38

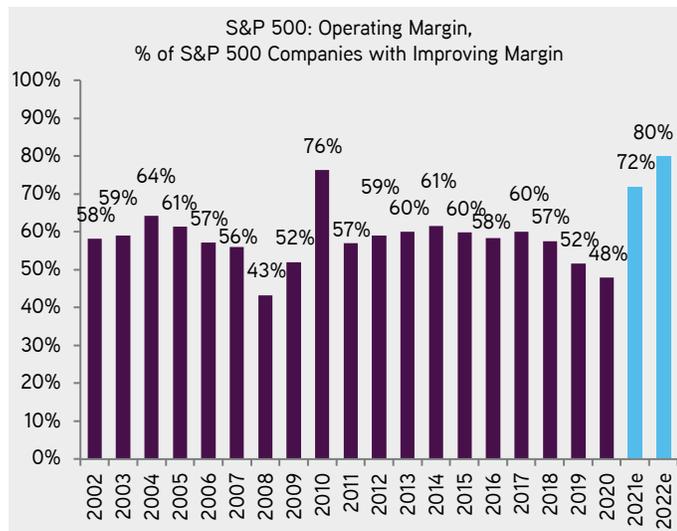
Our Projected Path Has S&P 500 Ending 2021 At Around 4,450 on \$200 of EPS and Ending 2022 At About 4,650 on \$219 of EPS



Data as at June 28, 2021. Source: S&P 500, KKR Global Macro & Asset Allocation analysis.

### Exhibit 37

Consensus Margin Expectations Appear at Extremes, Particularly Relative to History



Data as at June 28, 2021. Source: Factset.

### Exhibit 39

We Raise Our S&P 500 2021 Fair Value Estimate to 4,450, Up Modestly From 4,320 Previously

	5.25%	5.00%	4.75%	4.50%	4.25%	4.00%	3.75%
2.50%	3,513	3,691	3,888	4,106	4,351	4,626	4,937
2.25%	3,609	3,792	3,995	4,220	4,472	4,755	5,075
2.00%	3,707	3,895	4,104	4,335	4,594	4,886	5,216
1.75%	3,806	4,000	4,214	4,453	4,719	5,019	5,359
1.50%	3,906	4,106	4,327	4,572	4,846	5,154	5,504
1.25%	4,008	4,214	4,441	4,693	4,975	5,292	5,652
1.00%	4,112	4,323	4,557	4,816	5,106	5,432	5,802

Data as at June 28, 2021. Source: S&P 500, Professor Damodaran, KKR Global Macro & Asset Allocation analysis.

Even though growth expectations are peaking and monetary/fiscal stimulus momentum is fading, we believe the U.S. economy is simply transitioning to mid-cycle from early-cycle. Said differently, until credit spreads really start to deteriorate, earnings revisions start to decline, and/or monetary policy starts to tighten restrictively, any equity market consolidation should be viewed as a buying opportunity, we believe. Our equity risk premium work suggests a similar conclusion. In fact, we note that while today's implied equity risk premium of 4.4% is low relative to the post-GFC average (5.5%), it is actually modestly above its longer-term average (4.2%) going back to the 1960s. As such, we do not think valuations will be a major impediment to further equity gains in today's low interest environment.

### Exhibit 40

**Multiples Often Contract on the Heels of Rising Rates and Strong Economic Growth. We Don't Think This Cycle Will Be Any Different**

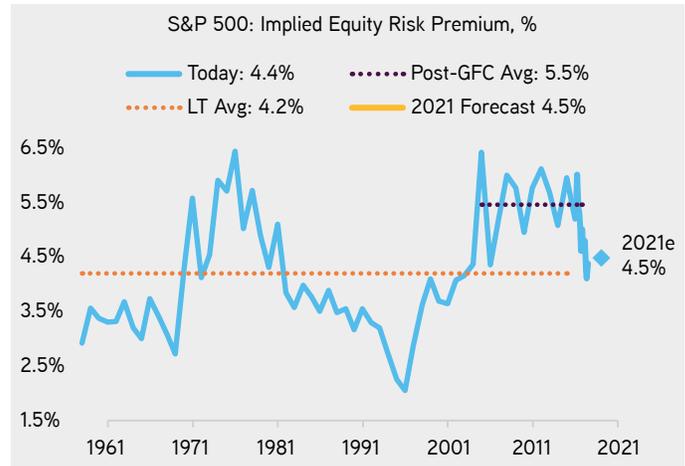
S&P 500: EPS, Multiples and Rates			
	EPS Growth, %	Trailing P/E Multiple	Change in 10-Year UST Yield, bps
1994	18%	(17%)	+203
2004	21%	(10%)	-3
2005	14%	(9%)	+17
2010	38%	(18%)	-54
2011	14%	(13%)	-142
2021e	40%	(15%)	+84
2022e	9%	(5%)	+25

Data as at June 2021. Source: Haver Analytics, Bloomberg, S&P 500, KKR Global Macro & Asset Allocation analysis.

**Even though growth expectations are peaking and monetary/fiscal stimulus momentum is fading, we believe the U.S. economy is simply transitioning to mid-cycle from early-cycle.**

### Exhibit 41

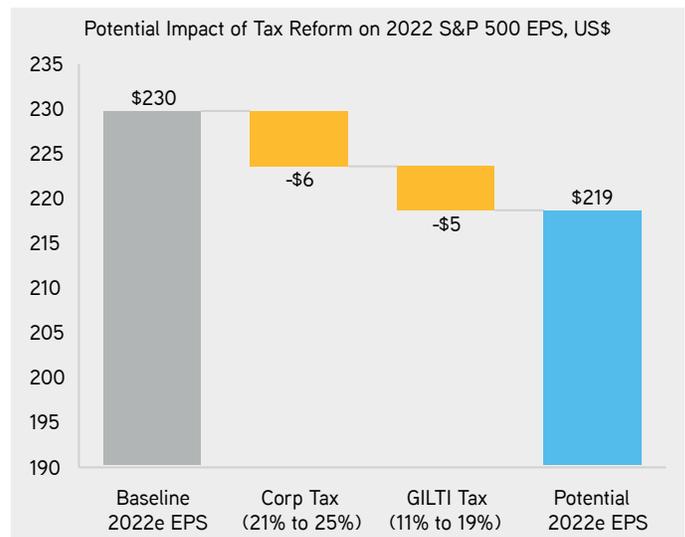
**Today's Risk Premium Is Low Relative to the Post-GFC Period, But Actually About Average vs. Longer History. We Now Assume a 4.5% ERP, Down From 4.7% Previously**



Data as at June 28, 2021. Source: Bloomberg, Professor Damodaran, KKR Global Macro & Asset Allocation analysis.

### Exhibit 42

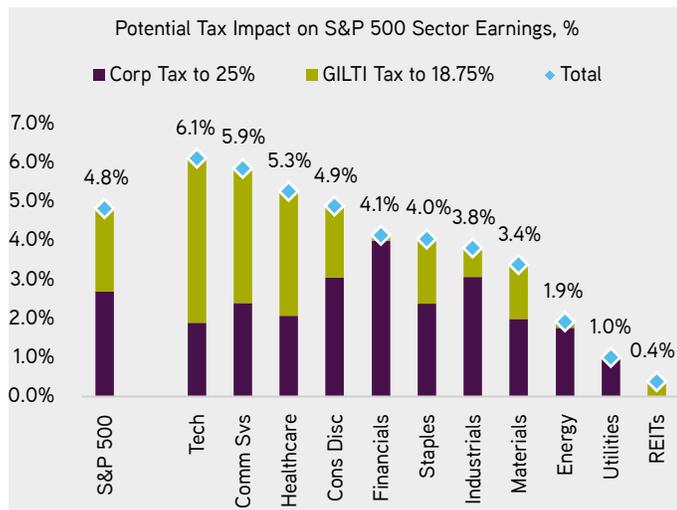
**Our Base Case Expects Biden's Tax Reform to Be a 4.8% Headwind to 2022 S&P 500 Earnings, Assuming Corporate Taxes Rise to 25% (From 21%) and GILTI Tax Rises to 18.75% (From 11%)**



Data as at June 28, 2021. Source: Bloomberg, Factset, KKR Global Macro & Asset Allocation analysis.

### Exhibit 43

#### Technology, Communication Services and Healthcare Are Likely to Get Hit the Hardest From a Tax Increase



Data as at June 28, 2021. Source: Bloomberg, Factset, KKR Global Macro & Asset Allocation analysis.

Meanwhile, in Credit, things generally look a little more expensive. Indeed, as *Exhibit 87* shows, our proprietary High Yield default rate monitor is now down to 1.7%, compared to a nearly 15% reading in 2020 during the height of the pandemic, and a historical average of six percent. Against this type of backdrop, we think relative value matters a lot. As such, we asked our colleagues Kris Novell and Rachel Li to identify some potential areas of opportunity. One can see some of their work in *Exhibits 44* and *45*.

What's the punch line? Kris and Rachel suggest that floating rate paper currently offers more convexity relative to fixed rate, especially in the BB/B Loan space (U.S. and Europe) and CLO paper across the various rating classes (in particular CLO BB's). Both of these asset classes have been a beneficiary of the recent rising interest rates concerns, a trend we expect to continue.

On a spread basis relative to comparable Treasuries, the riskiest portions of the market (CCC HY/Loans) continue to offer spreads near/above 600 basis points. However, as the market has rallied, these spreads are now at historical tightness in absolute terms. Meanwhile, even though spreads in Loans/CLO tranches have compressed significantly during the past year post the height of the COVID crisis, current spread levels are *relatively* cheaper compared to 5 and 10-year historical averages. So, for higher returning and riskier types of credit exposure, we think adding to CLO BB's looks attractive. CLO BB's are income generating, and Moody's suggests – and we agree – that CLOs have shown lower impairment rates over time.

### Exhibit 44

#### BB/B Loans and BB CLOs Look the Most Attractive

	Spreads Percentile			
	Current Spread	1yr	5yr	10yr
<b>US Bonds</b>				
US High Yield	304	100%	100%	100%
US BB	219	98%	85%	92%
US B	349	98%	95%	97%
US CCC	583	100%	100%	100%
US BB to BBB	112	98%	37%	62%
<b>US Loans</b>				
US Bank Loans	406	95%	66%	83%
US BB	300	54%	42%	71%
US B	420	97%	74%	87%
US CCC	763	100%	100%	100%
<b>US CLOs</b>				
US A	205	80%	77%	88%
US BBB	310	89%	81%	90%
US BB	635	84%	62%	66%

Data as at June 30, 2021. Source: ICE BofA, LCD, KKR Credit analysis.

## Exhibit 45

On a Risk-Reward Basis, Given Lower Historic Impairment Rates and Wider Spreads, We Favor US BB CLOs

Spreads, bps	Market	Spreads Percentile		
		1yr	5yr	10yr
Above 640	EU CLOs B, US LL CCC, EU HY CCC			
635	US CLOs BB	84%	62%	66%
600	EU CLOs BB	71%	49%	
583	US HY CCC	100%	100%	100%
420-445	US/EU LL B	88%	72%	86%
405	EU HY B	84%	86%	90%
349	EU LL BB	61%	35%	67%
349	US HY B	98%	95%	97%
310-325	US/EU CLOs BBB	86%	72%	
300	US LL BB	54%	42%	71%

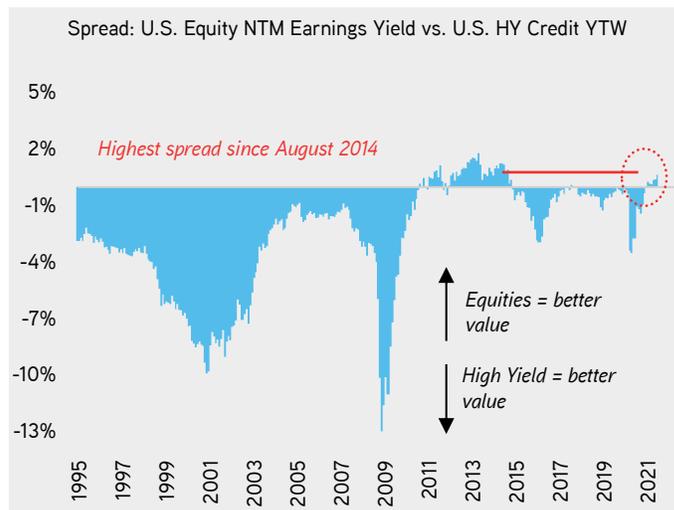
Data as at June 30, 2021. Source: ICE BofA, LCD, KKR Credit analysis.

Looking at the bigger picture, our work shows that Equities generally look more attractive on a relative basis than Credit. One can see this in *Exhibit 46*, which shows the earnings yield on stocks relative to yield-to-worst on HY credit is as high as it has been since 2014. It also reinforces our view within Credit to maintain an opportunistic bias, with an ability to toggle across asset classes, including Loans, Bonds, and Structured Products.

**Looking at the bigger picture, our work shows that Equities generally looks more attractive on a relative basis than Credit as the earnings yield on stocks relative to the yield-to-worst on HY credit.**

## Exhibit 46

At the Moment, the Earnings Yield on Equities Is At Its Highest Level to High Yield Since August 2014



Data as at June 30, 2021. Source: Bloomberg.

## Oil

Given the large upward move of late, **crude oil futures are now more fully embedding the structural improvement in long-term pricing trends that we have been anticipating.** One can see this in *Exhibit 47*. **However, we think that there could be more good news to come.** Key drivers of our thinking:

- **We are seeing a structurally altered price versus supply growth function in the post-pandemic era.** See more about our views on the energy transition in Section II of this note, but the surge in climate activism demanding that Big Oil drastically cut emissions and invest in low-carbon energy could result in a surge in oil prices in the not-too-distant future. We also note that in the *Net Zero by 2050* report the IEA made waves with a scenario analysis that linked “no new oil and natural gas fields are approved for development after 2021” to the world achieving the Paris Agreement climate goals.

- **We are also seeing more definitive improvement in physical market fundamentals.** Catalyzed by better spending trends, particularly in the U.S. and Europe. Importantly, we see oil demand rebound racing ahead of electric vehicle penetration that will, only over time, bring structural demand destruction.
- **The technical picture for crude oil trading also looks supportive.** Speculator positioning actually tilts net cautious (a contrarian 'buy' signal), which is somewhat surprising, given recent bullish price trends.

**So, when we pull all the pieces together, we are raising our average price targets marginally** to \$67.50 per barrel this year (from \$65.00), \$62.50 per barrel in 2022 (from \$57.50) and \$57.50 per barrel in 2023 (from \$52.50). One can see all the details in *Exhibit 47*.

**What are we watching?** OPEC+ restraint is still required to maintain healthy supply/demand. We do expect continued OPEC+ cohesion, particularly given the surprisingly staid U.S. shale rig count and alignment of fiscal interests amongst key OPEC+ members. However, cooperation does not come easy since core OPEC members want to secure long-term market share. The recent stand-off over baselines illustrates the fragility of OPEC+ cohesion. Looking ahead, the group's response to an expected return of Iranian exports remains an additional significant wildcard. Exacerbating the turbulent backdrop is that the oil supply is already in deficit, with investment bank Morgan Stanley estimating a two million barrel per day shortfall of supply relative to demand over the last few months. Maybe more important is that global demand could grow by as much as an additional three million barrels per day over the second half of 2021. Our bottom line is that inventories will likely be further depleted in coming months, ensuring price support, even as OPEC+ incrementally ramps its supply by a 400,000 barrels per day on a monthly basis throughout the second half of this year.

**Our bottom line:** The macro backdrop for crude oil has been a little better than expected so far this year, and as such, we are raising our price targets marginally. In particular, we want to emphasize that we have even higher conviction in the structural improvement story we have been championing. At the same time, we acknowledge much more good news is now in the price. Hence, while we want to retain some upside optionality, we endorse sticking with our existing game plan to hedge some of our 2024 production in the high-50s/low-60s WTI range that we expect futures will offer us in coming months.

**We are seeing a structurally altered price versus supply growth function in the post-pandemic era. The surge in climate activism demanding that Big Oil drastically cut emissions and invest in low carbon energy could result in a surge in oil prices in the not-too-distant future.**

### Exhibit 47

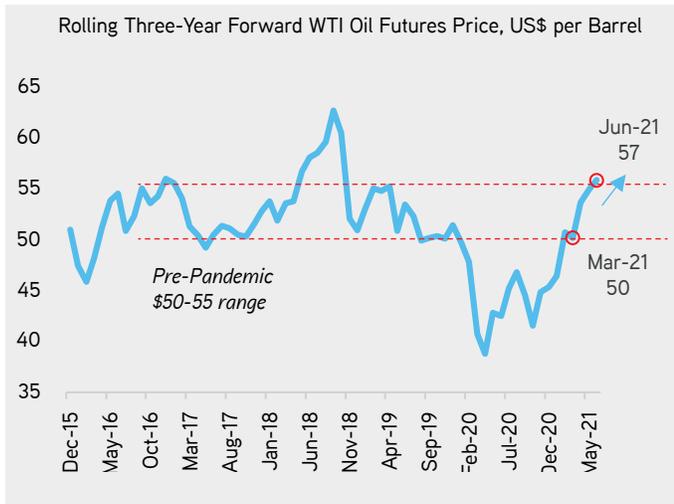
#### We View Long-Term Pricing Trends As Durable With Further Upside Potential

	KKR GMAA (Jun'21)	WTI Futures (Jun'21)	Jun'21 Forecasts GMAA vs. Futures	KKR GMAA (Mar'21)	WTI Futures (Mar'21)	Mar'21 Forecasts GMAA vs. Futures	Change in GMAA Forecasts: June'21 vs. Mar'21	Change in Futures: Jun'21 vs. Mar'21
2019a	57.04	57.04	0.0	57.04	57.04	0.0	0.00	0.0
2020a	39.34	39.34	0.0	39.34	39.34	0.0	0.00	0.0
2021e	67.50	64.71	2.8	65.00	62.07	2.9	2.50	2.6
2022e	62.50	63.57	-1.1	57.50	58.02	-0.5	5.00	5.6
2023e	57.50	59.04	-1.5	52.50	54.28	-1.8	5.00	4.8
2024e	57.50	56.06	1.4	57.50	52.10	5.41	0.00	4.0

Forecasts represent full-year average price expectations. Data as of June 2, 2021. Source: KKR Global Macro & Asset Allocation analysis.

### Exhibit 48

#### Consistent With Our Expectations, Dated Oil Prices Have Now Broken Out Above the Pre-Pandemic Range



Data as at June 28, 2021. Source: Bloomberg.

### Exhibit 49

#### Shale Rig Counts Have Been Slow to Reflect the Oil Price Recovery, As 2021 Capex Budgets Remain Constrained



## Currency

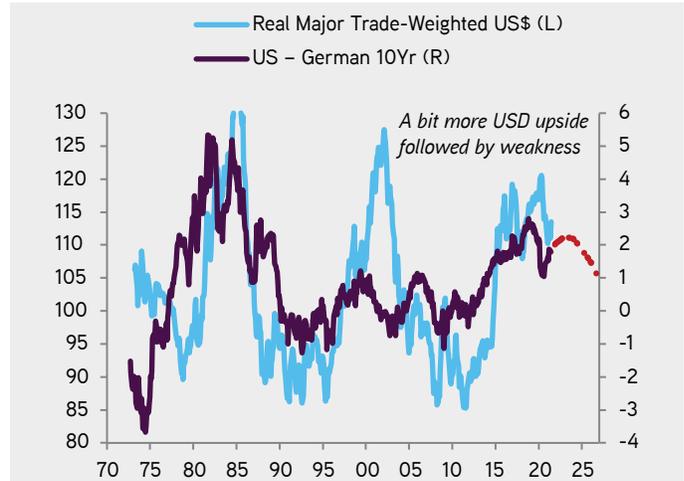
Frances Lim, who partners with Phil Kim on our hedging strategies, believes that the U.S. dollar could appreciate further in the near-term from its current slightly overvalued position during the last leg of interest rate normalization. The U.S. has spent the most stimulus wise, and has been among the first to vaccinate 50% of the population and reopen. As a result, growth is strong, inflation is rising, and rates have risen, all helping to drive the U.S. dollar higher.

However, any USD rally is likely to fade quickly, we believe. According to our research, we are now about two thirds through the normalization cycle (*Exhibit 50*), and as such, there is only a little more room for significant, sustained U.S. dollar appreciation, we believe. Trading currencies is a relative game, and we believe that, as other countries/regions catch up with vaccinations and re-openings, there will be a rotation back towards exchange rates of countries that have yet to begin the cycle of growth, inflation, and rising rates. Moreover, longer-term considerations, including structurally wider current account and capital account deficits in the United States, suggest a weaker U.S. dollar. Major players are taking notice. Indeed, while the U.S. dollar is still the largest reserve currency representing 55.2% of global reserves, its share has eroded by 300 basis points since the third quarter of 2018. During this same period the yen, euro, and renminbi have all gained share. One can see examples of these market share shifts in *Exhibit 51*.

**However, any U.S. dollar rally is likely to fade quickly, we believe. According to our research, we are now about two thirds through the normalization cycle, and as such, there is only a little more room for significant, sustained U.S. dollar appreciation, we believe.**

### Exhibit 50

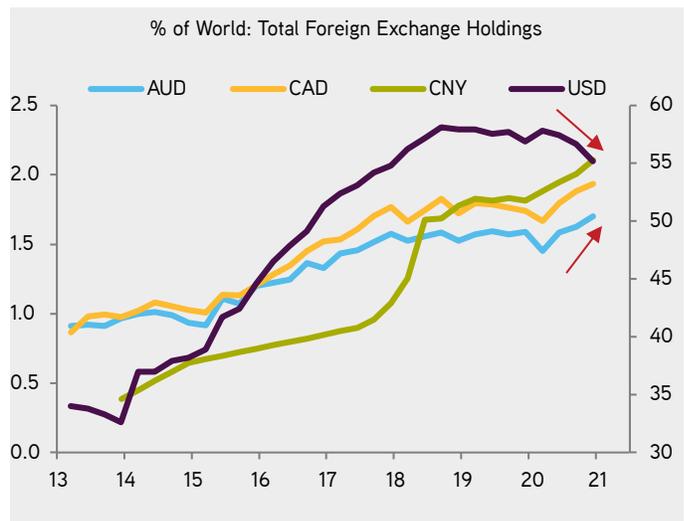
#### Rising U.S. Rates Suggest a Little More Upside to the USD



Data as at June 21, 2021. Source: Federal Reserve Board, Bloomberg, Haver Analytics.

### Exhibit 51

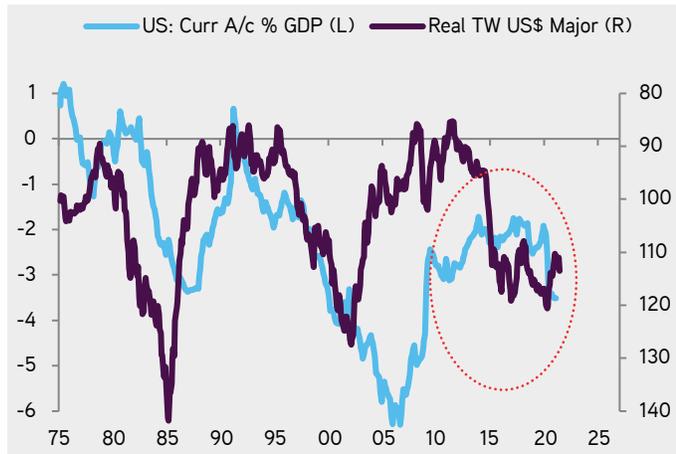
#### The U.S.'s Dominance As a Reserve Currency Is Beginning to Erode



Data as at March 31, 2021. Source: IMF, Haver Analytics.

## Exhibit 52

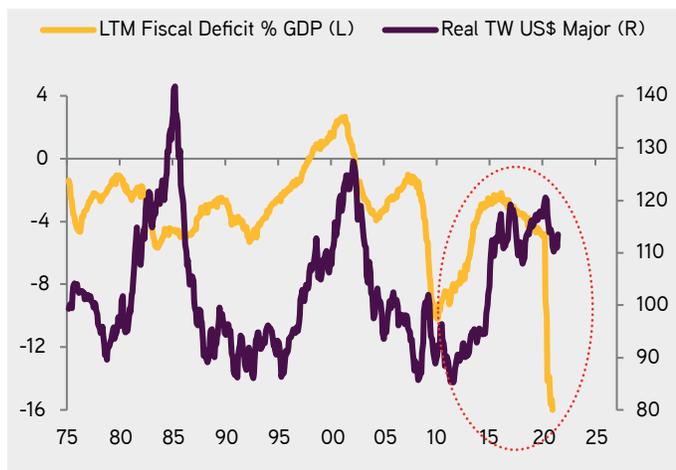
### Current Account Deficit Suggests An Overvalued USD



Data as at May 30, 2021. Source: Federal Reserve Board, Bureau of Economic Analysis, Haver Analytics.

## Exhibit 53

### U.S. Fiscal Deficit Suggests a Lot More Downside



Data as at May 30, 2021. Source: U.S. Treasury, Federal Reserve Board, Bureau of Economic Analysis, Haver Analytics.

## SECTION II: SIX REASONS WHY THIS CYCLE WILL BE MORE REFLATIONARY

As mentioned earlier, we *do* expect some near-term downward pressure on growth trends as rate of change slows. However, we still have high conviction that something more structural on the inflation front is under way that will define this cycle. To this end, we describe in detail below what we believe are the six key structural inputs to our reflation thesis.

### Point #1: A Structurally More Accommodative Approach to Monetary Policy

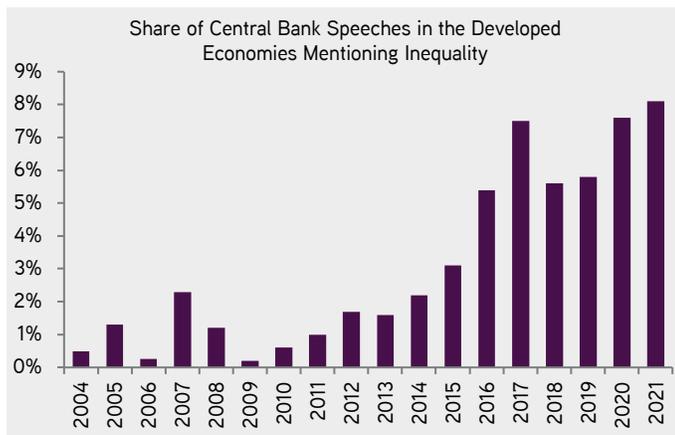
As we discussed in our last note, [Testing the Limits of Reflation](#), the Federal Reserve has shifted away from a stated two percent average inflation rate to a more 'flexible form of average inflation targeting'. This shift allows inflation to run for some time above the target of two percent (to make up for periods when inflation is below the target) before hiking interest rates. This shift also signals that a majority of the Fed's committee members believe that inflation is so structurally low that "a robust job market can be sustained without causing an outbreak of inflation." As we've highlighted previously, this statement is important because it suggests that, despite the Fed's dual mandate, they appear to be intently focused on employment relative to price stability. Powell confirmed this view by stating that, "This change (in the inflation mandate) reflects our appreciation for the benefits of a strong labor market, particularly for many in low- and moderate-income communities."

While the Fed has made the most dramatic changes to its framework amongst the central banks, it is not alone. Global central banks remain almost universally dovish, despite what we perceive to be a faster than expected rebound in GDP. In fact, we believe that the Eurozone, not the U.S., will prove to have the more durable monetary stimulus. The key point is that the latest Eurozone core inflation print came in at a paltry 0.9% year-over-year, which is still substantially below the new, expressed target of more than two percent. So, as long as core inflation remains meaningfully below target, ECB policymakers have no choice but to provide substantial,

continuing stimulus. Against this backdrop, the ECB is likely to be the first central bank to take its balance sheet to \$10 trillion, having already reached \$9.5 trillion as of June 2021, compared to the Fed's having 'just' \$8.0 trillion.

### Exhibit 54

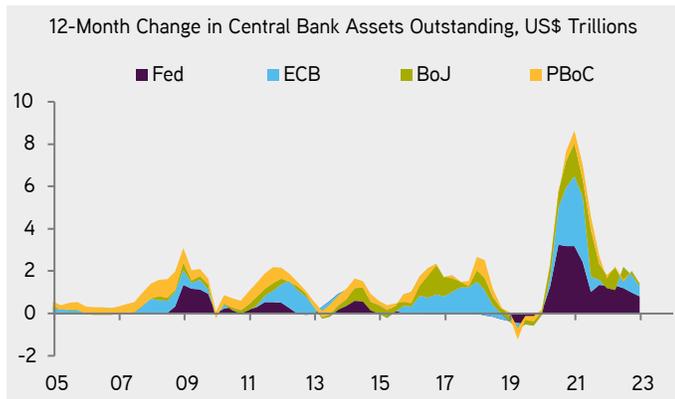
#### Monetary Policy Is Increasingly Viewed As a Tool to Address Structural Factors Contributing to Inequality



Data as at June 7, 2021. Source: BIS, Deutsche Bank.

### Exhibit 55

#### Global Central Banks Are Universally Dovish But, the U.S. Has Made the Most Dramatic Changes in Its Approach to Monetary Policy



Data as at June 30, 2021. Source: Federal Reserve, ECB, Bank of Japan, PBOC, Morgan Stanley estimates, Haver Analytics.

Given how accommodative policy is, there is now some risk that the reflation trade overshoots at some point during the current cycle. As such, we encourage the Fed to start to talk with a more hawkish tone as it relates to — at a minimum — mortgage buying. The reality is that the housing market does not need central bank stimulus at this point, given strong household formation and limited supply (*Exhibits 56 and 57*).

### Exhibit 56

#### We Are Not Sure That the Federal Reserve Still Needs to Be Buying Mortgages, Given How Robust the Housing Market Already Is

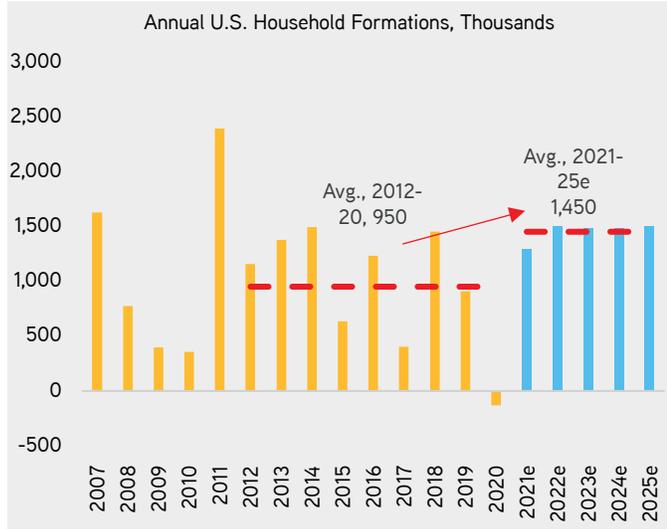


Data as at May 31, 2021. Source: Census Bureau, Haver Analytics.

Given how accommodative policy is, there is now some risk that the reflation trade overshoots at some point during the current cycle.

## Exhibit 57

### Household Formation Is Now Running About 500,000 Above the 2012-2020 Levels



Data as at May 31, 2021. Source: Census Bureau, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

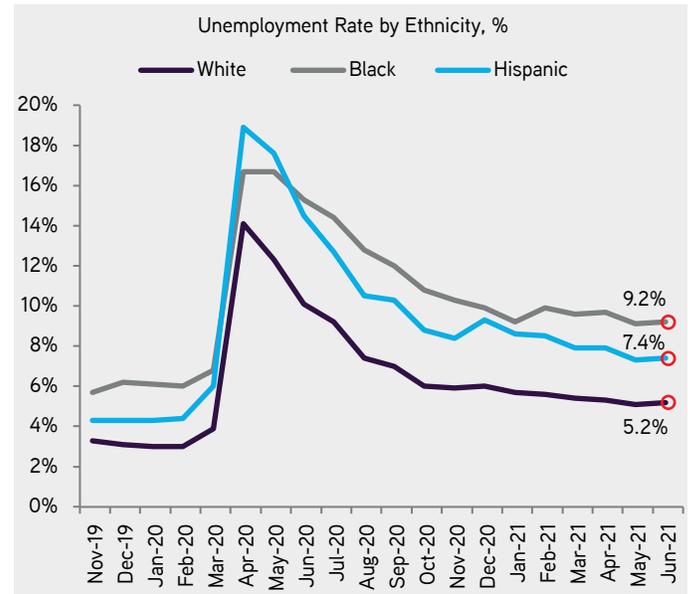
If there is good news, it is that Powell finally did what we have been suggesting: During a recent Q&A session he firmly separated the bond buying/tapering decision, which we link to the pandemic and overall financial conditions, from the interest rate decision, which we think is more tied to AIT and employment levels. This distinction is an important one and something that we think investors should pay more attention to as they think about overall monetary policy. At the moment, our base view is that the Fed starts to introduce the taper in either July or at the end of August at Jackson Hole. However, the Fed will likely not actually begin to taper until late 2021 or 2022, and then it will pause before raising rates in late 2022 or 2023. Said differently, Powell is very committed to a sequencing, and the Fed will likely be a lagging indicator this cycle. Remember under its new framework, the Fed would never have raised rates in December 2015.

So, despite growing concerns about a more hawkish Jerome Powell, we believe that the Federal Reserve and its peers will

find ways to remain highly accommodative when it comes to short-term interest rates, which ultimately supports our reflation thesis. Beyond AIT (which we view as a structural change towards looser policy), we think the Fed's intensifying focus on diversity of employment — who is actually getting hired — will also serve as an important influence. Indeed, as published in the April FOMC policy statement, Chairman Powell indicated that, maximum employment is a 'broad based and expansive' goal. Said differently, Powell's focus remains distinctly tilted towards the 'employment' end of his full employment plus price stability mandate. From what we can tell, he wants not only to drive unemployment back down to 3.5%, but also to do so in a way that is inclusive by race, gender, and income. As Exhibits 58 and 59 show, we are nowhere near the Fed declaring victory on the employment picture. Bottom line: the Fed may slow down its bond buying (particularly mortgages), but investors should look for looser monetary policy for longer this cycle.

## Exhibit 58

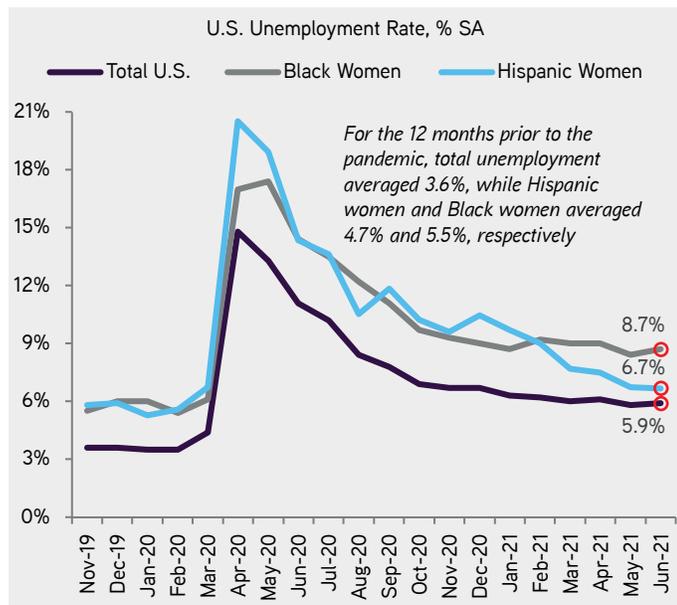
### We Don't See the Fed Becoming Hawkish Until Employment Trends Are More Uniform



Data as at June 30, 2021. Source: Bureau of Labor Statistics, Haver Analytics.

## Exhibit 59

### Minority Women Unemployment Trends Remain at Unacceptable Levels



Data as at June 30, 2021. Source: Census Bureau, Bureau of Labor Statistics.

### Point #2: More Stimulus and More Direct Stimulus

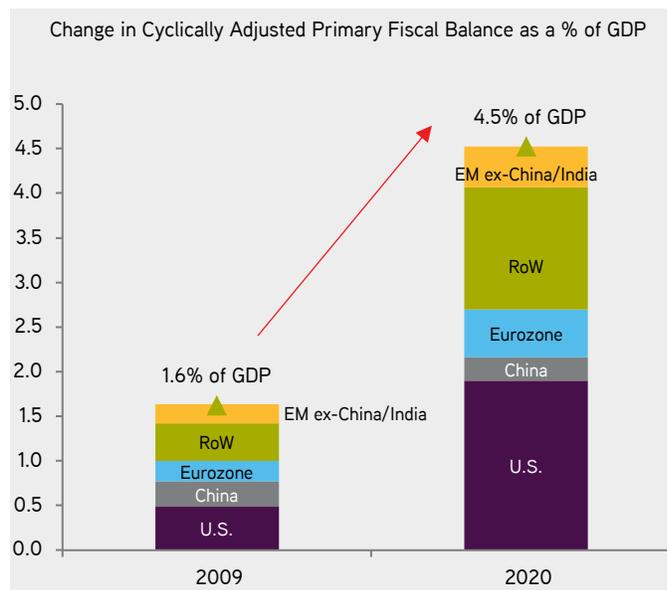
While the monetary support has been massive, there has also been a large shift in the fiscal response too. For starters, we think that we are seeing a structural change in the way governments look at deficits and growth. Simply stated, austerity is out, larger deficits are in, and more payments are likely to be direct. Indeed, whereas Reaganomics and Thatcherism were terms that defined the 1980s, we believe we have entered a new period when the role of big government in tackling big challenges, such as economic crises, inequality, climate change, etc., is becoming mainstream.

To put things in perspective, we looked at fiscal spending in 2009, and then we compared to it to 2020. One can see the output in Exhibits 60 and 61, respectively. The punch line is that today's fiscal spending is about three times as large as the GFC, with more of it coming out of the West than the East, and it is going more directly to the consumer. Bears on

growth will suggest that we will soon enter a period of 'fiscal payback' that could lead to slower growth. We don't think so for several reasons.

## Exhibit 60

### The Global Response to COVID Has Ballooned Deficits by 3x Compared to the Support Provided During the GFC



Note that these are UBS estimates measuring the change in cyclically adjusted primary fiscal balance, which includes only net new measures and adjusts for the influence of the economic cycle on public finances. Data as at April 30, 2021. Source: UBS Research.

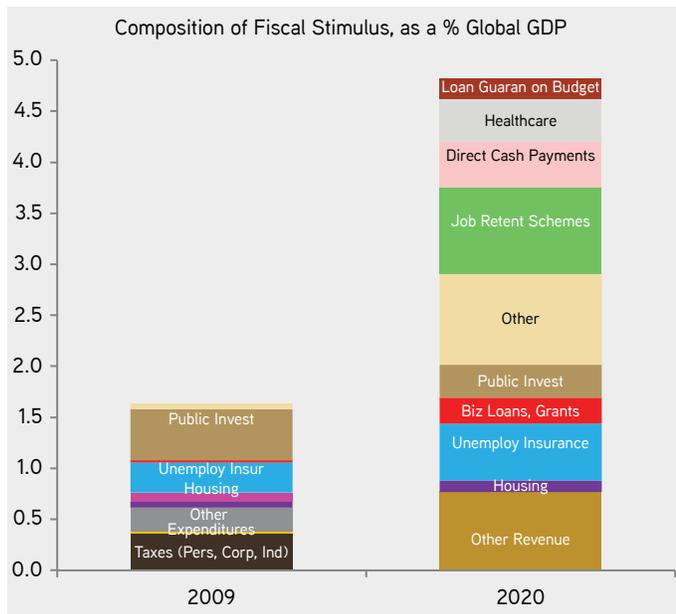
First, there is already a lot more savings in the system (see Point #6) that will support a smoother than expected transition to private sector spending from public sector spending. Second, as we mentioned at the outset of this piece, we think we have entered a period of more sustained

**The punch line is that today's fiscal spending is about three times as large as the GFC, with more of it coming out of the West than the East, and it is going more directly to the consumer.**

government spending to support areas of the economy that appear disadvantaged. As such, we fundamentally believe that governments will run with bigger deficits than in the past, as they spend more to narrow the inequality gap. Finally, because rates are lower, we think that politicians will be emboldened to spend more per unit of interest expense relative to other cycles. Said differently, there is now a lower hurdle rate amongst politicians in positions of power, we believe.

### Exhibit 61

#### Direct Consumer Support Has Become the Focus This Crisis



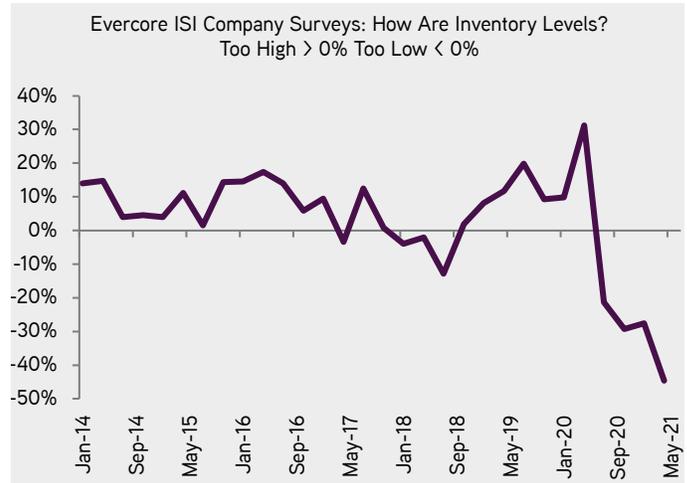
Note that these are UBS estimates measuring the change in cyclically adjusted primary fiscal balance, which includes only net new measures and adjusts for the influence of the economic cycle on public finances. Data as at April 30, 2021. Source: UBS Research.

In the end, we think that heightened fiscal spending will revive animal spirits in both the corporate and consumer sectors. When it does, we think it will ultimately prove to be more reflationary relative to the more muted approach that was adopted following the GFC.

### Point #3: More Input Cost Pressure This Cycle

### Exhibit 62

#### U.S. Inventories Are Still Too Low, As the Recovery Remains Much Better Than Expected



Data as at April 30, 2021. Source: EvercoreISI.

Unlike the disinflationary tilt that defined the post 2009 recovery, the frontloaded nature of this recovery is leading to higher input costs, again another reflationary trend. Without question, we think that we have now entered a period where

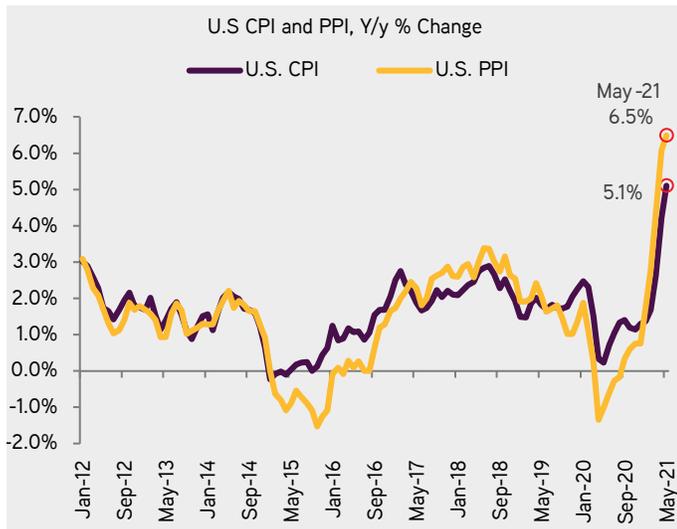
**Unlike the disinflationary tilt that defined the post 2009 recovery, the frontloaded nature of this recovery is leading to higher input costs, again another reflationary trend. Without question, we think that we have now entered a period where input costs are increasing faster than consumer prices. This type of environment heavily favors companies with pricing power, we believe.**

input costs are increasing faster than consumer prices. This type of environment heavily favors companies with pricing power, we believe. Often price makers will have the ability to reprice their goods and services quickly, or they operate in an industry where their offering is a critical item and the overall cost is relatively small compared to the overall price of the finished product.

Importantly, against the backdrop we envision, companies with pricing power, or what we term price makers, will be re-rated upward at the same time that price takers will be de-rated. This bifurcation is not to be underestimated, as the consensus now suggests that almost all the companies in the S&P 500 will deliver improving margins. In our humble opinion, these forecasts will prove way too optimistic, leading to heightened volatility during the summer months, as margin estimates are ratcheted down.

### Exhibit 63

**Looking at the PPI Compared to CPI Is a Clear Indication That Companies Will Get Squeezed As the Costs Aren't Passed to Consumers**



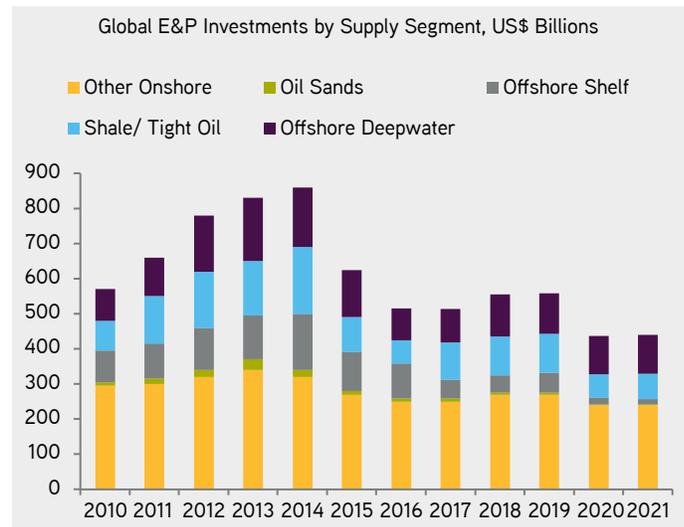
Data as at May 30, 2021. Source: Bloomberg.

While we do expect easing of some input costs during the next few quarters, we don't think that supply will overwhelm

demand as much as some investors think. What is different this time is that there has not been the traditional capital expenditure response that we have had in past economic rebounds. One can see this in *Exhibit 64*, which shows the dramatic fall-off in Oil and Gas expenditures relative to the beginning of the last recovery period in the early 2010s. However, this phenomenon is not particular to just Energy; rather, we are seeing capex spending lag in other important inputs such as copper.

### Exhibit 64

**Oil Exploration and Production Capex Is Down More Than 50% From Its High in 2014...**

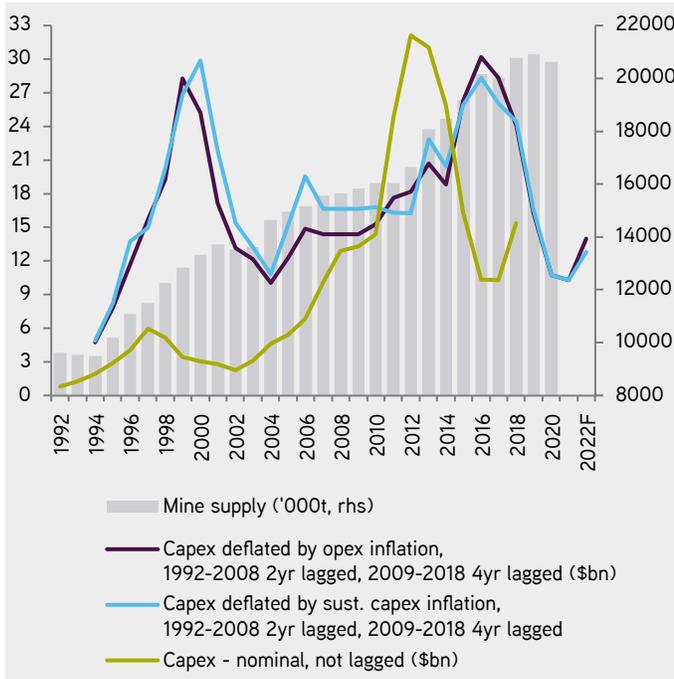


Data as at May 2021. Source: Rystad Energy, UCube, Citi.

**Often price makers will have the ability to reprice their goods and services quickly, or they operate in an industry where their offering is a critical item and the overall cost is relatively small compared to the overall price of the finished product.**

**Exhibit 65**

**...While Copper Capex Is Back to 2002 Levels**



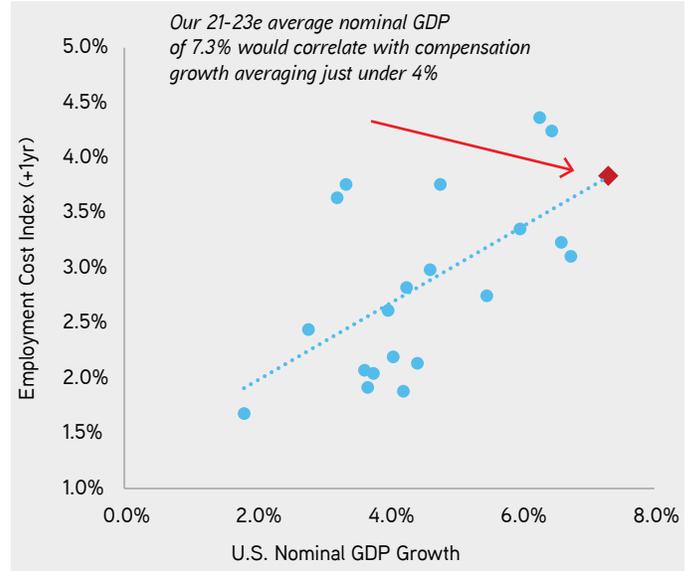
Data as at May 30, 2021. Source: Rystad Energy, UCube, Citi.

The second part of the increase in input costs that we are monitoring is labor. Importantly, we think that the Federal Reserve is too optimistic about a quick improvement in the participation rate. Remember that, outside of the travel and leisure sector, there are really very few jobs being added to the workforce. As such, our forecast, which we show in *Exhibit 68*, calls for real wages to start to finally creep back up after years of deflating. This shift is not to be under-estimated, as higher wages are typically the best indicator for higher nominal GDP. One can see this in *Exhibit 66*.

**What is different this time is that there has not been the traditional capital expenditure response that we have had in past economic rebounds.**

**Exhibit 66**

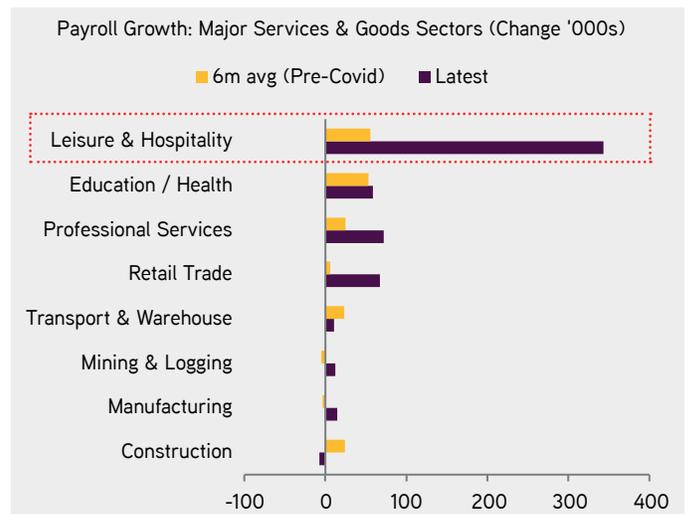
**We Anticipate Compensation Growth to Average Just Under Four Percent Thru 2023**



Data as at December 31, 2020. Source: BEA, Haver Analytics.

**Exhibit 67**

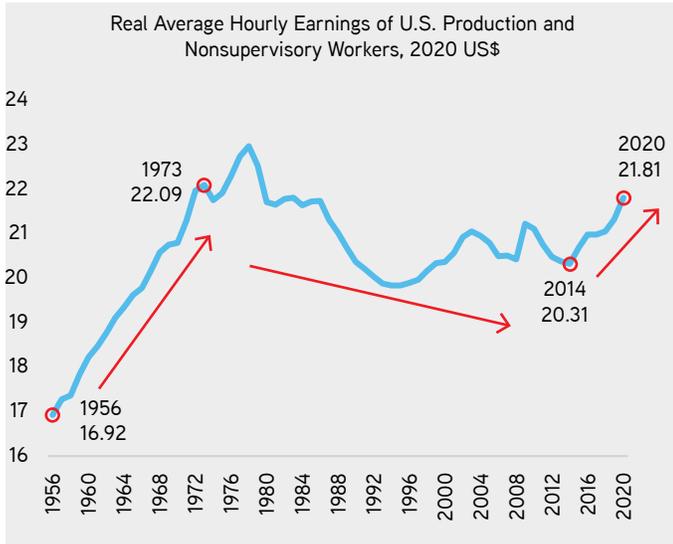
**Despite Major Supply Chain Shortages in the Goods Side of the Economy, We Are Only Really Seeing Job Growth in the Travel and Leisure Sector**



Data as at June 30, 2021. Source: Bureau of Labor Statistics, Haver Analytics.

### Exhibit 68

#### U.S. Real Wages Are Now Finally Headed Higher



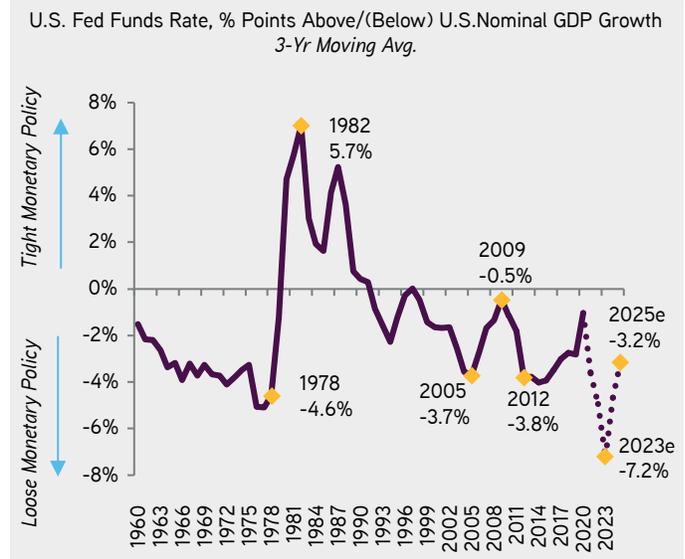
Data as at May 31, 2021. Source: Census Bureau, Haver Analytics.

#### Point #4: Lower Real Rates for Longer Create a Reflationary Backdrop

While nominal rates have increased, real rates — which we believe are key to financial conditions — will remain at much lower levels this cycle than in the past. Remember the ‘Authorities’ have four options to stimulate growth — and three of them are usually unpalatable. They can *devalue* their currency to improve exports, they can *default* on their debt to remove the overhang (e.g., Greece has defaulted on its debt nearly 50% of the time), and/or they can *deflate* their wages. The fourth D — and most politically palatable — is to *defease* one’s debt by holding nominal interest rates below nominal GDP to ultimately make the value of those fixed liabilities worth less in a higher nominal GDP environment.

### Exhibit 69

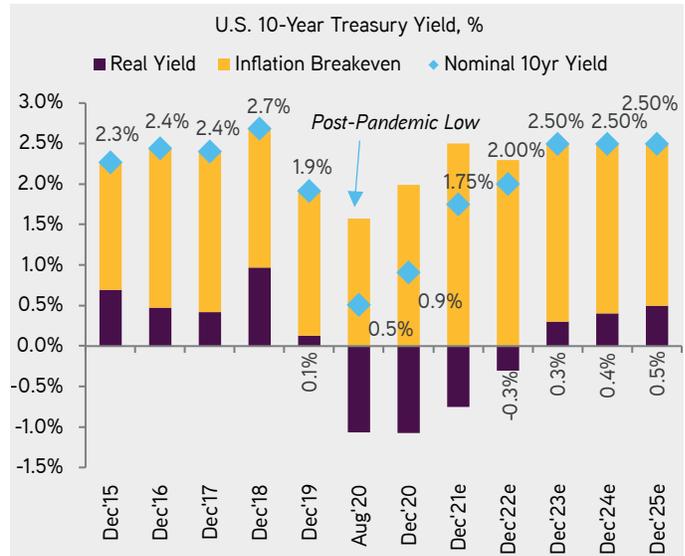
#### The Strategy to Reflate Is Based on Holding Nominal Interest Rates Below Nominal GDP



Data as at June 28, 2021. Source: BEA, Federal Reserve, Haver Analytics.

### Exhibit 70

#### Record Stimulus by the Federal Reserve and Treasury Are Finally Lifting Inflation Expectations

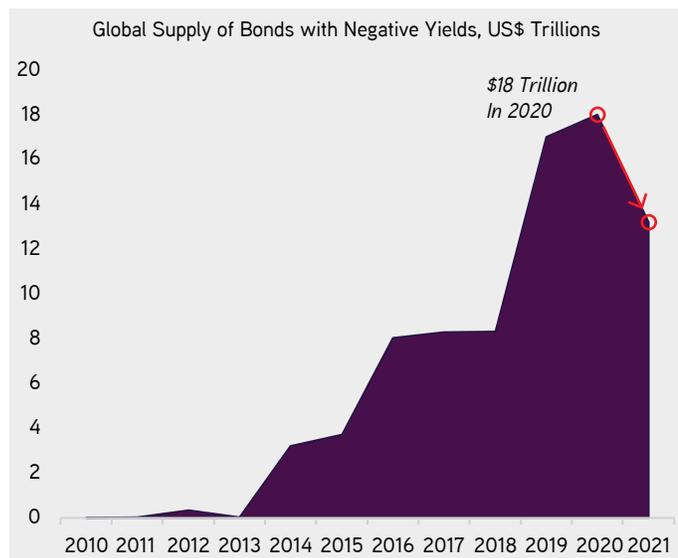


Data as at June 28, 2021. Source: Bloomberg.

As one might think, an investing environment where interest rates are held materially below nominal GDP is generally an accommodative backdrop for risky financial assets, Equities, Real Estate, and Infrastructure in particular. The reality is that investors who leave their money in low yielding or low total return securities actually *lose* basis points of return in real terms. We ultimately believe that they will feel inspired to move out on the risk curve in favor of higher returning assets in a reflationary environment. Moreover, when it comes to owning collateral-based cash flows, there is replacement cost theory to consider. Simply stated, the value of today's existing collateral, particularly if it is cash flowing, will go up tomorrow because it has now become more expensive to replace in a reflationary environment.

### Exhibit 71

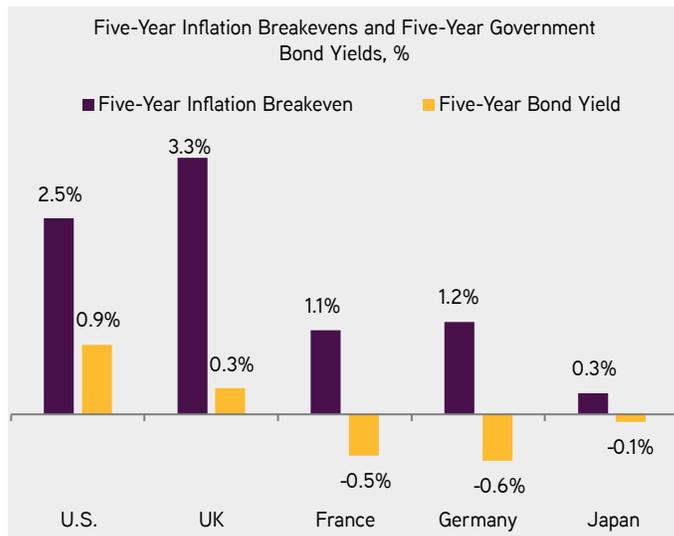
#### Negative Rates Are Coming at the Expense of Savers...



Data as at June 1, 2021. Source: Bloomberg.

### Exhibit 72

#### ...Particularly When One Considers Rates on a Real Basis



Data as at June 30, 2021. Source: Bloomberg.

#### Point #5: The Global Energy Transition Is Actually Inflationary; In Fact, It Requires More Inputs Amidst Restricted Production

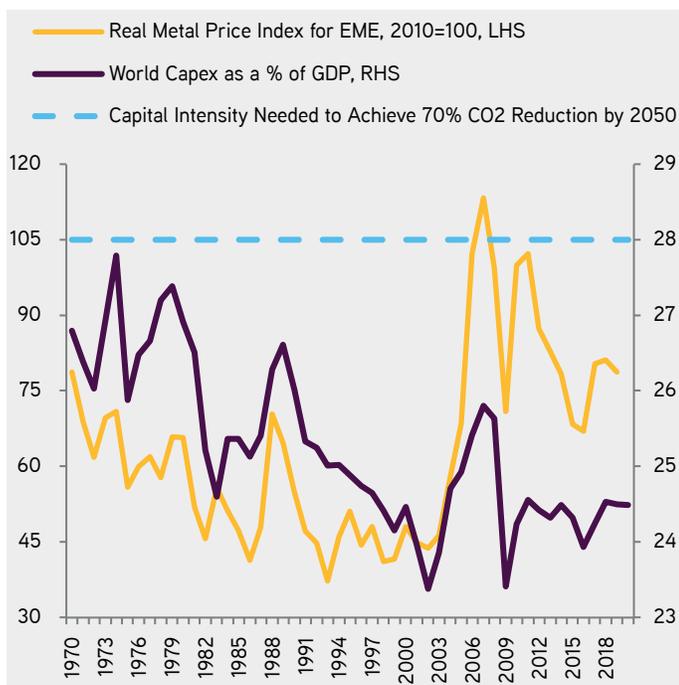
As a team, we have spent a lot of time of late around the energy transition that is unfolding. This movement is quite large and moving very quickly. All told, we estimate that countries accounting for over 70% of world GDP and greenhouse gases now have formalized targets for net-zero emissions, typically by 2050 — though Goldman Sachs suggests a target of 2060–70 is more likely to be achievable (due to the current investment gap). If we are right, then the annual spend could surprise many investors. Indeed, while estimates are all over the map, our research at KKR suggests that the energy transition space is an approximate \$1.5–2 trillion per year growth opportunity.

In general, we think more established sectors like renewables and select areas of transportation may represent the 'lower hanging fruit' of the opportunity set. In most instances, these strategies efficiently de-carbonize, carry relatively low costs,

and provide more straightforward investment avenues. Achieving total net-zero policy goals will also require investments in potentially high-growth, less-established areas where the economics are not yet as attractive to investors. However, as these areas develop and become more economically viable, we believe they could ultimately affect the entire cost curve and likely represent targeted opportunities.

### Exhibit 73

#### Environmental Policies Could Drive a Capex Boom on Par With the 1970s and 2000s, We Believe



Data as at December 30, 2020. Source: World Bank, Goldman Sachs, Haver Analytics.

In terms of specific increases in the energy transition, we see four primary areas of opportunity:

- **Opportunity #1** focuses on decarbonizing electricity: renewable power (hydroelectric, offshore/ onshore wind and solar), energy networks/grids (including distributed generation and microgrids), digitization, efficiency, and energy storage (especially batteries) expenditures. These areas are technologically and commercially proven, often

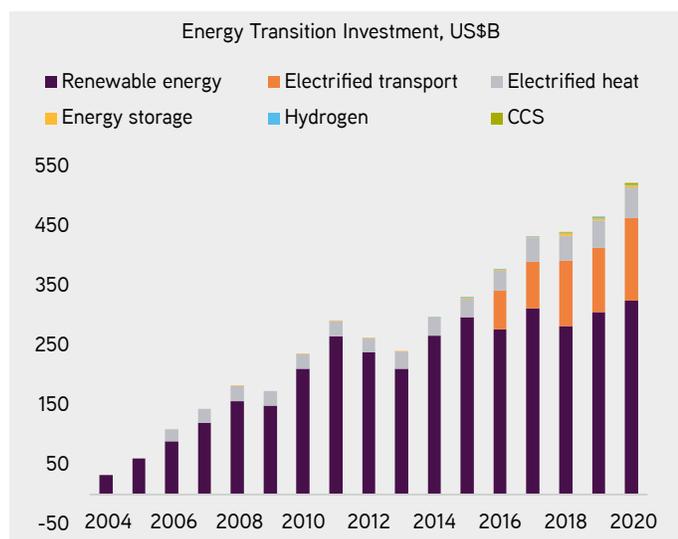
are more competitive than conventional technologies, and enjoy a suite of policy supports. Spending on renewables currently hovers around \$300 billion per year, but will soon require investment of around \$1 trillion per year through approximately 2060–70, we believe. Importantly, total renewables investment has remained relatively flat in recent years because of cost deflation (our research suggests three to five percent per year), disguising what has been robust activity beneath the surface. Looking ahead, though, we expect better pricing dynamics as well as increased volume.

- **Opportunity #2** involves transportation, which will require expenditures of at least \$250 billion per year, doubling from around \$125 billion in 2020. Passenger EVs have been the fastest growing energy transition sector and increased \$31 billion (+29% Y/y) in 2020. With major automakers announcing 100% EV goals and proliferation of policies banning new internal combustion engines, we think EVs are nearing an inflection point for investment. We also see palpable increases in interest for sustainable liquid fuels, especially to tackle emissions in aviation and shipping.
- **Opportunity #3** comprises industrial processes and building upgrades. These areas of investment will require sums of more than \$250 billion per year, up from approximately \$30 billion currently. Clean hydrogen (blue and green) is the technology du jour with high expectations to be a breakthrough technology to decarbonize industrial processes that cannot be addressed directly with renewable power. Clean hydrogen also overlaps strongly with sequestration (see below), necessitating a jump in investments from its current \$3 billion in 2020 to over \$75 billion per year.
- **Opportunity #4** centers on the challenge of making hydrocarbons and to offset other hard to decarbonize areas. At present, Goldman Sachs estimates that 15–20% of emissions are un-abatable with current commercially competitive technologies. Proving commercial viability of carbon capture and sequestration technologies could generate considerable large-scale opportunities, while

still emerging advancements in carbon management (reuse in materials, natural sinks, and direct air carbon capture) will be necessary to achieve net zero.

### Exhibit 74

**Global Energy Transition Investment Has a CAGR of 8.3% Since 2010 and Topped \$500 Billion in Spending for the First Time in 2020**



Data as at January 31, 2021. Source: BloombergNEF.

Importantly, the pace of de-carbonization matters, and it is not linear, given that it takes less time and money to clean up the low hanging fruit. As one can see in *Exhibit 76*, the nature of the cost curve means that reaching early-target emissions goals (e.g., Biden’s 50% by 2030) will be significantly easier and cheaper than reaching net-zero. In either case, a dramatic uptick in investment across the board supported by policy actions, technological advancements, and improving economics is required.

In terms of who will lead the charge on spending, we note that China’s focus on renewables and their absolute need for power investment ensured that they led the way in clean energy transition investment as recently as 2019 (*Exhibit 77*). The global pandemic, however, stalled China’s spending (the U.S.’s too) while European investment surged behind

targeted spending and policy actions. As such, from 2019 to 2020, Chinese and U.S. investment dropped 12% each. By comparison, European spending increased 67% (including the Middle East, up 55%) over the same period.

### Exhibit 75

**However, the Future Is Bright. All Told, Cumulative Investment Needed by 2070 Would Require About \$1.6 Trillion per Year for Several Decades**

Cumulative Investment Needed Through 2070, US\$ Trillions	
<b>Power generation and grids</b>	<b>\$57.8</b>
Renewables (Power generation)	\$47.3
Power networks	\$8.8
Energy storage (batteries)	\$1.7
<b>Transportation</b>	<b>\$7.1</b>
EV and FCEV charging and fueling stations	\$6.3
Biorefineries	\$0.8
<b>Industrial processes and building upgrades</b>	<b>\$10.1</b>
Industry (incl. CCUS)	\$7.0
Building upgrades (incl. heat pumps)	\$2.7
Hydrogen pipelines	\$0.4
<b>Hydrogen and carbon sequestration</b>	<b>\$2.7</b>
Hydrogen plants (green and blue)	\$2.2
Direct air capture & storage (DACCS)	\$0.5
Natural sinks	\$0.1
<b>Cumulative less than two degrees path of investments to 2070</b>	<b>\$77.8</b>

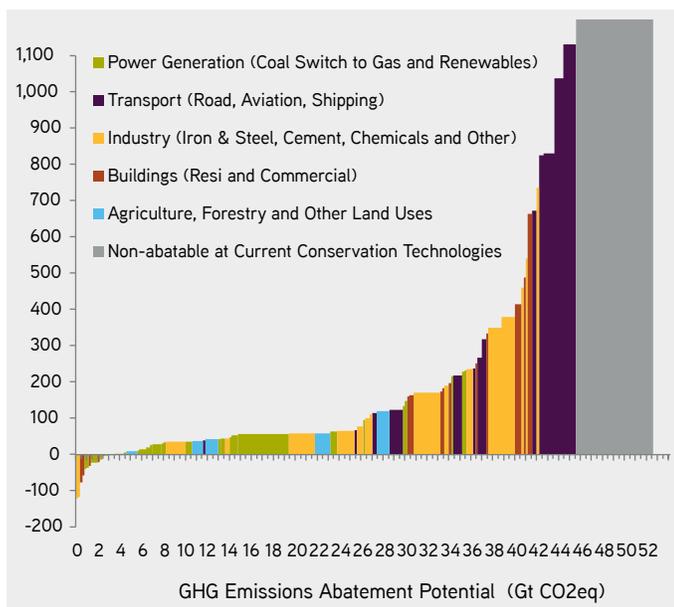
Note: GS transportation projections only include infrastructure, not manufacturing, likely skewing total transport expenditures slightly lower than some other estimates. Energy storage (batteries) investment will also bring positive externalities for transportation. Data as at April 30, 2021. Source: Goldman Sachs Global Investment Research.

In our view, the divergence in global investment during the pandemic highlights a key risk of energy transition analyses. In order to achieve global net zero, every country must *consistently* work to de-carbonize. Yet, there are still many outliers. India, for example, the world’s third largest and growing polluter, is not even in the top ten countries by energy transition investment. Moreover, as we show below in *Exhibit 77*, two of the major players in the de-carbonization

fight, China and the United States, actually showed flat to negative growth at best in 2020.

### Exhibit 76

**50% De-Carbonization Will Be Far Easier Than Net Zero, Which Will Cost More, Take Longer, and Is Heavily Dependent on the Development of New Technologies**

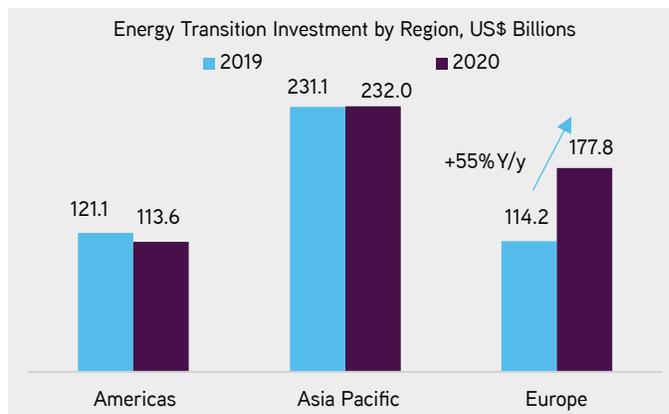


Data as at April 2021. Source: Goldman Sachs Global Investment Research, IHS Global Insight.

**In our view, the divergence in global investment during the pandemic highlights a key risk of energy transition analyses. In order to achieve global net zero, every country must consistently work to de-carbonize.**

### Exhibit 77

**Asia-Pacific Has Accounted for More Than 40% of Total Energy Transition Investment. Europe Accounted for More Than 100% of the Investment Growth During COVID**



Data as at January 31, 2021. Source: BloombergNEF.

**Our bottom line:** The energy transition space is an approximate \$1.5–2 trillion per year growth opportunity. As part of this spend, we think that established sectors like renewables and select areas of transportation may represent the most near-term areas of investment, as they efficiently de-carbonize, have commercially proven technologies, carry relatively low costs, and provide more straightforward investment avenues (e.g., infrastructure). Net-zero policy goals also necessitate investments in potentially high-growth, currently less-established areas like building upgrades (heating), hydrogen, and sequestration, which, as they develop, may ultimately affect the entire cost curve and represent targeted opportunities.

*Somewhat ironically, though, the push for a cleaner environment may actually create more reflationary trends in the near-term.* Production of critical minerals and manufacturing of clean energy components may need to rise materially — even from current levels — on an annual basis to meet the demand we are forecasting. At the same time, geopolitical competition and the pandemic has made the world more fragmented regarding the flow of commodities and goods — especially goods in critical

technology including clean energy that are a focus of re- or near-shoring industrial policies. We are paying attention to a split between low income economies that will have less access to technology, with many likely remaining more heavily commodity dependent and wealthier economies, who will utilize technology more to drive ESG and shift away from certain types of commodities. Also, higher income economies consume more services while lower income consumption tends to be tilted towards physical and commodity intensive goods (food, fuel, capital goods). Against this backdrop, we continue to forecast bull markets in several commodities, including copper, uranium, and to a certain extent, lithium.

### Exhibit 78

**Though Down From Peak Levels, Input Prices Generally Remain Much Higher Than They Were Pre-Pandemic**



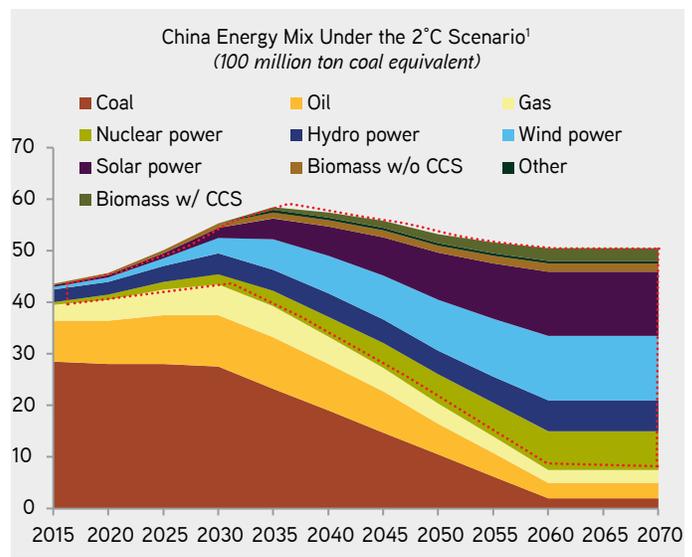
Data as at June 21, 2021. Source: Bloomberg.

One final thought: While we are primarily focused on reflation impacts in this *Insights* piece, we would be remiss to not mention how climate change policy has now morphed into trade policy, particularly as climate and related environmental issues have risen to the top tier of policy actions across most major economies. As part of this transition, policy formation around creation of an emissions border adjustment tariff

could force supply chains to assign cost to emissions from their production in third-world countries and for the emissions required to operate global transport of those goods. All in all, these changes will impact many different sectors and countries, dramatically shifting the supply chain landscape, including increases to the cost of production.

### Exhibit 79

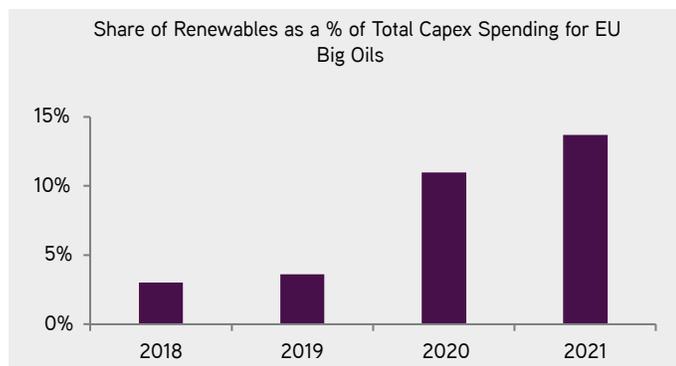
**Environmental Policy Is, Unwittingly, Trade Policy as Alternative Energy Is Domestically Sourced**



**Somewhat ironically, though, the push for a cleaner environment may actually create more inflationary trends in the near-term. Production of critical minerals and manufacturing of clean energy components may need to rise materially – even from current levels – on an annual basis to meet the demand we are forecasting.**

## Exhibit 80

### EU Big Oils Are Spending 10-15% of Their Total Capex on Low Carbon Energy As Traditional Oil and Gas Capex Falls by 20% in 2020–2021



Note: Big Oil includes BP, Equinor, TOTAL, RDSHELL, ENI, Respol, Galp; 2020 and 2021 are GS estimates. Data as at June 30, 2020. Source: Goldman Sachs.

### Point #6: The Amount of Excess Global Savings Could Be a Signal for Strong Future Demand (Too Strong?)

Unlike during the Global Financial Crisis, governments have been much more aggressive around the fiscal impulse required to re-accelerate the economy. According to some work by my colleague Dave McNellis, the average U.S. household had an expansion of disposable personal income of 4.6% in 2020, despite the U.S. experiencing a recession that was five times as bad as the average one. Moreover, we forecast disposable income will grow by almost five percent further in 2021. Driving this unusual outcome is direct deposits issued by the government. Consumers have been able to increase their disposable incomes during the pandemic with the assistance of government transfers, despite high unemployment.

So, the net result is quite positive. First, savings is ballooning because of this increase in disposable income. In fact, we now estimate that U.S. consumers will have banked about \$2.5 trillion in extra savings by year end, equivalent to fully 17% of pre-pandemic annual consumption spending. In Europe, my colleague Aidan Corcoran thinks excess savings by Eurozone households in 2020 alone reached close to half

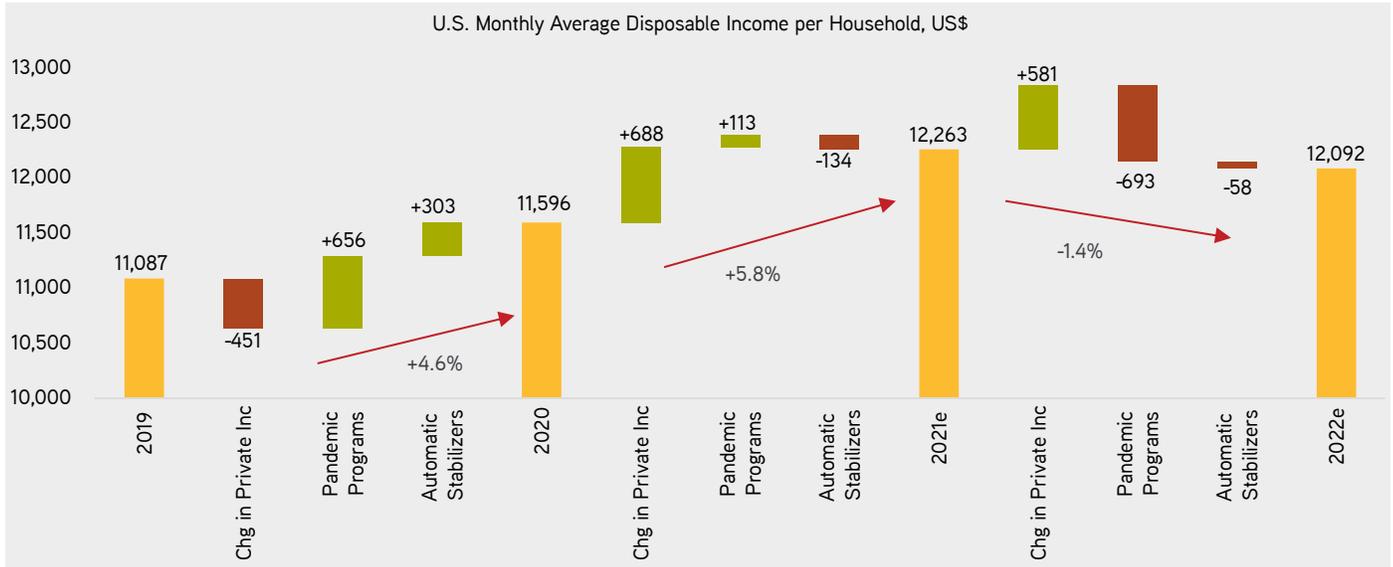
a trillion euros, about 75% of which reflected the restricted ability to consume during the pandemic, with the remainder mostly reflecting increased precautionary saving. Meanwhile, Changchun Hua, our greater China economist, thinks the number is close to RMB 6.2 trillion in China, equivalent to 18.2% of pre-pandemic annual retail sales in China. Second, unemployment is coming down much faster than in prior cycles across many regions of the world, which should further lend support to our thesis that this recovery will be more robust relative to the prior recovery in 2009.

Our bottom line: While we are still troubled by the unemployment trends of low income and minority workers, middle and high income consumers in the United States appear poised to significantly bolster their spending habits heading into 2022. U.S. consumers have saved, paid down debt, and improved their cost of capital on what debt remains. Moreover, there is pent-up demand that we think could lead to something akin to a 'Roaring 20s' if our base case unfolds as expected. Indeed, as Federal Reserve Vice Chairman Richard Clarida noted in a speech from November, "This was the only downturn in my professional career in which disposable income actually went up in a deep recession, and a lot of that has been saved." Unspent state and local stimulus dollars will likely add fuel to this spending flame as well. One can see this in *Exhibit 83*.

**So, our bottom line is that the demand side of the equation is likely to be much more reflationary this cycle than in the past. Debt balances have been paid down, savings have recovered, and employment opportunities outside of the travel and leisure sector are quite robust.**

### Exhibit 81

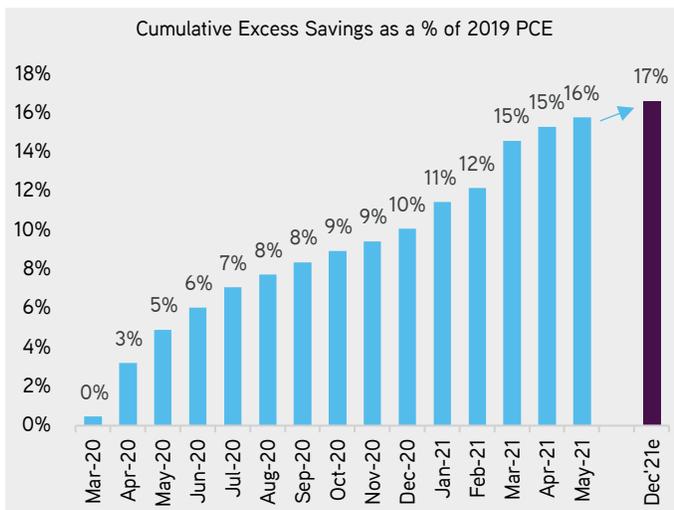
#### While Disposable Income Growth Will Moderate in 2022, It Will Still Be Well Above 2019's Level



Income from private sources excludes employment income funded via PPP. Data as at June 28, 2021. Source: Bureau of Economic Analysis, IHS, GS Investment Research, KKR Global Macro & Asset Allocation analysis.

### Exhibit 82

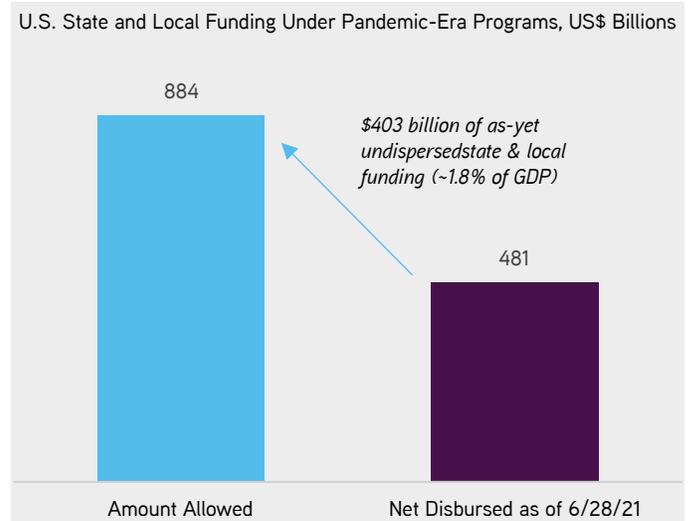
#### Pandemic-Era 'Excess Savings' Are Set to Peak Around \$2.5 Trillion, or Fully 17% of Annual Consumption Spending



Excess Savings = Savings in excess of 7.7% run-rate savings rate (based on the 2018-19 average). Data as at June 28, 2021. Source: Bureau of Economic Analysis, KKR Global Macro & Asset Allocation analysis.

### Exhibit 83

#### In Addition, Unspent State and Local Stimulus Funds Amount to a Further \$400 Billion, or 1.8% of GDP

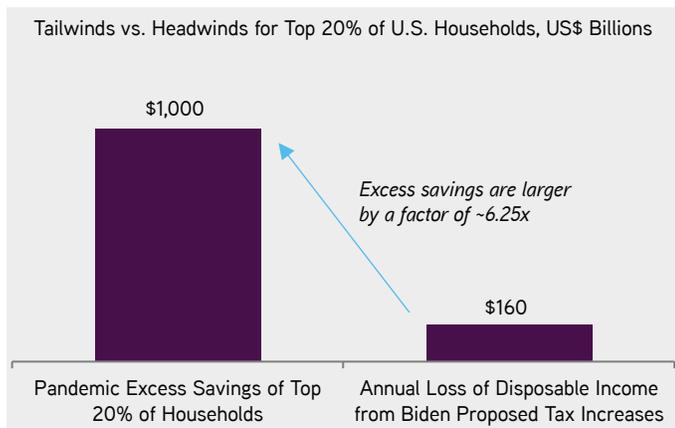


Data as at June 28, 2021. Source: Covidmoneytracker.org.

Importantly, even if taxes go up, we think that the firepower remains outsized. As we show in *Exhibit 84*, we estimate that the top 20% of Americans, which typically account for about 50% of all spending in the United States, have gained about \$1,000 in additional savings per household. As such, the \$160 of loss from disposable income per annum represents less than a 20% hit to an already sizeable increase in net worth for this important segment of the population.

### Exhibit 84

#### For High-Income Households, Pandemic Excess Savings Dwarf the Potential Loss of Income from Biden's Proposed Tax Increases

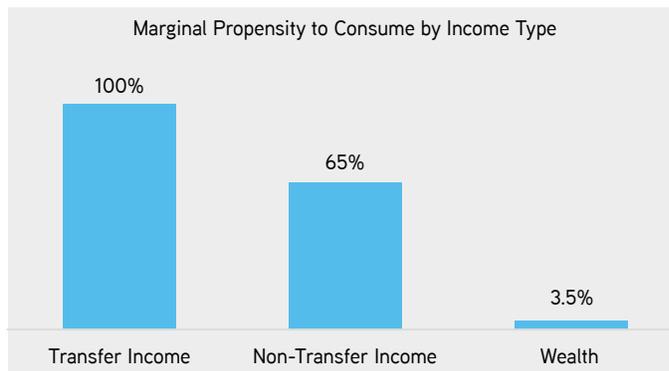


Data as at May 31, 2021. Source: White House, Tax Policy Center, Tax Foundation, CBO, JCT, Cornerstone Macro, Goldman Sachs Research.

So, our bottom line is that the demand side of the equation is likely to be much more reflationary this cycle than in the past. Debt balances have been paid down, savings have recovered, and employment opportunities outside of the travel and leisure sector are quite robust. In fact, we envision a war for talent that further drives up real wages, something that has been missing from prior recoveries. Moreover, there is a lot of pent up demand that will get unleashed over the next few years, we believe.

### Exhibit 85

#### Middle and Lower Income Households Are Likely to Spend 100% of Any Stimulus



Data as at May 31, 2021. Source: Department of Labor, NY Fed.

Unlike during the Global Financial Crisis, governments have been much more aggressive around the fiscal impulse required to re-accelerate the economy. According to some work by my colleague Dave McNellis, the average U.S. household had an expansion of disposable personal income of 4.6% in 2020, despite the U.S. experiencing a recession that was five times as bad as the average one. Moreover, we forecast disposable income will grow by almost five percent further in 2021.

## Exhibit 86

**Our Work Shows the Next Leg Up in Consumption Will Come From the Services Sector. By Comparison, Purchases of Goods Are Already Above Pre-Pandemic Levels**

	Current, US\$ Billions	US\$ Billions Above / Below Pre-Pandemic Trend	% Above / Below Pre-Pandemic Trend	% of GDP Above / Below Pre-Pandemic Trend
<b>Personal Consumption Expenditures (SAAR)</b>	\$13,662	-\$133	-1%	-0.7%
PCE Goods	\$5,585	\$570	10%	2.9%
PCE Services	\$8,077	-\$703	-9%	-3.6%
<b>Manufacturing &amp; Trade Inventories</b>	\$2,104	-\$221	-10%	-1.1%
<b>Net Exports (SAAR)</b>	\$1,212	-\$211	-17%	-1.1%

Pre-Pandemic Trend = Linear extrapolation of January 2011–December 2019 trend. Data as at May 31, 2021 for PCE; as at April 30, 2021 for inventories; as at March 31, 2021 for net exports. Source: BEA, IHS, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

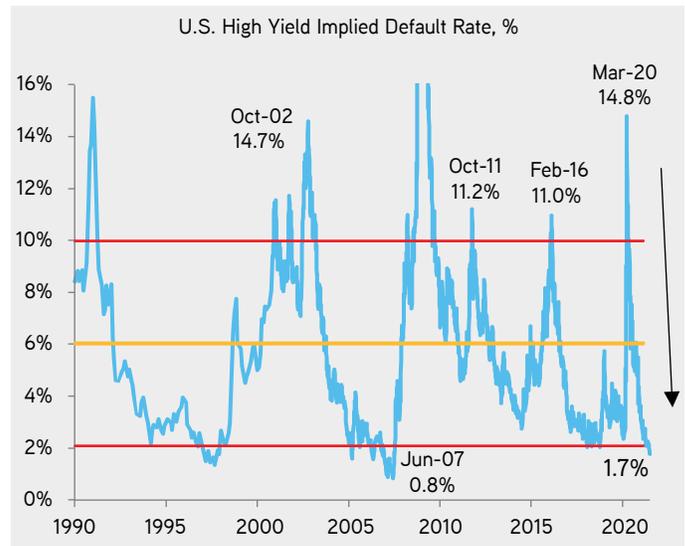
## SECTION III: RISKS

While we remain constructive on the overall outlook, there are several macroeconomic and geopolitical storm clouds emerging. We note the following:

**Concern #1: Credit Conditions Unravel** If there is a potential Achilles heel of this market, we think it is that credit conditions could deteriorate unexpectedly. Even after slowing meaningfully, money supply is growing considerably faster than nominal GDP growth, and this is happening at a time when there is little available income/yield for savers. As such, financial conditions, especially credit conditions, are extremely robust across all parts of the global capital markets. Indeed, as we show in *Exhibit 87*, the implied default rate on High Yield is now down to 1.7%, which is more than one standard deviation below its long-term average. This optimism actually makes sense to us, as earnings will likely remain robust well into 2022.

## Exhibit 87

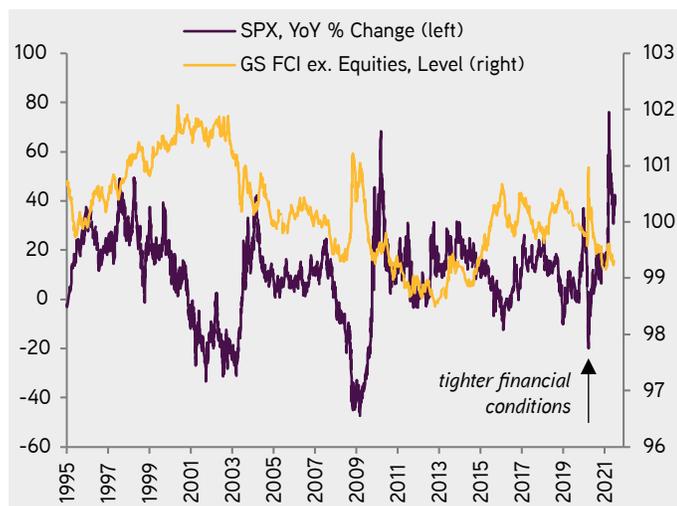
**Our U.S. High Yield Default Monitor Is One Full Standard Deviation Below the Long Term Average**



Data as at June 30, 2021. Source: Bloomberg, ICE-BofAML Bond Indices.

## Exhibit 88

### If Credit Deteriorates, It Will Affect Financial Conditions and Ultimately the Performance of Stocks



Data as at June 30, 2021. Source: Goldman Sachs Research, Bloomberg.

However, as the implied default rate monitor chart shows (and we certainly learned last year), things can change — and quickly. So, to hedge against a potential credit mishap, our suggestion is to spend a little on some direct hedges. To best hedge the potential risk of an overheated economy, my colleague Phil Kim believes that an investor could consider purchasing a 2-Year swaption on the 5-Year USD swap rate locking in the right but not the obligation to pay fixed and receive LIBOR. Struck at approximately 100 basis points out-of-the money at 2.4, the swaption would return 6.5x at maturity if the market were to correct to 2018 levels of 3.2%.

#### Concern #2: A Policy Mistake Leads to Uncomfortable

**Inflation** As we detailed above, we think a potential risk is that the economy runs too hot, not too cold, this cycle. Stimulus has been front-loaded this cycle, and central bankers have committed to a higher resting rate for inflation. While we do agree with the Fed's original premise in 2020, we must all, including central bankers, acknowledge that things have snapped back much faster than expected in the United States. As such, we think now is the time that some

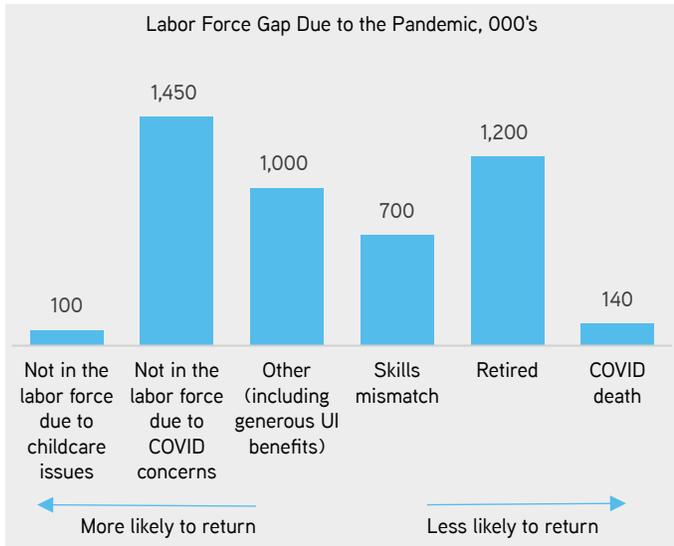
of the emergency programs linked to the pandemic should be sidelined — and quickly. Our concern, which we believe is growing in significance, is that there could be a labor shortage that leads to permanently higher inflation, lower corporate profits, and more volatility. Already, we are seeing more examples where increases in key cost of living inputs such as housing, healthcare, and food are more than offsetting any increase in wages.

Our research shows that there are three reasons why Chairman Powell may be wrong about a sharp rebound in the participation rate starting in September. First, upwards of 1.2 million baby-boomers left the workforce due to early retirement. With strong capital markets fueling gains in pensions, many older workers felt more comfortable heading for retirement. Plus, the COVID-related health shock prompted many to reevaluate priorities in life. Second, we are in the early stages of a significant skills mismatch occurring for displaced workers. Re-employment will likely require significant retraining, which will take some time. All told, 40% of the total unemployed have been unemployed at least 27 weeks; in many instances, they have just a one in five chance of re-entering the workforce in a smooth fashion.

**We think a potential risk is that the economy runs too hot, not too cold, this cycle. Stimulus has been front-loaded, and central bankers have committed to a higher resting rate for inflation. While we do agree with the Fed's original premise in 2020, we must all, including central bankers, acknowledge that things have snapped back much faster than expected in the U.S.**

### Exhibit 89

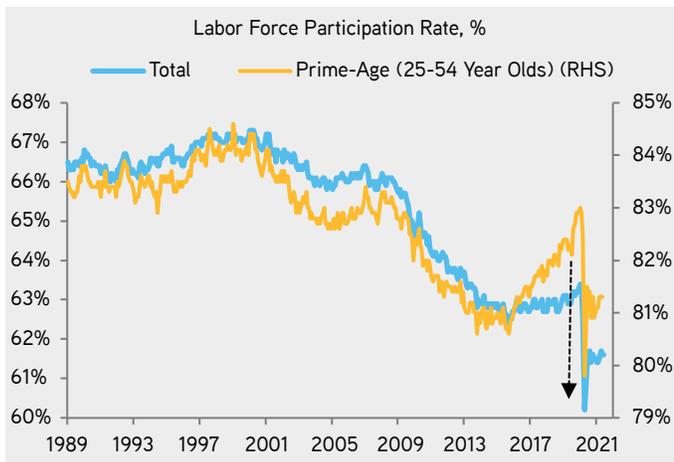
**Of the 4.5 Million Workers Missing from the Labor Force, 2.5 Million Should Return by Year-end. The Remaining Are Much Less Certain**



Data as at March 31, 2021. Source: BofAML Global Research, Bureau of Labor Statistics.

### Exhibit 90

**The Participation Rate Continues to Lag Pre-Pandemic Levels**



Data as at June 30, 2021. Source: Bloomberg.

### Concern #3: Rising Geopolitical Tensions, Including China

While the Biden Administration is taking a different approach to the U.S.-China relationship by trying to create more of a global 'coalition of the willing' to balance the influence of China, its intentions are not dissimilar, we believe, to the Trump Administration's. Specifically, we think that there is consensus in Washington today for being tough on China as an emergent/emerged competitor capable of threatening the United States' status as a superpower.

This mentality is probably best exemplified by Secretary of State Antony Blinken's construct for bilateral relations with China that the U.S. will 'Compete where needed, Confront when necessary, and Cooperate where possible.' However, this approach is not simply just a U.S. — China issue, as many other countries and regions including Australia, Japan, India and the European Union are all reexamining political and economic partnerships/cooperation as well as regulatory and data privacy issues as they try to navigate and balance the shifting world order.

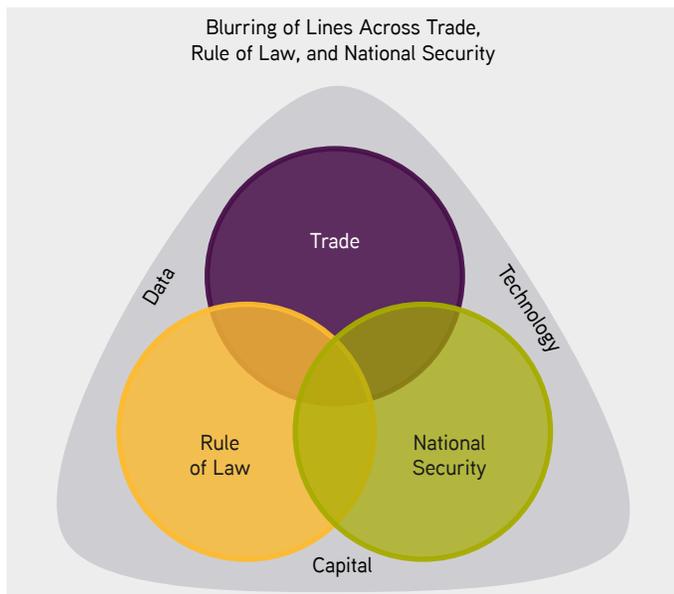
There are also no easy answers. Already, rule of law issues and data concerns have become increasingly tense across a wide swath of countries, but we acknowledge that the scope of the lens could widen even more. For example, we expect supply chains to splinter further, particularly in key areas such as 5G, data, semiconductors, and healthcare. That said, there are still trade-offs, including low cost production, that must be considered before moving aggressively. Just consider that the AmCham China 2021 white paper found nearly 85% of members are actually not considering relocating manufacturing or sourcing from the China market.

In terms of capital flows, we do want to underscore that our base view remains that capital will continue to flow freely across borders, albeit with greater oversight and approval requirements. The reality is that China needs foreign inflows into its capital account to sustain its growing consumption economy. At the other end of the spectrum, many other countries not only rely on China's exports but also want access to its large consumer market.

So, how does one hedge rising geopolitical risks? We start with the base premise that global investors should not be wildly over-committed to China — or any country for that matter. Consistent with this view, we have seen an increasing number of advisory boards encouraging CIOs to agree to a more diversified Asia-Pacific portfolio, including deploying capital in ‘new’ markets such as the Philippines, Vietnam and Indonesia. Moreover, within allocations to more complicated markets like China, we also favor investing with local players that understand the nuances of the Venn diagram that we detail below in *Exhibit 91* and can align themselves with China policy.

**Exhibit 91**

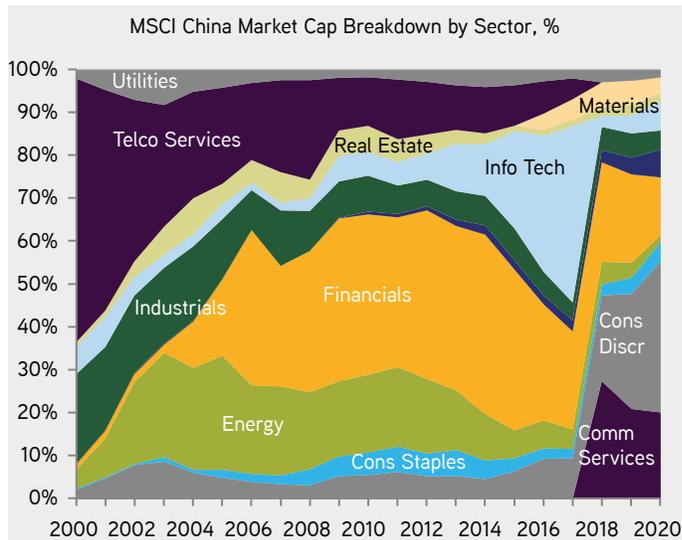
**National Security Is Now Bundled With Rule of Law and Trade Negotiations. Increasing Digitalization Only Further Complicates the Situation**



Data as at November 30, 2020. Source: KKR Global Macro & Asset Allocation analysis.

**Exhibit 92**

**China Is Showing Growth in Sectors That Are More Sensitive to Geopolitical Concerns**



Note: Some changes are due to reclassification. Data as at December 31, 2020. Source: MSCI.

For those who want to actively hedge China (i.e., beyond limiting exposure), we favor a simple 1-Year put option on CNH versus USD struck at-the-money forward at 6.65. At a cost of 3.75%, we believe current 1-Year implied volatility at five percent and attractive skew provides a favorable entry point to hedge with an option based approach.

Our bigger picture comment is that rising geopolitical tension is a risk that is not isolated to the United States or Asia Pacific. Rather it is now a global phenomenon, and there are other influential actors, including Russia, Syria, and Iran, with the capacity to unsettle global markets too. To this end (and consistent what was laid out at the outset of this note), we favor a more diversified portfolio this cycle that not only skews positively towards reflation *but also that can lean in opportunistically during periodic bouts of dislocation.*

**Concern #4: Cyber as a Battleground** We are increasingly concerned that cyber risk is a real and growing threat that could create a shock in a market where a lot of things are priced to perfection. Just consider a few statistics my colleague Rebecca Ramsey found from the McAfee, Center for Strategic and International Studies (CSIS) survey of 1500 companies<sup>1</sup>.

- Losses from cybercrime totaled more than one percent of global GDP in 2020, an increase of more than 50% from 2018
- 66% of the companies surveyed reported experiencing cyber incidents in 2019, costing an average of more than \$500,000 and disrupting operations by 18 hours per incident
- IP theft and financial crime accounted for more than two-thirds of the cyber losses; companies viewed these losses as posing the greatest threat to operations
- Reduced efficiency, operational downtime and brand reputation also suffered damage
- More than half of the survey respondents admitted to having no plan to both prevent and respond to a cyber-incident

In short, cyber-attacks are growing more sophisticated, more frequent, and more disruptive. In this respect, our KKR Global Institute colleague Vance Serchuk has argued that cyber risk represents a growing threat not only to individual firms at the enterprise level but across the global economy at a systemic level, especially as infrastructure and other critical structures on which everyone depends come under attack. Vance believes that the escalation in cyber risk is being driven by multiple intersecting secular trends, including intensifying great-power competition at the geopolitical level and the ‘weaponization of everything’ it is fueling alongside the ‘digitalization of everything’ — as almost every aspect of the physical world becomes connected to

<sup>1</sup> Data as at December 7, 2020. Source: The Hidden Costs of Cybercrime, McAfee and CSIS.

the Internet — and thus vulnerable to it. The more research we do in this area, the more we believe that cyber risk is not something that can be eliminated or even hedged. Rather, it can only be managed through a comprehensive integrated approach that creates heightened resiliency.

### Exhibit 93

#### Geopolitical, Societal, and Technological Changes Are Now Having a Substantial Impact on Both Economies and Markets

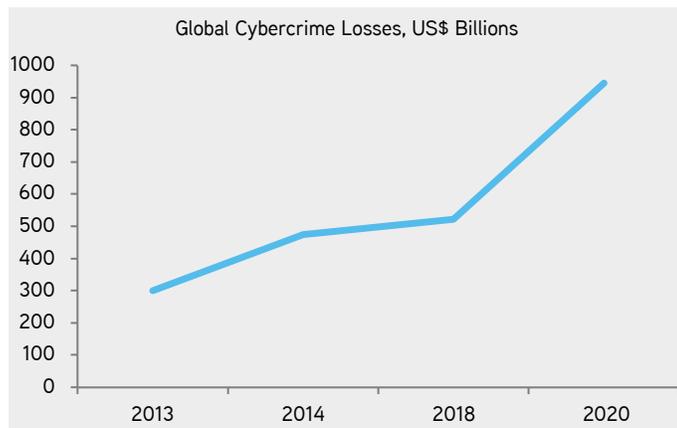
Geopolitical	Societal	Technological
Failure of governance (global, national, regional)	Failure of urban planning	Adverse consequences of technological advances
Interstate conflict	Food crises	Breakdown of critical infrastructure and networks
Large-scale terrorist attacks	Large-scale involuntary migration	Large-scale cyberattacks
State collapse or crisis	Profound societal instability	Data fraud/thefts
Weapons of mass destruction	Infectious diseases	—
—	Water crises	—

Source: 2018 The Global Risks Report, World Economic Forum.

**Our bigger picture comment is that rising geopolitical tension is a risk that is not isolated to the United States and Asia Pacific. Rather it is now a global phenomenon, and there are other influential actors, including Russia, Syria, and Iran, with the capacity to unsettle global markets too.**

## Exhibit 94

### The Cost of Cybercrime Has Increased More Than 50% Since 2018



Data as at December 7, 2020. Source: The Hidden Costs of Cybercrime, McAfee and CSIS.

## SECTION IV: CONCLUSION — SAME AS IT EVER WAS?

As we wrote this piece, it filled us with some optimism. Reflation of the global economy means that growth is returning, individuals are finding jobs, and wages are likely going up. We also finished our mid-year work with a positive view that the current cycle is sustainable for some period of time. However, is it the same as it ever was? We don't think so. In conjunction with the human toll that has been placed on many families and their friends over the past 16 months, there is also a growing risk that efforts to front-load economic growth could lead to more of a boom and bust environment than the 'great moderation' that defined recent economic cycles.

Given this new reality, we think that asset allocators and macro investors need to reposition portfolios. To this end, we have highlighted six structural reasons that we believe this cycle will be notably different from the last one. They are as follows:

1. **There is a more accommodative approach to monetary policy, including Average Inflation Targeting in the United States**
2. **Austerity is out; global fiscal stimulus is in, with more of it going directly to consumers**
3. **We see more input cost pressures in already fragile supply chains, particularly as the PPI rises above the CPI; labor shortages too are part of this emerging conundrum**
4. **Lower real rates mean easier financial conditions for longer**
5. **The current global energy transition towards a cleaner environment is actually inflationary**
6. **There is now a record amount of savings to be spent earlier in the cycle**

Against this backdrop, our clear message is to get long pricing power. Consistent with this view, macro investors and asset allocators should be overweight collateral-based cash flows in key sectors such as Real Estate, Infrastructure, and Asset-Based Finance. Allocating more capital to opportunistic strategies that allow CIOs to lean into periodic dislocations has also become a prerequisite for success, we believe.

We also think that reflation is synonymous with an overweight position in Global Equities. We favor both Private and Public Equities. Importantly, cash flow conversion, not total addressable market (TAM), will define the winners for this next leg up, we believe. In terms of styles, we also believe that a balance between growth and value is warranted (*Exhibit 95*) at this point in the cycle.

## Exhibit 95

### Our View Is That a Balance Between Value and Growth Is Now Warranted Relative to More Extreme Periods Defined by 2015–1H21



Data as at June 30, 2021. Source: KKR Global Macro & Asset Allocation analysis.

Within Fixed Income, we are most constructive on Opportunistic Credit on the liquid side of the business. Within Private Credit, we still favor Asset-Based Finance, but we are increasingly bullish on capital solutions that can be provided to cash flowing, growth companies that need to raise capital but do not want to dilute their equity.

**In the near-term, one will need to have high conviction to add to positions in the reflation portfolio, as rate of change in the global economy slows. To some investors, this strategy could be perceived as a risk, given all the uncertainty. However, to us, it represents a unique opportunity to invest today on what we think the portfolio of tomorrow should look like.**

While we are advocating a pro-risk portfolio, our Risks/Concerns section hopefully underscores our belief that there are several potential headwinds on which to focus. Hedging clearly can help, but our experience over time, particularly last year, has taught us that portfolio construction and portfolio diversification are the real levers that sustain portfolios when the macro environment changes unexpectedly.

Overall, the ‘once in a lifetime’ event that defined 2020 informs our view that it is not time to adopt a ‘same as it ever was’ mentality. Policy shifts across the globe have shifted the skew from disinflation towards reflation. In the near-term, one will need to have high conviction to add to positions in the reflation portfolio, as rate of change in the global economy slows. To some investors, this strategy could be perceived as a risk, given all the uncertainty. However, to us, it represents a unique opportunity to invest today on what we think the portfolio of tomorrow should look like.



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