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GLOBAL MACRO TRENDS

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State of Play

KKR
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State of Play

No doubt, war is a human tragedy. It requires heavy reflection on what has transpired and how it can be avoided in the future. However, the current situation also demands that, as fiduciaries, we delve deeply into what the implications are for all our constituencies, including our portfolio companies, our limited partners, and our employees. From our perch at KKR, we believe that the pandemic started — and the war in Europe has now accelerated — structural shifts in the global economic system that warrant investor attention. For starters, we began this cycle with 'sticky' inflation that is both broad-based and accelerating; the Russia/Ukraine war as well as the recent surge in Omicron cases in China should only intensify this headwind in the near-term. Yet, surging inflation is occurring at a time when central banks will lag to tighten financial conditions, which means real rates will likely lag this cycle. We are also seeing a further splintering of supply chains. Importantly, we believe that Russia's attack on Ukraine may only reinforce the notion that security of energy, communications, healthcare, and data is not only an economic priority but a geopolitical one as well. It also has the potential to reinforce populism, geopolitical rivalry, institutional distrust, and political tumult, all recent trends we've written about that have significant long-term economic implications. Against this backdrop, we strongly advocate for macro professionals and asset allocators to prioritize inflation protection and pricing power by overweighting collateral-based cash flows, including Infrastructure, Asset-Based Finance, and Real Estate. We also expect Private Equity with high cash flow conversion characteristics as well as opportunistic strategies across both liquid and private Credit to perform well in this new macroeconomic environment we envision.

The past is prophetic in that it asserts loudly that wars are poor chisels for carving out peaceful tomorrows.

—**Martin Luther King, Jr.,** American Baptist minister and activist

At KKR our hearts and minds go out to all those individuals adversely affected by the war against Ukraine. War is many things, but foremost it is a human tragedy. Unfortunately, as we detail below, the adverse human element of war will only be exacerbated by knock-on economic realities that are likely to further extend the pain and suffering, we believe.

From our perch at KKR, uncertainty around the situation remains high. However, the Ukraine crisis does not fundamentally alter the macro environment we have been forecasting for some time. Rather, it just aggravates the existing narrative we laid out in our *A Different Kind of Recovery* thesis. Specifically, we still see higher headline nominal GDP growth this cycle, but the underlying mix is increasingly shifting towards inflation relative to real growth. This reality is taking place against a backdrop of central bank tightening, ongoing supply chain disruptions, and liquidity withdrawal.

KKR's Macro Framework: The attack on Ukraine does not fundamentally alter the macro environment we have been forecasting for quite some time. Rather, it simply aggravates the existing narrative.	
GDP	Lowering our GDP forecasts in the West; no real change in the East. We do not forecast a European or U.S. recession, but growth will slow substantially by 2023.
Inflation	Moving our U.S. and European CPI forecasts even further above consensus to 7.0% and 6.0%, respectively, for 2022. Higher expected energy and food prices are the key drivers.
Cycle	Our economic cycle indicator is now firmly late cycle, which is an important change. A robust labor market and an ongoing inventory restocking cycle remain bright spots for the economy, but most of our other lead indicators, including slowing ISMs, are now decisively past peak.
S&P 500	No change to our S&P 500 price target of 4,750 for 2022. In 2023, our price target remains modest at 4,840, driven by slowing earnings and ongoing multiple compression.
Oil	Raising our per barrel WTI forecasts to average $110 in 2022 and $100 in 2023.
Interest Rates	We raise our 2022 target for the U.S. 10-year yield to 2.50% from 2.25% previously. There is no change to our 10-year target of 2.75% for 2023 and beyond.
The Fed and the ECB	Given our view on inflation, we continue to forecast seven hikes in 2022, with fed funds ending the year at 1.875%, and potentially even further upside to our forecast, given that we do think the Fed could decide to hike by 50 basis at one or more meetings this year. We also raise our 2023 forecast to reflect four additional hikes, versus our prior expectation of just one hike next year. Meanwhile, we still see only one ECB hike by year end 2022.

Key Investing Conclusion	We still see higher headline nominal GDP growth this cycle, but the underlying mix is increasingly shifting towards inflation relative to real growth. This reality is taking place against a backdrop of central bank tightening, ongoing supply chain disruptions, and liquidity withdrawal. As such, we continue to advocate that asset allocators prioritize inflation protection by overweighting collateral-based cash flows, including Infrastructure, Asset-Based Finance, and Real Estate. We also expect high cash flow conversion Private Equity and Opportunistic Credit to perform well.

Not surprisingly, we have spent a lot of time of late discussing what all of this means for investing. Simply stated (and as we laid out in our January Outlook piece), we think that the pandemic started — and the war has now accelerated — a regime shift that warrants investor attention. To this end, we want to highlight the following five points that support our latest thinking:

1 **First, we are again lowering our global GDP forecasts for 2022, including the U.S. and Europe**. At the same time, we are raising many of our already-above consensus inflation forecasts. However, we make no changes to our China forecasts, given our already conservative economic outlook. In general, we believe that growth is the greatest challenge Europe is facing, while in the U.S., inflation is presenting the toughest challenge, driven by the trifecta of surging wages, rising rents, and broad-based commodity shortages. Importantly, our cycle indicator moves firmly towards later cycle, which generally portends lower returns amidst slowing earnings and multiple compression.

2 **Second, we now have even higher conviction in several significant new structural forces at work that we think will redefine the current global economic footprint**. We enter this crisis with interest rates near the lower bound of history; we are also seeing a splintering of supply chains, driven by political regionalization, COVID-19, and war. As a result, inflation, driven by wages, housing, and commodities, will likely be more 'sticky' than central bankers had been forecasting. Just consider that we forecast core PCE inflation to be above the Fed's two percent target on a year-over-year basis for essentially three years ending December 2023 (and it could be longer). By comparison, core inflation ran above the Fed's target in just four of the 48 running quarters between 2009 and 2020. This unfortunate economic reality will fuel more populism and distrust of those in power, we believe. Finally, the 'weaponization' of economic policies for war now means a more sustained blurring between the fault lines that once distinctly separated geopolitics from macroeconomics during the rise of globalization in recent decades. Ultimately, we see some greater form of economic polarization as the most plausible outcome.

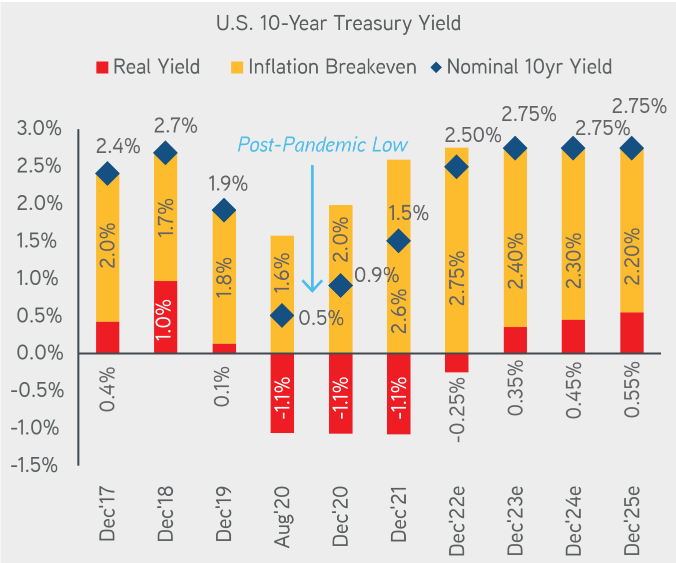
3 **Third, the macroeconomic and asset implications of the current environment could end up being quite profound over time, we believe**. We advocate shortening duration, leaning into collateral-based cash flows, and overweighting opportunistic vehicles across liquid and private markets. We continue to steer away from high beta growth equities with low cash flow conversion prospects. Overall, portfolio diversification matters now much more than in the past 10 years.

4 **Fourth, these macroeconomic trends are also likely to reinforce other recent trends**. We envision that more economic polarization and inflation will reinforce populism, further challenging the authority of those in power. These trends will also enhance already high institutional distrust as families see their purchasing power declining amidst higher prices. The regionalization of supply chains will add a new dimension to geopolitical rivalry that investors must consider as more industries and sectors become 'strategic' from a national security perspective.

5 **Finally, the democratization effects of trade many envisioned post the creation of the WTO in 1995 may now be replaced by 'like-minded blocks' rather than global markets**. Nowhere is this trend more on display than in Europe, as the surprising speed and unity of governments, businesses and individuals in expressing outrage over the invasion of Ukraine may have reinvigorated NATO, and ultimately could meaningfully change energy policy, defense spending, supply chains, and even consumption patterns. The war is also more likely to accelerate and intensify the dynamic between China and the industrialized democracies that has been building for several years, including the mutual hardening against economic and technological dependence on each other. Consistent with this view, we think that the definition of 'security' for governments and corporates extends beyond the military playing field to include data, search, payments, communications, and healthcare.

Exhibit 1

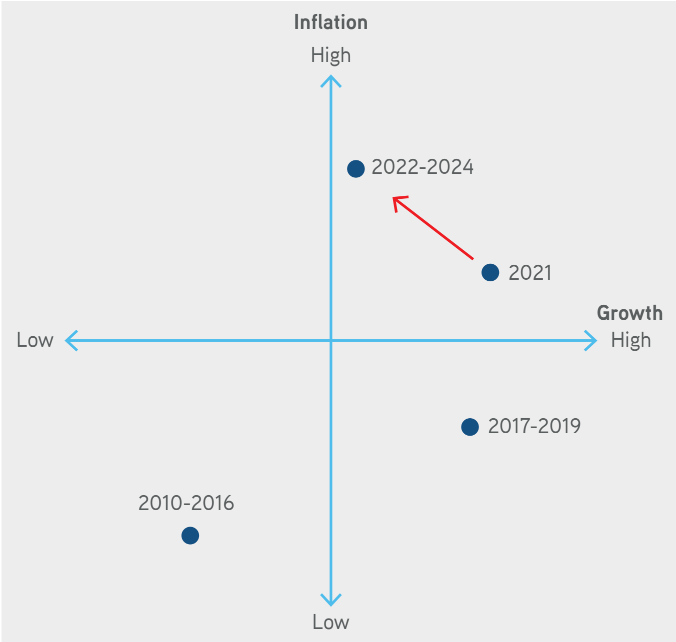
We Expect Real Rates to Remain Below Pre-Pandemic Levels, Even as Nominal Rates Rise Towards 2.75%



Latest data as at March 17, 2022. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 2

In General, We Are Entering a Regime Change



Data as at March 9, 2022. Source: KKR Global Macro & Asset Allocation analysis.

Exhibit 3

We Are Generally Below Consensus for Growth and Above Consensus for Inflation

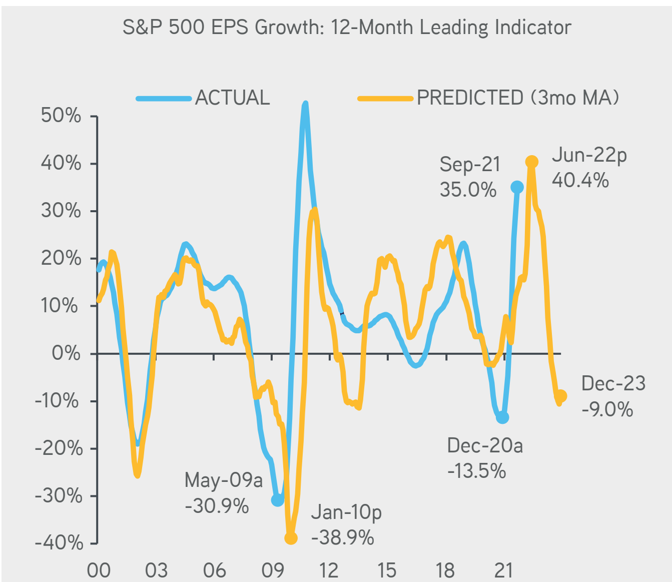
	2022e Real GDP Growth			2022e Inflation			2023e Real GDP Growth			2023e Inflation		
	GMAA New	GMAA Prior	Bloomberg Consensus	GMAA New	GMAA Prior	Bloomberg Consensus	GMAA New	GMAA Prior	Bloomberg Consensus	GMAA New	GMAA Prior	Bloomberg Consensus
U.S.	**3.2%**	3.8%	3.6%	**7.0%**	6.5%	6.1%	**1.8%**	2.25%	2.4%	**3.0%**	3.0%	2.6%
Euro Area	**2.6%**	3.5%	3.5%	**6.0%**	4.7%	5.0%	**2.1%**	2.1%	2.5%	**2.1%**	1.5%	2.0%
China	**4.8%**	4.8%	5.1%	**2.6%**	2.6%	2.2%	**5.4%**	5.4%	5.2%	**2.3%**	2.3%	2.2%

Data as at March 17, 2022. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Looking at the bigger picture, we think we are entering another uncertain period, driven by tightening financial conditions, a new form of war that includes both military action and unprecedented — for an economy of Russia's size — economic sanctions, and more supply chain disruptions, driven in part by a surge of Omicron cases in China. The technical picture too is also important, as many investors are still overweight high beta growth and tech stocks (which remains one of our Pans; see Picks and Pans in *A Different Kind of Recovery*).

Exhibit 4

Our Earnings Model Is Now Suggesting a Notable Slowdown in 2023. If Inflation Stays High, It Could Feel Like Stagflation in Many Parts of the World

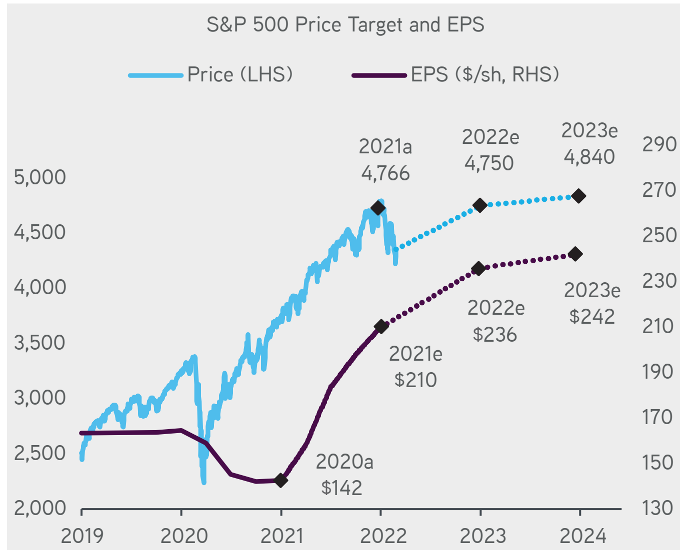


Our Earnings Growth Leading Indicator is a combination of seven macro inputs that in combination we think have significant explanatory power regarding the S&P 500 EPS growth outlook. Data as at January 31, 2022. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

If there is good news, we think that the marriage of a solid top-down macro framework with sound bottom-up analysis is very well positioned to deliver both outsized relative and absolute performance. Importantly, though, we are following a different playbook than the one we used after past crises. Key to our thinking is that global central banks are entering this difficult macroeconomic period near the lower bound of their rate targets; by comparison, in 2001, 2008, and 2020, central banks had both more interest rate and balance sheet capacity to serve as cushions. Meanwhile, inflation will continue to run hot for some time, adding another layer of complexity for all politicians and especially elected officials, we believe.

Exhibit 5

Our Forecast Has the S&P 500 Reaching Just 4,750 on $236 of EPS in 2022 and 4,840 on $242 of EPS in 2023



Data as at February 25, 2022. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Factset.

As such, deployment should be at a walk, not run, pace; by comparison, at the outset of the pandemic, our bias was to lean much more into the uncertainty. From an asset allocation perspective, we continue to focus on pricing power stories, with a particular bias towards Infrastructure, Real Estate, and Asset-Based Finance areas. We also prefer more value and defensive-oriented Global Equities and favor opportunistic approaches to both traded and non-traded Credit. Finally, we would spend some capital to hedge that long-rates catch up to the 'sticky' inflation we are forecasting. And in all decisions, investors must incorporate social, geopolitical and societal lenses, given the turbulence in each.

Section I: Economic Forecast Updates

Though the situation in Ukraine remains fluid, we believe that there is no easy off-ramp for Vladimir Putin. However, even before the war (and as indicated by *Exhibit 4*), our models were suggesting slowing growth amidst higher inflation and tightening financial conditions. So, as we detail below, our cautious bias has served us well thus far and we are making tweaks rather than huge changes to our global macroeconomic forecasts. We note the following:

- **Lowering our GDP forecasts in the West; no changes in the East.** By region, our Euro Area estimates move the most. Specifically, in the Euro Area, my colleague Aidan Corcoran is lowering his estimate for 2022 Real GDP growth to 2.6% from 3.5%, though there are no changes to his 2023 estimate of 2.1%. Higher fuel costs, lower consumer confidence, and slowing exports are all to blame for the downgrade to 2022 growth. Importantly, though, Aidan is not calling for a recession, but he is still more bearish than the consensus for growth, which is currently at 3.5% for 2022 and 2.5% for 2023, respectively. Meanwhile, in the U.S., Dave McNellis is lowering his Real GDP growth forecast for 2022 to 3.2% from 3.8%, compared to a consensus 3.6%. For 2023, Dave's U.S. Real GDP growth forecast falls to 1.8% from 2.25%, below consensus expectations of 2.4%. Finally, in Asia, our Chief Economist for Greater China Changchun Hua still forecasts China Real GDP growth for 2022 of 4.8% (i.e., no change), below consensus of 5.1%. Changchun is also not changing his 2023 Real GDP growth estimate of 5.4%, which is slightly above consensus of 5.2% His earlier forecasting conservatism allows for some slowdown from Omicron, partially offset by increased government measures to try to hit the 5.5% target.

- **We move our European and U.S. CPI forecasts even further *above* consensus.** Higher expected energy and food prices are the key drivers to this change. All told, in the Euro Area our 2022 CPI forecast jumps to 6.0% from 4.7%, well above the consensus estimate of 5.0%. We also raise our 2023 inflation forecast to 2.1% from 1.5%, above consensus of 2.0%. In the U.S., KKR's 2022 CPI increases to 7.0% from 6.5%, meaningfully higher than the consensus estimate of 6.1%. For 2023, we remain at 3.0%, above the current consensus of 2.6%. In China, there are no changes to our 2022 and 2023 inflation forecasts of 2.6% and 2.3% respectively. Even with the recent surge in Omicron and subsequent shutdowns of economically sensitive areas, we believe that our estimates already reflect this downside skew.

- **Our economic cycle indicator has moved to late cycle from mid-cycle.** After spending the last approximately 18 months in the mid-cycle 'expansion' phase, the U.S. economy has moved into a more stagflationary late-cycle environment. A robust labor market and an ongoing inventory restocking cycle remain bright spots for the economy, but most of our other lead indicators, including slowing ISMs, are now decisively past peak. See below for full details, but this viewpoint is consistent with the 'stall-speed' sequential forecast the Federal Reserve gave when it updated its forecasts on March 16, 2022.

- **We keep our S&P 500 target for 2022 the same at 4,750.** In 2023, our price target remains 4,840. Similar to what we highlighted earlier in 2022, our call remains that slower earnings growth and more multiple compression will continue to limit S&P 500 upside at this point in the cycle. As we show in *Exhibits 4* and *5*, we continue to expect more muted returns at this point in the cycle amidst tighter financial conditions, decelerating growth, and stubbornly high energy prices.

- **We raise our per barrel WTI forecasts to $110 in 2022 and $100 in 2023** from $100 and $85, respectively. See below for details, but the impetus for the change to our forecast is due to physical disruption in oil supply brought about by self-sanctioning.

- **Our Fed call for 2022 remains unchanged, but…**Given our view on inflation, we continue to forecast seven hikes in 2022, with fed funds ending the year at 1.875% and potentially even further upside to our forecast, given that we do think the Fed could decide to hike by 50 basis at one or more meetings this year. We raise our 2023 forecast to reflect four additional hikes, versus our prior expectation of just one hike next year. What shifts our thinking is the fact that the Fed is exhibiting a new inclination to tighten policy even in the face of much slower growth. As Powell recently stated, "I want to say that…I saw a committee that's aware of the need to return the economy to price stability and determined to use our tools to do exactly that."

- **…We are building in a little more cushion at the long-end of the curve.** Reflecting the Fed's near-term hawkishness (including our belief that it needs to shrink the balance sheet to cool the housing market), we raise our 2022 target for the U.S. 10-year yield to 2.50% from 2.25% previously. There is no change to our 10-year target of 2.75% for 2023 and beyond. We still see one ECB hike by year-end 2022.

Section II: Structural Forces at Work

Structural Forces At Work: In terms of investment conclusions, our message is that there are several important structural forces at work that warrant investor attention at this time of heightened uncertainty. Specifically, we see long-term trends shifting in the following areas:

Era of Sustained, Heightened Geopolitical Risks	As a firm, KKR believes that we have shifted from a period of benign globalization to one of great power competition. Given this view, we think that domestic economies will change to incorporate the reality of a more unsettled world. • Sectors most impacted include defense spending and cyber/cyber security. • As part of this evolution, cyber risks have escalated in an exponential fashion. • More restrictions and scrutiny on the transfer of capital, technology, and data are also likely to occur, as economic warfare becomes an increasingly critical tool in the era of great power competition.
The Intersection of Energy Security and the Energy Transition	For quite some time, we have been cautioning that the global energy transition would be inflationary. The global economy is still largely dependent on 'old economy' natural resources. Moreover, there has been a substantial under-investment in existing capital expenditures, as investors have shied away from the traditional energy sector. • Looking ahead, we think that the energy transition will expand to include energy security. • We believe there will be greater acceptance and support by investors for the transition of existing assets from brown to green. We view this opportunity, similar to what we have long said about corporate carve-outs, as a buy complexity, sell simplicity investment. All told, we think that there could be an 800–1,000 basis point difference in the cost of capital between the two types of investments. • We believe that there is going to be a massive capex cycle that leads to new factories, homes, and jobs, as supply chains become more regional and/or redundant to survive the growing number of geopolitical shocks that are occurring. • This phenomenon is not just a U.S. one; rather, as Europe rethinks its dependence for food and fuel on actors like Russia, we envision a wholesale review of energy platforms, including partners, production, distribution, and reserve capacity. Looking at the bigger picture, we envision energy production and delivery that is inherently more localized and decentralized, with the potential to reduce vulnerability to oil and gas price manipulation.
Shifts in Globalization	At KKR, we do not believe that globalization is dead; the world is too interconnected across too many basic industries at this point. However, we do acknowledge that globalization's rate of change is slowing, and in some areas it is actually going backwards. • We think that the epicenter of the globalization debate will increasingly focus on supply chains. Our take is that, within the corporate world, we are quickly transitioning from 'just in time' to 'just in case.' Redundancy and diversification too will be emphasized, as multi-national CEOs seek out the security and certainty for delivery of goods and services across their substantial global footprints. • Maybe more important, even within existing supply chains, security has become a top priority. Notably, security does not matter just for fuel inputs; rather, security now extends to global payments, soft commodities, communications, and data. Given this view, we believe that politicians in large economies such as the U.S. and China will further accelerate industrial policies to support critical components (e.g., semiconductors, pharma, etc.) as well as industries of the future like tech, clean energy, and synthetic bio fuels. Counterparty and supplier scrutiny too will intensify.

We Think We Are Shifting From Disinflation Towards Inflation, or Even Stagflation	With more than 96% of CPI inputs well above the Fed's 2% long-run inflation target, the 'transitory' part of the central bank's thesis has disintegrated. Said another way, inflation is no longer confined to a small set of pandemic-dislocated categories around autos and other scarce consumer goods. Rather, it is widespread across many of the inputs that KKR uses to assess the macroeconomic landscape. To be sure, there are lots of factors that we watch, but three stand out. They are as follows: • ***Wages:*** Though an indirect input into inflation, we see increasing wages as an important part of the inflation story in certain major economies, including the United States. We believe that ongoing tightness in the labor market will lead to higher wages across multiple industries on a sustained basis. • ***Housing:*** Across many developed markets, housing supply is extremely tight. Unfortunately, this lack of supply is coming at a time of increased household formation. In many instances, young adults are being forced to rent for longer at higher costs which has the impact of driving up inflation. This reality is important, because in the U.S., for example, actual and implied shelter rent is the largest single input in the government's inflation calculation. • ***Commodities:*** As we indicated above, we have for some time viewed the energy transition towards renewables as inflationary. Lack of investment in 'old economy' energy, which still powers 83% of global electricity, is leading to a $500 billion to one trillion dollar cumulative spending shortfall. At the same time, the surge in demand for renewables is creating outsized need for commodities that are in short supply, including lithium, nickel, and copper. Further exacerbating these issues are the war against Ukraine and the recent surge in Omicron cases in China.
Starting a Crisis Near the Lower Bound of Interest Rates	In our view, the Russia/Ukraine war only aggravates what is one of the biggest structural challenges that the global capital markets now face. Specifically, having, both ballooned its balance sheet with bond purchases and slashed short-term rates to zero, the Fed is entering this latest crisis with monetary policy near its absolute lower bound relative to history. Said differently, the Fed and its peers don't have the same arsenal of tools they had, for example, after the tragic events of 9/11 occurred, or when the investment banking community began a forced deleveraging at the onset of the GFC, or when the pandemic surprised everyone in early 2020. Looking ahead, our base view is that inflation does not quickly fall back towards central banks' target levels. With tight unemployment, rising wages, surging commodity prices, and increasing rental incomes, we maintain our view that we are in a higher-for-longer environment for inflation this cycle. This viewpoint is significant because, as we detail below, it heavily influences our asset allocation tilts.

Section III: Investment Conclusions and Asset Allocation Decisions

Asset Allocation Decisions: As we indicated in December of 2021, well before the Ukraine crisis, we see a different kind of recovery this cycle. We believe the inflation outlook will worsen on the back of the Ukraine war, which likely means lower consumer confidence and even more demand for wage increases. Importantly, we see the war — either formally or informally — continuing for some time. Thus, we envision a world where both soft and hard commodity prices remain higher for longer. Beyond the war in Ukraine, we are also increasingly concerned that the recent breakout of Omicron in China will lead to a bumpier, more inflationary global economic outlook. As such, we continue to advocate that asset allocators prioritize inflation protection by overweighting collateral-based cash flows, including Infrastructure, Asset-Based Finance, and Real Estate. We also expect high cash flow conversion Private Equity and Opportunistic Credit to perform well.

Shorten Duration	Investors, in our view, should continue to shorten duration in both Public Equities and Global Fixed Income. In equities, focus on companies with real pricing power and high cash flow conversion. Last cycle (i.e., 2010-2019), being long secular growth and long-duration fixed income was what worked.
Focus on Opportunistic Strategies	Overweight opportunistic strategies in both liquid and illiquid markets: Volatility, in our view, is creating real alpha opportunities. We are very bullish on Opportunistic Liquid Credit as well as flexible capital in the private markets that can deliver financial solutions to good companies with bad capital structures. Preferred, convertibles, and convertible preferred securities could all be appealing in the new environment we are envisioning.
Play Offense and Defense	Dislocations bring opportunity, and to this end, we need to not only focus on defense but also to play offense as well, including leveraging a more thematic bent to our investing. We encourage all investors to focus on getting the themes right. Lean into high conviction ideas and/or complexity including the energy transition/security, cyber, defense spending, digitalization, automation/logistics, and the rise of the global millennial.

Investing Conclusion	Our bottom line is that we think that in many instances, portfolio construction and asset allocation need to be rethought. In particular, we believe that the recent success of the traditional 60/40 asset allocation benchmark will be seriously challenged in the macroeconomic environment we envision. As such, we advocate shortening duration, leaning into collateral-based cash flows, and overweighting opportunistic vehicles. We also suggest increasing diversification by allocating across more strategies, including some non-correlated ones. At the same time, we continue to directionally steer away from high beta growth equities with low cash flow conversion prospects.

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