KKR

Flash Macro Update

U.S. FOMC | March 2024

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

Dave McNellis
Head of U.S. Macro

Ezra Max
Associate, U.S. Macro

What You Need to Know

1 How are we thinking about the March FOMC meeting?

The March FOMC statement and dot-plot, as well as Chair Powell's comments, support our base case that the Fed initiates gradual cuts in 2H24 in response to cooler inflation and easing labor market conditions. At the same time, we see signs that the FOMC is adjusting to the reality that achieving two percent inflation will be really difficult this cycle. We continue to think that we have permanently exited the low-growth, low-inflation, low-rate environment of 2010-2019.

Importantly, the implications of this acknowledgement cut both ways, including higher resting rates for both nominal GDP and interest rates. Consistent with this view, this new normal has material implications for asset allocation (hence, why we have been calling this cycle a Regime Change).

WHAT HAPPENED?

- **While acknowledging stronger growth and inflation, the Fed remains convinced that the economy is "coming into better balance"...** FOMC members upgraded their GDP forecasts significantly, but Chair Powell emphasized that inflation has come "way down" thanks to a surge in labor supply from higher participation and a pickup in immigration, along with cooler rent growth. All told, these developments reduce the tail risk of services inflation running away to the upside (something we emphasized after last month's inflation report).
- **...so, while he still wants more data, Chair Powell maintains his conviction that rate cuts will be appropriate in the back half of 2024.** The Fed expects to cut rates

three time this year in order to hold real rates around two percent (see below, but we assume two cuts, as we see inflation taking longer to cool). At the same time, Chair Powell indicated that QT would slow in coming months, consistent with our forecast for the Fed's balance sheet to trough out around 6.5-7 trillion in late 2024 (down from a peak of about 9 trillion in 2022).

- **Bottom line: No change to our forecast/framework for interest rates, growth, and inflation.** We maintain our outlook for two Fed cuts in 2024 amidst resilient GDP growth (we are at 2.5% vs. consensus of 2.1%) and moderating but still elevated inflation (we are at 3.1% for CPI vs. consensus of 2.8%). Bigger picture, we continue to think the Fed will struggle to bring inflation fully back to its two-percent target, which is why our base case envisions rates settling at 3.125% over the longer term (versus Fed expectations of 2.625%).

WHAT DOES THIS MEAN FOR MARKETS?

1. **"Coming into better balance": This report is a market friendly one**, **especially for Credit**. The most striking part of this release was the upward revision to 4Q24 GDP, which now implies 'full-year' 2024 growth of about three percent. By comparison, we are using 2.5% for GDP growth this year, and the consensus is still stuck at 2.1% (though this forecast will need to rise). At the same time, a more balanced labor market means that the Fed can still cut rates despite stronger growth. As Chair Powell explained it: "The economy is strong, the labor market is strong, and inflation has come way down."
2. **Inflation/interest rates: Higher for Longer thesis intact**. Chair Powell and his colleagues used this meeting to increase their forecast for 2024 Core PCE inflation to 2.6% from 2.4% in December. Importantly, this increase reflects only what has occurred on inflation so far, and if it does not slow quickly, we could see the Fed needing to increase its inflation forecast again in 2024. Meanwhile, the Fed also raised its 2025 year-end forecast to 3.875%, compared to 3.625% previously. For 2026, the Fed is now at 3.125%, compared to its prior estimate of 2.875%. Stated simply, we think the Fed is adjusting to a world where inflation is typically above – not below – its two percent target.
3. **We still expect the Fed to slow the pace of balance sheet QT in the near-term.** The Fed is signaling that it will soon address its balance sheet policy. Our base view that the Fed will announce it is tapering QT in May, with QT fully ending sometime this year, remains unchanged. We think that the market will view this outcome quite favorably, as our base case is that we end up with the G4's central bank balance sheets being much larger in steady state than in prior cycles.
4. **What to watch for and where we could be wrong**? For some time, we have been arguing that we are in a Regime Change. So, if inflation collapses and **unemployment surges more than we have laid out, then our Regime Change thesis would be out of step. However, given the Fed's acknowledgement of higher inflation in their forecast, we feel good about our framework from both a macroeconomic and asset allocation perspective**. Importantly, when asked about bringing inflation down, Chair Powell indicated that it will need to happen "over time," underscoring that the Fed is not rushing to squash inflation immediately (and at the risk of spiking unemployment).
5. **Longer-term, productivity will matter a lot**. The U.S. just printed a 2.6% productivity report. That level is high enough to allow the Fed to keep policy rates higher, and it would – to some degree – help with the nation's current large deficits. In some ways, the current backdrop reminds us of the early to mid-1990s, which was a good time for both growth and capital markets. If productivity falls off again and deficits stay balloon, then we might want to take a more defensive stance, but today is not that day.
6. **What does this mean for investing**? **Today's press release as well as Chair Powell's follow-on commentary are market friendly.** They suggest our Regime Change thesis of higher nominal GDP and rates, driven by a higher resting heart rate for

inflation, is intact, while still confirming our view that the Fed will lower nominal rates this year. As such, we continue to overweight Real Assets, including Infrastructure, Real Estate Credit, and Asset Based Finance. We also think that the recent surge in corporate carve-outs and public-to-private transactions suggests that there is a lot of value and value creation potential in Public Equity markets outside of the Magnificent 7. Finally, given a higher risk-free rate and higher nominal GDP this cycle, we think the potential for both Liquid and Private Credit to compete against other asset classes on a total return basis is significantly higher.

Exhibit 1: The March FOMC Release Featured a Significant Upgrade to the Fed's GDP Forecast for 2024, But No Change to Its Outlook for Three Cuts This Year

	2024e	2025e	2026e	Long-Run
Central Tendency of Economic Projections				
Real GDP Growth	**2.1%**	**2.0%**	**2.0%**	**1.8%**
Dec'23 Meeting	*1.4%*	*1.8%*	*1.9%*	*1.8%*
Memo: Bbg Consensus	*1.3%*	*2.1%*	*2.0%*	*N/A*
Unemployment Rate	**4.0%**	**4.1%**	**4.0%**	**4.1%**
Dec'23 Meeting	*4.1%*	*4.1%*	*4.1%*	*4.1%*
Memo: Bbg Consensus	*4.1%*	*4.1%*	*4.0%*	*N/A*
PCE Inflation	**2.4%**	**2.2%**	**2.0%**	**2.0%**
Dec'23 Meeting	*2.4%*	*2.1%*	*2.0%*	*2.0%*
Memo: Bbg Consensus	*2.2%*	*2.1%*	*2.1%*	*N/A*
Core PCE Inflation	**2.6%**	**2.2%**	**2.0%**	**N/A**
Dec'23 Meeting	*2.4%*	*2.2%*	*2.0%*	*N/A*
Memo: Bbg Consensus	*2.3%*	*2.1%*	*2.1%*	*N/A*
Year-End Fed Funds Forecast				
March Meeting	**4.625%**	**3.875%**	**3.125%**	**2.625%**
Dec'23 Meeting	*4.625%*	*3.625%*	*2.875%*	*2.500%*
FF Futures	*4.68%*	*4.01%*	*3.74%*	*3.89%*
GMAA Base Case	*4.88%*	*4.13%*	*3.38%*	*3.13%*

Data as at March 20, 2024. Source: Federal Reserve Board, Bloomberg.

We also think that the recent surge in corporate carve-outs and public-to-private transactions suggests that there is a lot of value and value creation potential in Public Equity markets outside of the Magnificent 7. Finally, given a higher risk-free rate and higher nominal GDP this cycle, we think the potential for both Liquid and Private Credit to compete against other asset classes on a total return basis is significantly higher.

Important Information

KKR

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