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KKR Credit & Markets

3 Three Key Market Themes

9 The Pursuit of Mastery

11 Bob & Carl Venture to Club Private Credit

12 Rates Ripple Effects on the Market

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As we began to witness this January, 2022 was certainly going to look and feel very different than the year prior. Closing out 2021 the market began to grapple with discrepancies in perception versus reality after a year of unprecedented and record-breaking issuance, performance and deal activity. January quickly snapped us back to the staunch reality of inflationary pressures, a hawkish Fed and an increasingly tepid market environment. Many of the market's performance drivers over the last 24 months were borne out of the crisis manifested from the onset of COVID-19 in the first quarter of 2020. We are now starting to witness expansive ripple effects unfold as the Fed sits between a rock and a hard place to combat historically high levels of inflation and a devastating war in Europe sends geopolitical shockwaves through the global markets.

Last quarter we turned to the timeless words of Charles Dickens in our piece *Great Market Expectations* as we examined 2021 market performance and January's market volatility spurred by the fears of looming rate hikes. We highlighted then that even with the market needing to calibrate to a new equilibrium and persistent near-term volatility, we remained steadfast in our conviction that now is the time to be even more forward leaning and structurally nimble across the public and private global corporate credit spectrum.

The twists and turns of the first quarter and current market tone now take us back to Jack London's adventure novel, *The Call of the Wild*. Like the novel's protagonist Buck, our goal was to not only withstand the market's wild but also to ensure we are in a position to thrive in it. We believe we are doing so by leveraging our experienced and expansive tool kit to originate, invest, and structure compelling credit investment opportunities across our global platform. We are in a unique market environment today. It is clear that there is currently no true consensus amongst market participants on what is to come and how the landscape will continue to shift. However, there is a growing need to turn the discomfort of the rules of the past into an opportunity set for the future and we believe this environment is beginning to look ripe for doing so. In the words of London, "it marked [our] adaptability, [and our] capacity to adjust to changing conditions."

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Key Themes

As we look across the market, the "changing conditions" have become most pronounced in the following areas:

01
Survival of the Supply & Demand Technicals

02
The Shift and Impact on Private Credit

03
Rapidly Moving Rates Have Ripple Effects on the Market

We have seen this thesis play out two-fold in the first four months of the year. On the equity side, the S&P is off to its worst start since 1939 and the NASDAQ has sold off nearly 21% as of April 30th[1] catapulting a shutdown of the IPO market and igniting a new fear of slowing growth. On the credit side, the globalization of markets over the last decade, which also fueled growth, is starting to experience the impacts of the impending Fed unwind. Although we have been highlighting this for some time, it is now apparent due to the exacerbated market conditions which have prompted volatility in asset pricing, currencies and FX derivatives and fund flows across the ecosystem. Importantly, this market is now highlighting the decoupling of the stock market and credit markets which will be an important dynamic for portfolio construction and asset allocation across investment portfolios. Additionally, given the intrinsic relationship between fund flows and market making — this event kick started a domino effect on the heels of Russia's invasion of Ukraine — the primary credit calendar froze and universally stalled capital markets activities. This resulted in the redirection of deal flow from issuers and simultaneously ignited private credit market activity. We are now experiencing credit moving from one segment of the market as a result of the volatility and decoupling effect to another segment — privates. Private credit investors have been excited about this recent flow as it brings forth bigger businesses and capital structures to lend to. On the rate side the short end of the curve first experienced considerable movement and then flipped to the long end in the last weeks of April. Long duration assets such as investment grade bonds and high yield BB's endured rate pain while floating rate leveraged loans weathered the mark to market storm, ending the quarter near flat. As a stark pall of uncertainty ensued, cash reserves continued to increase and pending M&A sought to find a new capital base and home. **However, it is important to highlight that the increased dispersion in the market is more tied to technical headwinds than it is to fundamentals.**

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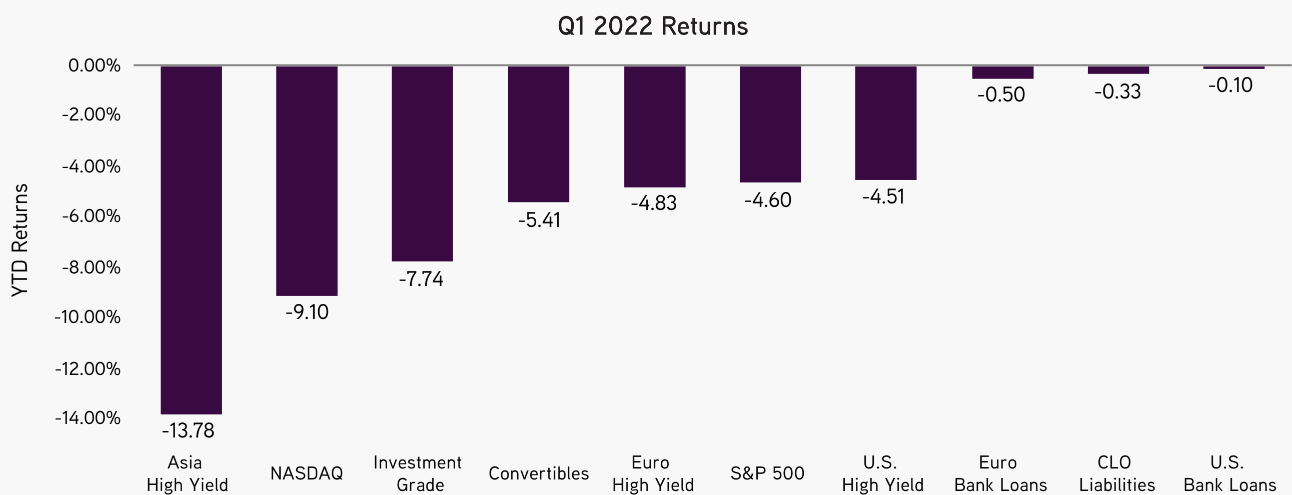
The Incline

As the March 16th Federal Open Market Committee ("FOMC") meeting grew near, we saw the market find more of its footing, albeit cautiously and almost akin to a sigh of relief, as Fed Chair Powell finally confirmed what the market and market participants already were expecting: a 25bps increase to the Federal Funds rate. With the FOMC meeting under our belts and now the great debate focused on how many hikes we could potentially see in 2022, the global credit markets continued to recalibrate with large inflows into bank loans and outflows out of high yield. The outsized swath of flows, both institutional and retail, were moderated by the on-going supply demand imbalance technical in the market, which we will discuss further in this note. While Russia's attack on Ukraine, coupled with inflation and a rising rate environment have introduced additional complexity for market participants to navigate, the demand for consistent income, down-side protection and preservation of capital remains persistent and is arguably even more important than ever before.

Furthermore, the current rotation from fixed to floating interest rates has been an asset allocation call versus a specific credit thesis or selection. Market participants are shifting into floating rate for the sake of the floating rate over the quality of the credit and over liquidity. This lack of acknowledgement highlights favoring a technical attribute over credit selection and also confirms that the market is not experiencing a traditional flight to quality, which often happens in markets wrought with concern and lack of conviction. In many cases, the exact opposite is happening as the loan market has a higher concentration of single B assets and lower rated assets than the high yield or investment grade markets.

Notwithstanding the exogenous shock the crisis in Ukraine has catalyzed across the global markets, and in Europe in particular, the market volatility has been orderly until recently in Q2. There continues to be growing anxiety around what the future holds. It is important to remember there is still plenty of dry powder sitting on the sidelines assessing the market's moves but simultaneously the market construct has created less incentive for investors to lean into risk.

Floating Rate Assets Have Demonstrated Resilience



Source: ICE BofAML, S&P LCD, Bloomberg, and KKR Credit Analysis as of March 31, 2022

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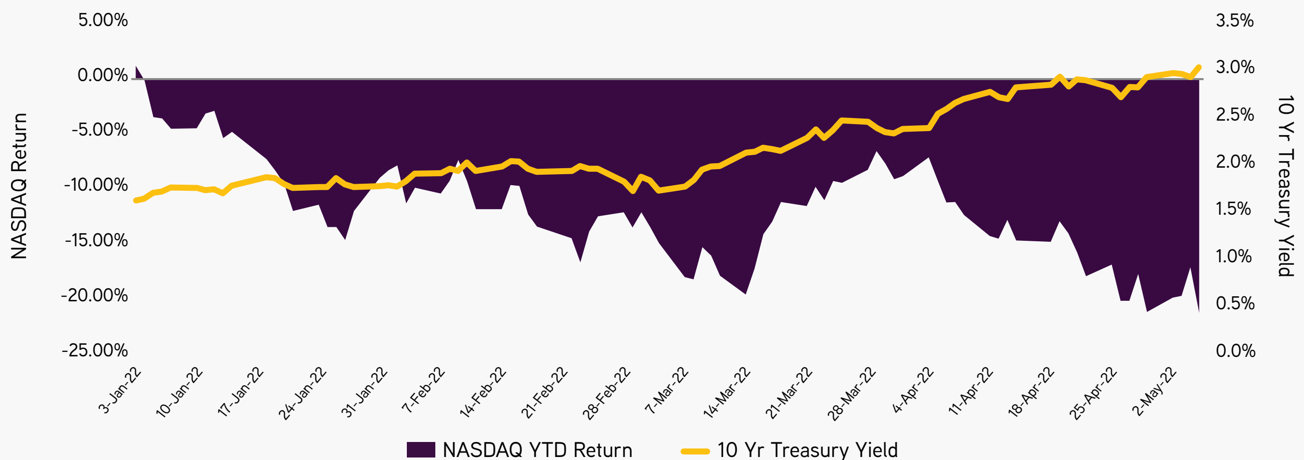
Over the quarter we have witnessed the following trends unfold:

- **Thinning liquidity accentuating the importance of sourcing and agile execution;**
- **Widening bid/ask spreads across asset classes;**
- **Primary deals that were sidelined in the syndicated market offering deeper concessions to clear the finish line; and**
- **Some large public transactions opting to flip from syndicated to private debt solutions.**

Overall, the U.S. has been more insulated from the immediate shocks of the geopolitical crisis, although, not immune. In Europe the conflict has already taken a toll, most notably stunting growth which many believe is likely to eventually lead to a recession. Globally, we have been witnessing the severe impact on commodity prices, currency depreciation coupled with foreign exchange volatility, and further exacerbation to existing inflationary headwinds. On the whole, U.S. Bank Loans closed out the first quarter nearly flat at -0.10%,[2] demonstrating the greatest resilience across asset classes. At the same time, European Bank Loans ended the quarter -0.50%,[3] CLO Liabilities -0.33%,[4] U.S. High Yield -4.51%,[5] and European High Yield -4.83%[6] on a total return basis as of March 31, 2022. As we compared public liquid credit returns to private credit returns, which are in the low single digits for the first quarter, it has become clear there is dispersion between asset classes.

Rate Movements Rattled the Market Cage in 2022 Resulting in De-Valuing Growth Stocks and Raising the Cost of Credit



Source: Bloomberg and KKR Credit Analysis as of May 5, 2022

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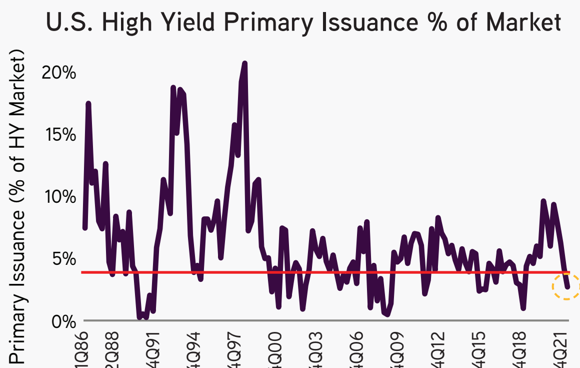
The Ride: Survival of the Supply & Demand Technicals

The central character in *The Call of the Wild* is a dog named Buck who must quickly learn how to adapt from the comfortable life he once led on a ranch in Santa Clara California, to the harshness and cold of a new life working as a sled-dog in Alaska. Buck's journey portrays a story of learning to adjust quickly in a challenging environment while performing consistently and showcasing leadership. Similar to Buck's journey to the cold north, market participants were thrust into an uncomfortable place this quarter, which tested the stamina and resilience of credit selection, portfolio construction and asset allocation — the holistic underwriting toolkit. As we reflect back on the quarter, despite the unforeseen circumstances, there were many critical moments that illustrate the breadth of the market's creativity to seek balance and extract value amidst a supply demand mismatch and stalled distribution channels. This trend was abundantly evident as we witnessed issuers embarking on a dual process of exploring financing options in both the syndicated and private markets to hedge the market's uncertainty while seeking certainty of execution.

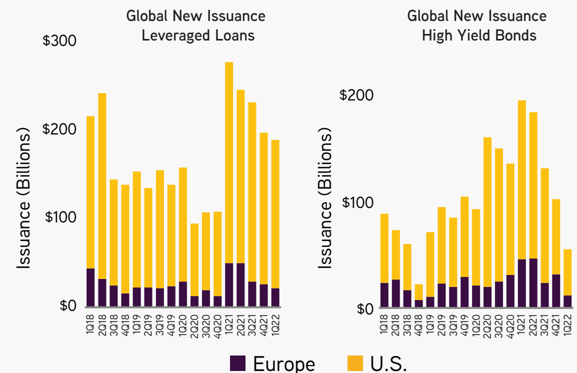
Taking a step back, the year started off with gusto as many anticipated a continuation of the deal making pace we saw in 2021; however, global new issuance was acutely impacted by the war in Ukraine, essentially coming to a halt while the secondary markets endured a steep sell-off. In a stark reversal from 2021 record highs, global leveraged loan issuance stood at $171 billion[7] and global high yield at $52.7 billion[8] as of March 31, 2022, with the bulk of activity front loaded in January. U.S. institutional loan volume fell to its lowest level since Q4 2020 at $113.5 billion[9] and high yield issuance was at $43.3 billion,[10] down 71% from 2021's unprecedented pace. In Europe, Russia's invasion of Ukraine sent pricing shockwaves through the market, heavily impacting issuance volumes. Q1 2022 was the slowest opening quarter in Europe since 2016, with European loan volume at €18.8 billion[11] compared to €41.2 billion[12] for the same period in 2021 and European high yield hitting a three year low of €10.77 billion[13] across 29 deals.

U.S. High Yield New Issuance Demonstrated Anemic Levels in Q1 as Levels Dipped to 2.7% of the Overall Market



Source: ICE BofAML, S&P LCD and KKR Credit Analysis as of March 31, 2022

Geopolitical Headwinds Coupled with Inflationary Pressures, Slowing Growth and Rate Volatility Impacted Global Issuance Across Leveraged Finance Markets



Source: S&P LCD and KKR Credit Analysis as of March 31, 2022

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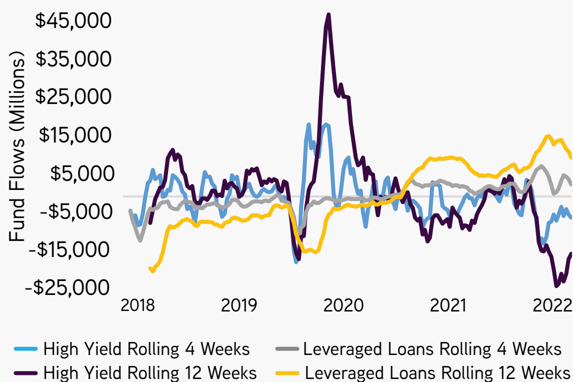
On the demand side, the year began with favorable technicals with retail inflows into loan funds as investors looked to rotate exposure back into floating rate assets in anticipation of higher interest rates. Loan fund inflows in the first quarter totaled $21.8 billion,[14] the most for any quarter since the third quarter of 2013. For context, loan funds have experienced $65 billion[15] of inflows since the start of 2021 following $86 billion[15] of outflows between the third quarter of 2018 and fourth quarter of 2020. Conversely, high yield funds saw consecutive outflows totaling -$25.3 billion,[16] of which $13 billion were ETFs, as investors reallocated away from the fixed rate asset class.

Investors Have Once Again Rotated Into Floating Rate Products and Out of Fixed Rate as Rate Hikes Continue

Rolling Leveraged Loan and High Yield Flows



Source: Refinitiv Lipper and KKR Credit Analysis as of May 4, 2022

Despite the fervor of floating rate assets being in favor over fixed rate, U.S. CLO issuance also experienced choppiness with $29.8 billion[17] in volume for the quarter, almost half of which came online in February. There was $30.4 billion[18] of primary CLO volume in the first quarter which fell 24%[19] short of the first quarter volume in 2021 and officially ended the four consecutive quarter streak of record prints. In Europe, however, 23 deals totaling €9.78 billion[20] of issuance demonstrated resilient performance and represented a 20% increase in output year over year for the same period.

The pattern of behavior we witnessed with CLOs was consistent with other segments of the market — a gravitational pull to balance the tipping scale: on one side of the equation, market volatility, a risk-off tone and relative value compared to other asset classes led to wider pricing in CLO liabilities and less deal activity. On the other side, loan assets were able to maintain more of a steady state and recover as a result of the support incurred by the large retail inflows into the bank loan market and slowing issuance. The slowdown of the CLO machine in the first quarter highlighted two important characteristics of the supply demand paradox. The intrinsic

Relative Value Across Credit Products Demonstrates the Need to Have an Agile Approach in Asset Allocation

				Percentile							
	Current Levels	End of April	End of 2021	3M	6M	1YR	3YR	5YR	7YR	10YR	Long Term
Spreads											
U.S. High Yield	393	343	310	13%	7%	3%	47%	36%	52%	61%	71%
EU High Yield	462	408	335	16%	8%	4%	20%	16%	23%	27%	45%
U.S. Bank Loans	415	440	417	63%	42%	25%	68%	47%	62%	73%	74%
EU Bank Loans	495	511	462	63%	32%	17%	30%	18%	32%	52%	50%
U.S. AAA	143	142	116	0%	0%	0%	19%	13%	26%	36%	38%
U.S. BB	738	764	655	18%	9%	4%	32%	22%	28%	25%	29%
EU AAA	119	123	98	38%	19%	9%	29%	17%	34%	45%	45%

Source: ICE BofAML, S&P LCD, and KKR Credit Analysis as of April 30, 2022

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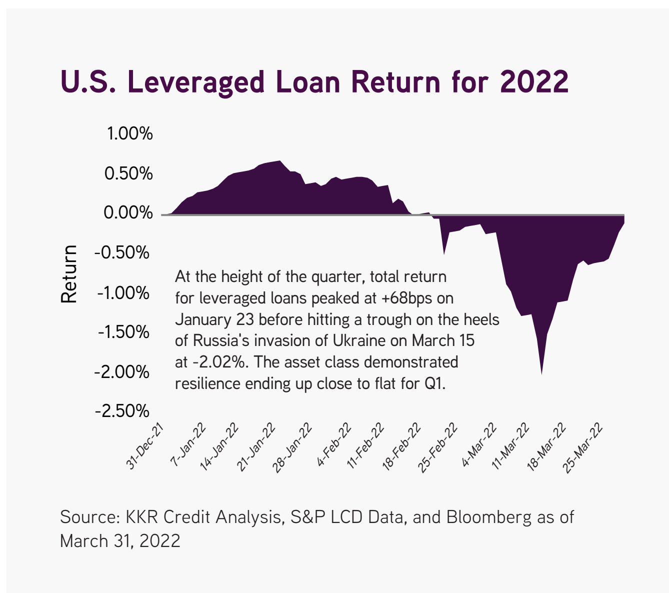
relationship between CLO creation and collateral assets as well as the force retail flows play in the market.

Although the pace of new CLO creation slowed, impacting AAA pricing, the average AAA coupon was SOFR + 136 bps.[21] We did not see as dramatic a widening in leveraged loan pricing relative to CLO liabilities. It is also important to note the increase in both LIBOR and SOFR levels as a result of rate movements. In particular for LIBOR, the decreasing use of the rate and the reliance on panel banks' assessment of credit risk has resulted in elevated levels that may continue to gap out as cessation nears for legacy facilities.

Between the lack of issuance, a geopolitical and humanitarian crisis overseas, soaring commodity prices, inflation and looming rate hikes — the first quarter tested investors' stamina for risk and fueled creativity for deployment and capital solutions in private capital markets. Private equity backed transactions continued to be the primary driver of supply, with $40.7 billion[22] of LBO volume. Accounting for more than half of that acquisition-related supply were large benchmark deals such as the $12.6 billion LBO of athenahealth. Loan issuance to support new LBOs compared favorably to the fourth quarter and exceeded the first quarter 2021 print of $36.9 billion.[23] With elevated levels of private equity dry powder still on the sidelines and pending M&A activity, we believe there will continue to be healthy loan activity, which may continue to oscillate between syndicated solutions and privately originated solutions. Even though private debt providers stepped up during the recent market uncertainty more than we have historically seen we do not think that the syndicated markets are now all of a sudden irrelevant. On the contrary, the syndicated market saw activity redirected to private channels this quarter as issuers sought to secure certainty of execution amidst an uncertain and volatile period where investors retreated and outflows were abundant. Moreover, this notable trend for the quarter demonstrates that issuers are now approaching the market wanting to understand all the financing options available to them. Similarly, across the KKR platform we see this duality of views from a variety of perspectives, including as an issuer, a private credit investor, an investor in syndicated loans and a distributor through our capital markets arm. KKR's LBO of Refresco traveled down the syndicated channel and cleared its multi-currency capital structure, totaling €3.4 billion cross-border first lien term loan B ("TLB") split across Euro, Dollar and Sterling tranches. As such, we believe the syndicated markets will always be a critical part of the functionality of the markets and a relevant path for issuers. Having the ability to simultaneously understand what an underwritten commitment could look like versus a private one will ultimately lead many issuers to choose hybrid solutions. The desire to toggle between syndicated and privately originated transactions demonstrates one of the market's newer pulls towards evolving beyond its past, but it is an approach our Credit & Markets platform has employed for some time now. Similar to Buck's progression in the wild, understanding the market from multiple dimensions is a specialized skill that enables mastery in navigating the market's wild.



Source: KKR Credit Analysis, S&P LCD Data, and Bloomberg as of March 31, 2022

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The Pursuit of Mastery: The Shift and Impact on Private Credit

As with most challenges, time and practice are positive contributors to the pursuit of mastery. Buck learned to refine his approach as he adapted to working with a pack and navigating the Alaskan slopes. As the private credit landscape has taken shape over the last decade, market participants and direct lenders can attest to the market segment's growth and relevancy. In 2021, KKR Credit & Markets led over half of the $1+ billion unitranche transactions in the U.S. and we continue to witness the inertia around this structure growing. As a result of the recent shift in market tone, there were several milestone transactions in the private credit arena that broke new ground and cemented a new definition for size, with loan or unitranche sizes north of $2 billion becoming more commonplace, although this is still mainly a U.S. trend.

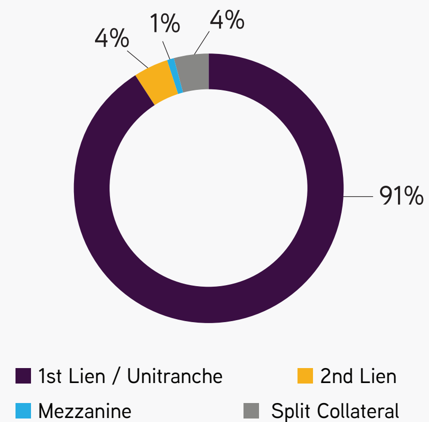
To contextualize, the average tranche size was over $3 billion and these companies have an average EBITDA of ~$440 million. These are large companies. Many of these loans were offered at SOFR + 5.75%+ with 2% of upfront fees or original issue discount and were in stable and defensive sectors.

The developing Australian dollar ("AUD") TLB market straddles the private credit and syndicated markets and has been growing quickly over the past 2-3 years. Earlier this year, Icon Group smashed the $1 billion threshold for an Aussie TLB, securing $1.165 billion in an all-AUD structure in February on the heels of another all-AUD deal for Probe CX in late 2021. We see these as the latest datapoints in the continued diversification of the broader Asia-Pacific private credit markets away from traditional bank-driven lending. This is an evolving market where we are a large player and continue to see compelling risk-adjusted returns.

We do believe this trend is here to stay as the market's volatility has increased pressure for underwriting banks

The Majority of Private Credit Deals are Being Structured as 1st Liens and Unitranches

Private Credit Deal by Type 2021



1st Lien / Unitranche | 2nd Lien | Mezzanine | Split Collateral

Source: 2021 Proskauer Private Credit Insights Report

to preserve more balance sheet capacity and thus inspire issuers to shift to private debt providers who can guarantee certainty of execution and swift execution. If you are a potential suitor of one of these companies, the quirks of the public markets may now be the difference between success and failure of execution. Many have opted to select certainty even if it costs a premium of +200bps more in credit spread to ensure successful execution.

As investors have witnessed, the private credit and middle market landscape has evolved immensely over the last decade. In particular, we have seen the number of deals almost double in 2021 versus 2020 and volume increase to 83%[24] totaling approximately $110 billion[25] of activity in the U.S. alone. In Europe, the deal count also continued to grow, increasing by 50%, with overall activity reaching €29 billion.[26] Additionally, we have seen middle market lenders opt for larger loan sizes, higher minimum EBITDA levels with 44% of loans made to companies with at least $30 million of EBITDA and senior secured deals becoming more prevalent,

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representing 91% of all deals.[27] In addition to senior secured loans, unitranche volume in particular saw steep growth from 2020 levels and the market has seen approximately $6.8 billion[28] of unitranche paper issued year to date with the expectation that it continues to climb.

As lenders to privately placed direct lending deals, as investors in syndicated loans, and as an arranger, we are in the global markets all day, every day. The symbiosis between our leveraged credit, private credit, and capital markets platforms is powerful and we have seen that come to fruition as many of our deals have been borne out of one strategy — but then morphed into another strategy as large deals that came down the syndicated route ended up being structured as unitranches or private deals. In today's market environment — this is even more evident as issuers look to dual track financing options with the ensuing market volatility and increased uncertainty. Our platform is uniquely positioned to facilitate and underwrite deals that transition from syndicated to private solutions across senior, junior and mezzanine. Many of our longstanding positions in leveraged and private credit have served to establish an incumbency position in a capital structure and led to an intimate understanding of the credit that enabled us to harness the power of our full platform, including distribution, to execute an expedited capital solution with speed, certainty and consistency.

For example, when Bain and Hellman & Friedman came to market with their LBO of athenahealth, the leading provider of electronic health records and revenue cycle management software and services to small group physician practices and ambulatory care providers, KKR was able to leverage its longstanding institutional knowledge of the issuer through our previous investments across the capital structure and role as joint lead arranger in Veritas' 2019 buyout. In this next round of athenahealth's financing journey, we were able to bring the full resources of our platform to bear.

Private Credit Today

- **Size and Scale Matters:** access to large businesses with matched capital enables portfolio diversification and investments that are insulated from rate and mark-to-market volatility.
- **Performance:** as we saw from the range in performance across public credit and private credit in the current environment, investors can access excess alpha and risk premium in private credit, which is evidenced by the recent fund flows into the segment.
- **Large Cap Subordinated Risk:** this is a unique time where there are increasing financing opportunities to invest in large and diverse businesses with a majority floating rate debt structure and accompanying call protection, which we believe is really attractive.

As we think about the opportunity set in an ever evolving market riddled with headwinds, most of which sit outside our control, we revert back to our roots: credit fundamentals, durability of cash flow, downside protection and consistency. Akin to Buck's journey from civilization to the wild and the need to tap into his primordial instincts, we are also constantly tapping into our credit instincts, which rely on our fundamental analyses. We are cash flow volatility assessors and have historically shied away from companies with significant exposure to commodities or regulatory influence over their cash flows. We continue to use our toolkit to identify companies that offer compelling credit risk premium as a percent of total return, contractual return through collateral and preservation of cash flow.

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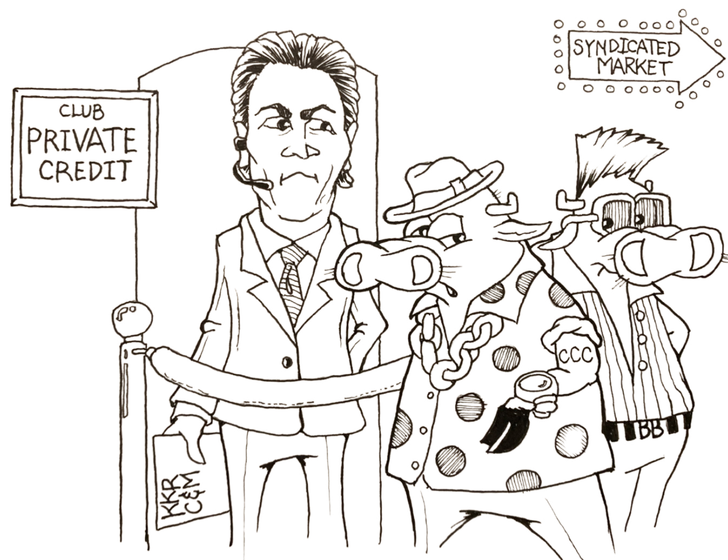
Additionally, we are also seeing more supply in junior debt behind large senior syndicated debt issuance. This is natural in an environment where sponsors are paying large multiples for very large, high quality companies, but senior leverage availability in public markets is limited. With the bond market and the syndicated market in a volatile period sponsors are turning to private credit lenders who can provide junior debt in these larger capital structures. Considering this acceleration in supply, and the ability to provide debt to these companies at double-digit contractual floating rate yield, we are excited by this flow. We believe these transactions will offer highly attractive relative value to equities in the current market uncertainty. The cross-pollination between private credit solutions and public credit was center stage this quarter. While this trend is not necessarily new, it is becoming more pronounced and inter-related and we have been fortunate to have a front-row seat to this evolution, driving our Credit & Markets sled to be able to structure, invest and distribute in many of these transactions.

Bob and Carl Venture to Club Private Credit



Shh…don't tell them your ratings…not easy to get into this Private Credit Club

Illustration by: Jerry Capria, KKR Credit.

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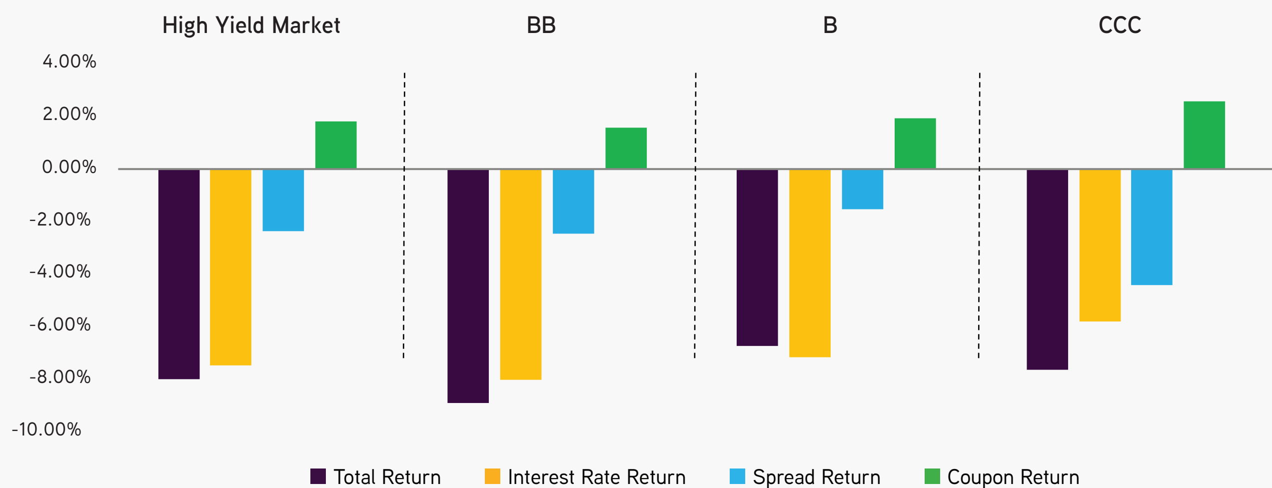
Adaptability: Rapidly Moving Rates Ripple Effects on the Market

Buck quickly realizes how important agility and adaptability are to his survival and pivots his behaviors accordingly. He also gains new knowledge as he learns from the wild and learns too how his previous actions may inform his future survival strategy. Similarly, market participants have also grappled with adapting to the rapidly changing environment in rates. Rates continue to be the common anchor for much of the market's volatility, which was on front row display in investment grade, high yield and equities in the first quarter and now continues to spill over into the second. While we believe the market understands that the Fed has no choice but to move swiftly with rate hikes to combat inflation, there continues to be a paradox in recognizing where the broader economy currently lies with respect to growth expectations and pricing risk assets.

In light of the highest nominal inflation in 40 years, the March FOMC decision represented a long awaited confirmation of reality and shift in Fed policy. Although we believe that the market had known for some time this was inevitable, it ultimately craved and simultaneously feared Powell's validation and acknowledgement of inflation and rate hikes. The time of a highly accommodative near zero-interest rate policy ended as Chairman Powell highlighted an acute awareness of "the need to restore price stability."[29] At the March FOMC meeting, the Fed stated it would raise fed funds to 1.875% by the end of 2022, up 100 basis points from its prior outlook of 0.875%[30] last December. On May 4th, the Fed raised its policy by another 50 basis points, temporarily relieving the market of a 75 basis point hike, but also confirming there is no slowing down and that the FOMC is inclined to implement additional 50 basis point hikes in mid-June and again in late-July.[31] Chairman Powell shared the Fed's plan to run down the balance sheet at a $95 billion per month capped rate starting June 1st.

Decomposition of Returns in the High Yield Market Highlight Rate Volatility



Source: ICE BofAML and KKR Credit Analysis as of April 30, 2022

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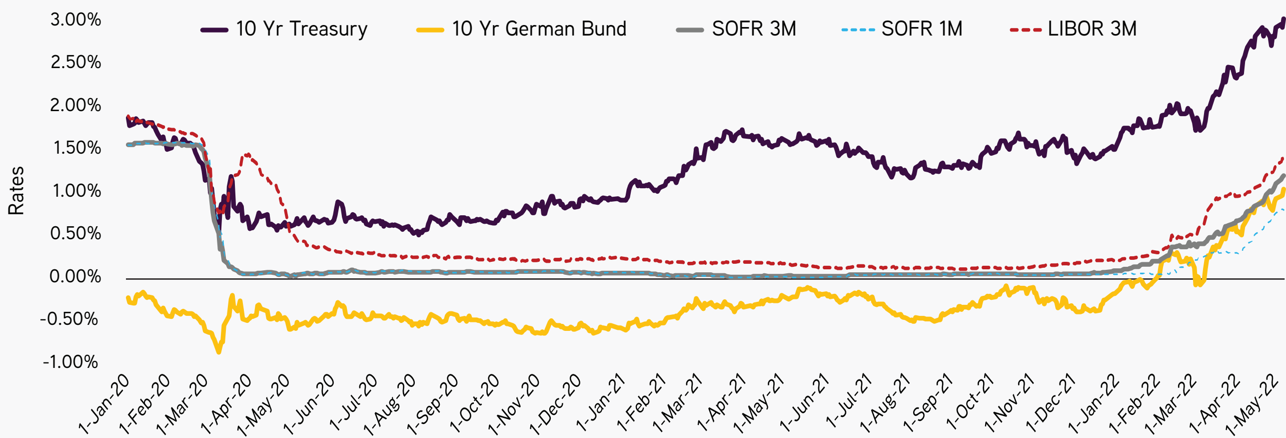
The stark reality of rising rates led to a bit of contagion across the global bond markets, turning returns negative. U.S. high yield returned -7.99%[32] in the first four months of 2022 with -6.61%[33] of total returns attributed to interest rate movements and European high yield was -8.30%.[33] Within the high yield market, the longer-dated BB names underperformed, returning -8.89%[34] while the shorter-dated CCC bonds returned -7.63%.[35] The rate story was even more pronounced in the longer-dated Investment-Grade market which returned -12.33%[36] in its worst first quarter since 1980.

The March projections and confirmation of a tightened monetary policy have had a larger impact on short-term rates while long-term rates have been more driven by economic outlook than monetary policy. This has created a larger shift in the short-end of the yield curve versus the long-end of the curve, with the 2-year Treasury rate widening by 198 basis points in the first four months of the year while the 10 year widened 143 basis points[37] in the same time period.

The shift of the yield curve was marked by a "yield curve inversion" on April 1st when the 2 year Treasury rate topped the 10 year Treasury rate.[38] As we compared the ratio of short-term yields versus long-term yields for the same issuer, we noted that long-term yields were trading tighter to short-term yields on March 31st 2022, than they did at any point in 2021.[39] However, the long-end of the curve caught up in April as the spread between the 10 year and the 2 year widened back into positive territory. Interest rate returns for BB names were down -1.96% in April.

In past rate hikes, negative interest rate returns have been compensated by tightening spreads as improving credit

Rates Are No Longer Hovering at Near Zero Levels



Level Over 28 Months

	10 Yr Treasury	10 Yr German Bund	SOFR 3M	SOFR 1M	LIBOR 3M
Max	3.04%	1.04%	1.59%	1.59%	1.90%
Min	0.51%	-0.86%	0.02%	0.01%	0.11%
Avg	1.31%	-0.29%	0.24%	0.21%	0.45%

Bloomberg and KKR Credit Analysis as of May 5, 2022

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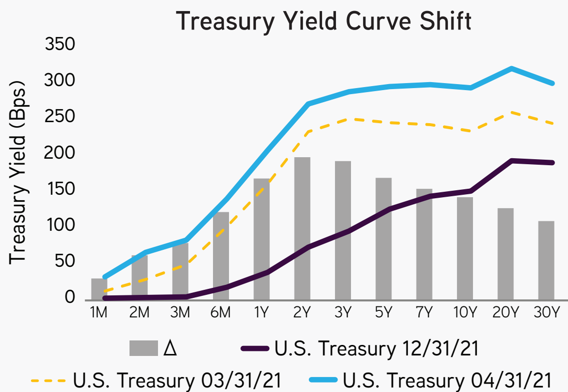
conditions increase the attractiveness of the high yield segment. During the 2016-2019 rate hike, spreads tightened by over 300 basis points, allowing for high yield bonds to outperform leveraged loans by 14%.[40]

However, this time the Fed is raising rates while high yield fundamentals are already strong and spreads are tight.

The Short-end of the Treasury Curve Widened More than the Long-end in the First Quarter but then Flattened in April



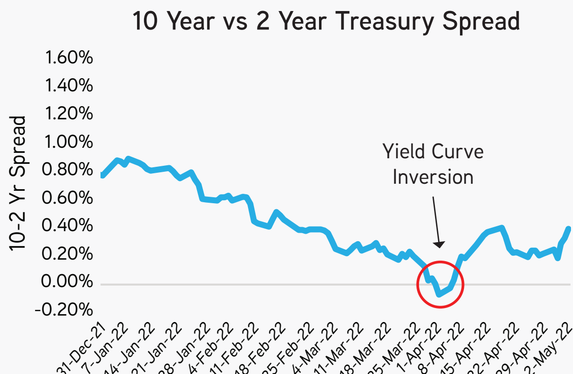
Source: Bloomberg and KKR Credit Analysis as of April 30, 2022

Leverage ratios in the high yield market were 4.5x at the end of 2021 compared to 4.9x in 2015. Similarly, interest coverage ratios were at 5.7x at the start of the year versus 4.5x in 2015.[41] Improved fundamentals are translating to historically low default rates well below 1% with the highest recovery rates in the asset class in the last decade.

Instead of tightening, high yield spreads widened from 310 basis points to 397[42] basis points in the first four months of the year as the Fed bumped rates for the first time since 2018. Fears around Russia's attack on Ukraine and sustained inflation were not mitigated by improving credit fundamentals. On the contrary, high yield fundamentals slightly weakened in the first quarter of 2022, with leverage ratios increasing by 0.1x and interest rate coverage ratios decreasing by 0.3x.[43] The exposure to fallen angels in the market fell below 10% for the first time in two years as the market experienced more downgrades than upgrades in a month for the first time since February 2021.

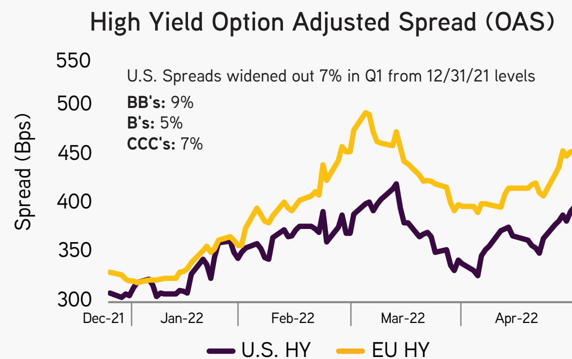
In spite of macro and rate headwinds, high yield still appears to lack its full risk premium compared to leveraged loans or the investment grade market. As of April 30th, high yield spreads are at the 3rd percentile of "tightest spread over

We Witnessed a Yield Curve Inversion on April 1st, However, the Long-End Regained Its Steepness Later that Month



Source: Bloomberg and KKR Credit Analysis as of May 6, 2022

U.S. High Yield Spreads Fluctuated During the Quarter but did not Materially Widen Depsite Growing Fears of Inflation and the Conflict Abroad



Source: ICE BofAML and KKR Credit Analysis as of May 4, 2022

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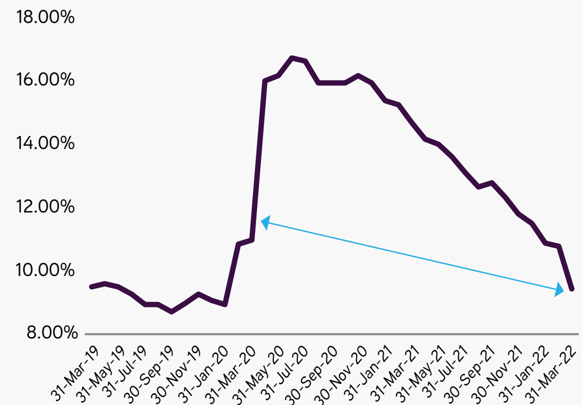
the last year" and at the 71st percentile of "tightness" over the last decade. In contrast, loans and investment grade are trading at their 25th percentile tightest spread over the last year and only ~74th percentile tightest over the last 10 years. By the end of April, a little less than 65% of high yield bonds with maturities below five years were trading below par compared 11%[44] at the start of the quarter. This demonstrates that spreads could still have more room to ride. Given where dollar prices are for the underlying securities paired with future movement and roll down the interest rate curve, there could be an opportunity for greater total return. **The market is grappling with how much more spreads can widen and investors should not solely benchmark to historical spread and yield levels, but also incorporate the current dollar discount trading levels. It is clear — the convexity is real and that will also a big driver of total return potential.**

While we witnessed large outflows out of high yield retail funds in January, robust technicals during the rest of the quarter mitigated a more drastic repricing of the market and kept valuations elevated. We believe the sharp and sudden decrease in high yield primary volumes, down 70% year-over-year and down 36% versus the average over 2015–2030[45] were behind these strong technicals. As a result, net supply became negative in the first quarter of 2022, leaving fewer reasons for high yield managers to raise cash in the secondary market and ultimately exercised downward pressure on prices.

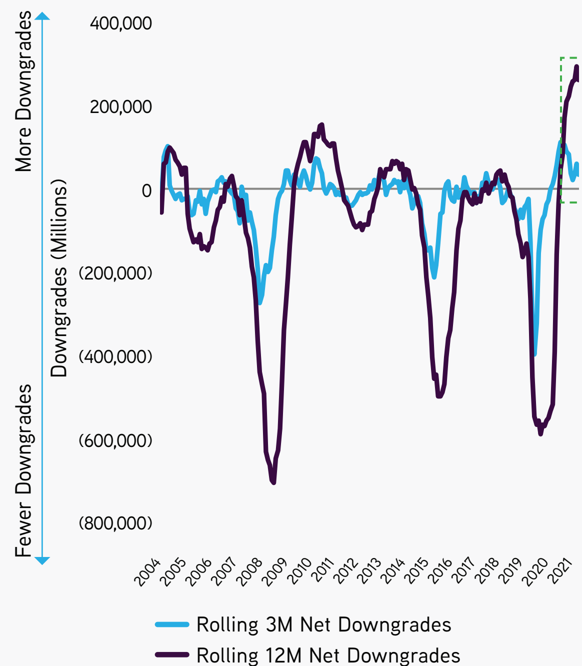
As the market continues to find its footing and interest rates inevitably continue to rise, we expect to employ more of a multi-asset credit approach given the fundamental need to toggle and pivot as the market evolves and extract relative value where we see the greatest opportunity for total return. This market emphasizes the significance of credit selection and holistic portfolio construction, but we are in a walk not run environment. On the whole, we continue to favor companies in more defensive industries with lower sensitivity to GDP growth and lower exposure to labor, raw material and wage inflation.

The Concentration of Fallen Angels in the High Yield Market has Decreased by 8% and are Now Below Pre-pandemic Levels

Fallen Angels % of the Market



3M and 12M Rolling Rating Downgrades in the U.S. High Yield Market



Source: ICE BofAML and KKR Credit Analysis as of March 31, 2022

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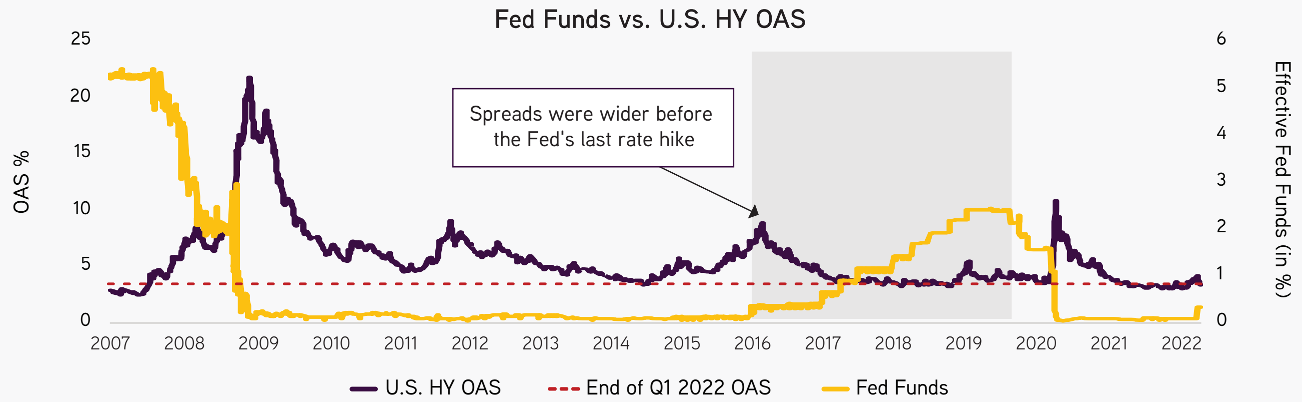
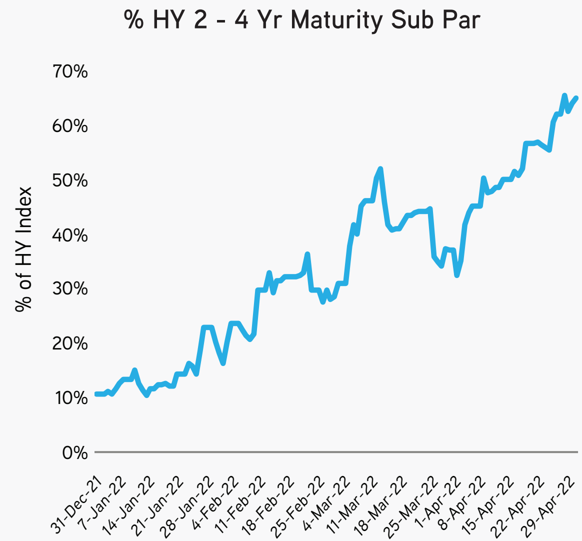
Last Time the Fed Hiked, OAS Levels Were Wider Allowing for High Yield to Outperform on Spread Compression During the Period



Source: KKR Credit Analysis, ICE BofAML, and Bloomberg as of March 31, 2022

While our focus shifts to more defensive industries, our opportunistic funds continue to embrace the volatility and seek out opportunities to add to high conviction credit themes during market dislocation. We are seeing more opportunities fall into our favorite zip code of *"No Man's Land"* given the supply demand technical in the current market — we continue to keep it simple and do not feel compelled to overly reach for risk. Some of the discounts we are seeing in no man's land are a result of rate uncertainty, but also portray compelling risk/reward. We are actively assessing how slowing growth will filter through the credit ecosystem and continue to seek out companies that can stay long pricing power in their respective sectors. It is important to remember not all yield is created equally and as such, embarking on our favorite path of *good yield hunting* is now back. Similarly, we have been selectively adding higher quality names with steep discounts in early April as the Treasury curve steepened. Nonetheless, we remain disciplined and nimble in our approach as sustained inflation, geopolitical uncertainty, and a hawkish Fed are continuously impacting the relative value equation across market segments, asset classes, sectors, ratings and duration inputs. The ability to adapt and pivot quickly across the credit spectrum is here to stay.

A Majority of Short-Dated Bonds are Trading Below Par



Source: ICE BofAML, Facset and KKR Credit Analysis as of May 6, 2022

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The Wild's Reward

"You can't wait for inspiration. You have to go after it with a club" —Jack London

We have been known to say it is important to get comfortable being uncomfortable — this is one of those moments. The market ride is likely to continue to be bumpy but we think it is prudent to stick with conviction, fundamentals and seek out opportunity through the volatile moments. We are facing a lot of uncertainty with unclear catalysts. This market is our call to the wild — one that may appear to be a bit murky and unsettling but undoubtedly riddled with opportunities. We have always believed in driving our own destiny, through reverse inquiries and creating our own issuance, and we are going to continue create our own capital solutions as the market further evolves.

The globalization of markets we have witnessed has created an influential interdependency amongst a broad range of macroeconomic inputs that can often times result in volatility — a thematic we have highlighted many times. In the same vein, this globalization effect has also prompted a decoupling amongst market segments such as fund flows and stocks and credit that will take some time to filter through the system. With the market still demanding a "show me" fundamental results story as corporate earnings roll in, acute attention paid on margin compression, currency fluctuations and the long-term net effects of slowing growth, we believe there could be real dispersion on the horizon. We are living through an environment where the Fed has openly acknowledged there is a need to actively dampen consumer demand to temper inflation but the supply side headwinds cannot be controlled by the Fed further spotlighting the interconnectedness and globalization of the markets. If inflation continues to stay elevated coupled with slowing growth, credit should become an even larger portion of an investment portfolio.

Overall, we think this all points to the perpetual need for a diverse and sustainable approach to investing in corporate credit, an approach that marries the fundamentals and bottom up analysis with the swift ability to act, pivot and execute across a holistic set of solutions and broad range of market segments and capital bases. As a result, we have real time access to market movements that inform our views and promotes our ability to execute with speed and certainty across all of our core competencies. At our core we are long term fundamental credit investors focused on delivering consistent returns with downside protection. The scale and breadth of KKR's global portfolio means that our team is in the market all day, every day, sharing insights globally and working collaboratively to identify, extract and underwrite value. That is one element that is unique to us — we operate as one global team and similar to Buck, the value of leadership and teamwork is unparalleled when it all comes together in a challenging environment. Given this market is going to test the time of patience, we believe it is important to have dry powder to lean in when there is volatility, scaled capital to address a multitude of investment scenarios and to remember to stay focused on the long term goal — delivering for our clients.

As we continue to see, the market is having a tough time digesting change and the whipsaw of equity volatility will penetrate credit markets, in large part as a result of the large concentration of equity-linked and daily liquidity vehicles. But as rates continue to move and yields continue to rise patience and the instinct of selling on fear will be tested. While uncertain environments like these can provoke the basic instincts to retreat, it is exactly in times like these when the strength of our culture and business model become even more apparent.

Thank you to our investors for your continued trust and partnership. As always, we welcome your feedback on our letter and are grateful for the opportunity to discuss our market views with our readers.

Christopher A. Sheldon

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