KKR

Flash Macro Update

U.S. CPI REPORT | January 2024

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What You Need to Know

1 How are we thinking about the December U.S. CPI report?

Headline U.S. CPI data for December came in at 3.4% year-over-year, above consensus and clearly above the Fed's two percent target. Drivers of the hawkish beat included a surprisingly strong reading for core goods, as well as ongoing elevation in the critical shelter inflation component of core services.

On net, however, this report leads to no change to our +2.6% CPI forecast for 2024, which is now in-line with consensus. We continue to see core inflation cooling towards the mid-two percent range by the end of the year, as shelter inflation catches down to real-time rent measures and core goods prices continue to moderate.

Further, details of this report and other recent economic data suggest that Fed rate hikes are doing their job. Importantly, the breadth of inflation and job gains are both slowing, and we think the evolution of the data will give the Fed confidence that the two percent real rates it has achieved are sufficiently restrictive. As such, we expect the Fed to walk nominal rates lower in the second half of the year. **So, despite the hawkish report, however, we now expect four cuts in 2024 (versus three previously) followed by three more in 2025.**

That said, we want to be clear: We think markets are likely putting too much emphasis on the view that cyclical disinflation is upon us. Depending on the day, our rates forecasts still remain 25-50 basis points above near-term market pricing, which we continue to think is too dovish relative to the resilience we are seeing in price and wage inflation (we see CPI is settling at a higher resting heartrate this cycle, a concern which is likely shared by policymakers).

As for bond yields, we think they are near fair value. Importantly, our 10-year targets are unchanged at four percent for both 2024 and 2025, as we think Treasury supply/demand technicals remain challenging, and the yield curve needs to de-invert as the Fed cuts.

Bottom-Line: We see less volatility around interest rates this year on both the long-end and the short-end. We expect the bid – ask on the cost of capital between buyers and sellers to narrow, which should lead to a rebound in deal activity and new issuance. **Additionally, our conviction is that the global economy is not heading for a hard landing, and that inflation and rates are now on a shallow glide path lower. Against that backdrop, we are focused on dislocation opportunities in capital markets (capital markets liquidity is rising) and on washed-out valuations across many asset classes outside of the S&P.**

A peak in the rate cycle should promote better liquidity and put a floor under valuations. The opportunity set looks particularly attractive for private markets, where valuations are finally back at parity with public markets. There are several things to consider:

1. ***The technical picture remains quite compelling* as there is no supply. IPO/High Yield/Leverage Loan issuance is at levels as a percentage of GDP not seen since the depths of the Global Financial Crisis.**
2. ***Investors are under-invested*. Retail and institutional money market funds are at $5.6 trillion, a record level and reflective that most investors have missed this rally and are still on the sidelines.**
3. ***We are leaving earnings contraction and moving towards early recovery phase in profits*. Our thesis remains that earnings bottomed in the second quarter of 2023, despite entering a slowing GDP growth environment in 2024.**
4. ***Determining the cost of capital will get easier.* All told, zero percent (i.e., none) of the top 25 central banks are expected to raise rates in 2024. Recall that percentage was 84% near the end of 2022. A lack of central bank tightening on its own is almost always constructive for an acceleration in deal activity, given it helps to narrow the bid/ask on the cost of capital.**

KEY TRENDS IN THE DATA

Headline U.S. CPI data for December came in somewhat above consensus. Strength came from a surprisingly elevated reading for core goods (the first non-negative print since May 2023), as well as ongoing elevation in the critical shelter inflation component of core services (it has been rangebound between 0.4-0.5% monthly all throughout the second half of 2023, against consensus expectations for a shallow glidepath lower).

On net, no change to our +2.6% CPI forecast for 2024, which is now in-line with consensus, as consensus has ticked down from +2.7% in recent weeks. Moving parts beneath the surface include a slight increase in core goods inflation to reflect the resilience displayed in this report. We also raise our outlook for energy inflation to reflect recovering natural gas prices. At the same time, however, we lower 'supercore' services ex shelter/medical/education. We also lower our outlook for food slightly, to reflect ongoing weakness in grain and protein prices, which tend to lead food CPI.

Our longer-term message stays the same: This CPI report bolsters our thesis for a higher resting rate of inflation. We continue to think that we are not going back to the 'old world' in which a surplus of workers, commodities, and housing allowed the Fed to undershoot its two-percent inflation target.

Headline readings for nonfarm payrolls, CPI, and wage growth data have all recently surprised to the upside, but the breadth of sectors showing elevated inflation and job growth has cooled down significantly. On net, this development actually leads us to see a slightly more dovish outlook. Consistent with this view, we are moving our base case for 2024 to four cuts, from three cuts previously, and keeping 2025 at three cuts.

We think the evolution of the data will be giving the Fed confidence that the two percent real rates it has achieved are sufficiently restrictive to meet its inflation and employment goals. We think this will support walking nominal rates lower to hold real rates around two percent as inflation comes down heading into the second half of the year, and eventually lowering real rates to 1.5% as the Fed becomes confident that core PCE is stabilizing near target.

However, we would not over-emphasize the speed or magnitude of cyclical disinflation. Depending on the day, our rates forecasts still remain 25-50 basis points above near-term market pricing, which we continue to think is too dovish relative to the resilience we are seeing in price and wage inflation (markets currently expects five to six cuts, with the first one coming as soon as March). Importantly, our 10-year targets are unchanged at four percent for both 2024 and 2025, as we think Treasury supply/demand technicals remain challenging, and the yield curve needs to de-invert as the Fed cuts.

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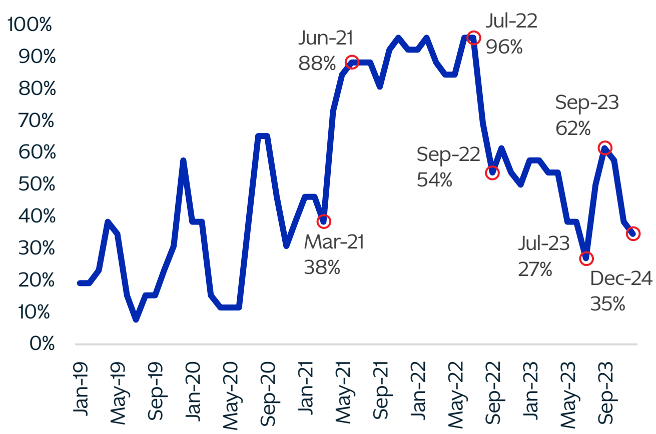
Exhibit 1: Despite the December Inflation Reading, the Breadth of Sectors Showing Elevated Inflation Is Back Near Post-Pandemic Lows...

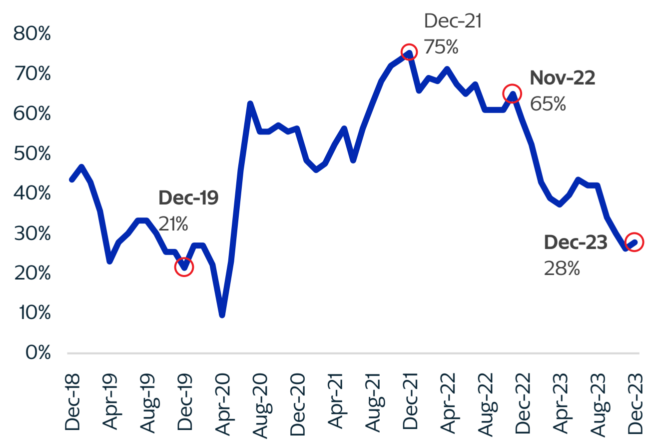
% of CPI Sub-Components Increasing at 3+% Annualized



Data as at December 31, 2023. Source: U.S. Bureau of Labor Statistics, Haver Analytics.

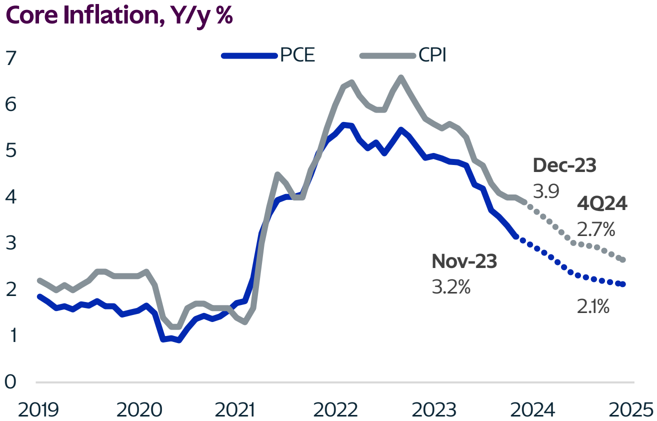
Exhibit 2: ...Meanwhile, Job Growth Breadth Has Almost Fully Normalized to Late 2019 Levels

% of Job Categories Growing 2+% Annualized



Data as at December 31, 2023. Source: U.S. Bureau of Labor Statistics, Haver Analytics.

Exhibit 3: We Still Continue to See Cooler Inflation by the End of 2024



Data as at December 31, 2023. Source: U.S. Bureau of Labor Statistics, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Exhibit 4: We Are Adding One Cut to Our Forecast for 2024, Though We Remain More Hawkish Than Consensus

Fed Funds	**Today's Rate:**	**5.33**		
Scenario Wgt	**60% Base**	**20% High**	**20% Low**	**Wgtd Avg**	**Futures Pricing***
2023e	5.38%	5.38%	5.38%	5.38%	
2024e	4.38%	5.13%	3.13%	4.28%	*3.99%*
2025e	3.63%	4.88%	1.88%	3.38%	*3.30%*
2026e	3.13%	4.63%	1.38%	3.08%	*3.36%*

*Market pricing for 2025 onward based off current 3M SOFR curve. Data as at January 11, 2024. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Additionally, our conviction is that the global economy is not heading for a hard landing, and that inflation and rates are now on a shallow glide path lower. Against that backdrop, we are focused on dislocation opportunities in capital markets (capital markets liquidity is rising) and on washed-out valuations across many asset classes outside of the S&P.

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