KKR

Outlook for 2024

KKR Global Macro Trends | December 2023

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How Are We Thinking About Expected Returns?

We view 2024 as an important transition year in our Regime Change thesis as we are finally forecasting below consensus inflation for much of the next 12 months. However, the four key pillars of our Regime Change thesis – a sizeable fiscal impulse, sticky labor costs, a messy energy transition, and a fundamental restructuring of global supply chains – remain in play and all argue for a different approach to asset allocation, including a meaningful reduction in the role government bonds can play in a diversified global portfolio. We still see the push and pull of loose fiscal policy versus tight monetary policy, which are working against one another to heighten volatility as well as increase dispersions alongside a backdrop of rising geopolitical tensions. Against an increasingly complex macro backdrop, we think that all global allocators will need a 'glass half full' approach that encourages them to direct capital towards investment themes that not only have attractive growth characteristics but also serve as foils to some of the current obstacles to what was once a more synchronized and well-integrated global economy.

This note is a summary from the Q&A portion of our full note, which is available on KKR.com via the link below. We encourage interested readers to reach out to your KKR Relationship Manager for additional information.

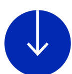

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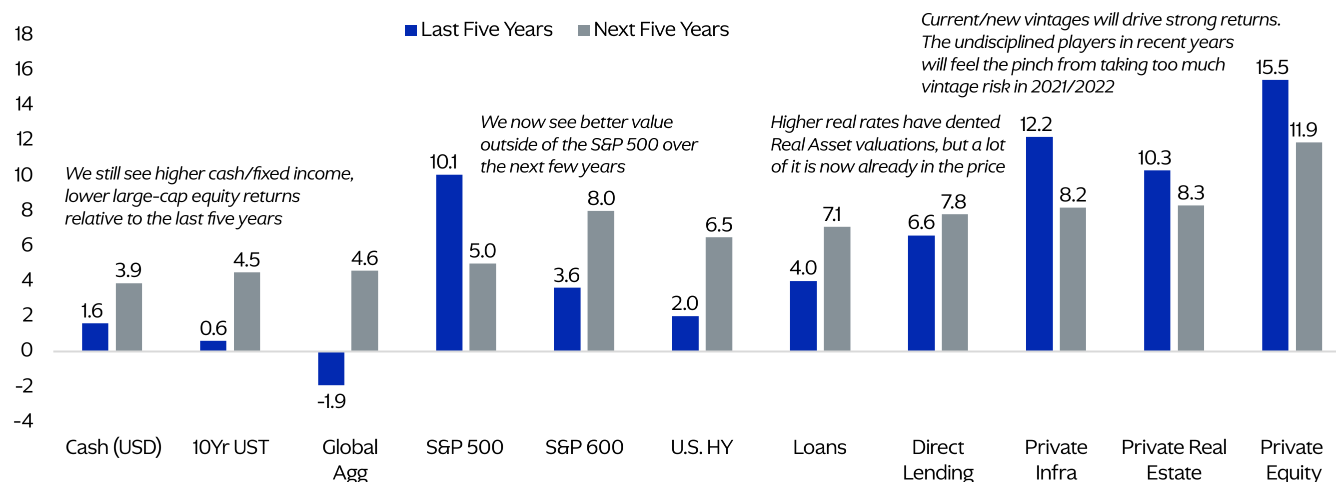
Exhibit 1: We Continue to Think That Returns Will Look Different Relative to the Past Five Years

Expected Returns, %



Data as at December 5, 2023. Source: Bloomberg, BofA, Cambridge Associates, Greenstreet, KKR Global Macro & Asset Allocation analysis.

Given our team's focus on asset allocation – including the approximate $26 billion of capital we manage on the firm's balance sheet – we have spent a lot of time pressure-testing our assumptions around expected returns across asset classes. See below for our key takeaways, but the bottom line is that we are in a year of 'transition' within our Regime Change thesis. Specifically, the public markets are still adjusting to an environment of higher-for-longer rates, and parts of the next twelve months will feel like a typical downturn (including a potential fixed-income rally). At the same time, however, private asset valuations have now compressed quite a bit in recent quarters, earnings likely bottomed this year, and the potential to create value through operational improvement is significant, in our view. As such, we firmly believe that investors who pull back on deployment today will miss out on some very compelling vintages. Against this backdrop, we think now is still a time to 'Keep It Simple', with more of a bias towards quality and less need to stretch on risk, while still deploying thematically.

- We continue to think that this is a good time to be a lender. No doubt, higher risk-free rates mean that investors can now be well compensated for sitting higher in the capital structure. One can see this in *Exhibit 3*, which shows that HY yields now exceed S&P 500 dividend yields by one of the widest margin since 2009. Importantly, we are not forecasting a sharp widening of credit spreads this cycle; a key to our thinking is that defaults will not experience a 'full' spike as in past downturns, as the quality of High Yield has improved significantly.
- Within one's credit portfolio, we think this may be the time to pursue more balance between fixed vs. floating assets. To be sure, we also still like cash as an uncorrelated asset class, but we think it makes sense to add some duration, too, as there is a compelling opportunity to lock in cash-like yields over a multiyear period.
- Within private markets, the cost of capital has started to normalize. The excess return earned on Private Credit is still quite compelling (in general, we think private credit outperforms HY and Loans by about +100 basis points or more over the next five years), but we do acknowledge that we are starting to see more competition, which is leading to spread compression in certain instances. Hence, we maintain a preference to overweight areas such as Asset-Based Finance, Structured Credit, and even parts of Real Estate Credit. Meanwhile, private market valuations now look more reasonable compared to public markets. As we detail below, we think that the

Exhibit 2: How Our Forecasts Have Changed

Asset Class	Next 5 Years Return, %, Nov-23	Next 5 Years Return, %, Aug-23	Delta, Basis Points	Key Dynamics	Comments
Cash (USD)	3.9%	3.7%	+20	We see slower Fed cuts in 2024 versus the consensus view	We think that Cash can act as an important diversifier, especially for allocators who are using more Alternatives this cycle
10Y UST	4.5%	5.0%	-50	We see UST yields staying higher for longer	We advocate leaning into duration only selectively, as bonds may not rally as much this cycle
Global Agg	4.6%	4.8%	-20	Closely linked to UST forecast, but a more supportive backdrop vs. Treasurys	We think it makes more sense to lend to corporates vs. over-indebted governments this cycle
S&P 500	5.0%	5.1%	-10	Top-12 AI-related stocks have helped lift index-level valuations	Limited upside to multiples; we favor cash-flowing equities with strong EPS outlook
U.S. HY	6.5%	6.3%	+20	More confidence that yields are compensating investors for default risk	We think that HY performs better this cycle, given more collateral and higher ratings
U.S. Loans	7.1%	6.8%	+30	Wider spread and higher average SOFR	We are constructive on loans, but think the best way to gain exposure to this space currently may be through high-quality CLO liabilities
Direct Lending	7.8%	8.3%	-50	Competition has narrowed spreads modestly	Illiquidity premium + lower losses = outperformance, but cost of capital is normalizing
Private Infra	8.2%	8.2%	-	The asset class has proved to be an effective inflation hedge	We remain constructive as a play on our collateral-based cash flow thesis
Private Real Estate	8.3%	8.5%	-20	Roughly parallel shift in entry/exit cap rates	Cap rate widening has not been even across sectors
Private Equity	11.9%	11.9%	-	Current/new vintages will drive returns, but more of a drag from undisciplined PE investments made during 'go-go' years	This is a good time to have a control position in equities

Data as at November 30, 2023. Source: Bloomberg, BofA, Cambridge Associates, Greenstreet, KKR Global Macro & Asset Allocation analysis.

market is currently underestimating the opportunity to create operational improvements, especially in carve-out and bolt-on acquisitions.

- Today is not necessarily a good time to buy passive, non-control positions in Equities. As we show in *Exhibit 1*, we think the most disappointing asset class for investors this cycle may actually be large public companies that are exposed to slower growth. Meanwhile, there are a lot of smaller cash-flowing companies in the S&P 600 that are trading at deeply discounted valuations at a time when market breadth is set to improve. This backdrop is one of the reasons we look for more public-to-private transactions in 2024.
- We still see a world of higher real rates, but certain parts of real asset prices have largely discounted this with more attractive entry points for Real Estate and Infrastructure. Cap rates and infrastructure price/book have improved meaningfully in recent months, and now in some instances are at levels that can offset the long-term impact of higher real bond yields, we believe. Within Infrastructure, we are most focused on opportunities to create core-type assets linked to our major themes (digitalization, the energy transition, and security of everything). Within Real Estate, meanwhile, we think there is a lot investors can do without going too far out on the risk spectrum (e.g., today is not the time to make a big bet on return-to-office), as cap rates have widened in a lot of thematic and stable sectors like housing and industrials/warehouses.

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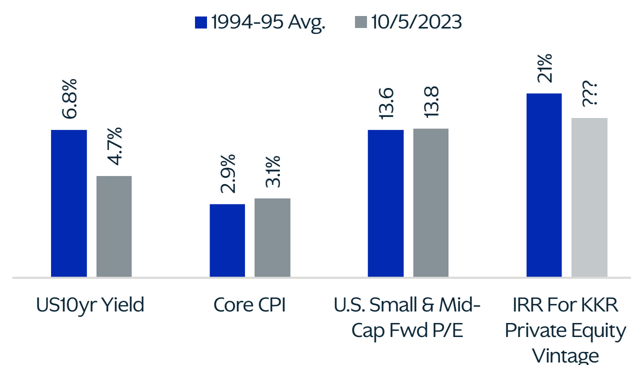
Exhibit 3: We Have Often Seen Very Strong PE Vintages in High-Rate Environments

Private Markets Investing: Back to the Future?



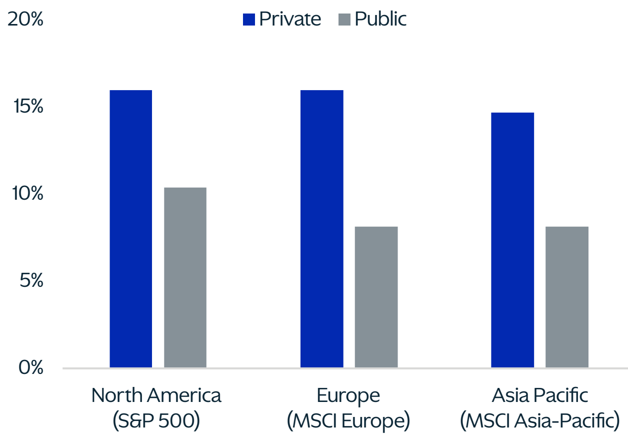
Note: October 5 represents annualized rate over April-August (latest four months for CPI. Small/Mid-Cap is aggregate of S&P 400 (Mid-Cap) and S&P 600 (Small-Cap). 1994-95 represents average IRR for 1993 Fund (23.6%) and 1996 Fund (18.0%). Data as at October 5, 2023. Source: Bloomberg, Cambridge Associates, KKR Global Macro & Asset Allocation analysis.

Interestingly, out of all the asset classes we cover, we have gotten the most questions on Private Equity, and specifically, whether we think the ‘model’ for investing in this strategy will still work in an environment of higher rates. No doubt, we do believe that the current macroeconomic landscape will require a different playbook relative to what worked over 2010-2019. We think this reality has the potential to surprise investors who ‘grew up’ investing in an environment of stable and falling rates. However, as we detail below, we are likely more optimistic than the consensus about the outlook for Private Equity, despite interest rates at today’s levels. Key to our thinking: sponsors have become more thoughtful about leverage, the headroom for operational improvement is quite attractive these days, and ‘patient capital’ is in high demand in an era where IPO markets are no longer receptive to unproven growth names. In our view, we are in an environment where late-stage startups are struggling to secure funding while IPO markets are only open for successful and thematic businesses with a proven track record. We think PE can thrive as a source of ‘patient capital’ in this market, helping to bridge the gap for cash-flowing businesses that have room for operational improvement.

Exhibit 4: For Liquid Investors, a Tactical Overweight to Credit Relative to Equities Makes Sense to Us

Data as at December 6, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 5: Across Geographies, Private Equity Returns Tend to Exceed Public Equity Returns



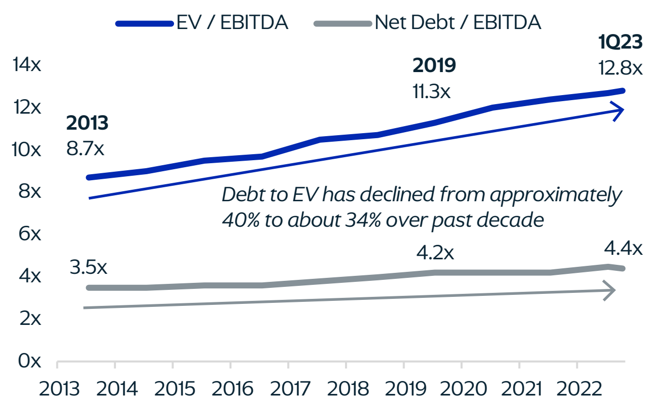
Note: Public Equities IRR is calculated as a modified public market equivalent (mPME), which is defined as the returns that an investor would achieve by deploying the PE cash flows into public equity markets. Data as at September 30, 2022. Source: Cambridge Associates, Bain, Bloomberg, KKR Portfolio Construction analysis.

To this end, we think that investors need to break the debate down into three areas of analysis:

CAPITAL STRUCTURE

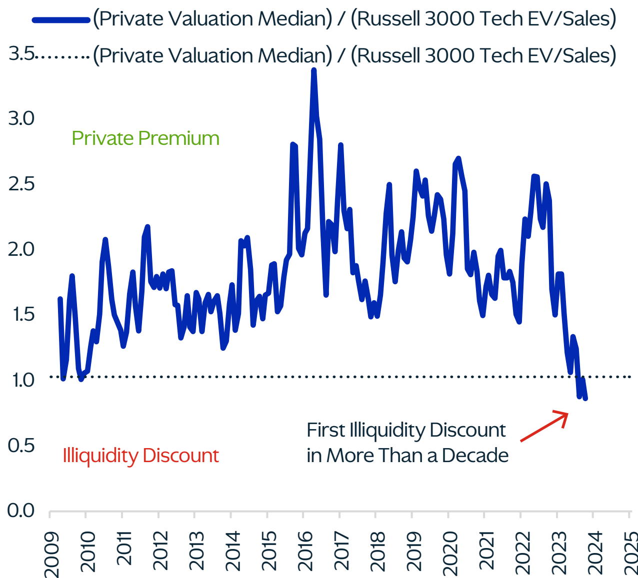
The equity cushion in most of the recent deals is actually much higher than in the past. For example, in 2013, debt as a percentage of total capital structures reached about 40%. Today, by comparison, that percentage is closer to 30%. In addition, sponsors have become more sophisticated about 'smoothing out' the impact of Fed policy decisions: consider that maturities on debt structures have been materially extended from around 6.6 years for the average HY borrower in 2019 to nearly eight years as of 2023, while a larger share (perhaps about 40%) of loan borrowers have hedged floating-rate interest exposure. Against that backdrop, we think that the impact of Fed tightening on existing PE deals may be both gentler and more gradual than many today fear, with pain largely being concentrated in companies that took on too much leverage when rates were at zero and did not hedge out their floating-rate exposure.

Exhibit 6: While Prices Did Increase, Managers Have Been More Disciplined About Leverage This Cycle



Data as at March 31, 2023. Source: Burgiss.

Exhibit 7: We Are Starting to See an Illiquidity Discount Emerge in Private Markets, a Backdrop Which Is Consistent With Our Vintage Analysis



1.0 equals parity and differentiates between premium and discount. Data as at October 31, 2023. Source: Bloomberg, Pitchbook, Morgan Stanley.

VALUE CREATION

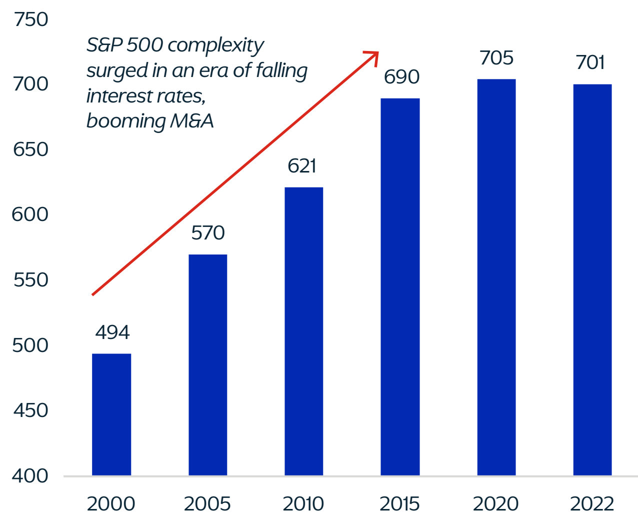
The other offset to higher rates is that the private equity industry is not sitting still. The math is quite simple. Companies need to create enough value through operational improvements, acquisitions, and strategic changes to more than offset the decline in cash flow from higher rates and/or a higher cost of capital. So, the more levers one has to pull, the better the opportunity is.

Against that backdrop, we think PE companies may have a strategic advantage over larger firms in the public markets, which in many cases have become too complex, with a growing number of undermanaged subsidiaries that cannot justify the current cost of capital. One can see this in *Exhibit 8*. In our view, the potential opportunity set for PE-led carve-out transactions among public conglomerates is quite significant this cycle.

EXIT MULTIPLES

This area is the one we think deserves the most scrutiny. Our simple math indicates that exit multiples should fall – in theory and all else being equal – as rates have increased. However, we also note that public markets have been willing to pay higher multiples for companies that are big, thematic, and 'simple' rather than complex. On the other end of the spectrum, there are a lot of VC-backed firms that cannot find the capital needed to scale and are raising at lower multiples. That 'gap' offers a lot of potential for PE as a source of 'patient capital' that can partner with management teams to drive operational efficiency and create profitable companies that can command higher multiples in public markets.

Exhibit 8: Public Companies Have Become More Complex, Which Is Why We Are Seeing More Carve-Outs Occur



Data as at December 31, 2022. Source: Factset.

Our bottom line: With both interest rates and prices starting to normalize, we think existing PE vintages may hold up better than many investors currently expect. Maybe more importantly, we believe current vintages will ultimately deliver strong performance, as history should be on our side. Indeed, as we show in *Exhibit 9*, de-leveraging cycles are often productive times to be deploying capital. Moreover, dislocations around rates can often create opportunities, which is what we saw during the bond market sell-off in 1994 (probably the most similar historical comparison to today).

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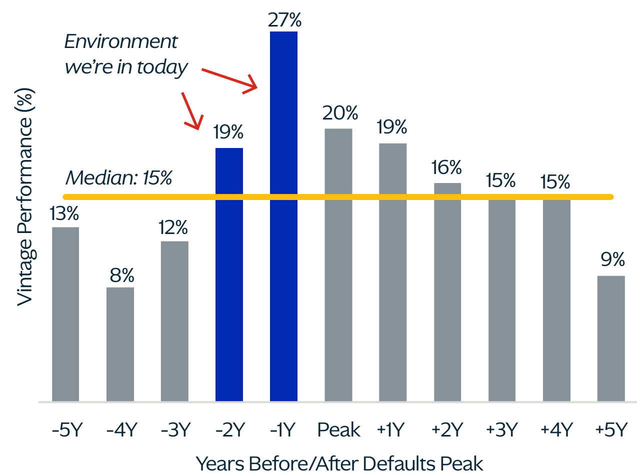
Overall, though, as we show in *Exhibit 1* in our expected returns discussion, we do believe we are entering a lower return world where the coupon on fixed income can serve as an important driver of overall total returns, which was certainly not the case over the past decade. Against this backdrop, we want more operational improvement stories, especially across Private Equity; and we want to favor capital structures that have plenty of equity cushion when considering a preferred, convertible, or convertible preferred. Finally, we continue to advocate for collateral-based cash flows that are linked to nominal GDP growth. Within this universe, Real Estate Credit, Infrastructure, and Asset-Based Finance appear quite interesting to us.

Exhibit 9: Deleveraging Cycles Have Coincided With Some of the Best PE Vintages



Data as at March 31, 2023. Source: Federal Reserve Board, Preqin, KKR Global Macro & Asset Allocation analysis.

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