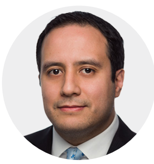
KKR

KKR Credit & Markets

Written by:

Christopher A. Sheldon
Partner and Co-Head
Credit & Markets

Tal Reback
Director, Client Partner Group



Kristopher Novell
Director, Credit & Markets

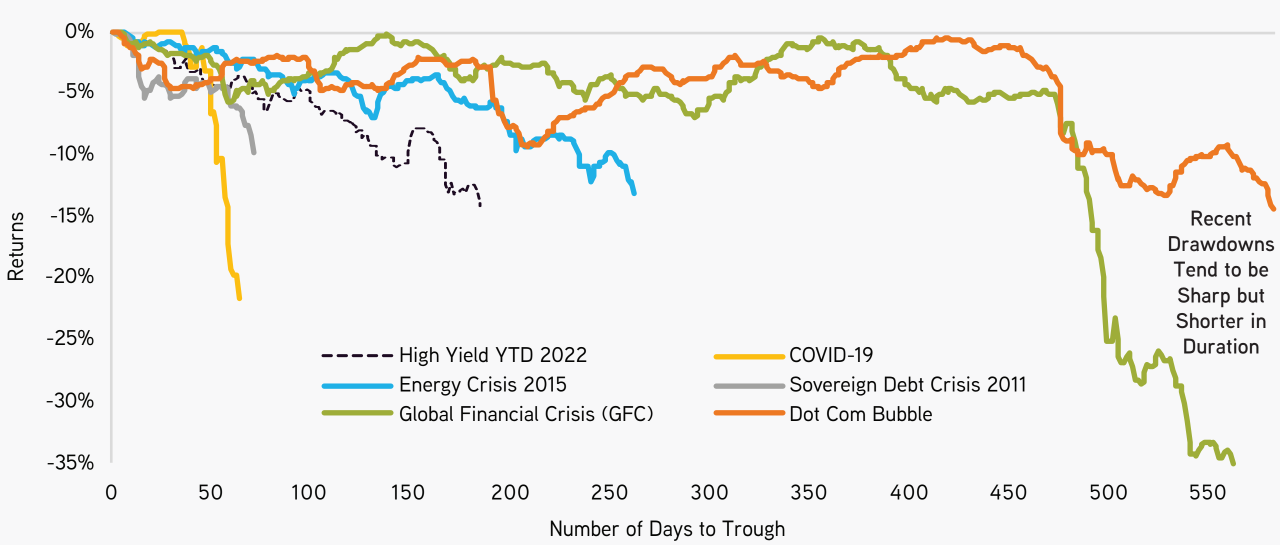
It would be an understatement to say that the second quarter's volatility left global investors on the edge of their seats. Rising rates continued to rock the equity and credit cages as the risk-off sentiment persisted, driving spreads and yields wider and stunting the primary markets. We continue to live in an ever-evolving market and dare we say, one that feels a bit aimless. The economic outlook has rapidly narrowed as we continue to combat historic levels of inflation paired with the reality of an ensuing recession and slowing growth. Market volatility has evolved from the initial January jitters that focused on high-valuation, high-multiple growth companies recalibrating downward, to the reality of rising rates and the end of cheap money. The market's oscillating direction of travel has created an environment that can feel manic at times; however, we do continue to believe that amidst the volatility and as we now enter the back half of the year, the public markets have priced in much of the risk in the system to date, and the private markets have also begun to adjust.

As global central banks continued onward with their hawkish moves, the pulse of the market began to hone in on the resulting economic implications. The market grew more defensive when, despite a strong labor market, the quarter cemented no growth, and consumer sentiment echoed a negative tone globally. Indeed, the past quarter was a stark reminder of how hard it is to price uncertainty. And we were all reminded how much the market dislikes uncertainty. We witnessed that sentiment unfold through the scaled pricing pressure downward and volatility, which often times did not connect back to core fundamentals.

As we reflected on the second quarter we were reminded of Hemingway's timeless 1926 novel *The Sun Also Rises*. Jake Barnes, the protagonist, yearns for direction while embarking on the exhilarating, but chaotic, running of the bulls in Pamplona, Spain. Hemingway's renowned novel captures the common struggle of being uncomfortable. We all navigated significant turbulence in 2020, and yet, today's volatility is creating a new level of discomfort. Why? The post-war world in which disenfranchised expatriate Jake yearns for meaning has uncanny similarities with the one we are operating in today. It also resembles what we feel to be a "leaderless" market, where the lack of consensus, depth of capital and conviction on the go-forward investment sentiment has manifested into chaos. We continue to yearn for stability in the aftermath of the pandemic, but the implications born from the 2020 drawdown continue to ripple through the financial ecosystem. As investors and market participants look to find their footing in this market, we look to Hemingway's masterful prose in an effort to distill this market's bull run of an existential journey.

The starting jolt to the year prompted us to look to Jack London in our first quarter note, *Call of the Market Wild*, which reminded us to embrace and learn how to thrive in the market's wild. The second quarter's persistent volatility and macroeconomic headwinds only confirmed our thesis that it is critical to have an expansive credit toolkit to thrive and navigate the market's twists and turns. It also affirmed our view that having an agile, multi-strategy and interdisciplinary approach to investing, originating and structuring capital solutions and credit opportunities is more relevant now than ever. Although this approach to portfolio management has not fully proven itself out to date, we continue to believe it is the optimal long-term positioning strategy for both public and private credit markets. 2022 has already introduced new headwinds that few could have predicted and has also underscored the interconnectedness of global markets. Meanwhile, the elevated and sharp declines in public debt and equity markets have raised concerns about the structural bifurcation between public and private credit markets.

Drawdowns of High Yield Over History



Source: KKR Credit Analysis, ICE BofAML, and S&P LCD as of July 25, 2022

We have seen this dynamic play out with liquidity needs and broader asset allocation decisions and models. For example, in the liquid markets increasing redemptions on the basis of asset allocation rebalancing contributed to downward price pressure. With few new flows coming in, lack of CLO creation and an anemic forward pipeline, volatility was exacerbated. On the other hand, in private markets, where capital is locked up for longer periods, there was a less immediate and noticeable mark-to-market ("MTM") impact as the risk-off sentiment permeated the markets. The private credit markets appear to be in better shape, albeit are starting to adjust now post the public market drawdown, and have experienced less volatility, in part as there is less of an ability to force sell assets. More importantly, the private markets continue to exhibit steady leadership. As we think about dispersion between public and private markets, it has become more apparent that there has been a structural breakdown in public markets, and as a result, they have experienced the brunt of this market's wrath.

We believe the whipsaw will persist for the near-term. It appears inevitable that the U.S. economy has already entered a technical recession and, most of Europe is already in a recession. Thus growth will remain challenged. The current environment highlights the complexity of the central banks double-edged sword predicament. Ultimately, the central banks will have no choice but to continue to keep rates higher for longer, but a deep recession may provoke a more dovish response going forward. So, amidst the fog and slog of this market, we are cautious, but also feel conviction that there are now attractive entry points into both public and private credit. The market may appear directionless as we continue to go through the motions of day-to-day combat, but as Hemingway demonstrates to us, this is our time to get in the ring with the bulls. We are relying on our regimented approach to credit investing and selection to give us a clear perspective against the market's visceral and bull-like behavior, similar to the calm of mind Jake achieved on a fishing trip in the Spanish countryside. Having a disciplined approach to deploying and investing capital is paramount in this environment. This frenetic market requires not only the traditional playbook but also patience, ingenuity and discipline of process.

Key Themes

As we look across the blurred edges of this market, we highlight the following themes:

01
Structural bifurcation of leadership between public and private markets

02
Volatility continues to be predominantly disconnected from fundamentals

03
Why Credit Now

The Running of the Bulls: Technical Chaos Leads to Volatility

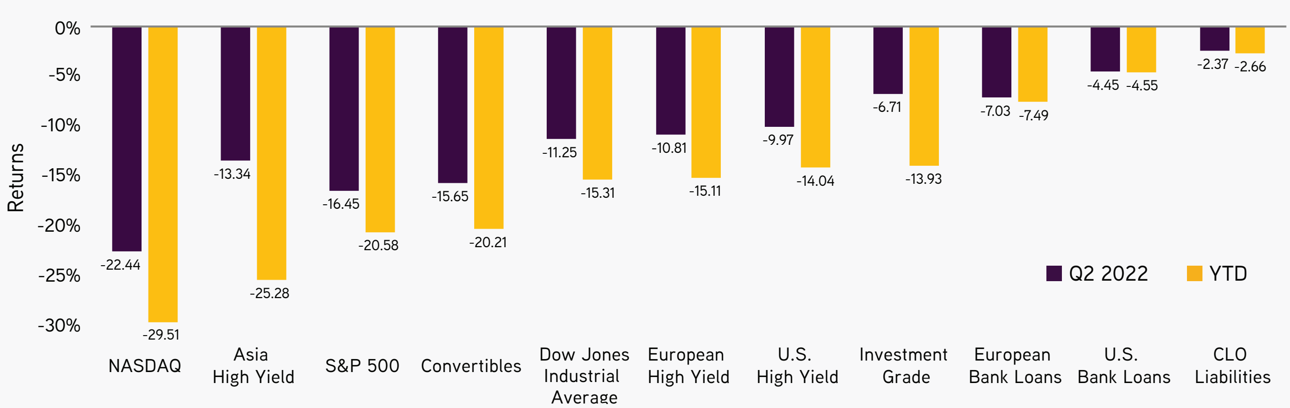
The Festival of San Fermin has been held in Pamplona for centuries. For a week in July, the typically sleepy capital of Navarra transforms into an adrenaline-infused bull-mad, street-rushing and plaza-filled spectacle as the encierro (running of the bulls) proceeds. In a similar vein, June 30, 2022 provided an ephemeral breath as market participants began to digest what was the worst first half of stock market performance in nearly 50 years, with the S&P returning -20.58%,[1] DJIA -15.31%,[2] and NASDAQ -29.51%[3] on a year to date basis. On the credit side, continued concerns surrounding rising rates, inflation, supply chain backlogs and a tepid market sentiment set the stage for stunted new issuance and downside pressure in the secondary markets. On a total return basis, U.S. high yield returned -9.97%,[4] European high yield -10.81%,[5] U.S. bank loans -4.45%[6] and European bank loans -7.03%[7] as of June 30, 2022.

Global deal activity in May and June was predominantly driven by the immediate need for M&A financing. M&A issuance of $37.6 billion[8] accounted for 67% of total loan issuance in the quarter. But LBO volume sank to $19.5 billion,[9] down considerably from $40.7 billion[10] in the first quarter and $42.6 billion[11] in Q2 2021. M&A from private equity backed borrowers also sank to its lowest level since the second quarter of 2020, at $7.2 billion,[12] a 58% quarter-over-quarter drop, although a number of acquisition-related add-on deals were privately placed. Those who did not need to tap the markets continued to stay on the sidelines, which contributed to institutional issuance hitting a near two-year low at $56 billion[13] with a 62% decline from Q1.

U.S. CLO origination stood at $40.2 billion,[14] down from an average print of $47 billion per quarter in 2021. Retail outflows from loan mutual funds and ETFs were some of the largest we have seen since the first quarter of 2020 — rounding out -$7.7 billion[15] of outflows as of June 29, 2022.

Although the leveraged loan market remained fairly resilient in the first quarter, the second quarter started to present more of a challenge for the asset class, especially for lower rated borrowers. New deals from borrowers with at least one B-minus equivalent rating were at a two-year low of 34% after setting a record in the first quarter, with a 51% share of total deals.[16]

Total Return Across Markets

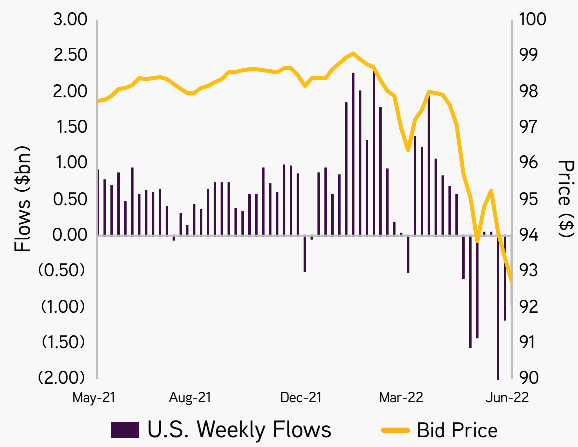


Source: ICE BofAML, S&P LCD, Bloomberg and KKR Credit Analysis as of June 30, 2022

It's worth noting that, even as primary issuance from these borrowers waned, the share of loans from borrowers with B- ratings in the S&P/LSTA Leveraged Loan Index ("LLI") reached a new record high as of June 30th at 28%,[17] reinforcing the growing credit risk in the loan market, a trend we continue to highlight.

Many issuers faced pricing disruption in the past quarter amidst some of the most volatile periods for the leveraged loan market since the early days of the pandemic. Pressure built up in the secondary market amongst broader selloffs in other risk markets, pushing the weighted average bid of the LLI below the $94 threshold in May for the first time since November 2020. June 16th brought forth what felt like market capitulation after the Federal Open Market Committee ("FOMC") hiked rates by 75bps for the first time since 1994, catalyzing the U.S. loan bid to sink to $92.16[18] on June 30th. Newly issued loans felt the brunt of the pain as spreads for single B institutional loans widened to 463bps[19] in June coupled with a rise in clearing yields with wider original-issue discounts ("OID") as well as rising benchmark rates, both LIBOR and SOFR. The average spread rose by 6bps, taking it to its highest level since December 2018, with the original Powell "put" contributing to the second quarter average yield of 7.55%[20] for the syndicated loan market.

U.S. Weekly Flows Versus Average U.S. Bank Loan Bid



Source: KKR Credit Analysis, S&P LCD, and Lipper FMI as of June 30, 2022

Comparative Peak to Trough Returns Across the Credit Spectrum Since the 2000s

	U.S. Bonds				U.S. Bank Loans				U.S. CLOs		
	HY	BB	B	CCC	BLs	BB	B	CCC	AAA	BBB	BB
YTD 2022	-14.1%	-13.6%	-13.8%	-17.9%	-5.5%	-4.0%	-5.9%	-10.5%	-2.0%	-8.4%	-12.4%
COVID-19	-21.5%	-19.1%	-22.5%	-29.6%	-20.7%	-21.3%	-20.9%	-26.2%	-10.0%	-30.1%	-42.1%
Energy Crisis 2015	-13.1%	-8.2%	-14.2%	-29.5%	-5.3%	-2.2%	-5.9%	-17.3%	-0.8%	-13.8%	-25.0%
Sovereign Debt Crisis 2011	-9.7%	-7.7%	-9.3%	-18.5%	-5.8%	-5.0%	-6.6%	-16.1%			
Global Financial Crisis	-35.0%	-26.5%	-36.4%	-51.8%	-32.1%	-27.5%	-38.4%	-50.1%			
Dotcom Bubble	-14.3%	-13.9%	-15.9%	-36.9%	-3.4%	-1.2%	-3.1%	-43.1%			

	EU Bonds				EU Bank Loans		
	HY	BB	B	CCC	BLs	BB	B
YTD 2022	-15.8%	-15.8%	-15.9%	-19.3%	-8.4%	-6.5%	-8.9%
COVID-19	-20.5%	-18.0%	-25.7%	-28.9%	-20.1%	-16.4%	-21.1%
Energy Crisis 2015	-6.5%	-6.0%	-9.0%	-11.9%	-2.7%	-2.5%	-3.0%
Sovereign Debt Crisis 2011	-14.0%	-10.1%	-17.5%	-34.3%	-6.7%	-4.0%	-6.7%
Global Financial Crisis	-39.8%	-30.5%	-43.6%	-70.2%	-32.0%	-25.5%	-32.9%
Dotcom Bubble	-43.5%	-22.2%	-39.5%	-76.8%			

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

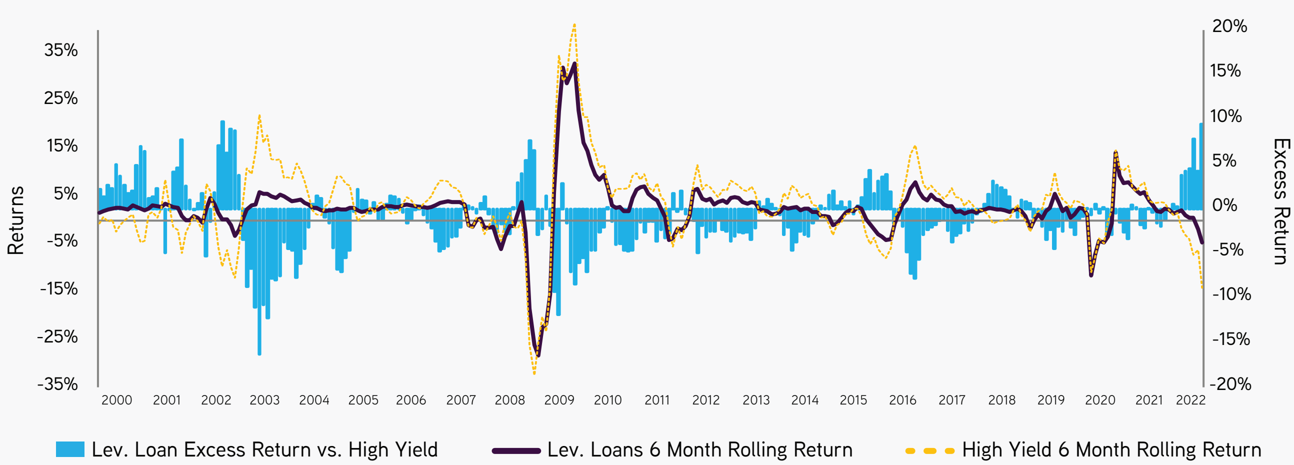
Bull Riding Part II: The Significance of Leadership

Last quarter we discussed the significance of having the ability to flexibly toggle between the syndicated and private markets as issuers vetted financing options available to them in an increasingly uncertain market. Although deal volumes remained suppressed, we do believe volatility is good for private credit and we intend to continue serving as a stable source of capital in environments like these. We also continue to exercise caution given the widespread impact of inflation, which only promotes our continued selectivity. As we have witnessed this year, hung deals stuck in purgatory will most likely not clear without marginal and/or opportunistic buyers stepping in and flows continue to be anemic. Our thesis remains steadfast: credit selection is paramount and larger companies with pricing power are likely to weather the storm better through the cycle. It is important to note that the growth and maturation of the private credit space has been significant. Private credit is a mainstream asset class that is well understood, and increasingly favored, by privately held companies for acquisition financing, growth financing and refinancings. The benefits of privately originated debt solutions ranging from corporate direct lending, mezzanine financings and asset-based finance are on front-row display in environments like the 2022 market.

It is important to note how private junior debt is different than corporate direct lending and why it is a financing avenue that does not necessarily compete with private senior debt or traditional corporate lending.

In fact, this market has cultivated a wide range of compelling and idiosyncratic investment opportunities whereby the subordinated nature of junior debt enables a premium to be placed on large capital structures where the senior debt is broadly syndicated.

History Continues to Point to Leveraged Loans Being a Destination for Excess Return During Rate Volatility



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

That premium can come in the form of an increased rate compared to the subordinated high yield market or the inclusion of more significant call protection. The sharp volatility in the public markets, particularly in the subordinated high yield segment creates an attractive real-time opportunity. We believe this could be a golden vintage for junior debt. Given M&A deal activity has been predominantly sidelined, providing borrowers with access to private credit markets and junior debt is another avenue to keep deal activity going. We are able to leverage our relationships to source these opportunities to provide borrowers with a lower cost structure. This market dynamic highlights the current lack of leadership in the public markets, ultimately contributing to the structural bifurcation we are now witnessing as well as catalyzing additional opportunities for the private market leadership to lean-in to innovative financings.

As many market participants were sidelined for the first half of 2022, and as caution picks up, so will the dry powder balance. We believe the quantum of private equity dry powder, supplemented by private equity firms' ability and desire to raise more capital, will support continued transaction activity in our preferred sectors (those having predictable and recurring cash flows), underpinning an attractive, under-served market for private junior debt for large leveraged buyouts and privately-owned companies. There is a significant amount of debt maturing for existing leverage issuers over the coming years. If we consider the last three decades, they have been largely deflationary. But the world has now changed. With the present interest rate environment, inflationary pressures and re-evaluation of supply chain, we believe there will be more stability in gross margins and cash flows in large businesses, $100mm+ EBIDTA versus smaller businesses. We continue to be constructive on the outlook as we lend to businesses that are more resilient than most.

We are seeing real leadership in private debt and debt-like solutions and an improved opportunity set, especially through our global origination footprint.

If current market volatility persists, an increasing number of borrowers may turn to private debt as a solution to partially or to fully refinance existing broadly syndicated capital structures, presenting yet further potential opportunity for private debt.

The FOMC Hangover: Volatility Predominantly Disconnected from Fundamentals

Originally published as *Fiesta in England*, Hemingway's portrayal of expatriates' search for meaning in a post-World War I world creates a stark contrast between exhilarating activities and the serene calm of fishing in the Spanish countryside. While we could joke that the pace of rate hikes and the market's whipsaw reactions to each FOMC meeting may feel like we are still trying to tame the bull, this topic is not new nor should it come as a surprise to our readers. The Federal Reserve ("the Fed") continues to play a leading role in the market's recalibration of risk assets post a historic gesture born out of the pandemic's onset in March 2020.

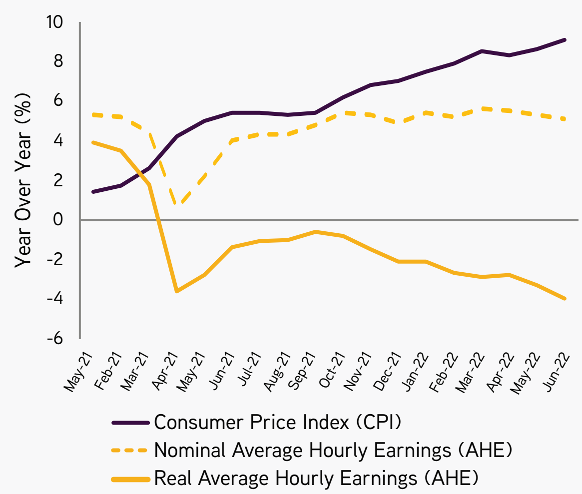
Now how does this all relate back to credit?

Inflation continued to roar in the second quarter with historic back to back prints in May and June of 8.6%[21] and 9.1%[22] respectively on a year-over-year basis. While inflation seemingly peaked in June, KKR revised its forward CPI projections up to 8.25%[23] in 2022 on the heels of persistent core inflation trends driven by continued scarcity of labor, housing and commodities. Scarcity in these resources are explained by deep structural changes post Global Financial Crisis ("GFC") that will likely lead to a long-term inflation of over 2%, compared to 1.5% in the last cycle.

Despite inflation being anything but transitory, underestimating long-term inflation risks in 2021 has forced Chairman Powell and others to play catch-up now. After a 25bps hike in March, the Fed hiked rates by 50bps in May, 75bps in June, and now another 75bps on July 27th, bringing rates to the 2.25–2.5% range. The July meeting brought a laser focus on Powell's guidance for how the Fed would balance slowing GDP and labor-market readings against extremely high inflation figures. Powell made it clear that inflation was the single most important economic indicator going forward, but the meeting's tone suggested the Fed may be more interested in seeing cooling core inflation data over the long term and less headline focused. In the end, the July meeting may have signified that we may be at a place where the steep pace of hikes can begin to slow.

The pace of rate hikes is historic and is a stark contrast to the slower pace of hikes in 2015. While market participants have welcomed an aggressive Fed to combat a broader macroeconomic issue, the Fed will most likely have a hard time engineering a soft landing. Its forecasts imply personal consumption expenditures ("PCE") inflation slowing to the 2.6% range next year.[24] We think that they may be surprised, to the downside, by the persistence of inflation in core categories, particularly around services (our forecasts have CPI inflation at +4.25% in 2023),[25] meaning that the path for the Fed to cut rates in 2023 is becoming slimmer. KKR's higher outlook for front-end rates also leads us to revise our 10-year yield target to 3.75% from 3.5% for 2022, though our 2023 target remains unchanged at 3.5%.[26]

While Nominal Wages are Growing, Real Wages Remain Negative



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

Amidst the race to raise rates and the capital markets being more shut than open this year, the size of the high yield market began to shrink and the leveraged loan market plateaued. Looking at SOFR futures, the market believes that rates will decrease again by mid-2023, underlining the belief that the Fed is likely to overtighten and then re-trace back. The risk that the Fed induces a recession to ensure price stability is acute and we see central bank policy as this market's version of the matador's red cape.

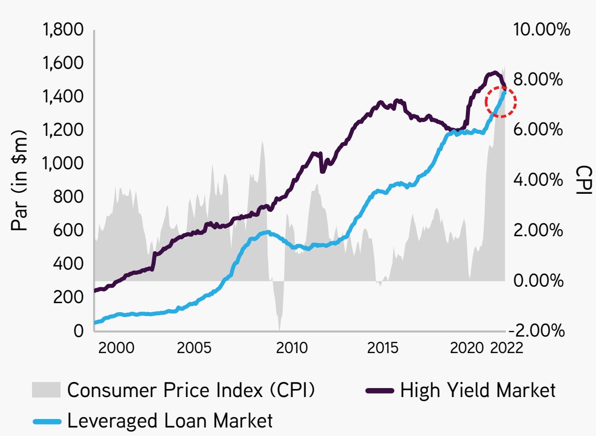
This is a global concern and one that showcases the interconnectivity of markets and infrastructure.

As of the end of the second quarter, we are knee-deep into a global hiking cycle, with central banks raising rates for the first time in years — the bulls are running aimlessly and the hawks are now here to prey.

The Bank of England ("BOE") hiked rates for the fifth consecutive time in June and on July 11th, the European Central Bank ("ECB") ended its grand experiment of negative rates on the back of the region's sovereign debt crisis, which commenced in 2014 with its first rate hike of 50bps in over a decade.

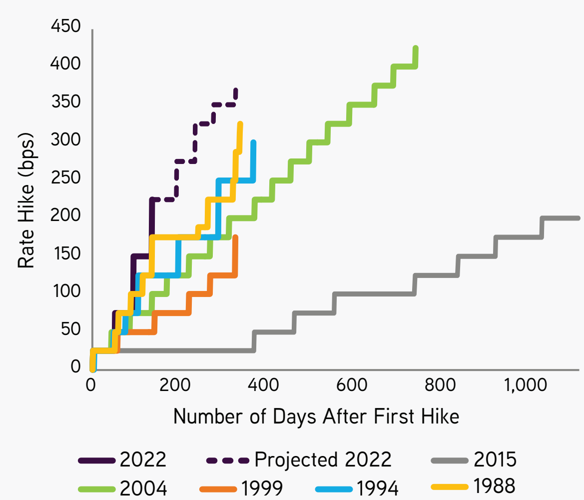
However, despite these tightening policies, the British Pound and the Euro have not been insulated from currency depreciation. In the first two quarters the Euro was down -7.79%[27] versus the U.S. dollar, and the British Pound was down -10.01%.[28] Beyond diverging economic conditions and geopolitical risks between the United States and Europe, market participants have punished the BOE and ECB for not raising rates quicker. Some regions have continued to be more accommodative, which has resulted in greater currency volatility. The Bank of Japan's reluctance to raise rates and halt the bond repurchase program has led the Japanese Yen to hit a 20 year low versus the U.S. dollar.

Year-Over-Year Consumer Price Index (CPI) Growth Compared to High Yield and Leveraged Loan Markets



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

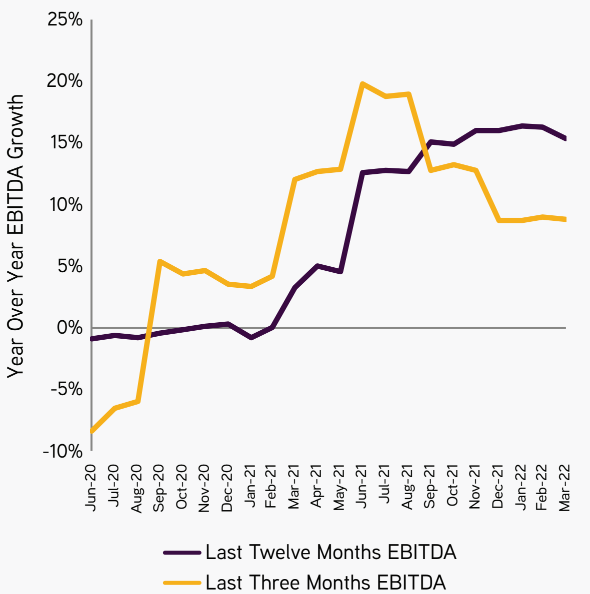
In the Last 35 Years, We Have Never Seen the Fed Hike Rates This Quickly



Source: KKR Credit Analysis and Bloomberg as of August 1, 2022

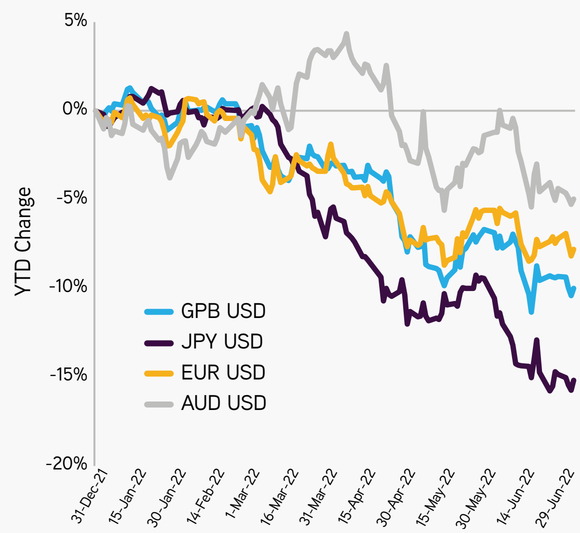
Given that Japanese, British, and EU investors represent an important share of the U.S. corporate debt market, currency depreciations and mark-to-market volatility on existing FX contracts and hedges have had an outsized impact on flows. Investors have had to manage liquidity and fund margin calls as currency swings ensued, leading to outflows in broader equity-linked products within credit and adding to downward pressure in the market as a result. Despite the current volatility, fundamentals have remained sound. As Q2 corporate earnings continue to roll in, the bulk of concerns to date have been focused on weaker future guidance. Overall, earnings have been better than many expected. While we expect many companies to experience slowing growth and decreasing margins in the second half of 2022, it seems to us that the market is expecting company fundamentals to deteriorate drastically from here.

Fundamentals Remain Sound: EBITDA vs. Prior Year



Source: KKR Credit Analysis as of March 31, 2022

The U.S. Dollar Materially Strengthened vs. Other Currencies in 2022 as a Result of Diverging Geopolitical Risks and Monetary Policies



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

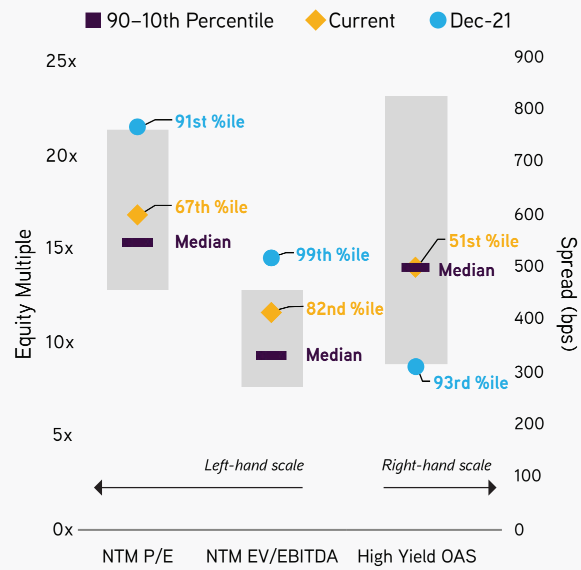
Taming the Bull: Why Credit Now

Year to date performance in both the credit and equity markets has highlighted that public markets have priced in fears around inflation and recession more acutely than private markets. Despite the steep sell-off across both asset classes, we believe that credit currently offers a more compelling risk-reward total return proposition over equities given current valuations, spread and yield levels, dollar discount and private credit's access to dry powder.

High yield spreads have already widened to their long-term historical median. On the other hand, equity multiples such as next twelve month ("NTM") P/E and NTM enterprise value ("EV")/EBITDA are still valued well over their historical median levels at their 67th and 81th percentiles,[29] respectively. In addition to valuations, credit is trading at attractive levels and the yields are inviting. The spread between high yield BB-rated credits and the S&P 500 dividend yield has reached its widest margin since November 2011 and we have not yet seen the true flight to quality that we typically witness going into a recession.

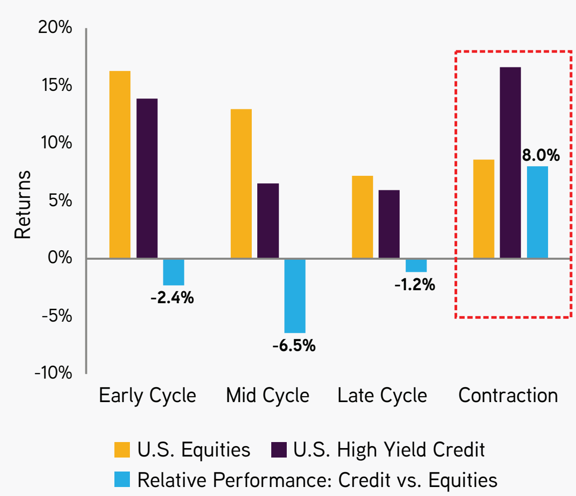
In addition, we have been paying attention to forward returns: both loans and high yield look attractive at current levels when looking at historical returns at comparable spreads. The average 1 year forward return for loans at the 500-599bps spread range is 8.1%[30] and the 1 year forward return for high yield is 7.8%.[31] When spreads are over 600bps, forward returns are positively bounded with low 12-month forward returns of 7.0%[32] for high yield and 10.7% for leveraged loans.[33] The late July rally in high yield and increased appetite for risk assets is a great example of why we are paying close attention to the total return opportunity in the credits we like as spreads compress quickly when the market decides to move. Bids for liquid credit re-emerged in late July, sending spreads tighter by ~100bps off their wides and high yield is now up +6.02%[34] for the month of July — its best month in 11 years.

Despite the Equity Sell-off, Equity Multiples Remain Elevated Versus High Yield, Which has Already Widened to its Historical Median



Source: KKR Global Macro & Asset Allocation Analysis, KKR Credit Analysis and Bloomberg as of May 18, 2022

Average Next Twelve Month Total Return by Cycle



Source: KKR Global Macro & Asset Allocation Analysis, KKR Credit Analysis, Bloomberg, Factset, and Haver as of May 18, 2022

Notably, BB's closed out the month up 6.23%,[35] outperforming CCC risk by 134bps. It is of note that this rally is heading into the depths of corporate earnings. Similarly, the loan market was up +2.1% as of July 31st, which has been its largest move since November 2020. July's resilient CLO demand of $9 billion coupled with a decade low for new issue supply of $2.2 billion[36] has been supporting technicals for positive price action. The recent activity has helped us get more comfortable that there may be a floor to additional dramatic downside risk as we are now starting to see pools of capital stepping into risk providing stability, albeit feeling leadership-less.

Beyond current valuations, history suggests that high yield is set to out-perform on a relative basis at this stage of the cycle. While we are still in the 'late-cycle' phase, we see a growing risk of slowdown as the Fed continues to raise rates.

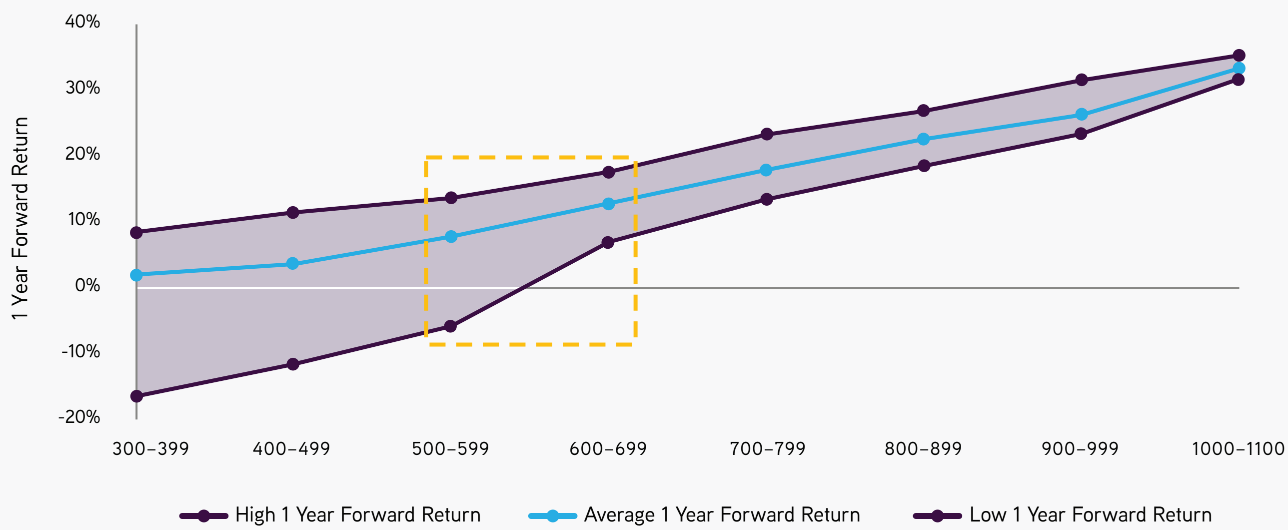
The caveat to historical analysis, as our CIO Henry McVey recently highlighted in the note *Regime Change Enhancing the 'Traditional' Portfolio*, is that the correlation between credit and equities has started to break down. Consistent with Jake's struggle throughout the novel, the market continues to struggle to recalibrate.

There is a gravitational pull to revert to what has worked in the past, but that is no longer a viable approach.

The market has now structurally changed. In such an environment, Credit investors will need to remain diligent as no one is immune from further weaknesses should investors' outlooks grow more pessimistic.

U.S. High Yield One Year Forward Returns: Past 10 Years

The average 1 year forward return for loans at the 500-599bps spread range is 8.1%[30] and the 1 year forward return for high yield is 7.8%.[31] When spreads are over 600bps, forward returns are positively bounded with low 12-month forward returns of 7.0%[32] for high yield and 10.7% for leveraged loans.[33]



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

Running with Rates

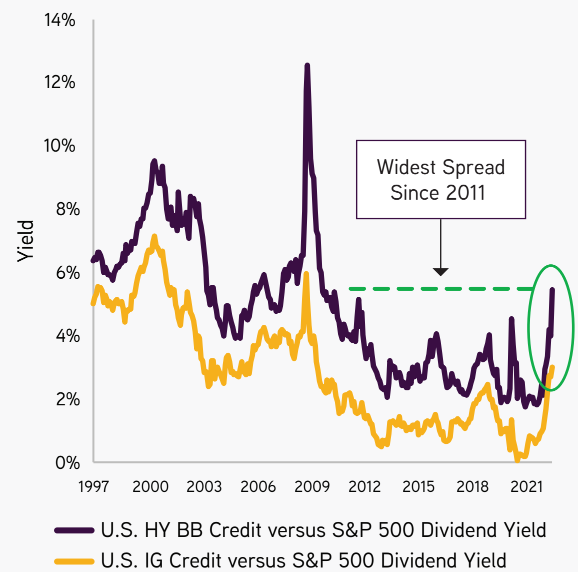
Following the worst first quarter since 1980, the high yield sell-off continued in the second quarter, which led to the worst start of a year in the history of the asset class. Negative returns were particularly pronounced in June, when high yield retraced its steps, showcasing its worst month since March 2020, following slightly positive returns in May.

Underperformance in the second quarter was driven by continued interest rate pain as the Fed raised rates by 75bps mid-June. However, with most of the rate hikes priced in (and futures now pricing in rate cuts in 2023), focus has shifted from interest rate returns to spread returns as high yield prices started to reflect increased recessionary fears.

In Q2 2022, -1.94%[37] of high yield returns were attributed to interest rates, while -9.96%[38] were driven by widening spreads.

Given larger negative spread returns, lower quality paper underperformed in the second quarter with spread returns of -16.74%[39] for CCC-rated assets versus spread returns of -7.95%[40] for BB-rated assets.

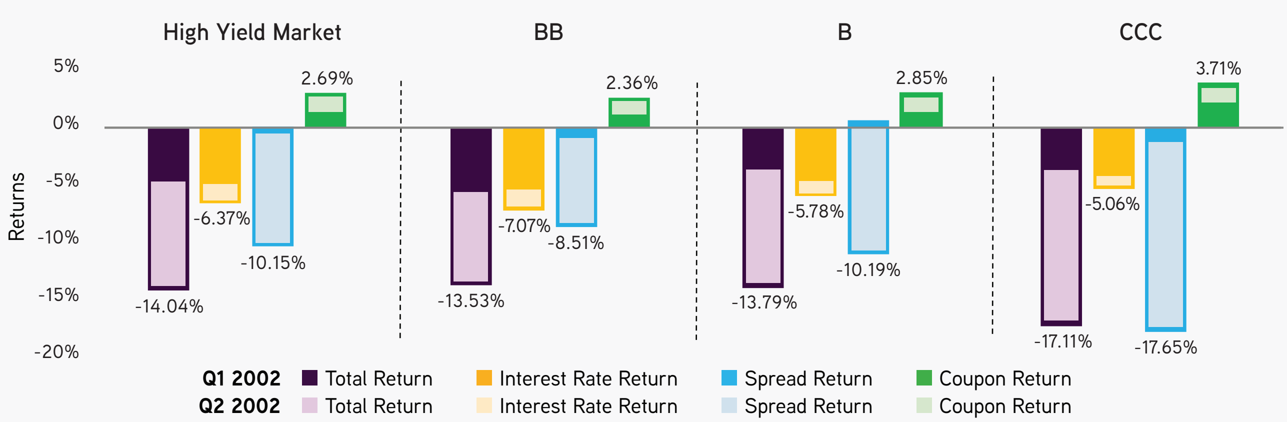
Credit Appears More Attractive than Equities



Source: KKR Global Macro & Asset Allocation Analysis, KKR Credit Analysis, ICE BofAML, and Bloomberg as of June 30, 2022

Decomposition of Returns in the High Yield Market Highlight Spread Widening

Q2 returns were spread driven over rate driven as we saw in Q1

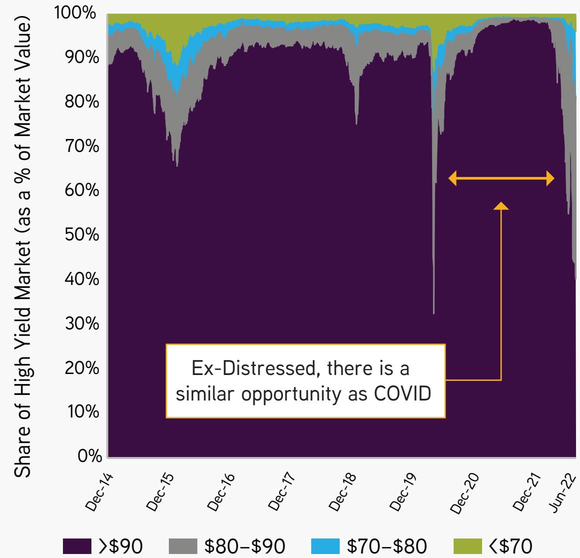


Source: KKR Credit Analysis, ICE BofAML, and Factset as of June 30, 2022

Underperformance relative to both investment grade and leveraged loans in the second quarter improved the relative value of high yield. Looking at historical spreads, U.S. high yield, investment grade, and bank loans were all trading close to their 10% percentile tightest over the last 10 years and close to 5% tightest over the last 5 years as of June 30, 2022.

While spreads may continue to widen if economic conditions materially worsen, the market has not spent much time at elevated spread levels post-GFC. Over the last 10 years, only 16.5% of days have recorded a spread between 500bps and 599bps and less than 12% of days over a 600bps spread.[41] In July, we saw some quick tightening with marginal buyers stepping in as the market grew comfortable with the notion that inflation may have peaked. Despite persistent fears around a recession and distressed ratios breaching 10% of the high yield market,[42] spreads plunged below 500bps in July.

U.S. High Yield Market Composition by Price



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

Look at the Difference One Month Can Make in these Markets — July Rally Moves Spreads

	U.S. Assets									
	7/29/22					6/30/22				
Percentile	IG	HY	HY BBs	BLs	CLO AAAs	IG	HY	HY BBs	BLs	CLO AAAs
Spread	151	477	312	538	175	164	587	417	586	185
3m	48%	59%	70%	44%	47%	0%	0%	0%	0%	0%
1yr	13%	15%	18%	11%	12%	0%	0%	0%	0%	0%
5yr	11%	18%	19%	11%	8%	5%	6%	6%	8%	4%
10yr	22%	32%	38%	19%	4%	11%	12%	12%	12%	2%

	EU Assets									
	7/29/22					6/30/22				
Percentile	IG	HY	HY BBs	BLs	CLO AAAs	IG	HY	HY BBs	BLs	CLO AAAs
Spread	183	590	460	635	240	212	653	518	724	205
3m	48%	34%	37%	38%	11%	0%	0%	0%	0%	0%
1yr	12%	9%	9%	10%	3%	0%	0%	0%	0%	0%
5yr	6%	6%	5%	7%	3%	1%	3%	1%	2%	3%
10yr	4%	6%	6%	8%	2%	2%	3%	2%	2%	2%

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

Historically short lived, high spread peaks and strong forward returns at the 500–600bps spread band highlight the need to remain vigilant and agile as spreads widen. This time, there is no Fed backstop. This is the other side of the that backstop.

With nearly 60%[43] of the high yield market trading in below $90, we believe investors can source high quality market-leading credits trading at a discount.

Additionally, large discounts on secured paper could enable investors to de-risk exposure by moving up in the capital structure without sacrificing too much yield. Spread widening has also enabled high yield investors to buy short-dated debt that is expected to be paid-down in the next couple of years at a steep discount. We saw a similar trade in Q1 2020 as we opted to go up in quality and capital structure for catalyst driven credits that would soon be taken-out due to a pending corporate action. Hunting for high quality discounted paper that will be paid down at par or better provides compelling total return in a short duration.

Overall, we continue to be opportunistic and take advantage of market technicals both in the primary and secondary markets across our credit platform. The primary markets have been choppy at best, and we continue to see anemic supply, with high yield accounting for less than 29% of total leveraged finance volume in the first half of the year. At $69.8 billion[44] issued year to date, 2022 levels represent a -78% decline from the $310.49 billion[45] priced over the same period last year. Nonetheless, the sparse high yield issuance has had to compel investors with steep concessions as banks looked to offload the exposure from their respective balance sheets. In the secondary market, high yield retail outflows continued with a reported $35 billion[46] of net outflows. The accelerating redemption trend built on more than $13 billion of outflows in 2021, while wiping out the $38.3 billion of inflows recorded in 2020.[47] Reflecting both withdrawals and losses, we are also seeing increased pressure to raise cash due to foreign investors taking large FX losses following USD strengthening. Forced selling from banks, retail funds and foreign investors have provided opportunities to play offense and source investment opportunities at wider levels amidst thin liquidity.

Ultimately, the invisible strain to this market's volatility has been the lack of liquidity. We have discussed many times how critical liquidity is during market drawdowns. Thin liquidity not only affects the pricing of assets but also the ability to execute. While the market has had a number of sharp moves this part quarter, we saw muted volumes. This was not a scenario of a contained bull fight in a ring, but rather bulls running the streets wild and as a result, required true patience. There are long-term opportunities swimming in the market but there has been a lack of the market-depth needed to take full advantage of them. The street has been remiss to provide new capital given underwriting and risk limitations are already at a constraint for the year, which has in turn re-directed deal activity and also echoed caution across all market participants.

Bob & Carl Tango to the Market's Encierro

Calm down Carl! Acting like a bull doesn't create a bull market.

Illustration by: Jerry Capria, KKR Credit.

Peering through the Clouds

"Courage is grace under pressure."

—Ernest Hemingway

The first half of the year has tested our market endurance and investment stamina in many ways. We have had to balance a volatile drawdown, lack of liquidity, macroeconomic headwinds and a continued barrage of news headlines. The structural gaps in the public and private markets were on front-row display as outflows in public markets exacerbated negative sentiment and sent market participants retreating as the bulls ran wild through the proverbial street.

The uncertainty and volatility are undoubtedly here to stay for the near-term as the markets recalibrate their risk profile. We have already begun to witness the network effects of asset allocation decisions driving the direction of travel of capital inflows and outflows in the market. As monetizations and paydowns near their lows, coupled with an uninspiring forward pipeline, a market denominator effect casts a large spotlight on the significance of liquidity and need for investment agility in the current environment.

Although sentiment has been negative and the market's wild bull like behavior has left us with a few bruises, we are thinking in decade-long increments, not moments. It is incumbent on us in times like these to continue to be creative, selective and work as a team. Our platform marries the global core competencies across public liquid credit, private corporate credit, asset-based finance and junior capital investment strategies with a full-service capital markets suite. It is often volatile markets that showcase our Credit & Markets platform's ability to seamlessly work in tandem to create and execute innovative financing solutions.

We are sticking to our principles of core credit fundamentals and downside protection, but we plan on continuing to evolve our playbook with every twist and turn. The markets will continue to test our patience and cloudy skies will be in the forecast for some time, but we are starting to see the sun peak through the clouds.

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

REFERENCES

1. Bloomberg and KKR Credit Analysis as of June 30, 2022
2. Bloomberg and KKR Credit Analysis as of June 30, 2022
3. Bloomberg and KKR Credit Analysis as of June 30, 2022
4. ICE BofAML and KKR Credit Analysis as of June 30, 2022
5. ICE BofAML and KKR Credit Analysis as of June 30, 2022
6. S&P LSTA and KKR Credit Analysis as of June 30, 2022
7. S&P LCD and KKR Credit Analysis as of June 30, 2022
8. S&P LCD and KKR Credit Analysis as of June 30, 2022
9. S&P LCD and KKR Credit Analysis as of June 30, 2022
10. S&P LCD and KKR Credit Analysis as of June 30, 2022
11. S&P LCD and KKR Credit Analysis as of June 30, 2022
12. S&P LCD and KKR Credit Analysis as of June 30, 2022
13. S&P LCD and KKR Credit Analysis as of June 30, 2022
14. S&P LCD and KKR Credit Analysis as of June 30, 2022
15. Refinitiv Lipper, S&P LCD and KKR Credit Analysis as of June 30, 2022
16. S&P LSTA LLI and KKR Credit Analysis as of June 30, 2022
17. S&P LSTA LLI and KKR Credit Analysis as of June 30, 2022
18. S&P LCD and KKR Credit Analysis as of June 30, 2022
19. S&P LCD and KKR Credit Analysis as of June 30, 2022
20. S&P LCD and KKR Credit Analysis as of June 30, 2022
21. Bureau of Labor Statistics and KKR Credit Analysis as of June 14, 2022
22. Bureau of Labor Statistics and KKR Credit Analysis as of July 13, 2022
23. Walk, Don't Run: Mid-Year Update 2022 KKR Global Macro Asset & Allocation Analysis
24. U.S. Federal Open Market Committee's Summary of Economic Projections as June 15, 2022
25. Walk, Don't Run: Mid-Year Update 2022 KKR Global Macro Asset & Allocation Analysis
26. Walk, Don't Run: Mid-Year Update 2022 KKR Global Macro Asset & Allocation Analysis
27. Bloomberg and KKR Credit Analysis as of June 30, 2022
28. Bloomberg and KKR Credit Analysis as of June 30, 2022
29. Bloomberg and KKR Credit Analysis as of May 18, 2022
30. S&P LCD and KKR Credit Analysis as of June 30, 2022
31. ICE BofAML and KKR Credit Analysis as of June 30, 2022
32. ICE BofAML, FactSet and KKR Credit Analysis as of June 30, 2022
33. S&P LSTA ,FactSet and KKR Credit Analysis as of June 30, 2022
34. ICE BofAML and KKR Credit Analysis as of June 30, 2022
35. ICE BofAML and KKR Credit Analysis as of June 30, 2022
36. JPMorgan Research and KKR Credit Analysis as of July 22, 2022
37. ICE BofAML, FactSet and KKR Credit Analysis as of June 30, 2022
38. ICE BofAML, FactSet and KKR Credit Analysis as of June 30, 2022
39. ICE BofAML, FactSet and KKR Credit Analysis as of June 30, 2022
40. ICE BofAML, FactSet and KKR Credit Analysis as of June 30, 2022
41. ICE BofAML and FactSet as of June 30, 2022
42. ICE BofAML and FactSet as of June 30, 2022
43. ICE BofAML and FactSet as of June 30, 2022
44. S&P LCD as of June 29, 2022
45 S&P LCD as of June 29, 2022
46. S&P LCD as of June 29, 2022
47. S&P LCD and KKR Credit Analysis as of June 30, 2022

DISCLAIMER

This presentation is furnished on a confidential basis exclusively to the named recipient of this presentation (the "Recipient") and is not for redistribution or public use. The data and information presented are for informational purposes only. The information contained herein should be treated in a confidential manner and may not be transmitted, reproduced or used in whole or in part for any other purpose, nor may it be disclosed without the prior written consent of KKR Credit. KKR Credit currently conducts its activities through the following advisory entities: KKR Credit Advisors (US) LLC, which is authorized and regulated by the SEC, KKR Credit Advisors (Ireland) Unlimited Company, which is authorized and regulated by the Central Bank of Ireland, and KKR Credit Advisors (EMEA) LLP, which is authorized and regulated by the Financial Conduct Authority. By accepting this material, the Recipient agrees not to distribute or provide this information to any other person. The information in this presentation is only as current as the date indicated, and may be superseded by subsequent market events or for other reasons. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. This presentation should not be viewed as a current or past recommendation or a solicitation of an offer to buy or sell any securities or to adopt any investment strategy. The information in this presentation may contain projections or other forward-looking statements regarding future events, targets or expectations regarding the Funds or the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this Presentation, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Employees of KKR Credit Advisors (US) LLC, and KKR Capital Markets LLC located in the United States are dual employees of Kohlberg Kravis Roberts & Co. L.P. (together with its affiliates, "KKR"). In Australia, this presentation is being distributed by KKR Australia Pty Limited (A.C.N 126 516 336 A.F.S.L 336127) and is directed to wholesale clients only as defined by Corporations Act 2001. The distribution of the information in jurisdictions outside Australia may be restricted by law and persons into whose possession the information comes should inform themselves about, and observe, any such restrictions. Any failure to comply with these restrictions may constitute a violation of the laws of an applicable jurisdiction. KKR and its directors or employees advise that they and persons associated with them may have an interest in the financial products discussed and that they may receive brokerage, commissions, fees and other benefits and advantages, whether pecuniary or not and whether direct or indirect, in connection with the Funds and KKR Products. Any fund or funds mentioned in this document have not been authorised by the Hong Kong Securities and Futures Commission for sale to the public and accordingly this document is intended only for use by persons who are "professional Investors" as defined in the Securities and Futures Ordinance (Cap. 571) of Hong Kong and any rules made under that Ordinance. This document and any information contained herein may not be used other than by the person to whom it is addressed and may not be reproduced in any form or transferred to any person in Hong Kong. This document does not constitute an offer for any fund and any subscription for a fund must be made pursuant to the fund offering document. In the United States and Canada, this presentation is being distributed by KKR Capital Markets LLC ("KCM"), a broker-dealer registered with the U.S. Securities and Exchange Commission ("SEC") and a member of FINRA and SIPC. For investors being marketed by KKR MENA, this presentation is being made available by KKR MENA Limited on a confidential basis solely to professional clients (as defined by the Dubai Financial Services Authority) on a "one-on-one" basis for the purpose of providing certain information about KKR and certain investment funds and other investment vehicles and products managed by KKR. KKR MENA Limited is a Dubai International Financial Centre company which is regulated by the Dubai Financial Services Authority.

The contents of this presentation is a Securities Advertisement within the meaning of the Authorized Persons Regulations issued by the Capital Market Authority of the Kingdom of Saudi Arabia (the "AP Regulations") and is being circulated by KKR Saudi Limited in accordance with the AP Regulations. KKR Saudi Limited's address is Faisaliah Tower, 18th Floor, Riyadh, Saudi Arabia. KKR Saudi Limited is authorized and regulated by the Capital Market Authority of the Kingdom of Saudi Arabia under license number 11154-10. In the United Kingdom and Europe this presentation is being distributed either by KKR Credit Advisors (Ireland) Unlimited Company, KKR Alternative Investment Management, which are authorised and regulated by the Central Bank of Ireland, KKR Credit Advisors (EMEA) LLP, and KKR Capital Markets Limited which are authorized and regulated by the Financial Conduct Authority. This presentation is only being distributed to (A) persons who are outside of the United Kingdom or (B) persons who are (i) investment professionals falling within both Article 14 of the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2005 (the "CIS Promotion Order") and Article 19 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Financial Promotions Order"), (ii) high net worth companies and other persons falling within both Article 22 of the CIS Promotion Order and Article 49 of the Financial Promotion Order, (iii) other persons who fall within an exemption both in the CIS Promotion Order and of the Financial Promotion Order or (iv) other persons to whom both an invitation or inducement to engage in investment activity (within the meaning of section 21 Financial Services and Markets Act 2000 ("FSMA")) participate in a collective investment scheme (within the meaning of the FSMA) and an invitation or inducement to of section 238 FSMA) can lawfully be communicated. The persons specified in (B)(i), (ii), (iii) and (iv) above are collectively referred to as "Relevant Persons". Any person in the United Kingdom who is not a Relevant Person should not act or rely on this presentation or any of its contents or attachments. This presentation is only being made available to qualified investors in Switzerland as defined in the Swiss Collective Investment Schemes Act of 23 June 2006 as amended and its implementing ordinance. No marketing materials relating to the shares have been or will be filed with, registered or approved by any Swiss regulatory authority and the Funds are not approved by FINMA for distribution in or from Switzerland to non-qualified investors. In Japan, this presentation is being distributed by KKR Capital Markets Japan Ltd., and is directed to "Professional Investor" only as defined by Article 2 of the Financial Instruments and Exchange Act (Act No. 25 of 1948). KKR Capital Markets Japan Ltd. is a Financial Instrument Operator registered with the Kanto Financial Bureau under registration number Kinsho 1797, and a member of Japan Securities Dealers Association. When transactions involving financial instruments are being discussed in conjunction with this document, you should thoroughly read the all the materials on financial instrument transactions in addition to this document. When entering into a transaction involving financial instruments, you may be required to pay a predetermined commission fee on specific instruments. All financial instruments entail particular risks, and holders of these instruments can incur significant losses or payment obligations as a result of changes in domestic or overseas political, economic, or financial conditions, foreign exchange markets, equities markets, commodity markets, interest rate levels, the creditworthiness of the issuer, and other underlying assets designated as reference indices. Inherent risks and commission fees differ for each instrument. Please read the pre-trade documentation, prospectus or customer information thoroughly. Participation of, and discussions with, KKR private markets personnel, KKR Capital Markets and KKR Capstone personnel, Senior Advisors, Industry Advisors and, if applicable, RPM and other Technical Consultants, in KKR Credit's investment activities is subject to applicable law and inside information barrier policies and procedures, which can limit or restrict the involvement of, and discussions with, such personnel in certain circumstances and the ability of KKR Credit to leverage such integration with KKR.

KKR

Kohlberg Kravis Roberts & Co. L.P.
30 Hudson Yards
New York, New York 10001
212-750-8300
www.kkr.com

Twitter: @KKR_Co

Linkedin: /company/kkr

Visit us on **YouTube**