Thoughts from the road

ASIA | October 2023

I recently traveled across Asia with my colleague Frances Lim, who heads our KKR macro effort in the region. We made stops in Singapore, China, and Japan and were fortunate to spend time during our visit with leading CEOs and policy makers as well as our deal teams and limited partners in every country.

What's our bottom line? In recent months we have typically spent time focused on what sluggish growth and heightened politics mean for China and its counterparts in the region. Those points are certainly important ones that we must all factor into consideration. Yet I actually left Asia, already my third trip of the year so far, thinking that the investment story in this region is evolving in a way that may be underappreciated by investors. In particular, there are two important viewpoints to consider:

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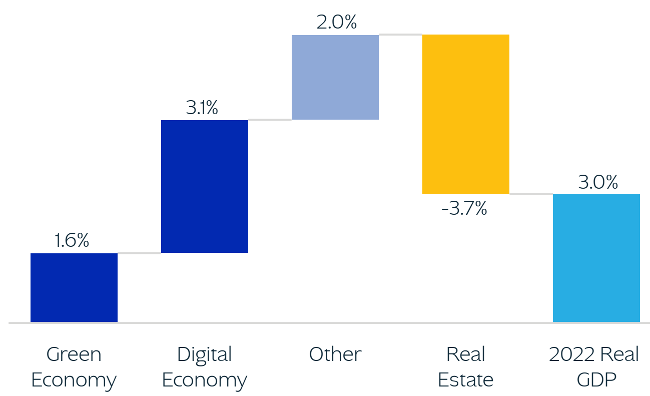
POINT NO. 1

There Is a Transformation Happening, and a New China Is Emerging to Which All Investors Should Pay Attention.

Prior to COVID, a lot of market capitalization was created in China by entrepreneurs who leveraged technology to create an improvement in the consumer experience, including online shopping, social media, and e-commerce. Today, by comparison, the new growth drivers of the Chinese economy look quite different: They are industrial digitalization and the energy transition. According to some of the policy makers and executives with whom we spoke, both of these industry segments are growing about 40% year-over-year, and each sector now represents about 10% of the Chinese economy. Importantly, China has a cost and resource advantage across both of these areas, and we think that they will look to increase their competitive advantage, especially in the EV sector. So, our base view is that – over time – investors will talk more about these drivers than they will about housing and exports, both of which we think have already peaked as a percentage of GDP, and as such, now represent actual drags on the economy. One can see the transition unfolding in *Exhibit 1*.

Exhibit 1: A New Economy: China's Green and Digital Economy Will Soon Fully Offset the Slowdown in Fixed Investment, Including a Saturated Housing Market

Breakdown of China GDP Growth, 2022



Note: 'Green economy' based on energy transition investment as reported by BNEF. 'Digital economy' added value is as reported by CAICT, including added value of the information industry and added value that the information industry brings to other industries. The drag of real estate is estimated by the KKR GMAA team with an IO table and includes the real estate industry itself and the industry's impact on upstream and downstream. Data as at December 31, 2022. Source: China National Bureau of Statistics, BNEF, CAICT, KKR Global Macro & Asset Allocation analysis.

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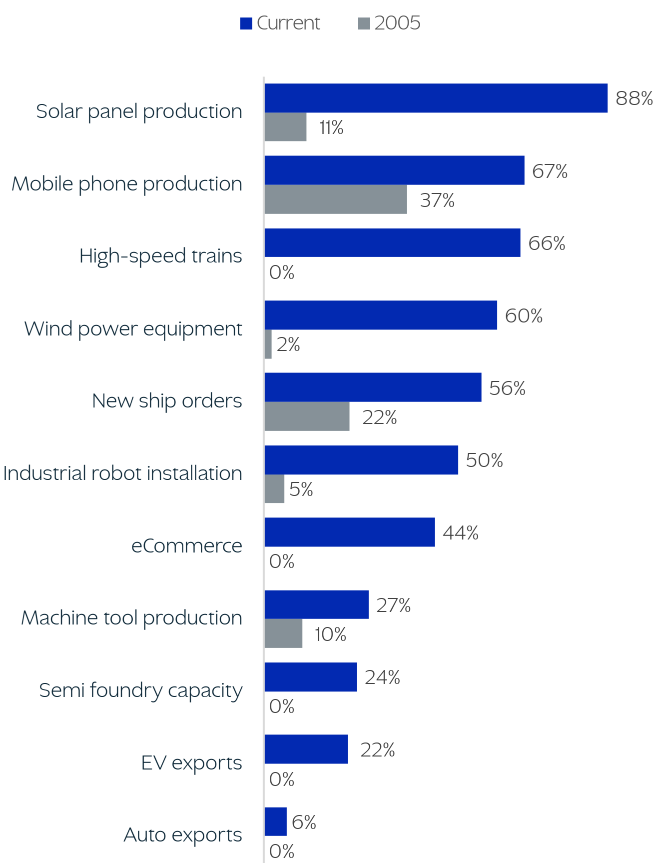
Exhibit 2: This Transition Is Necessary and Rapidly Picking Up Pace, Given That Until Recently China Had Been Too Focused On Fixed Investment and Government Spending

China's Global Share, %



Data at December 31, 2022 or latest available. Source: WIND, Baidu, Forbes, China Today, eeNews Europe, Statistica, World's Top Exports, HQEW, CDM Fund, and China.com.

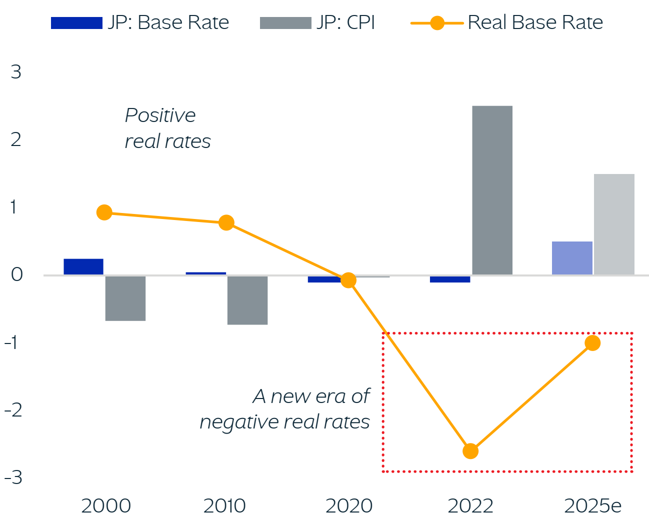
POINT NO. 2

Asia Is Much More Than Just China.

Maybe most importantly, the growth story in Asia is much bigger than China. Across the region, growth in low cost manufacturing of goods as a source of competitive advantage in the global economy has been over-taken by industrial services, including logistics, waste management, and data centers. We think that there is both internal demand and an external component to this story. Against this backdrop, the bid for infrastructure and logistics could accelerate even more meaningfully, we believe, in key markets such as India, China, Indonesia, the Philippines, Vietnam and even Japan. Not surprisingly, we left quite bullish about what this means for our Real Assets franchise.

What has not changed is our team's conviction around two countries: Japan and India. Japan remains a 'must own' country, we believe. We think that Japan is exiting deflation for the first time in decades, which means it is one of the few countries in the developed world whose stock market is benefitting from our thesis about a higher resting heart rate for inflation. At the same time, Japan is having a corporate reform renaissance that may ultimately rival what investors saw during the 1980s in the United States (see below for details). Finally, while monetary policy is definitely changing, we left more confident that the long end of the curve will not compromise economic health and/or the positive trajectory of the capital markets. Importantly, Unlike the U.S., Japan is a great story that is not trading at a full price. Indeed, despite a 37% positive move upward year-to-date, valuations are still reasonable at 14.5x, and there are a lot of single stocks trading with net cash positions and/or below book value. Against this backdrop, we look for more corporate carve-outs, margin improvement stories, and public-to-private opportunities (which we think are going to accelerate on the back of more activist pressure).

Exhibit 3: We Are in a New Era of Negative Real Rates in Japan, Which Makes Cash Less Interesting. This Backdrop Will Likely Fuel a Shift in Asset Allocation



Note: Total factor productivity is the average of the past five years. Data as at July 19, 2023. Source: National Bureau of Statistics of China, PBoC, KKR Global Macro & Asset Allocation analysis.

Meanwhile, while we did not go to India this trip, we spent enough time with corporate executives during our visit to confirm our positive investment case for that country. Simply stated, India is booming, including accelerating domestic infrastructure investment and growing exports. These two changes – more investment and more exports – mean that the economic story is becoming more balanced and less volatile, both inputs that we believe will help support the country's premium valuation. And with this greater and more stable growth, Asia is becoming a more diversified and balanced economic arena.

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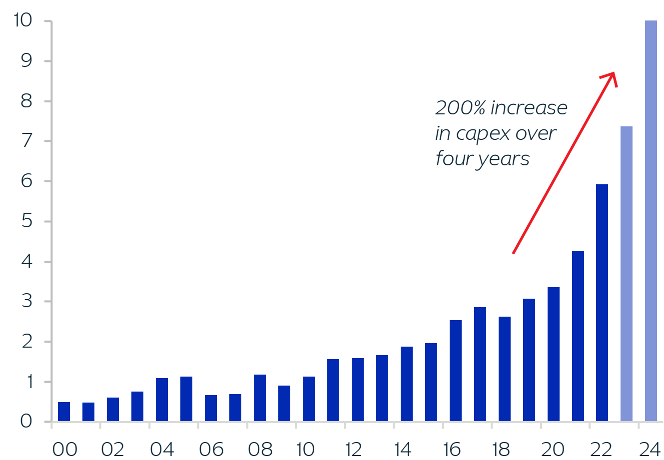
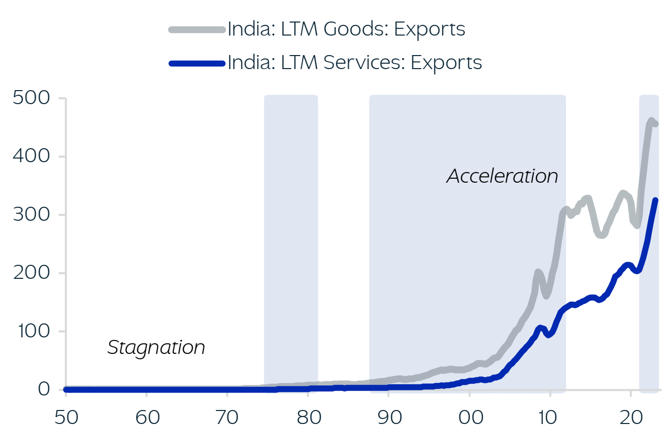
Exhibit 4: Investment in India, Especially Within Infrastructure, Has Risen Sharply in Recent Years

India: Public Capital Expenditure (INR tn)



Note: Years are financial years ending in March. 2023 and 2024 are budget estimates. All other years are actual spending. 1trillion rupees = 12 billion USD. Data as at March 31, 2023. Source: CEIC, Indian Ministry of Finance.

Exhibit 5: After a Decade of Stagnation, India's Export Engine Has Been Unleashed



Data as at March 31, 2023. Source: Reserve Bank of India, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

On the more cautious side, nationalism – similar to what we see in Europe, the U.S., and Latin America – is running high across parts of Asia. Almost every conversation included some discussion about geopolitical / trade tensions. Consistent with this view, we think that political considerations must be more deeply integrated into all our investment strategies. However, this reality is not code for don't invest. We still feel quite good about KKR's 20% balance sheet allocation to the region, particularly given its diversity across asset classes (PE, Credit, Infrastructure, and Real Estate) and countries.

Looking at the bigger picture, there is no doubt we are living in complicated times. Our trip to Asia certainly strengthened our belief that the level of fixed investment, including more specialized deal makers, capital, more technology capital expenditures and more legal/support staff, that will be required to be effective in Asia is going up, not down. This shift is a secular, not cyclical, one, in our opinion. However, we don't support the premise that China is totally un-investable or that Asia in general is too complicated for many global investors. Regardless, it is also clear from our discussions that many global investors have already pulled back their exposures from Asia. Interestingly, though, this reduction in exposure comes just at a time when we believe deal making is poised to accelerate, which we think will lead to further gains in risk assets across the region. As such, our message is to stay the course, but still `keep it simple' by leaning into select markets and products where competitive advantage can be built, especially in key growth areas such as decarbonization, industrial digitalization, and corporate re-positioning stories.

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Details

In the following section we provide additional updates on what we learned on the ground in both China and Japan.

China

Right now there is a lot of noise surrounding growth in China, including such questions as "Is there actually any growth happening and if so, where is it coming from?" To this end, we thought we might try to simplify what is really going on. From our vantage point at KKR, the China economic growth story can be broken down into two parts: the 'new' China and the 'old' China. As we showed earlier in *Exhibit 1*, China's new growth economies are being driven by decarbonization and industrial digitalization. Importantly, the two are linked; so we think that there is a multiplier effect from the combined 20% of the economy that the two sectors represent. By comparison, housing is likely to be in a multi-year 'funk', while exports as a percentage of the Chinese economy *and* the global economy are now at a peak, we believe.

On the positive side of the ledger, overall growth in the country appears to be bottoming, which was not the case when we went in April and June. Moreover, we began our time in China this visit with executives from 'new' China and we left impressed. In particular, the EV (electric vehicle) sector is surging. All told, my colleague Frances Lim believes that China is now not only the biggest consumer and producer of automobiles in the world, but also that the country is now emerging as an influential exporter of autos to many other parts of the world. Just consider that:

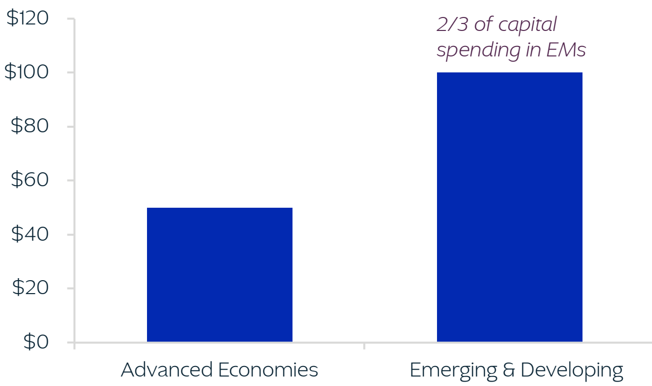
- China surpassed Japan, Germany and Korea in July 2023 as the largest auto exporter globally.
- Japan, Germany and Korea have been the key 'drivers' of the traditional car or global ICE (internal combustion engine) market for some time, but China now dominates in the fast-growing electric vehicle

market, with a 59% market share versus 26% for the ICE market.

- Four percent of cars sold in Europe are imported from China.

Exhibit 6: Two Thirds of Decarbonization Spending Will Be in the Emerging Markets, Especially Asia

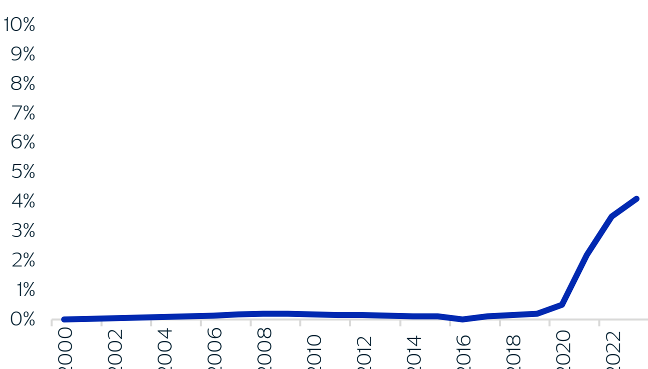
$150 Trillion of Global Capital Spending Required for a Net Zero Transition



Data as at November 12, 2021. Source: McKinsey "COP26 made net zero a core principle for business. Here's how leaders can act".

Exhibit 7: Since the Start of the Pandemic, China Has Gained Notable Market Share of Cars Sold in Europe

China-Produced Cars: Market Share of Total European LV Sales, %

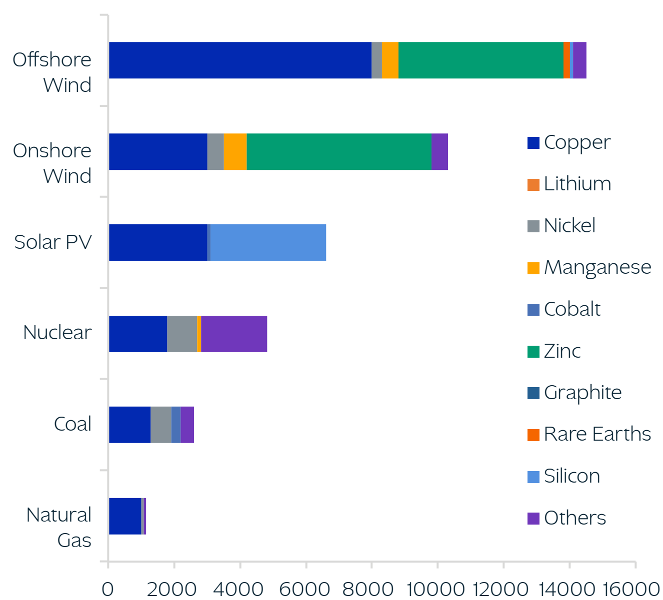


Data as at July 31, 2023. Source: Morgan Stanley "At First, A Trickle... How China EVs Will Reshape Autos", UBS "The rise of China EV giants", GS "Opportunities, challenges, and potential NEV business model evolution".

We also spent time on why the efforts surrounding decarbonization will turn even more 'green', with a shift from battery and solar production towards production of environmentally friendly steel, petrochemicals, and re-usable paper, we believe. Without question, both the government and the private sector are intently focused on extending gains in these markets. A critical component of this effort includes a sizeable jump in 'green financing' market, which has surged in size to RMB 30 trillion (approximately US$4.2 trillion) in June 2023 from RMB 8.9 trillion (US$1.2 trillion) in 2018. Moreover, China also owns many of the raw materials that are required to produce green products. One can see this in *Exhibit 10*, which shows that China is the dominant producer of most of the minerals required to build out a world class decarbonization effort.

Exhibit 8: Most Decarbonization Initiatives Require Commodities That Come From Difficult to Operate Locations

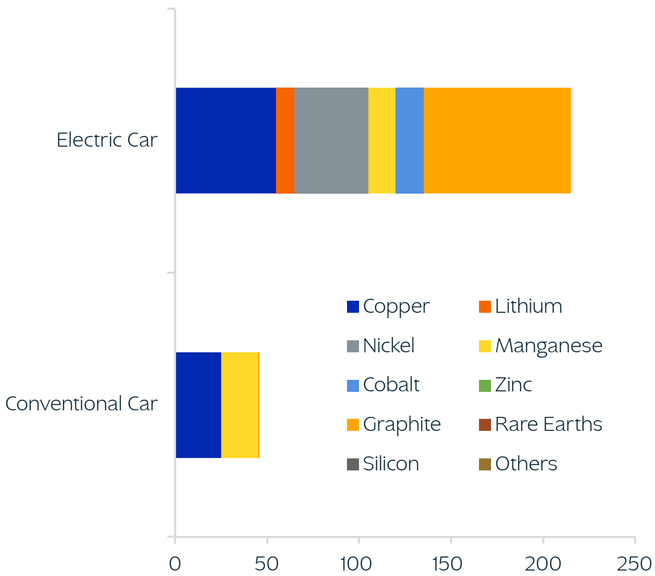
Minerals Required for the Energy Transition



Data as at December 31, 2021. Source: IEA.

Exhibit 9: Energy Efficient Vehicles Require Significantly More Inputs of Hard to Locate Minerals

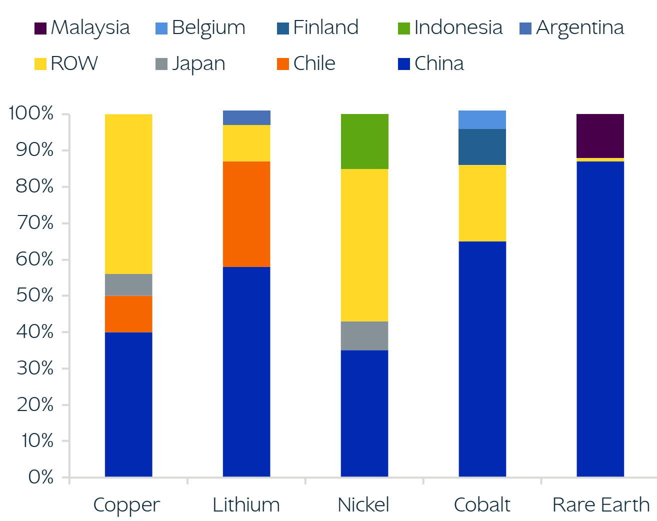
Minerals Required for Electic Cars, kg/Vehicle



Data as at May 4, 2022. Source: IEA.

Exhibit 10: Meanwhile, Processing of Many Key Minerals Is Largely Dominated by China

Share of Processing Volume by Country for Select Minerals, %

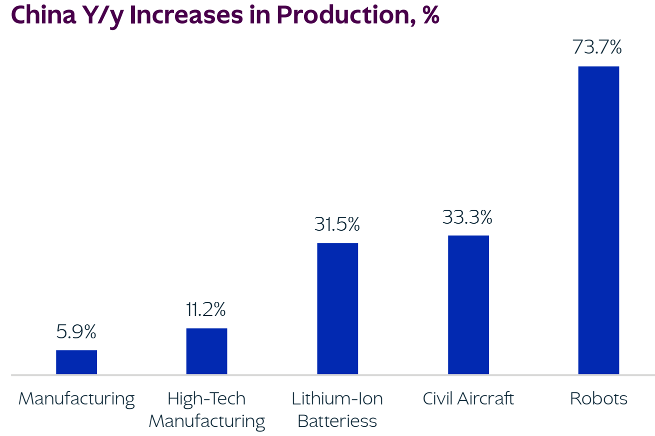


Data as at May 6, 2021. Source: IEA.

Meanwhile, we also left impressed by China's digitalization/automation efforts, especially as it relates to the manufacturing sector. One can see this in *Exhibit 11*, which shows that China is no longer the exporter to the world of commoditized products. Rather, it has migrated up the value chain to much more sophisticated offerings. As part of this transition, China's industrial companies are increasingly using better data collection to improve processes, reduce transportation time, and moderate temperatures and security more efficiently in warehouses. Indeed, there is no question, the complexity of global supply chains, especially in Asia, are on the rise. The good news is that many executives think that they can lower their costs by 10-20% in the next three to five years by implementing these aforementioned changes, and as such, we think that some portion of the capital required for these upgrades will be internally funded.

Exhibit 11: China Has Intensified Its Export Focus Towards Value-Added Industrial Segments of the Global Economy

China Y/y Increases in Production, %



Data as at August 31, 2023. Source: China Development Forum.

We also spent time on the Technology sector learning about how recent U.S. restrictions are impacting China's economy. This area is one where we received the most investor questions, and during our trip the local press was highlighting that scarcity and that the high cost of computing power was in fact constraining the development of AI. However, we learned that Huawei, for example, is now spending billions of dollars per year to become more competitive. It has also established technology 'colleges' and certifications with more than

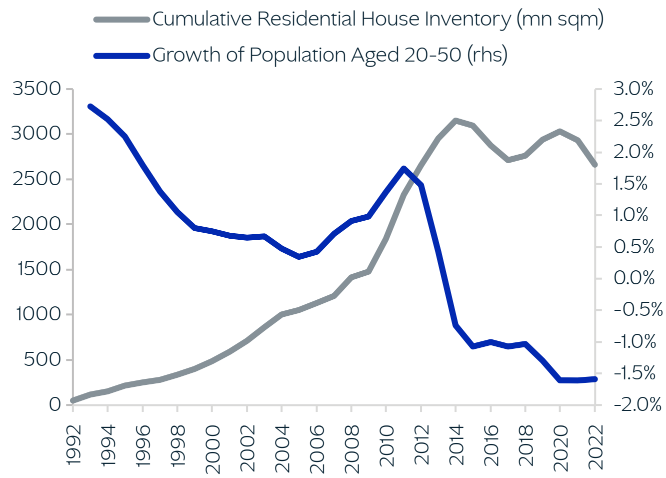
2,200 academic institutions across the globe, and now trains more than 200,000 students annually. Consistent with this intensifying focus on technological self-reliance, KPMG now estimates that revenues from core computing power will reach 4.4 trillion yuan (US$600 billion) by 2025, compared to just 1.8 trillion (or approximately US$250 billion) today.

On the other hand, there are clearly many traditional parts of the economy that are sputtering, or worse. Amongst all of them, we left thinking that housing clearly represents the Achilles heel of the traditional Chinese fixed investment economy. At almost 25-30% of the economy (including ancillary services), this sector is too big to ignore, despite a series of corrective actions by the government that we think could boost GDP by 60 basis points. For example, recent policy changes to allow lower down payments for first time home buyers is definitely helping, but there is still just too much supply. Estimates vary widely, as we heard unsold inventories now total three to 50 million homes (obviously a huge gap; we skew more to the three million estimate shown in *Exhibit 12*, given the 50 million includes housing starts as well as partial construction). Meanwhile, there are 1,000-2,000 developers, many of whom have shaky capital structures; and all the prior lending that has backed the whole real estate sector, including capital from banks, wealth products, and local government funding vehicles, will remain a problematic overhang, we believe. Moreover, we think that the government sees rescuing its property developers as a moral hazard. We agree. Estimates vary by economists, but the hope is that housing becomes only a small drag on the economy by the end of 2024 (i.e., down to the zero to minus one percent range, compared to the three to five percent annual drag of late). However, we think the view that housing becomes a neutral drag on the economy in 2024 might prove to be optimistic, especially given today's low inflation, high real rates, and excess inventory.

Said another way, 'low key luxury' has replaced the pre-COVID conspicuous consumption patterns for much of China's millennial population.

Exhibit 12: There Is a Huge Gap Between Housing Inventory and Population Growth in Prime Age Buyers

Population and Housing Inventory, % and Millions of Square Meters



Note: Total factor productivity is the average of the past five years. Data as at July 19, 2023. Source: National Bureau of Statistics of China, PBoC, KKR Global Macro & Asset Allocation analysis.

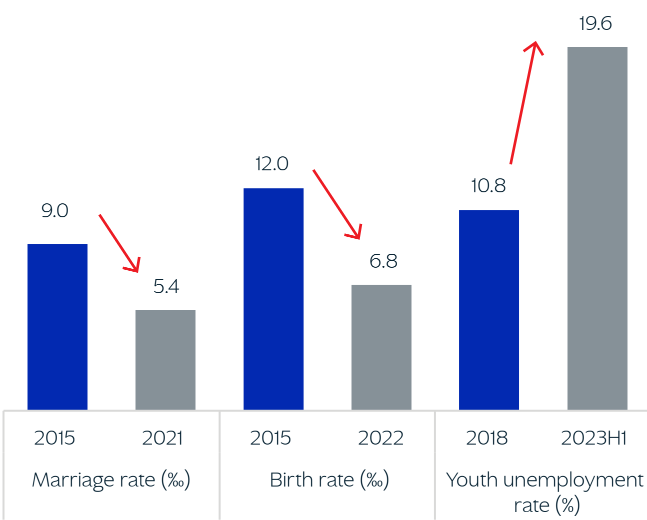
We also spent time digging into the Chinese consumer with the help of BigOne Lab, a proprietary data base company that tracks specific consumer activities and sentiments. Their work shows that consumer preferences in China have changed materially since COVID. For example, outdoor activities have become much more important to many millennials, and while luxury brands are still important, value/quality brands are now more acceptable to greater numbers of consumers than in the past. Said another way, 'low key luxury' has replaced the pre-COVID conspicuous consumption patterns for much of China's millennial population. Pets also remain an important driver of personal enjoyment in a post-COVID China.

However, the bigger picture reality is consumption relative to savings remains depressed, a trend we expect to continue into 2024. As we show in *Exhibit 14*, consumer sentiment is still cautious; this is against a backdrop of fewer births and marriages, among other factors (*Exhibit 13*). We have debated youth unemployment with several economists (many of whom were more optimistic about the problem), but our on the ground conversations confirmed that sentiment in this age group remains quite cautious, especially in areas such as Real Estate (where

BigOne Labs shows employment in their sample down 70-90%).

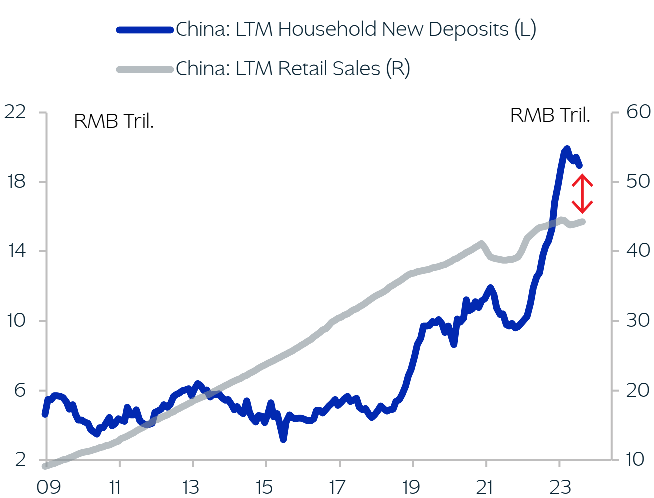
Exhibit 13: The Demand Side of the China Growth Equation Is Being Adversely Impacted by Several Important Trends

China Social Trends, % of Population



Data as at June 30, 2023. Source: Bloomberg.

Exhibit 14: Households Have Been Saving Instead of Spending Post COVID Reopening



Data as at August 31, 2023. Source: China National Bureau of Statistics, CEIC.

So, what does all this mean for growth and inflation, and where do we go from here? From a pure 'numbers' perspective, we are not changing our GDP and inflation estimates for China in 2024. Specifically, we look for real growth of 4.5%, in line with consensus. Meanwhile, on the inflation front, we expect an inflation rate of 1.9% in China in 2024, also in line with consensus.

Importantly, though, as we look ahead, we see the green and digital economies driving growth across consumption, investment and exports in China. Within these growth arenas, the most noticeable shift, we believe, will be that China begins to export more of these goods and services outside of its local economy in 2024 and beyond. So, as we indicated earlier, the economy's underlying structural drivers are changing. Specifically, China is now willing to cede extremely labor intensive manufacturing of lower value goods to other emerging countries. At the same time, however, it intends to grow its market share in higher value added goods and services including shipping, autos, airlines, EV batteries, and electric cars.

Japan

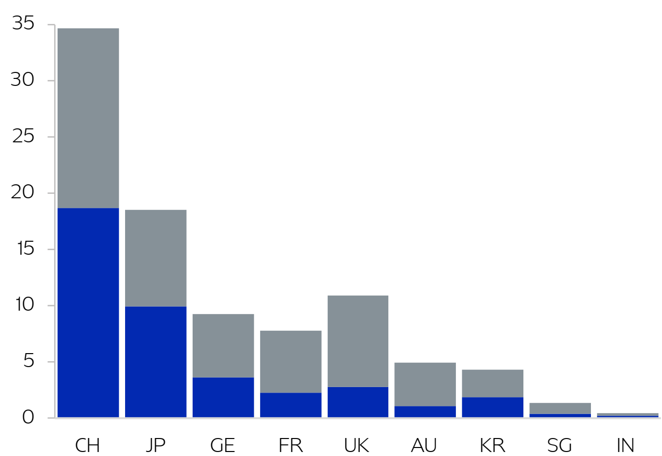
In our humble opinion, it is not too late for investors to appreciate that Japan is enjoying a renaissance, or a revival of sorts that warrants investor attention. Indeed, after multiple visits to Japan coming out of the COVID lockdown, we think that this country's equity market will continue to outperform. Key to our thinking are the following drivers:

1. **The first is that the technical backdrop is quite compelling**. Despite the recent run, many global investors are still underweight Japan after literally three decades of underperformance. At the same time, corporations are on track to buy back more than $100 billion of their own stock, which would surpass last year's total. Maybe more important, individuals are just beginning to recognize that their huge cash deposits may not yield the same real returns in today's more inflationary environment. All told, Japanese households hold 54% of their $18.5 trillion of financial assets in the form of household deposits, compared to an 11% weighting in equities. Interestingly, the government is rolling out an individual savings account program that would encourage more equity

ownership. All told, if Japanese locals shifted just one percent of their household financial assets into equities (from 10% to 11%) this re-allocation would add approximately $185 billion to inflows.

Exhibit 15: Japan Households Have $19 Trillion of Financial Assets...

Household Financial Assets, US$ Trillions

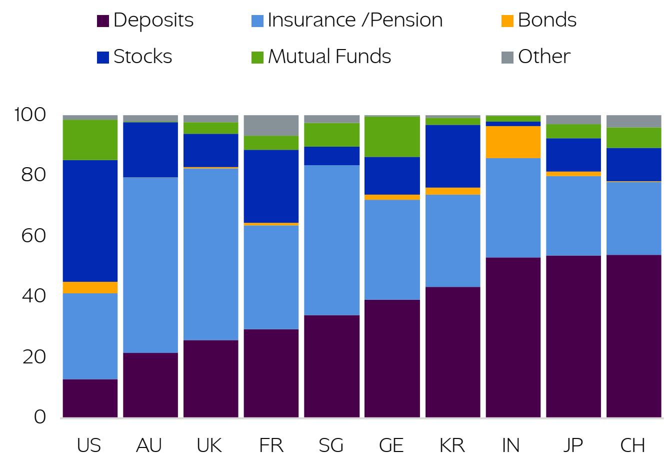


China's 24% Insurance/Pension includes 11.6% Insurance + 12.5% Financial Management products. Data as at December 31, 2021. Source: Wind, Cabinet Office of Japan, India Ministry of Statistics and Program Implementation, OECD, Department of Statistics Singapore, Australian Bureau of Statistics, Federal Reserve Board, Haver Analytics.

Such rapid improvement is a big deal, in our view, and it suggests that there is the potential for even more growth in book value ahead, we believe. In particular, we think the next phase of growth will harness the large cash position on balance sheets to invest more aggressively behind automation, AI, robotics and acquisitions.

Exhibit 16: ...With More Than Half of Japanese Household Financial Assets Held in Deposits

Household Financial Assets, 2021

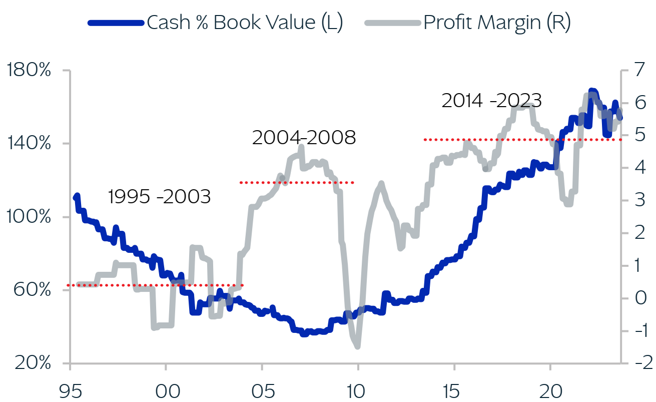


China's 24% Insurance/Pension includes 11.6% Insurance + 12.5% Financial Management products. Data as at December 31, 2021. Source: Wind, Cabinet Office of Japan, India Ministry of Statistics and Program Implementation, OECD, Department of Statistics Singapore, Australian Bureau of Statistics, Federal Reserve Board, Haver Analytics.

2. **The fundamental backdrop is encouraging too**. Japan's corporate profits in the second quarter were supposed to fall to minus 10% but they actually came in at a positive 12%. Rising margins, a weaker currency, better than expected GDP, and pessimistic expectations all led to the surprise. Our bigger picture view is that corporate reform in Japan will lead to a structural uplift in margins, and this improvement will likely occur against a backdrop of undemanding valuations. One can see this in *Exhibits 17 and 18*. Such rapid improvement is a big deal, in our view, and it suggests that there is the potential for even more growth in book value ahead, we believe. In particular, we think the next phase of growth will harness the large cash position on balance sheets to invest more aggressively behind automation, AI, robotics and acquisitions.

Exhibit 17: Japan Has Entered a New Era Focused on Corporate Efficiency and Profitability…

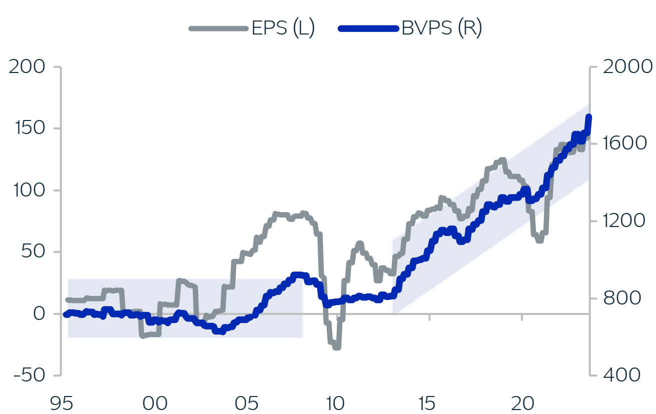
Japan: TOPIX Index



Data as at June 30, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 18: …With Marked Book Value, Earnings, and ROE Growth Across Many Sectors

Japan: TOPIX Index

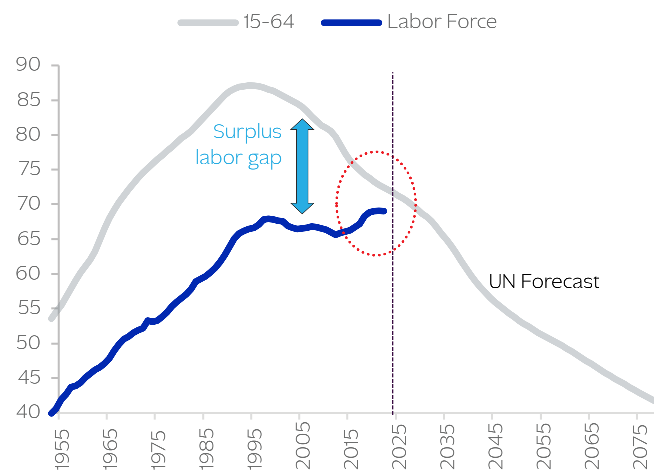


Data as at August 31, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

In terms of where to focus in Japan, we think the key area lies at the intersection of monetary policy, productivity, and labor costs. At the moment, we think wage growth will remain persistently higher. Key to our thinking is that Japan's surplus labor has now been depleted as labor participation rates are already very high; yet the working age population continues to shrink. This set-up is really important, as both Frances and Changchun Hua, who is our Chief Economist for China and Japan, believe that the linear relationship between the unemployment rate and wage growth goes exponential when the unemployment rate falls to two percent versus its current level of 2.7%.

Exhibit 19: Japan's Pool of Surplus Labor Has Now Been Fully Depleted…

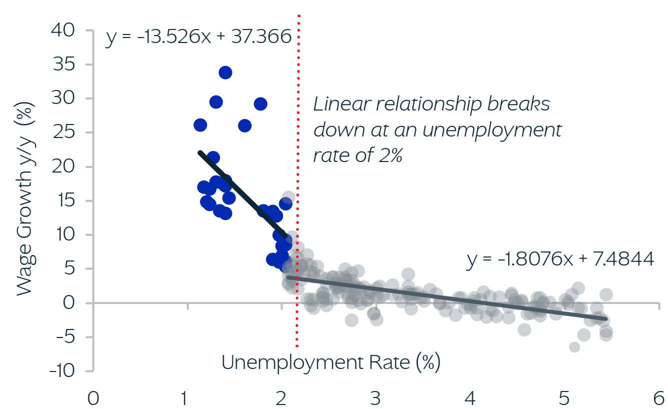
Japan: Population vs. Employment, Millions of Persons



Data as at July 12, 2022. Source: United Nations, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Exhibit 20: …Which Is Really Important as the Relationship Between the Unemployment Rate and Wage Growth Goes Exponential

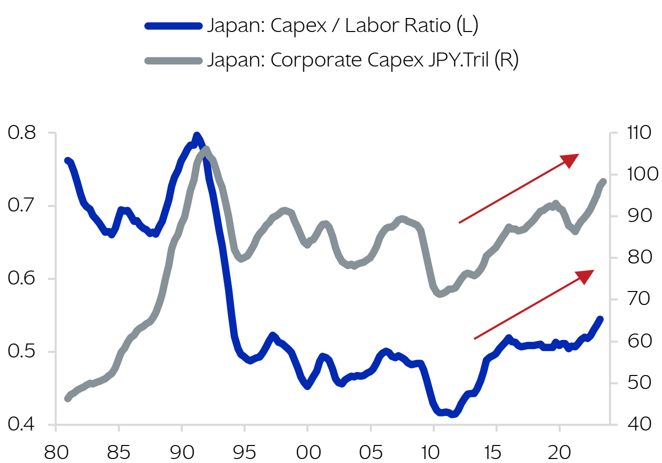
Japan: Unemployment Rate vs. Wage Growth, 1Q71 to 1Q23



Data as at June 30, 2023. Japan Ministry of Health, Labor and Welfare, Japan Ministry of Internal Affairs and Communications, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

It will be bumpy, but we think corporate Japan will be able to navigate this transition. Higher inflation comes with higher interest rates, and as such, we think this transition will need to be coupled with higher productivity to compensate for the demand for higher wages needed to combat inflation. With higher investment levels, Japan's work force should be more productive than before, we believe. A weaker currency too should help. Indeed, with the approximately 30% yen depreciation, Japan is now one of the most competitive countries in the world.

Exhibit 21: We See Japan's Capex to Labor Ratio Rising Further Increasing Japan's Productivity

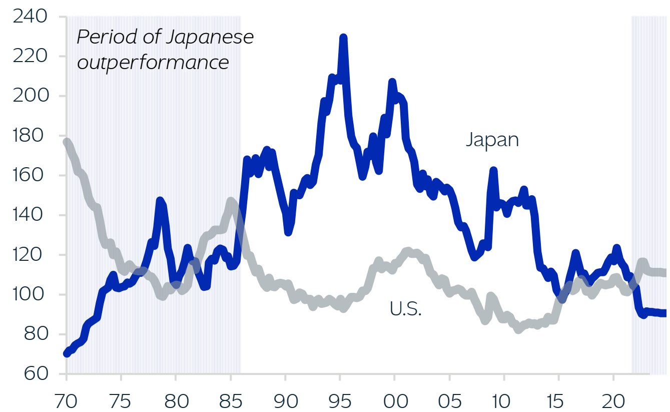


Data as at June 30, 2023. Source: Ministry of Finance Japan, Cabinet Office of Japan, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

A weaker currency too should help. Indeed, with the approximately 30% yen depreciation, Japan is now one of the most competitive countries in the world.

Exhibit 22: The Weaker Yen Has Also Made Japan Among the Most Competitive Economies in the World

Relative Unit Labor Cost, 2015=100

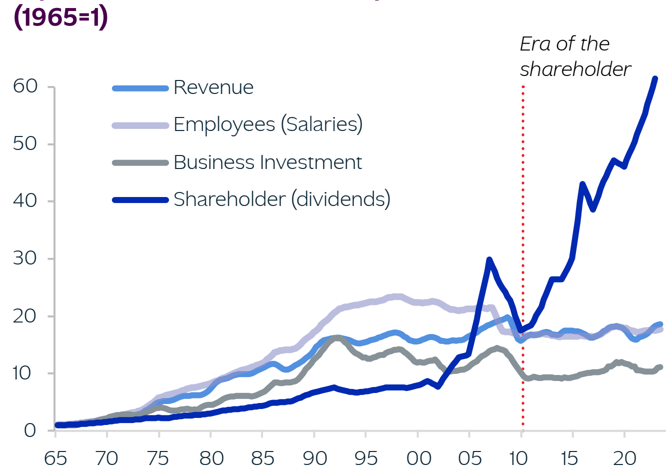


Data as at September 6, 2023. Source: OECD, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Maybe more importantly, corporate reform is still gaining momentum from multiple angles, including activist shareholders, foreign board members, younger and more innovative CEOs, and even the Tokyo Stock Exchange (which is arguing for companies to have their stocks trade above 1.0x price-to-book).

Exhibit 23: Importantly, Japan's Era for Shareholders' Has Been Released…

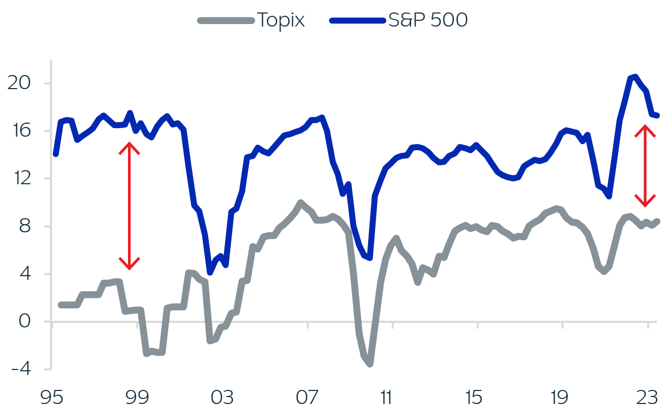
Japan: LTM Distribution of Corporate Revenue (1965=1)



Data as at June 30, 2023. Source: Ministry of Finance Japan, Haver Analytics.

Exhibit 24: ...And the ROE Gap Between the U.S. and Japan Is Narrowing

Return on Equity, %



Data as at June 30, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

In terms of interest rates, our base case is that the central bank does exit its Negative Interest Rate Policy (NIRP) in early 2024. While we are certain this news announcement surely will garner a lot of attention, we are not as convinced that it changes the economic trajectory of the country a huge amount. This viewpoint is a more optimistic one than we held prior to landing in Tokyo. Key to our thinking is that – even with a move from negative to zero on the short-end of the curve – Interest rates relative to nominal GDP are still extremely accommodative; moreover, we do not see the long-end of the curve rising as much as it has in the United States or Europe. The reality is that structural growth today in Japan is still around 0.5%, and domestic ownership of JGBs remains outsized at 54%. As such, we do not think the forward curve pricing of 150 basis points for the 10-year JGB in five years is too conservative.

So, our bottom line is that wages and productivity will find equilibrium, we believe. As part of this discovery process, however, we think the government needs to encourage the private sector – in partnership – to spend more capital on fixed investment that will boost productivity to compensate for the inevitable wage growth we envision in a population that faces significant growth challenges. The good news is that there are two mega-trends – de-carbornization and industrial digitalization—that require a lot of capital; moreover, if done correctly, these two sectors could both boost growth and lower operating costs over time.

Conclusion

There is no substitute for being on the ground in Asia. KKR's eight offices in the region are a source of competitive advantage, especially when the macroeconomic and geopolitical trends remain murky. Our biggest take-away from this trip is that, despite some notable impediments to consider, there is still a lot of investment opportunity. *China's economy is undergoing a major restructuring that is happening faster than most expect*. Even if one does not invest in China, one should know what their priorities are to better understand the global landscape in any sector. Meanwhile, Japan is likely to continue to surprise on the upside, we believe. We also see other pockets of compelling opportunity across India and select markets in Southeast Asia.

However, we will need to leverage our breadth of product across Private Equity, Real Estate, Infrastructure, and Credit to connect the dots as well as to discover relative value across asset classes and countries. This exercise will not be easy, but the starting point is now quite attractive when one considers the intersection of growth, valuation, and potential for operational improvement.

Our biggest take-away is that, despite some notable impediments to consider, there is still a lot of investment opportunity. China's economy is undergoing a major restructuring that is happening faster than most expect. Even if one does not invest in China, one should know what their priorities are to better understand the global landscape in any sector. Meanwhile, Japan is likely to continue to surprise on the upside, we believe.

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