

Europe | January 2023

THOUGHTS FROM THE ROAD

Down, But Definitely Not Out

By Henry H. McVey, Aidan Corcoran, Bola Okunade and Asim Ali



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When Aidan, Bola, and I penned our last *Thoughts from the Road* note on Europe in early August (see *Keeping Perspectives*), we indicated that sentiment was likely too bearish relative to fundamentals. This backdrop was an opportunity, we believed. Since then, European equities have outpaced those in the U.S., with the Eurostoxx up more than double the S&P 500 so far in 2023 (12% versus 5% as of January 26th).

Another trip in late January 2023 to Europe, which we detail in this piece, has only reinforced our view that there is actually still more running room ahead, especially within private markets. Key to our thinking is that the bear case on the European macro will not play out as badly as many prognosticators have been foreshadowing. While not immune to the recent war-induced commodity shock, economic growth in Europe is holding up better. In fact, after performing our most recent macro deep dive, we are raising, not lowering, our GDP forecast for the Euro Area. At the same time, we are lowering our inflation forecast.

Importantly, the better-than-expected growth and lower than anticipated inflation we are seeing is occurring at a time when allocations to Europe are at record lows across Public Equities, Private Equity, and Credit. As such, any additional spark of good news will further fan the flames of relative outperformance, a surprising reality we believe is catching many underweight global allocators off guard.

Another important variable to consider is the potential further strengthening of the euro relative to the U.S. dollar, which is one of our key calls for 2023 (see *Outlook for 2023: Keep it Simple*). Ultimately, we think that there is an exchange rate tailwind unfolding in Europe that will draw global investors off the sidelines, many of whom will be forced to rebalance their portfolios.

Finally (and probably most importantly), there are some very resilient and compelling investment themes unfolding in Europe, including fertility, automation/digitalization, energy efficiency and climate that are short capital. To this end, we think that global allocators should be allocating capital to these mega trends, despite what we agree is one of the more complex macro stories out there these days.



So, what did we learn along the way and what changes are we making to our outlook?

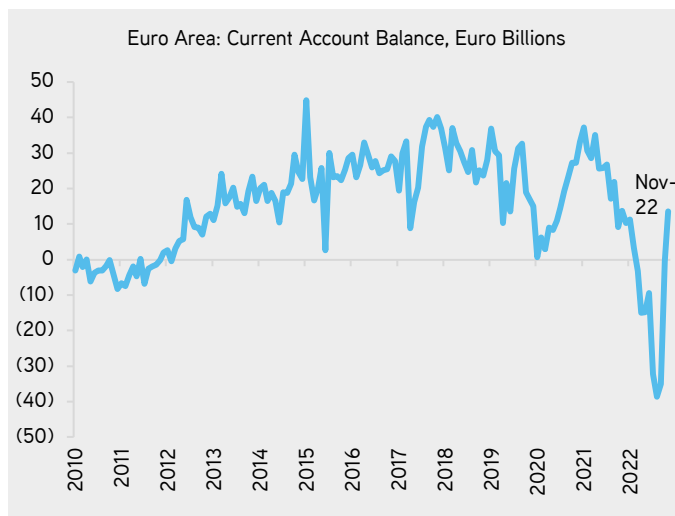
- **We are revising up our Euro Area GDP.** Our European macro team, led by Aidan Corcoran, is revising up estimates for Euro Area Real GDP growth in 2023 to +0.4% from -0.2%. The primary driver of this change is the unseasonably mild start to the winter in 2022-2023, which is leading to a less severe energy shortage. Our forecast for Euro Area Real GDP growth in 2024 is now +1.4%, down from our previous estimate of +1.6%, due to the tougher comparisons after we upgrade 2023 growth, as well as the lagged effect of tighter monetary policy. See *Exhibit 3* for our base, bear, and bull case scenario analyses.
- **At the same time, we are lowering our inflation forecasts.** While core inflation including sticky labor costs remains a headwind to corporate profit margins, we are trimming our inflation forecasts. A key catalyst for this reduction is the price of natural gas. Indeed, in oil equivalent terms, today's natural gas prices in Europe are now around \$105 per barrel, compared to an earlier peak of over \$500 in 2022. This massive decline is capping headline inflation risks. As such, we are cutting our expected inflation expectations for 2023 from 6.3% to 5.9% and for 2024 from 2.6% to 2.3%.
- **Consumer health is better than expected.** Consumers saved close to an extra trillion euros in the Eurozone alone during the 2020-2021 period. Employees are also seeing good nominal wage growth, partly offsetting the increased costs from energy, food and mortgages. As a result, key parts of the economy, including the shift from goods to services-based experiences, are performing strongly in 2023, a trend we look to continue for quite some time.
- **The U.K. game plan feels more sensible.** London was one of our stops, and what a difference a few months have made. The Sunak government has successfully steadied the ship following the U.K. pension fund liquidity crisis of last September/October. The fiscal plan feels better, there are some good growth initiatives,

and the extreme bear case on inflation is abating. On the other hand, the low-end consumer continues to face challenges, real incomes are being hit hard, and continued fiscal retrenchment will be necessary over the coming years.

- **From a thematic perspective, many of our continuing themes such as Automation/Digitalization, the Energy Transition, and the Resiliency of Everything are gaining momentum and are only strengthened by the current environment.**

Exhibit 1

The Euro Area Current Account Is Now Back Into a Surplus, as the Terms of Trade Shock Unwinds

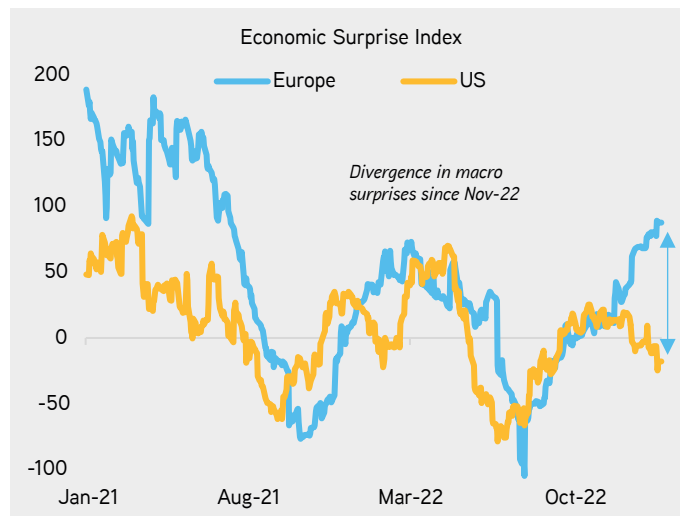


Data as at November 30, 2022. Source: Eurostat.

From a thematic perspective, many of our continuing themes such as Automation/Digitalization, the Energy Transition, and the Resiliency of Everything are gaining momentum and are only strengthened by the current environment.

Exhibit 2

Europe Has Been Consistently Surprising Consensus Since November Last Year, Whereas the U.S. Has Been In-Line



Data as at January 23, 2023. Source: Bloomberg.

Looking at the big picture, we reiterate our mantra to **Keep It Simple** in 2023. Many parts of Credit in Europe appear attractive, especially given banks have pulled back on lending. Consistent with this view, 2023 should be a good vintage for Real Estate Credit, Direct Lending, and even parts of Mezzanine. We also like what we hear around Infrastructure in Europe, especially as it relates to fiber build-outs (an ongoing theme we have been pursuing), as well as the energy transition. Finally, we continue to pound the table that Private Equity in Europe in many instances is a much more effective way to see value creation in the region than Public Equities. In particular, we are excited about the potential for public to private transactions and corporate carve-outs.

Details

Below, we provide further detail on what Aidan, Bola, Asim (a new addition to our European macro team), and I learned from our recent meetings after engaging with CEOs, deal teams, former central bankers and clients/prospects in Zurich and London.

Point #1: We are revising up our GDP forecast, thanks in large part to a mild winter. As mentioned earlier, we are boosting our Euro Area Real GDP forecast in 2023 to 0.4% from -0.2%, compared to a consensus of 0.0%. The relatively mild winter has limited the energy headwinds, and China's reopening is boosting external demand, leading to a much improved outlook for 2023. For 2024, we are slightly lowering our growth forecasts to 1.4% from 1.6% due to lagged effects from a tighter monetary policy. Consensus is at 1.3%.

However, given all the volatility in the region, we have also been working with our deal teams to consider a range of different outcomes. In our bear case scenario (20th percentile), stubbornly rising wage growth from structurally tight labor markets and inflationary pressure from China reopening results in the ECB overtightening, inducing a deeper downturn lasting into 2024. In our bull case scenario (80th percentile), energy deflation into 2023 combined with a quick recovery in consumer sentiment sends the region to above trend growth by 2024. One can find the details in *Exhibit 3*.

Many parts of Credit in Europe appear attractive, especially given banks have pulled back on lending. Consistent with this view, 2023 should be a good vintage for Real Estate Credit, Direct Lending, and even parts of Mezzanine. We also like what we hear around Infrastructure in Europe, especially as it relates to fiber build-outs (an ongoing theme we have been pursuing), as well as the energy transition.

Exhibit 3

We Are More Constructive on Euro Area GDP, But Inflation Is Still Too High

Eurozone Annual GDP Forecast Scenarios, %			
	2023	2024	Comments
Base	+0.4% (Prior: -0.2%)	+1.4% (Prior: +1.6%)	<ul style="list-style-type: none"> With gas storage levels above seasonal norms, the prospect of forced rationing in winter 2022/23 and 2023/24 has receded Expected rebound in the Chinese economy bodes well for external demand We expect growth to be close to trend in 2024 as the recovery runs up against the lagged impact of monetary tightening
Bear	-1.2%	-0.7%	<ul style="list-style-type: none"> <i>Severe cold snap, discontinuation of all Russian gas flows, and stronger than expected pick up in LNG demand from China leads to gas shortages</i> <i>Stubbornly rising wage growth from structurally tight labor markets pushes the ECB to overtighten, resulting in financial fallout that lasts well into 2024</i>
Bull	+1.6%	+2.2%	<ul style="list-style-type: none"> Further sustained falls in energy prices reflecting continued efficiency gains and fuel switching allow the ECB to achieve a lower terminal rate A swift run-down in household savings (currently there has not been much dissaving), boosts consumer spending
Eurozone Annual Inflation Forecasts, %			
Base	+5.9% (Prior: +6.3%)	+2.3% (Prior: +2.6%)	<ul style="list-style-type: none"> Improving energy situation leading to lower gas prices

Data as at January 20, 2023. Source: KKR Global Macro & Asset Allocation analysis.

Despite forecasting an almost three percentage point spread between our bull and bear case scenarios, our big picture takeaway is that we are seeing remarkable resilience in Europe's economy. Industrial production, which was directly in the line of fire with the energy squeeze, has hardly blinked in aggregate. Factories have cut gas consumption by a quarter with no impact on output.

We fully acknowledge that we have a long road ahead to a full return to normalcy in the region. As part of this economic remodeling, Europe will need to build out its independence across a variety of industries, including defense, energy, and strategic supply chains, all of which require time and money at a time when the cost of capital is rising in the region.

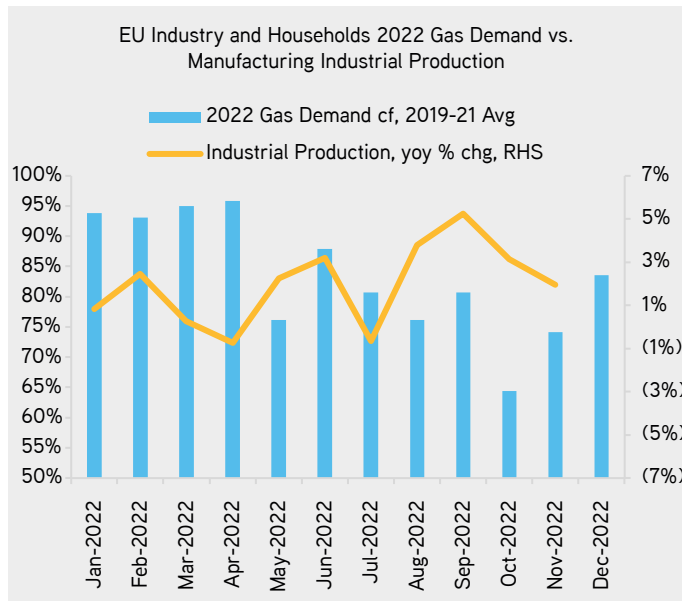
However, our observation is that when the EU takes on an objective, it usually executes. We've seen it with banking supervision, and with the pandemic response, and we believe

we will see it with energy, defense, and strategic supply chains (*Exhibit 5*). So, while it will take time and probably be a more wobbly path along the way than we would all like, we do believe Europe will achieve its policy objectives.

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Exhibit 4

Industrial Production Has Held Up Well, Despite Gas Demand Running Meaningfully Below the Historical Average



Data as at December 30, 2022. Source: Bruegel, Haver Analytics.

(though it did not feel that way in Zurich!). The upshot is that Europe will likely come out of the winter heating season with fully 30pp more gas in storage compared to the same time last year. One can see this in *Exhibit 6*. This excess capacity is causing gas prices to fall quite rapidly. In fact, gas prices today are 59 euros per Megawatt hour, compared to a peak of over 300 euros per MWh in 2022, and pre-crisis average prices of closer to 20. In oil equivalent terms, today's prices are around \$105 per barrel, compared to an earlier peak of over \$500. This massive decline is capping headline inflation risks, and as such, we are cutting our inflation expectations for 2023 from 6.3% to 5.9% and for 2024 from 2.6% to 2.3%. Consensus inflation expectations are 5.9% and 2.3%, respectively.

One problem area, though, is core inflation, which is running at about 5.0%. In our view, as long as it remains above 4.0%, the ECB will not be able to scale back their tightening. So, while macro trends are improving, our bottom line is that investors need to keep their guard up on inflation and rates until we are well into 2023 (i.e., probably later than the U.S.).

Exhibit 5

A Series of Mini-Crises Has Actually Advanced the European Policy Agenda

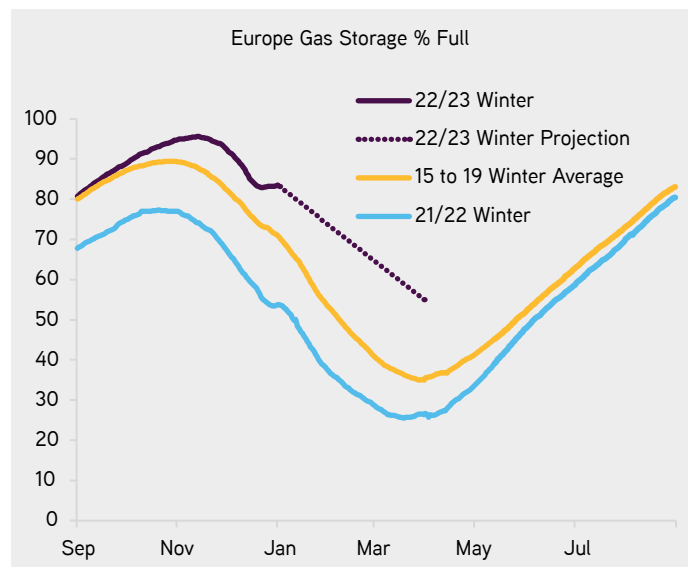
Critical Policy Objectives of the EU, Recent and Future	
	Progress
Bank Reform (2013-19)	●
Labor Market Reform (2010-)	●
€1.8tn EU Recovery Budget (2020-26)	●
Energy Transition and Independence (2015-)	●
Defense Inflection (2022-)	●

Data as at October 31, 2022. KKR Global Macro & Asset Allocation analysis.

Point #2: With better gas storage levels, we cut inflation forecasts; but headline remains much too high for our taste (and that of the ECB). Without question, Europe is in a stronger position today than at any point since the Russian invasion of Ukraine in 2022, compliments of a mild winter

Exhibit 6

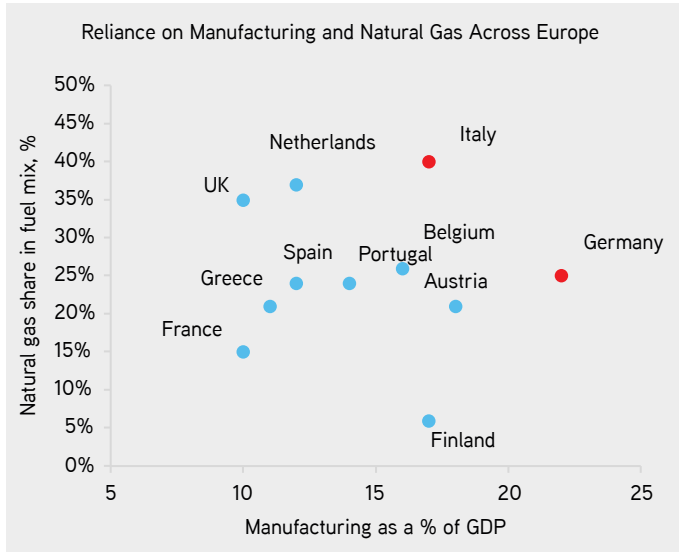
Healthy Gas Storage Levels in Europe Are Alleviating Pressure on Gas Prices



Data as at November 14, 2022. Source: Gas Infrastructure Europe, Bloomberg.

Exhibit 7

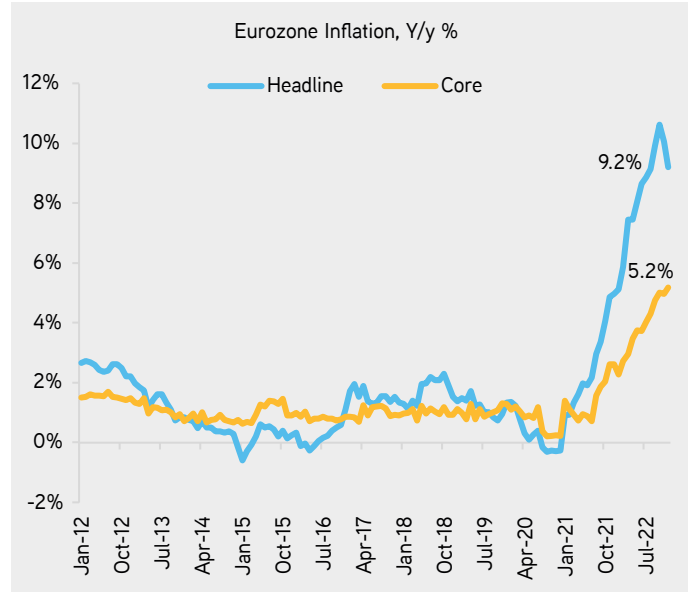
Germany and Italy Face the Greatest Challenges, Given Their Large Exposure to Manufacturing and High Gas Dependency



Data as at November 14, 2022. Source: Eurostat.

Exhibit 9

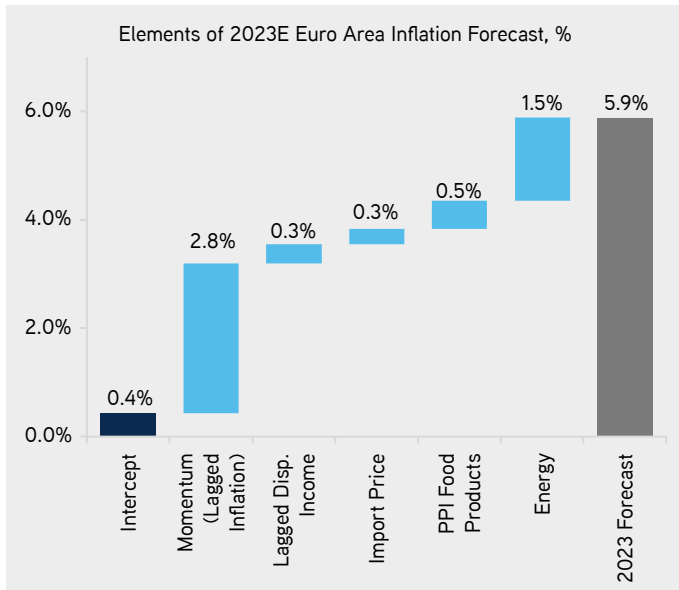
We See Underlying Core Inflation in the Eurozone Proving Stickier Than Anticipated



Data as at January 24, 2023. Source: Eurostat.

Exhibit 8

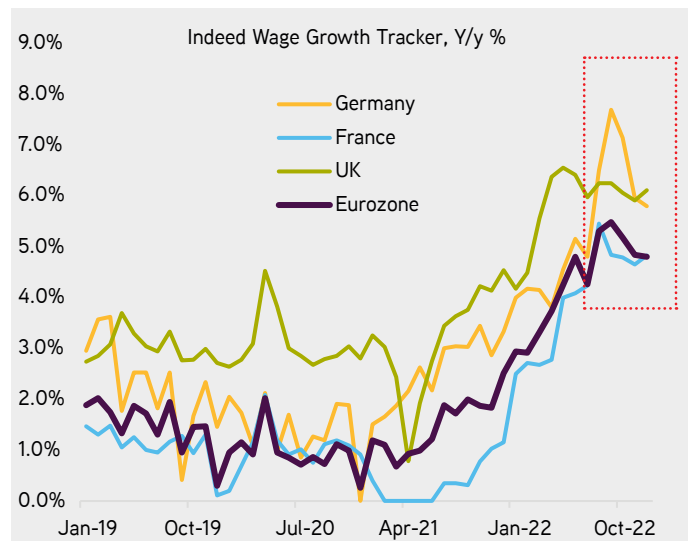
Our Euro Area Inflation Forecasts in 2023 Are Driven by Continuing Energy Inflation, As Well As the Lagged Effects of Energy Inflation in 2022



Data as at November 14, 2022. Source: KKR Global Macro & Asset Allocation analysis.

Exhibit 10

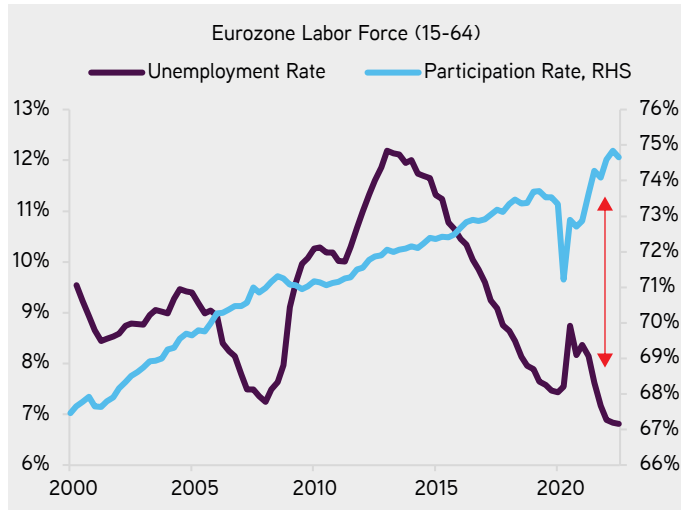
We Expect Wage Growth to Remain Robust, Albeit We Think It Will Fall From Currently Unsustainable Levels



Data as at January 18, 2023. Source: Indeed.

Exhibit 11

The Labor Market in the Euro Area Remains Structurally Tight



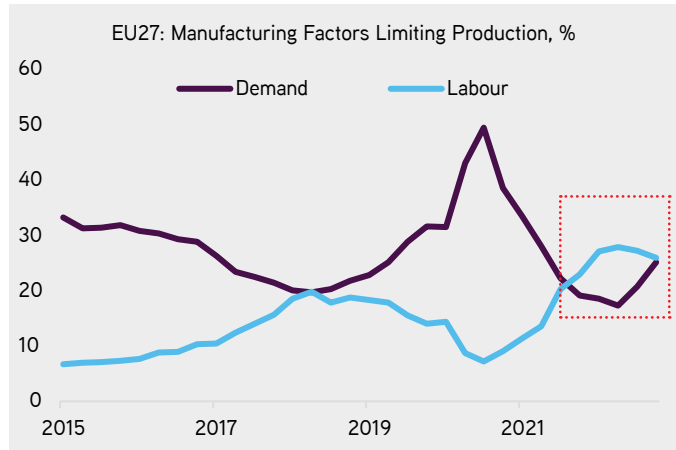
Data as at January 18, 2023. Source: Eurostat.

Point #3: Consumers have huge cash balances and wage growth is robust, so we believe the health of the consumer is not as dire as some would suggest. Similar to the U.S., European households saved an extra trillion euros through the pandemic – a meaningful buffer against rising input costs. However, and perhaps more importantly, the labor market is still performing strongly. In fact, Europe has the highest labor force participation rate and the lowest unemployment rate in the history of the EU. We are seeing some initial signs of weakening, but we believe the labor market will remain tight relative to history. Alternative wage growth trackers show elevated wage growth in the Euro Area at 4.8%, compared to official numbers at 2.9%.

Structural labor market tightness differs in each country, with Germany among the tightest markets in Eurozone (our view is that skills mismatch and demographics are the key drivers). As a result, wage growth in Germany is increasing at 5.0% Y/y as of 3Q22 (*Exhibit 10*). Meanwhile, U.K. wage growth is even higher at 6.4% Y/y in November, partly reflecting reduced labor supply due to Brexit. However, if there is good news on the wage front (albeit not great for the economy), it is that labor demand is beginning to weaken, as the hit to consumer real disposable incomes from record high inflation is now taking hold, we believe.

Exhibit 12

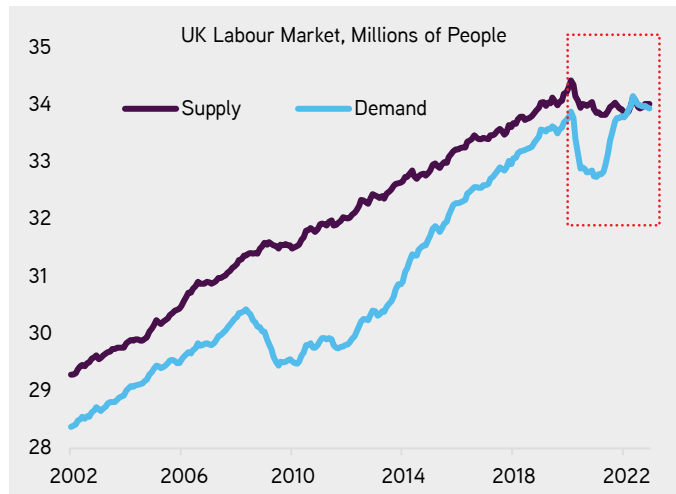
Labor Supply Has Been the Limiting Factor for Businesses in Europe...



Data as at January 18, 2023. Source: European Commission.

Exhibit 13

...While Demand Surpassed Supply in the U.K. Labor Market as Well



Data as at January 18, 2023. Source: ONS, Haver Analytics.

Our European macro team, led by Aidan Corcoran, is revising up estimates for Euro Area Real GDP growth in 2023 to +0.4% from -0.2%.

Exhibit 14

Wages and Salaries Across the Euro Area Have Increased 2.9% Y/y on Average...

Wages and Salaries by Sector, %			
Sectors	Latest, %	Pre-COVID, %	Delta, %pt
Average	2.9%	3.0%	(0.2%)
Mining & Quarrying	13.6%	0.8%	12.8%
Accomm & Food	4.8%	2.1%	2.7%
Admin & Support	4.0%	4.1%	(0.1%)
Transport and Storage	3.6%	2.8%	0.8%
Scientific & Profess	3.5%	2.8%	0.7%
Wholesale & Retail Trade	3.5%	3.1%	0.4%
Social Work	3.2%	3.5%	(0.3%)
IT	3.2%	3.2%	0.0%
Real Estate	3.1%	1.8%	1.3%
Public Admin & Defense	3.1%	2.6%	0.4%
Education	2.8%	3.4%	(0.6%)
Construction	2.8%	3.2%	(0.4%)
Finance	2.7%	2.7%	0.0%
Manufacturing	2.0%	2.9%	(0.9%)
Trade: Electricity & Gas	1.9%	3.7%	(1.8%)
Arts & Recreation	1.9%	5.5%	(3.5%)

Data as at January 26, 2023. Source: Statistical Office of the European Communities, Haver Analytics.

Exhibit 15

...Whereas Job Vacancies Are Eighty Basis Points Higher Than Pre-COVID, On Average

Job Vacancy Rate by Sector, %			
Sectors	Latest, %	Pre-COVID, %	Delta, %pt
Average	2.9%	2.1%	0.8%
Admin & Support	4.6%	3.7%	0.9%
IT	4.3%	3.0%	1.3%
Accomm & Food	3.9%	2.8%	1.1%
Scientific & Techn	4.1%	2.9%	1.1%
Construction	3.9%	3.4%	0.5%
Transport & Storage	2.8%	2.1%	0.8%
Wholesale & Retail Trade	2.7%	2.0%	0.7%
Manufacturing	2.3%	1.5%	0.9%
Real Estate	2.3%	2.0%	0.2%
Financial & Insurance	1.9%	1.4%	0.6%
Electricity & Gas	1.7%	1.0%	0.7%
Mining & Quarrying	1.2%	1.0%	0.2%

Data as at January 26, 2023. Source: Statistical Office of the European Communities, Haver Analytics.

So, our bottom line is that there is enough momentum on the wage, cash balances, and labor participation fronts to overcome both sticky inflation and a slowing economy. Thus, consistent with what we are saying about overall GDP, the consumer picture in Europe is one of surprising resilience.

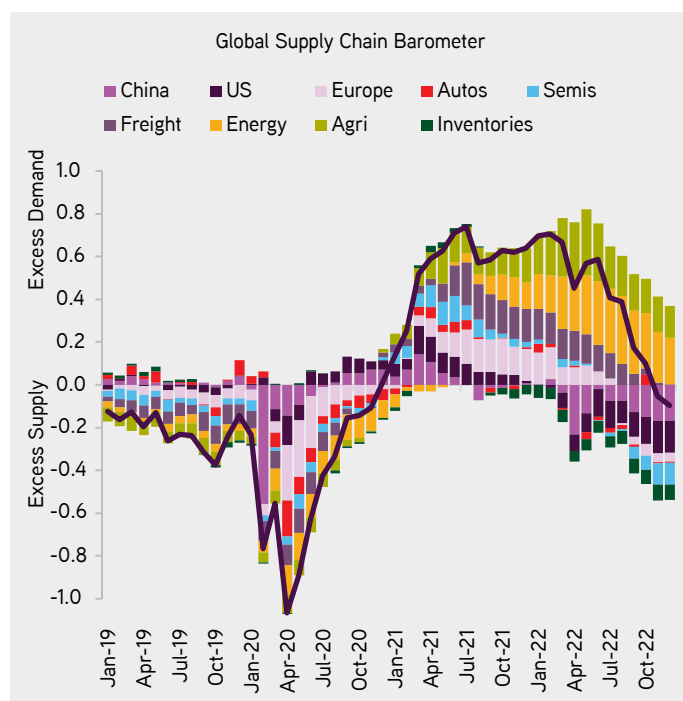
Point #4: Stay thematic in Europe: Automation, Digitalization, the Energy Transition, and the 'Resiliency of Everything' have emerged as thematic beneficiaries in the macro environment Europe is experiencing. We note the following:

- With labor costs rising amidst sluggish demographics and a dearth of trained workers for key sectors, we think that corporations will focus increasingly on technology-driven productivity gains. Indeed, if history is any guide, worker scarcity will inspire another era of automation discoveries including a greater focus on worker re-training and corporate streamlining, including software that makes everything from warehouses to accounting to logistics more efficient.
- Meanwhile, on the energy transition front, it feels like Europe, its politicians, and its investors are now ahead of the global competition on the move towards a more carbon-friendly footprint. Prior to 2022, its companies were already leading the charge on green technology, bolstered by policy initiatives such as the European Green Deal in 2020. Today 10 of the top 11 countries on the WEF's Energy Transition Index are in Europe. Without question, the drive for energy independence after the invasion of Ukraine has only turbocharged these preexisting initiatives.
- Finally, as my colleague Vance Serchuk often reminds me, we have shifted from a period of benign globalization to one of great power competition. Nowhere is this reality more apparent than in Europe right now. This shift is a big deal, and it means that countries, corporations, and even individuals will need to build out more redundancy across not only energy but also data, food, pharma, technology, water, and transportation. These sectors and their supply chains will be subject to greater geopolitical oversight, in terms of both industrial policy intended to build national providers of these services and also scrutiny of foreign

investment and resiliency of supply chains. Almost all aspects of defense spending are poised to surge, we believe. All told, our 'Security of Everything' concept represents hundreds of billions of dollars in opex and capex that may help to cushion the blow of the global economic slowdown we are experiencing.

Exhibit 16

Global Supply Chain Issues Have Been Improving in Aggregate, Though Disruption Remains in Food and Energy

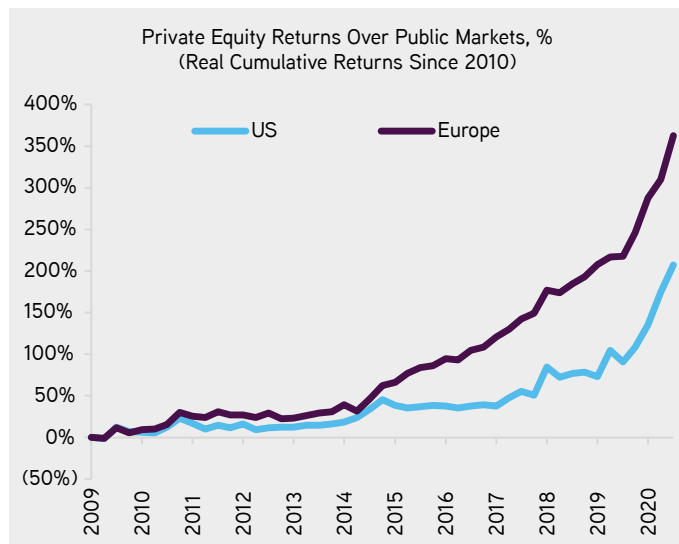


Data as at January 18, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Importantly, we retain our long-held view that Private Equity in Europe, rather than the Public Equity markets, will allow investors better access to key long-term investment themes. The issue is that the public market indexes are 'flawed' in that they are largely linked to Financials, energy companies, and large multinationals. As a result, an investor does not get the same level of growth and industry positioning that we believe is achievable through a targeted Private Equity approach. The numbers continue to support our insights: one can see the massive outperformance that European Private Equity has had in recent years relative to Public Equities in *Exhibit 17*.

Exhibit 17

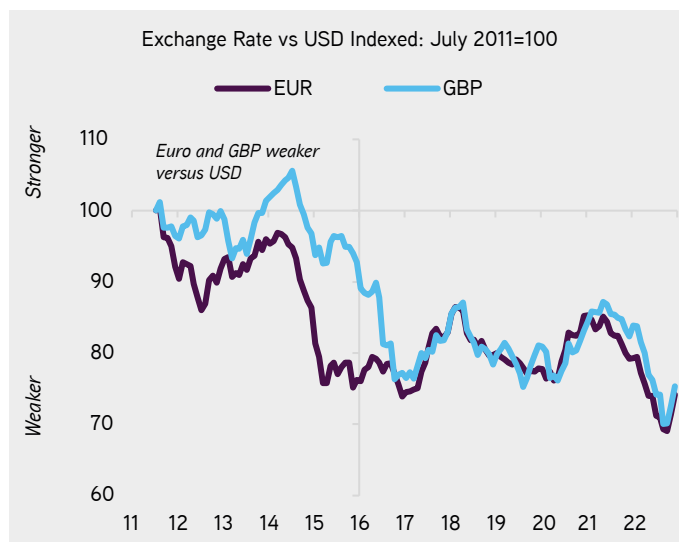
Private Equity Funds Have Notably Outperformed Their Public Market Equivalents In Both the U.S. and Europe



Data as at December 12, 2022. Source: Cambridge Associates, Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 18

The USD Relative to the Euro and GBP Is Still Quite Strong

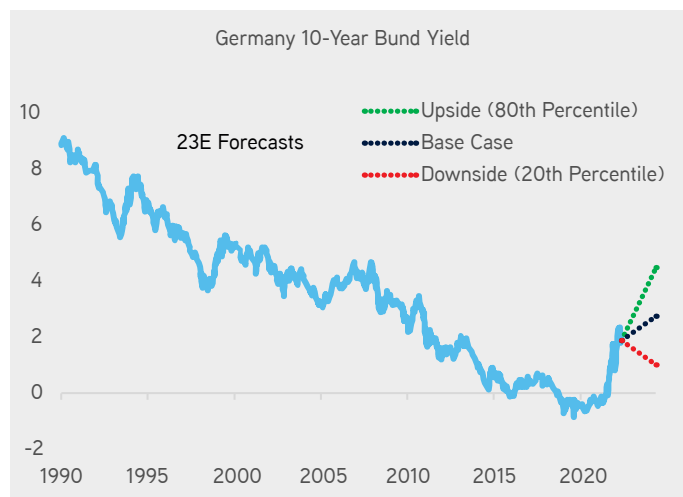


Data as at December 31, 2022. Source: Federal Reserve Board.

Point #5: Against this backdrop, we still expect the bund to drift higher. All told, we think the ECB will boost the depo rate to 3.5% from 2.0% currently. Our forecast compares to a consensus of 3.25%, but we would also note that we do not expect the ECB to ease into 2024, compared to a consensus view that the ECB eases to 2.5% by year-end 2024. Meanwhile, we look for the bund to reach 3.0% at the 10-Year point. The bund actually rallied from 2.5% to 2.0% earlier this year. It has now pulled back to 2.25%, but the consensus for year-end is pointing to a yield of just 2.1%. As such, we continue to be well above consensus (and have been for some time). Central to our thesis is that the ECB is reducing its massive balance sheet, which will put some upward pressure on the long-end of the curve in a way that the investment community is now underestimating. Already, the ECB's balance sheet has fallen from a peak of close to nine trillion euros to below eight trillion, with more pressure to come this year, in our view.

Exhibit 19

We Believe the Upward Inflection in Bund Yields Has Further to Go



Data as at December 12, 2022. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Conclusion

After several days of meetings with a variety of executives, macro folks, clients, and central bank watchers, our macro team concluded that the environment in Europe is “down, but not out.” Indeed, through a confluence of both intentional policy and some good luck, Europe will likely skate through what originally appeared to be thin economic ice as recently as November. More important to us though, is we continue to uncover secular, long-term growth themes that many investors have not included or fully invested behind as part of their portfolios. Top of our list after this trip are the Energy Transition, the Security of Everything, Revenge of Services, and Automation/Digitalization.

No doubt, Europe is a complex story; but the Credit markets, both Private and Public, are also offering above average yields that dovetail with our 2023 mantra of **Keep It Simple**. Our favorites remain Direct Lending, CLO Liabilities, Real Estate Credit, and Asset Based Finance. We also continue to be enthusiastic about Opportunistic Infrastructure in Europe, including fiber, transportation assets, and energy-linked generation and transmission. Finally, we are believers in the value creation of Private Equity over Public Equities.

In terms of key risks, we continue to stay away from companies with margin degradation risk, particularly those with an inability to pass on labor costs. The reality is that European core inflation could prove to be higher and stickier than core inflation in the U.S. for some time. We also expect more volatility around commodity inputs as the Russian invasion of Ukraine rages on and China reaccelerates its growth. That said, growth is holding up better than many expected and we do think the bear case on the macro will not play out as badly as many expected. This is occurring at a time when portfolio exposure to Europe is at low levels, and the possibility of ‘good news’ fanning the flames of relative outperformance is not to be discounted.

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