Europe: Managing Through

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Aidan Corcoran, who heads our European macro effort, and I recently spent time traveling across Europe, with informative stops in Frankfurt and London. If there is one take-away that resonated for us after all of our meetings, it can be summed in the quote often attributed to Mark Twain that the "reports of my death are greatly exaggerated".

We get it. Europe is never going to be a growth powerhouse, especially given the ECB's single mandate on inflation (not *both* inflation and growth), its challenging demographic profile, and its geopolitical position in today's world order. However, it is doing just fine. In fact, it is likely doing better than most investors think, and therein lies the opportunity, especially in the private markets. Just consider that over the past six years, Europe has been the best performing region on the KKR balance sheet on a combined basis across all asset classes.

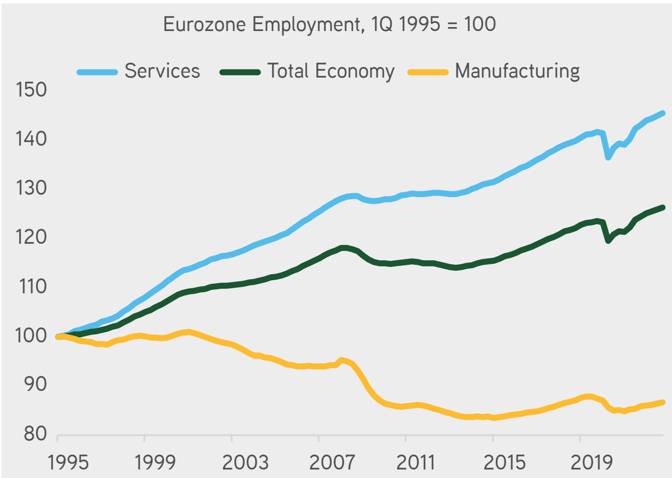
In terms of our main observations, we note the five key takeaways from our trip:

- **Europe has stickier inflation than most developed markets; unlike in the U.S., goods inflation has not come down very much**. All told, goods inflation was still running at 8.1% in Europe as of March, which is 650 basis points above the U.S (*Exhibit 7*). Moreover, the broadening out of inflation across the region has kept non-energy industrial goods (i.e., those more isolated from the energy crisis) still running at 6.6%, and unfortunately, we see few signs of a quick return to the ECB's target of two percent. Meanwhile, rising wages and decent demand for leisure and travel are keeping services inflation running at 5.1%, which compares to 2.7% a year ago and 7.2% in the U.S.

- Given that the ECB's singular focus is on inflation, **Europe will probably need to run the tightest monetary policy this cycle**. *This backdrop continues to argue for a higher euro relative to the dollar, and it also means that the cost of capital for this region will be higher on a relative basis this tightening cycle than in the past*. However, given structurally lower growth, there are limits to how high rates can go, which likely means allocators, especially including insurance companies, will ultimately need to harness the illiquidity premium to generate the returns they need to satisfy their liabilities. Consistent with this view on the ECB's focus, Aidan and his team remain above consensus on the direction of short rates. Specifically, they are looking for the ECB deposit rate to peak at 3.75% by September 2023, with cuts beginning only in mid-2024 and the depo rate ultimately resting at 2.5%.

Exhibit 1

Like the U.S., Services Over Goods Is Also the Story in Europe



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

- **It is not too late to invest behind our KKR theme of 'experiences over things' in Europe.** Travel and tourism are booming, but we think that 'revenge spending' will boost the services share of GDP from below trend to well above trend. Indeed, similar to what happened after World War II and 9/11, consumer spending on travel, dinners, entertainment, etc., will surprise on the upside, despite a lack of real wage growth. Meanwhile, data, towers, and parts of telecoms are still very investible themes.

- **Europe is near the top of the pack on two other global mega-investment themes: the energy transition and the security of everything**. There are no red versus blue state debates in Europe. Everyone is behind the energy transition, and as such, Europe has emerged as a leader in this area. At the same time, Russia's invasion of Ukraine has accelerated the 'security of everything'. Redundancy spending on energy, data, transportation, and security are providing an important buffer during this slowdown. Meaningfully, it is taking the form of both opex and capex this cycle.

- **Brexit has led to a different experience for the United Kingdom than in the rest of the Eurozone**, as supply-side disruption in several spheres has compounded inflationary pressures despite anemic growth when compared to the rest of Europe. The readjustment of supply chains and increased red tape have kept food inflation high. Also, at the height of the energy crisis, limited gas storage led to greater price volatility. Finally, the structurally tight labor pool (with net migration from Europe falling off) has kept alive the specter of a wage-inflation spiral. All of these factors have tested the relative dovishness of the Bank of England.

So, despite a lot of negative investor sentiment, most of what we saw and heard during our trip has reinforced our conviction that the Eurozone will again put up an acceptable GDP growth number in 2023. Specifically, we note the following:

1 We stick to our GDP forecast of 0.8% in 2023, followed by 1.1% in 2024. As a result, we are slightly more bullish than consensus, which is at 0.6% real GDP growth, and similarly for 2024, where consensus is at one percent.

2 Meanwhile, we shave our inflation forecast for this year slightly, to 5.8% from 5.9%. Investors should be aware that under the surface, there is more strength in both real activity and inflation than meets the eye. Importantly, though, we stick to our bearish tilt on monetary policy.

3 In terms of policy, we think investors need to be ready for a peak ECB deposit rate of 3.75%, versus 3.25% today, and a peak BoE bank rate of 4.75%, versus today's 4.25%. While these peak rates are lower than in the United States, they do represent a substantial increase relative to recent history as well as relative to structural growth in the region.

Our bottom line: Given our view on a higher resting heart rate for inflation, rising geopolitical tensions, and tighter financial conditions, we continue to advocate to 'Keep It Simple' when it comes to investing and to move from a 'Walk to a Jog' when it comes to deployment. Simply stated, unlike in 2021/2022, we believe today that it is possible to make a very good return in this market without having to stretch for risk, especially at the front end of the liquid credit markets. Meanwhile, we also think 2023 will be a very good vintage for private markets investments.

In terms of our key investment priorities, we continue to advocate aggressive deployment around Infrastructure, Asset Based Finance and Real Estate Credit. These three areas all represent elegant vehicles to play our focus on collateral-based cash flows in a world of both a higher resting heart rate for inflation as well as well as lower real rates. Second, we see more corporate carve-outs and public to private investments across Private Equity. Finally, we left Europe more bullish on our client solutions approach within KKR's Portfolio Construction team led by Racim Allouani. In particular, we see two emerging opportunities:

In terms of client flows, we are seeing more large pensions, family offices, and insurance companies that want to reposition their portfolios away from legacy assets towards a more 'current' or newer vintage pool of assets that harnesses the attractive short-term rate curve now offered in both Europe and the United States. Importantly, given that Cash and other short-term investments are typically non-correlated with the rest of their portfolios, this new asset allocation mix is allowing risk budgets to own more illiquid investments that have better upfront income, a higher Sharpe ratio, and/or a better total return.

Meanwhile, within the wealth channel, we are seeing greater interest in KKR's democratized products that can help create solutions for individual investors. It is still early days, but we think that there is the potential for leading wealth distributors to provide customized alternative solutions on both a discretionary and non-discretionary basis.

Details

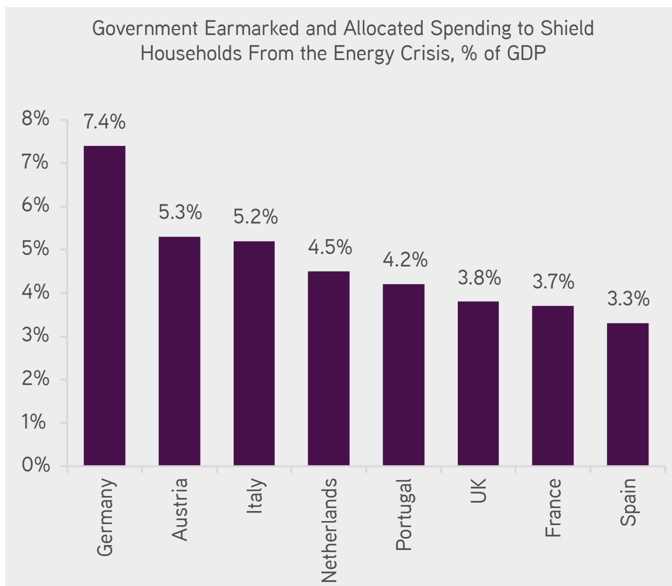
Overall, we left our meetings in Europe with renewed conviction in an upward path for GDP (as noted, we are looking for 0.8% in 2023 and 1.1% in 2024). On inflation, we believe that pulling core inflation back to two percent will be a more difficult task than markets currently expect. That is why we believe it is too soon to relax on interest rates – investors should be prepared for a peak 3.75% ECB deposit rate and a 4.75% U.K. bank rate.

Given this backdrop, we spent time thinking through what the consensus might be missing. We note three factors that the 'bears' may have missed:

1. **Macro data continues to surprise on the upside**. China's recent lift in activity is helping export activity in the Eurozone. Maybe more important, though, is the fiscal tailwind on key initiatives such as the transition towards 'Green' as well as subsidies to smooth out higher energy costs. Indeed, EUR 600 billion of the 1.8 trillion NextGenerationEU Recovery Plan is earmarked to finance the European Green Deal.

Exhibit 2

Governments Set Aside Large Sums of Money to Shield Consumers From the Energy Shock...

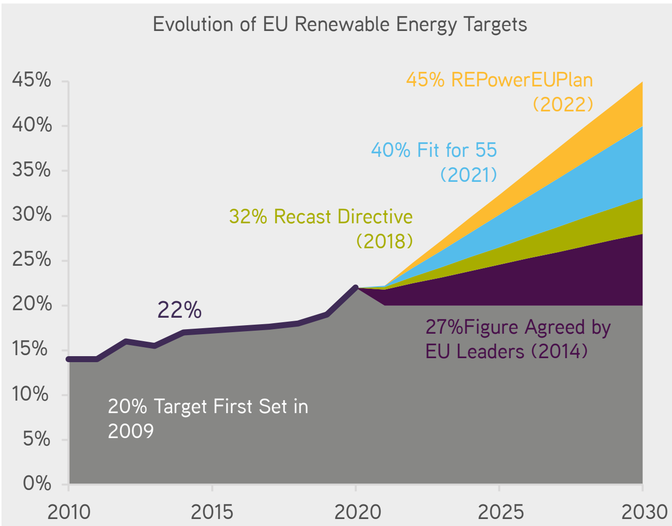


Data as at February 28, 2023. Source: Bruegel.

Energy storage initiatives are paying off, and prices are falling too.

Exhibit 3

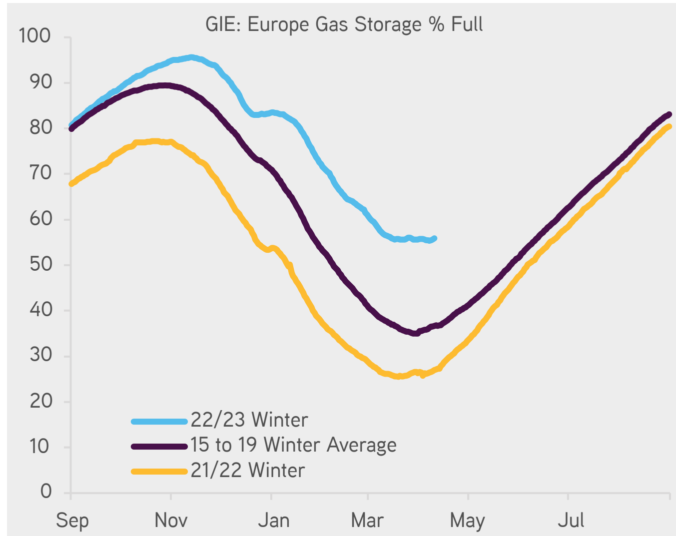
…But the Energy Crisis Has Only Strengthened European Climate Ambitions



Data as at April 20, 2023. Source: European Commission.

Exhibit 4

European Gas Storage Levels Continue to Be Healthy



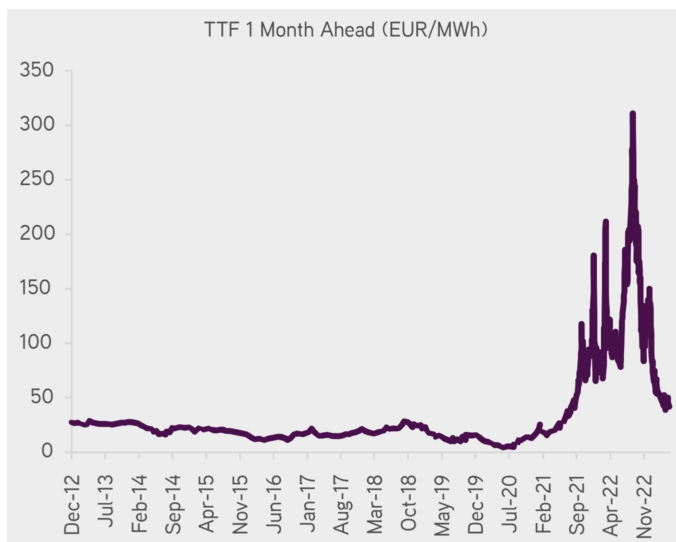
Data as at April 20, 2023. Source: Bloomberg.

2. **More workers are coming to work**. Unlike in the United States, 55+ and older workers are not leaving the workforce. The Ukraine war is also driving immigrants into the core[1] countries of Europe. So, both the participation rate as well as the number of new workers is much better than expected in 2023.

3. **Energy storage initiatives are paying off, and prices are falling too**. As we show in *Exhibits 4* and *5*, Europe will enter summer 2023 with record levels of gas storage, with gas prices down over 60% year on year, and baseload energy prices in Germany down 85% from peak. Demand switching has kept industrial production healthy, although current prices are in the band where producers may find it economical to switch back to gas, providing a floor to gas prices.

Exhibit 5

European Gas Prices Have Fallen Back Significantly



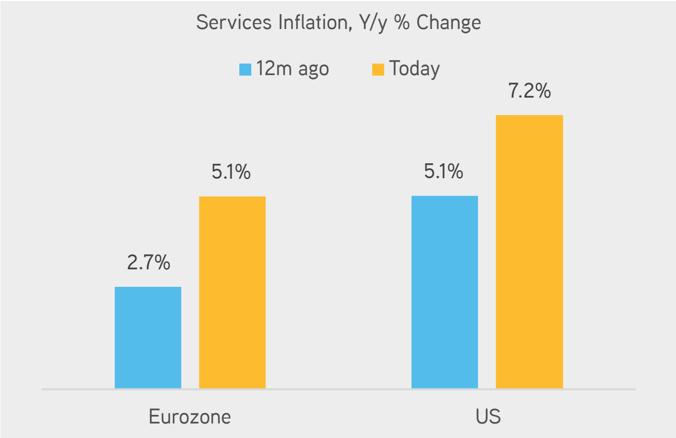
Data as at April 20, 2023. Source: Bloomberg.

1 European core countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

Similar to the U.S., Europe is seeing 'sticky' inflation. We have seen core inflation in Europe relentlessly pick up pace over the last 20 months, from 0.7% in July 2021 to 5.7% in March 2023, with no clear indication as of yet that tighter monetary policy has fed through to slower economic activity. Services inflation in the Eurozone has ratcheted higher in the past two quarters; however, unlike the U.S., goods inflation in Europe still remains a problem. Indeed, while falling energy prices have slightly pulled down goods inflation, it remains very high at 8.1% (*Exhibit 7*). Furthermore, the broadening out of inflationary pressure has seen even non-energy industrial goods inflation running at 6.6%.

Exhibit 6

Services Inflation Continues to Rise in Both the U.S. and Europe



Data as at April 20, 2023. Source: Bloomberg.

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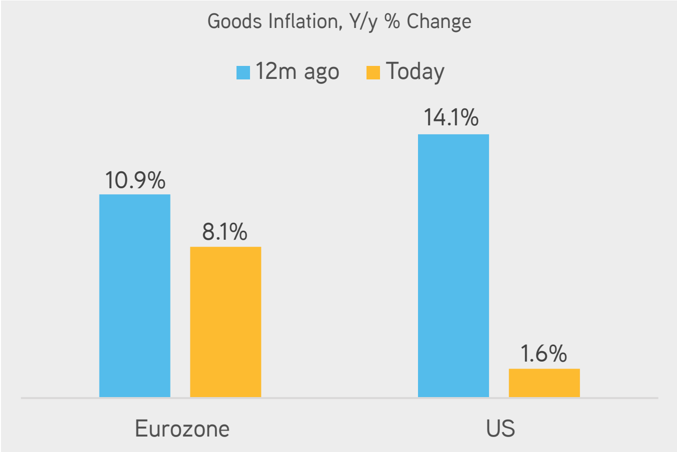
Exhibit 7

Europe Still Has a Goods Inflation Problem Despite Falling Energy Prices



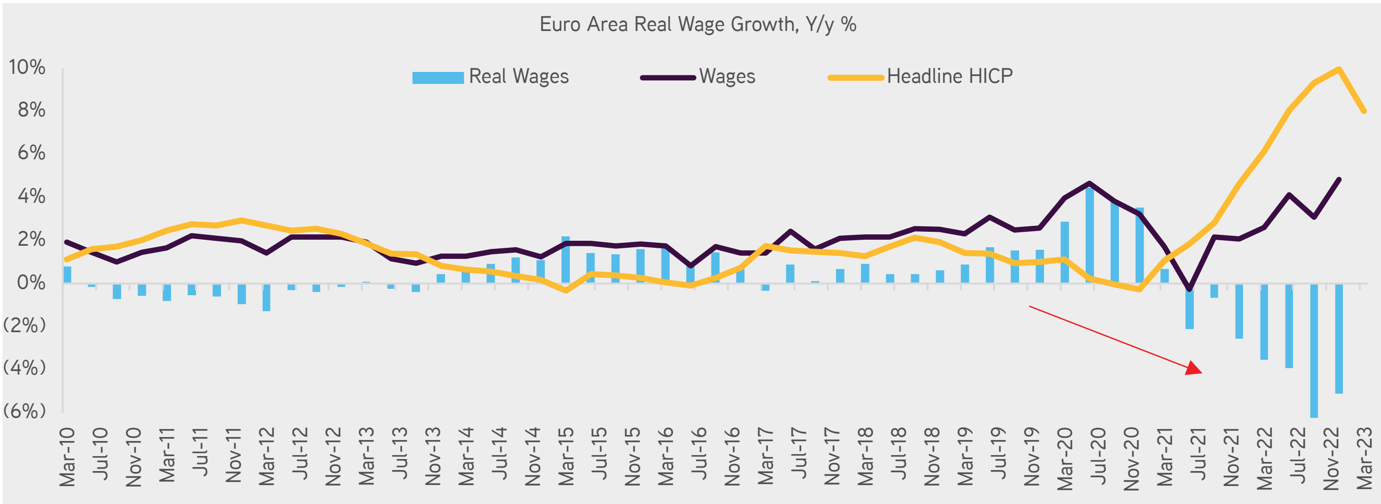
Data as at April 20, 2023. Source: Bloomberg.

Against this backdrop, how is the European consumer doing? As we show in *Exhibit 8*, real wage growth in the Eurozone remains very negative, driven primarily by residual energy costs as well as price increases for a broad array of consumer goods, especially services. There are, however, several important offsets.

First, unemployment remains low, while excess savings from COVID are providing an important buffer. Interestingly, though, as we show below in *Exhibit 9*, households have been slow to spend their extra cash. We take this signal as a positive one that partly reflects fiscal support that has offset some of the energy expense.

Exhibit 8

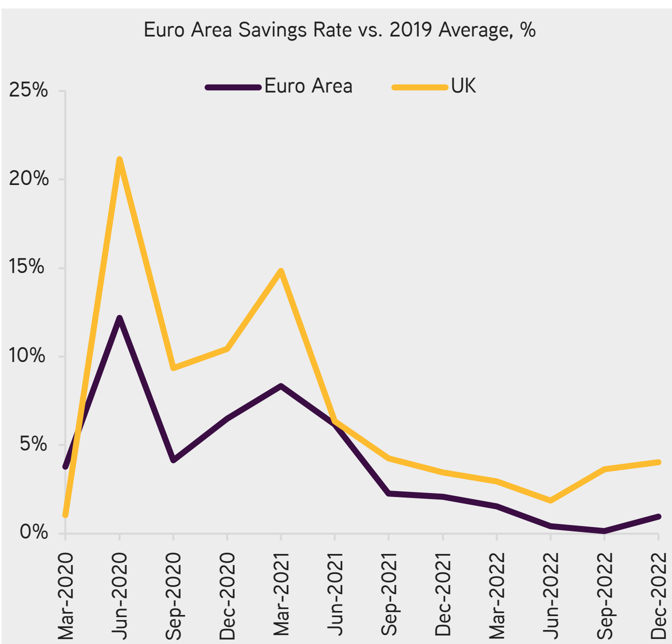
Inflation Continues to Eat Into Household's Purchasing Power



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

Exhibit 9

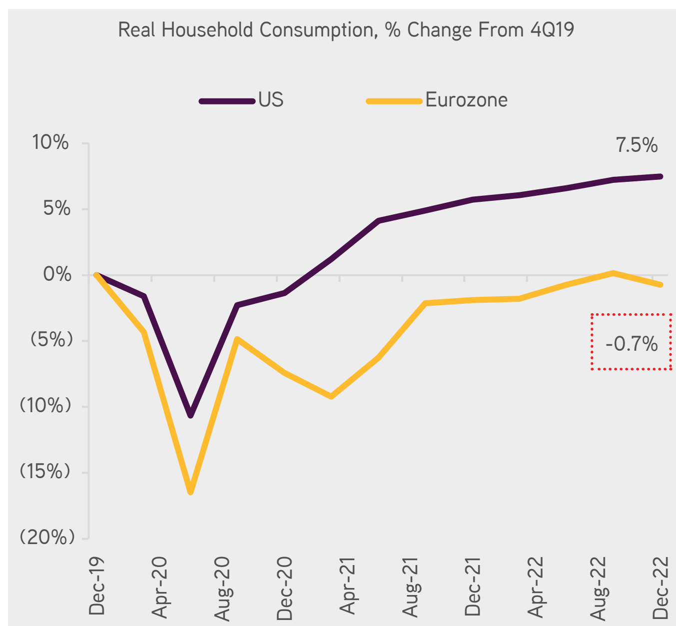
Households Have Been Slow to Spend the Extra Cash Amassed During the Pandemic...



Data as at December 31, 2022. Source: Eurostat, ONS.

Exhibit 10

...With Eurozone Consumption Running 70 Basis Points Below 2019 Levels

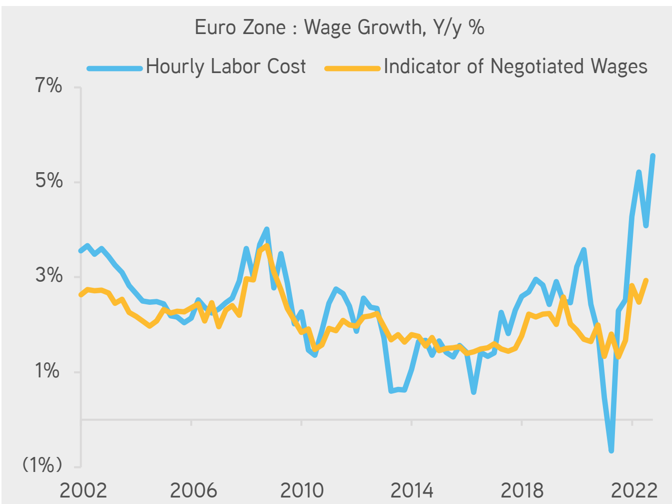


Data as at December 31, 2022. Source: BEA and Eurostat.

Second, nominal wages are continuing to grow handsomely. While not quite enough to offset the higher cost of living (real wages have fallen notably this year), we have seen that wage agreements are providing meaningful support to the consumer. We believe that these will continue into 2024, even as the cost of living crisis eases further.

Exhibit 11

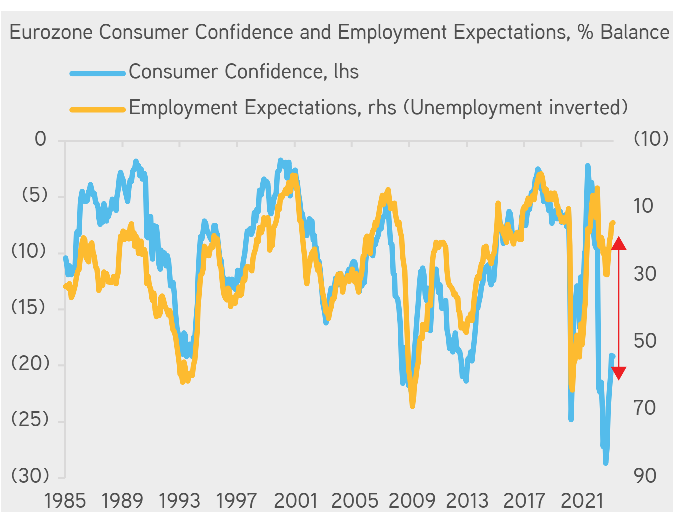
Nominal Wage Growth Is Running Historically Hot at 5.6%



Data as at December 31, 2022. Source: European Central Bank.

Exhibit 12

Consumer Confidence Has Sagged Despite Strong Employment Expectations

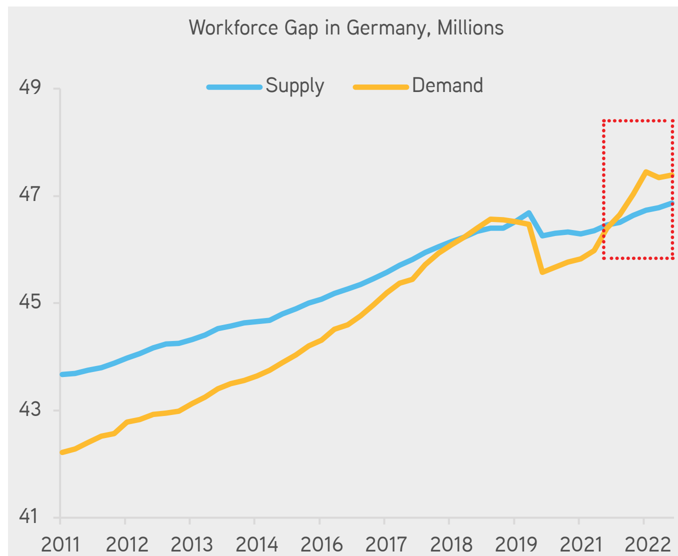


Data as at March 31, 2023. Source: European Commission, Haver Analytics.

Third, we continue to see long-term thinking by Eurozone companies who are reluctant to let staff go, understanding that it may be difficult as well as costly to rehire and retrain down the road. This 'labor hoarding' was a big feature in the pandemic, but we believe it is no less relevant to the macro picture today. This is a trend that may surprise some investors, but it is actually a feature of an aging society where labor supply is scarce. Indeed, this is a major structural support to the economy which many investors miss.

Exhibit 13

Despite Slowing Growth, Labor Demand Continues to Outstrip Supply in Germany…



Data as at December 31, 2022. Source: Institute for Employment Research, Federal Statistical Office, ONS.

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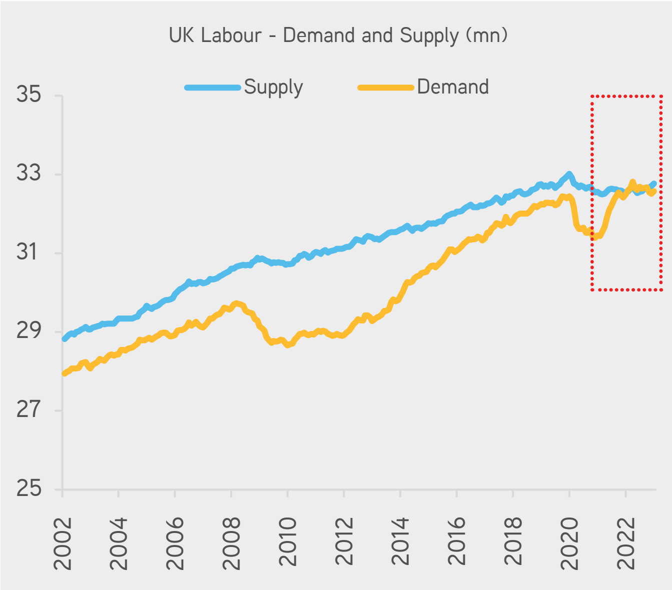
Exhibit 14

...With a Similar Picture in the U.K.



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

Which themes resonated the most during your trip? As we summarized above, Europe's private markets are flush with investment themes, many of which are not directly investable in the public markets. In Germany, for example, we learned more about our recent investment in Korber, a portfolio company focused on global supply chain software management. We think software is a play on both energy efficiency as well as automation, two mega trends. Importantly, many of these types of entrepreneurial companies in Europe, Germany in particular, are not publicly traded. All told, the technology sector in Europe is just eight percent of market cap, compared to 38% in the U.S.

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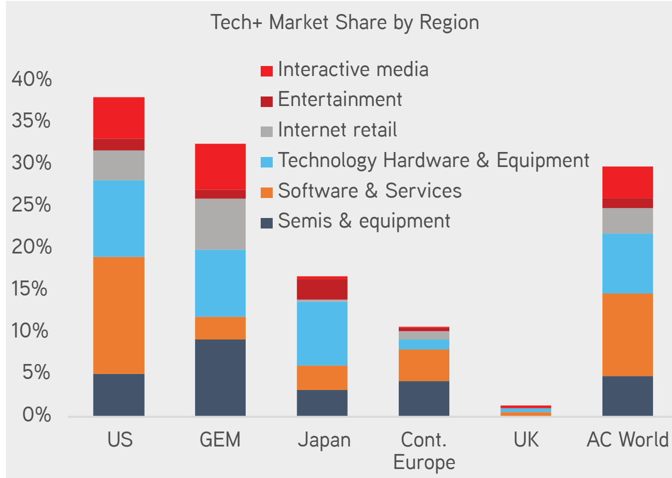
Exhibit 15

Tech Is Underrepresented in European Equity Markets

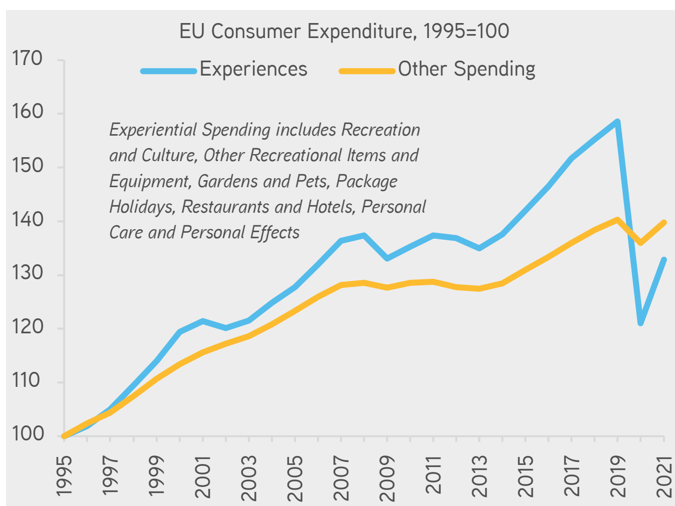


Data as at October 31, 2022. Source: MSCI, Datastream.

Meanwhile, we think that tourism and other travel services will continue to surprise on the upside. Stepping back, spending on experiences in Europe was structurally outperforming spending on goods in the decades running up to COVID, and still has significant room to expand as it returns to its pre-COVID trend. Travel is one of this trend's key components.

Exhibit 16

We Still See Significant Upside for Consumer Spending on Experiences



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

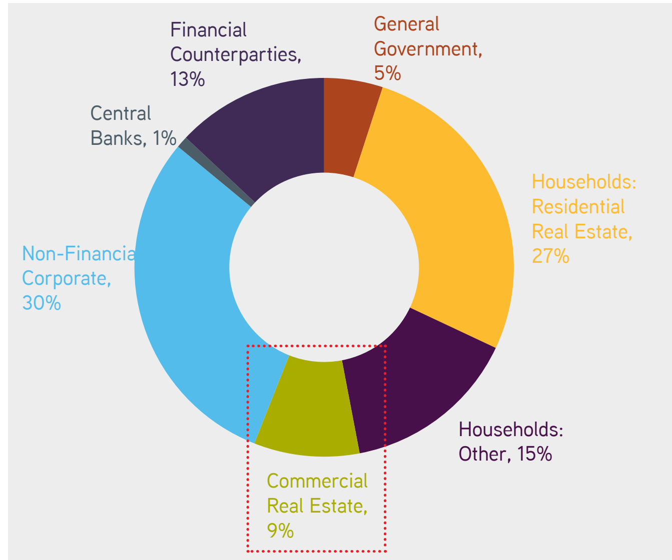
Within services, we are also bullish on financial advice. The reality is that despite challenging demographics, Europe is a wealthy place and its higher income citizens are now demanding more financial services, including portfolio construction, tax planning, and estate planning. Indeed, EU households hold around €35 trillion of financial assets, compared to €9.1 trillion of financial liabilities.

Europe is not the USA when it comes to commercial real estate. The current real estate dislocation is a global phenomenon. However, what distinguishes Europe somewhat is that the exposure of banks to commercial real estate (CRE) appears to be manageable, with only about nine percent of the total loan book in CRE as well as generally conservative loan to value ratios. That said, we are looking for continued dislocation in real estate markets, particularly in those markets where variable rate mortgages or mortgages fixed for a relatively short period are the norm (notably Sweden and the UK). While there is undoubtedly pain in the housing market, there is an important support that many investors miss: the continuing weak housing supply in most major European countries. That is the reason why we believe the downturn in this housing cycle will be relatively mild by historical standards.

However, what distinguishes Europe somewhat is that the exposure of banks to commercial real estate (CRE) appears to be manageable, with only about nine percent of the total loan book in CRE as well as generally conservative loan to value ratios.

Exhibit 17

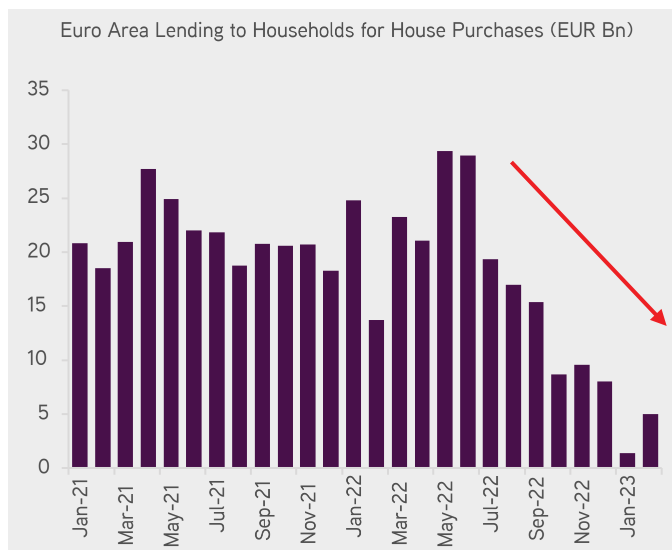
Out of €16 Trillion in European Bank Loans, Only Nine Percent Relates to Commercial Real Estate



Sample of major European banks, covering around 80% of total EU banking system assets. Data as at June 30, 2022. Source: European Banking Authority, Goldman Sachs.

Exhibit 18

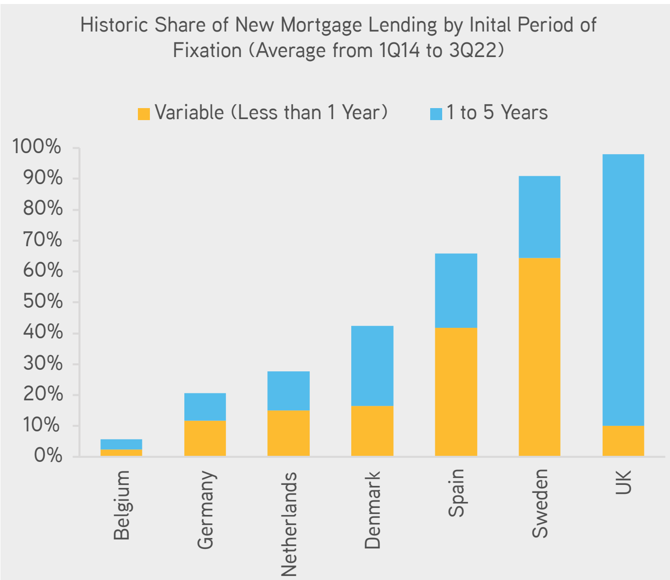
Eurozone Lending for Residential Real Estate has Collapsed Over the Last Six Months



Data as at February 28, 2023. Source: European Central Bank.

Exhibit 19

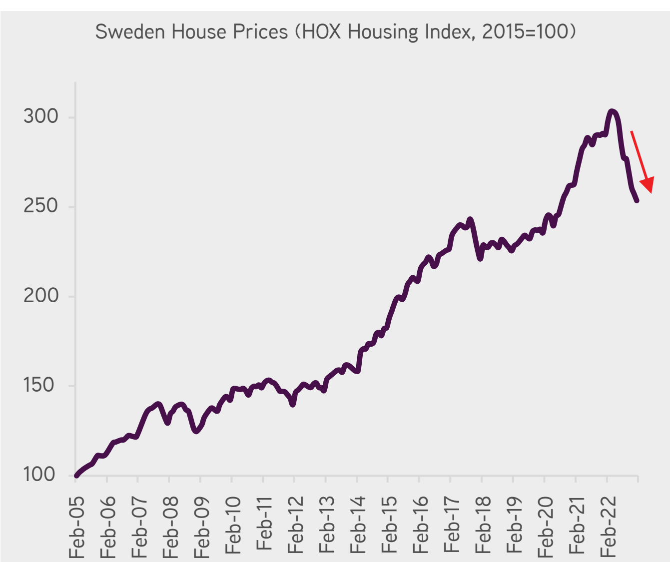
Sweden Stands Out With a High Share of Variable Mortgages, as Does the U.K. With Many Fixed Only in the One to Five Year Range



Note: Mix can differ substantially in outstanding stock. Data as at September 30, 2022. Source: European Mortgage Federation.

Exhibit 20

House Prices in Sweden Have Fallen ~15% From Peak



Data as at January 31, 2023. Source: Valueguard, Bloomberg.

Conclusion: Europe Is Still Moving Forward

Despite all the cross-currents affecting Europe these days, the economy is still moving forward, creating significant opportunity for investors. In particular, we finished our trip with high conviction on the following areas of the European economy:

1. **Europe is a clear, notable leader in the energy transition**. Russia's invasion of Ukraine has certainly turbo-charged an existing movement towards a cleaner, less carbon-intensive footprint. Importantly, we still think that we are in the early days, and we see multiple capital needs across a variety of sectors where private investors can deploy capital in the coming years.

2. **Our trip to Germany was a good reminder that there is a significant opportunity for private investors to partner with family-owned businesses that are considering a transition.** This backdrop is bullish for Private Equity, Infrastructure, and Real Estate, in our view, and as we look ahead, we expect these partnerships, including Germany's compelling Mittelstand[2], to rival corporate carve-outs as one of the most important investment themes over the next few years.

3. **We remain bullish on services after our trip.** Across Europe, airports are full these days, as travel regains momentum. We expect this movement to continue. Indeed, if we connect the dots with our most recent trip to Asia, we believe that global mobility is on the rise. We think that this tailwind will lead to more dollars spent on sports, recreation, dining services, etc. Meanwhile, demographics in Europe cause us to be structurally constructive on financial planning, chronic diseases and chronic care, and mobility.

4. **The security of everything is playing out in full force in Europe.** Aidan and I believe that the 'security' of not only energy (see *Exhibit 3*, which shows renewable energy

2 Mittelstand are mid-sized companies that are characterized by a common set of values and management practices.

going to 45% by 2030 from 20% in 2020) but also transportation, data, and food are now front and center with both politicians and CEOs.

5. **Expect a more hawkish tilt from the ECB for some time.** The ECB's single tilt on inflation – and not inflation and growth – is an important differentiator. Given our view on the stickiness of inflation this cycle, this insight leads us to believe that the ECB will need to not only get to 3.75% on short rates, but also that it will not ease quickly and will push through additional Quantitative Tightening over time.

Looking at the big picture, we continue to encourage investors to increase their pace of deployment back from a 'Walk to a Jog'. We are now 14 months into a bear market. Recall that the average bear market is around 14-18 months – so time is now on our side. To be sure, the next few quarters will be challenging from a growth perspective, but therein lies the opportunity, we believe, especially given the negative sentiment that is now so pervasive about the region's future prospects.

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Important Information