Thoughts from the road

EUROPE | November 2023

I recently traveled in the United Kingdom and Germany with Aidan Corcoran, who heads our European macro effort, visiting with policy makers, CEOs, and clients. Our key take-aways from this latest trip are as follows:

- **Across much of Europe, we continue to expect slow growth and/or another stall-speed recession in the coming quarters**. Importantly, however, we do expect to see some consumer resilience in 2024, as real wages begin to turn more positive and monetary policy becomes less restrictive. We stick to our 80 basis points Eurozone Real GDP growth forecast in 2024 (now slightly above consensus at 70 basis points).
- **We see the Bank of England on hold for longer than most developed market central banks; by comparison, we think that the ECB could turn more dovish more quickly**. Importantly, as we detail below, one of the ECB's favorite measures of inflation (the persistent component of core inflation index) has hooked down.
- **Changing of the economic guards?** When Europe had its sovereign debt crisis about a decade ago, it was Germany, the U.K., and the Netherlands that provided the economic ballast. Today, by comparison, these countries are each feeling the pinch of a slower China, the adverse impact of Russia/Ukraine on their energy

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policies, and more regulatory complexity. As a result, the economic momentum since COVID has been coming more from the traditional 'periphery', including Spain, Greece, and Italy.

- **On the investment front, we continue to spend time with companies within sectors that don't necessarily rely on traditional macro tailwinds**. In fact, in many instances, areas such as automation and fertility have emerged as attractive opportunities as they offer solutions to structural issues that are impacting growth in Europe (e.g., lackluster demographics). Meanwhile, tougher bank regulation is leading to more private lending and more risk transfer opportunities for opportunistic pools of capital, while over-indebtedness of both public and private entities is leading to some noteworthy corporate carve-out and divestiture opportunities. During this trip we also met with several growth companies that are eager to expand outside of their home countries and/or take their products and services to the United States or Asia. Finally, Europe continues to be a leader in several secular growth areas such as decarbonization and data.

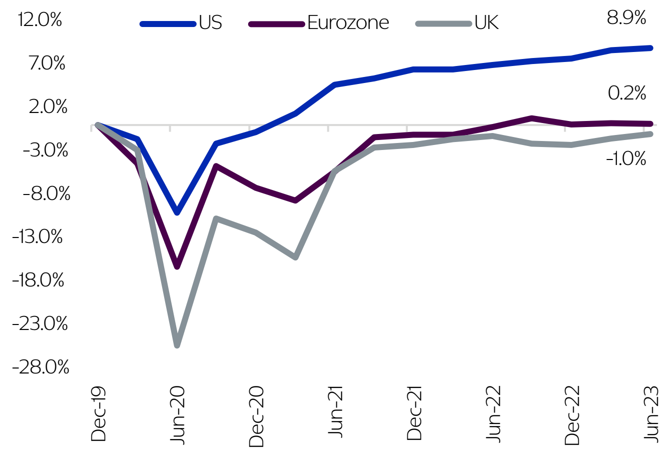
POINT NO. 1

Growth

We expect continued slow growth across much of Europe into early 2024, with improving momentum as the year progresses. Higher input costs, lower confidence, and increased regulation all left us feeling that there is very little upside to our current Eurozone Real GDP growth forecast of 80 basis points. However, the downside risk is also limited by the weak performance of the economy post-COVID, which we expect to continue in the second half of 2023. To borrow from an old adage, it is really hard to hurt yourself falling out of the basement window. Said differently, Europe's growth has been slow of late as it never regained demand-driven momentum (as say, the U.S. did) post-COVID. One can see this in *Exhibit 1*. As such, a surprise downside shift to growth would only amount to another retrenchment *back* towards the anemic level demand backdrop the economy would have just exited.

Exhibit 1: Household Consumption in Europe Has Struggled to Return to Pre-COVID Levels

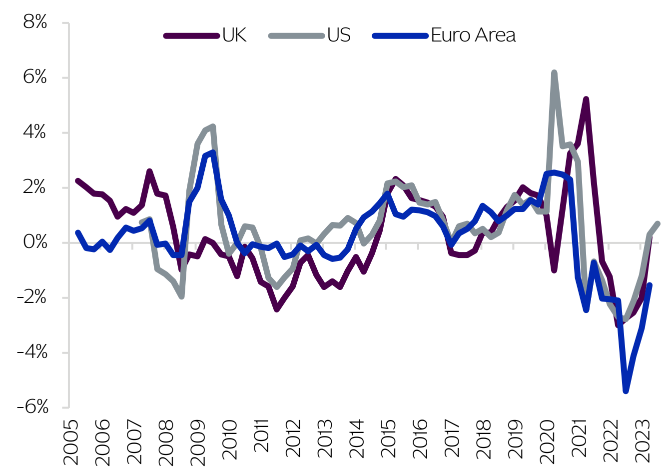
Real Household Consumption, % Change From Q4 19



Data as at June 30, 2023. Source: U.S. Bureau of Economic Analysis, Eurostat, ONS. Global Macro & Asset Allocation analysis.

Exhibit 2: European Real Wage Growth Is Lagging the U.K. and the U.S.

Euro Area, the U.K. and U.S. Real Wage Growth, Y/y %



Data as at June 30, 2023. Source: BEA, Eurostat, ONS, Global Macro & Asset Allocation analysis.

The U.K. outlook is more tenuous, as higher fuel costs, less immigration, and less savings since BREXIT and COVID are all weighing on the outlook. One can see this in *Exhibit 1*, which shows real household consumption in the United Kingdom lagging its global peers. To solve these issues, the U.K. will need to drive more productivity growth, to use savings as a domestic growth lever (rather than investing those savings abroad), and to reinvest into growth markets, including, for example, more life sciences (which is already a 100 billion GBP business with almost 10% growth), financial services, and the energy transition. It also likely needs to reinvest in its healthcare system's efficiency and effectiveness, so that it can get its labor participation rates back up to more competitive levels.

Overall, we expect some economic normalization between the U.S. and Europe in 2024. Simply stated, the U.S., with its huge fiscal impulse (which is why its ratings are falling) is probably over-earning at the same time that Europe is under-earning. Indeed, as we show in *Exhibits 3* and *4*, the U.S. fiscal impulse has driven what appears to be an unsustainable gap in consumption between it and Europe in recent quarters. We expect this gap to narrow next year. However, it is not just that the U.S. faces tougher year-on-year growth comparisons. Rather, we now think that Europe will begin to spend more of its excess savings, as falling inflation supports real disposable income and monetary policy potentially becomes less restrictive (see below on rates). In addition, job growth remains solid, and vacancy rates (the number of job vacancies over current employment) are at three percent in the Eurozone (vs. a long-term average of 1.7%), hovering just off highs since the data began to be tracked in 2004.

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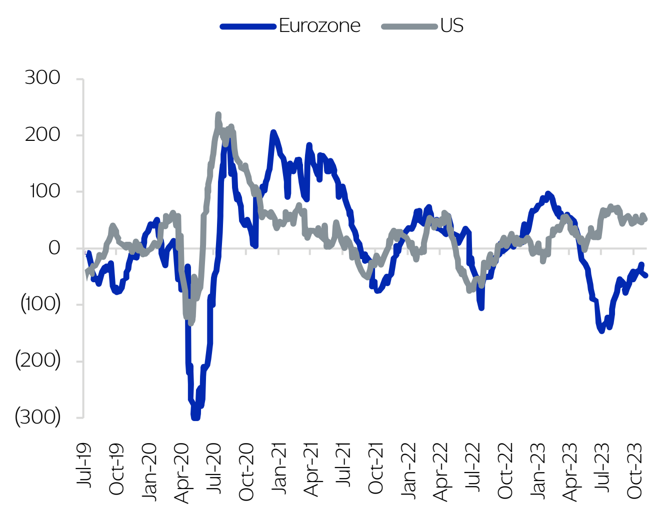
Exhibit 3: European Economic Data Surprises Have Been Persistently Bad, Especially Relative to the U.S.

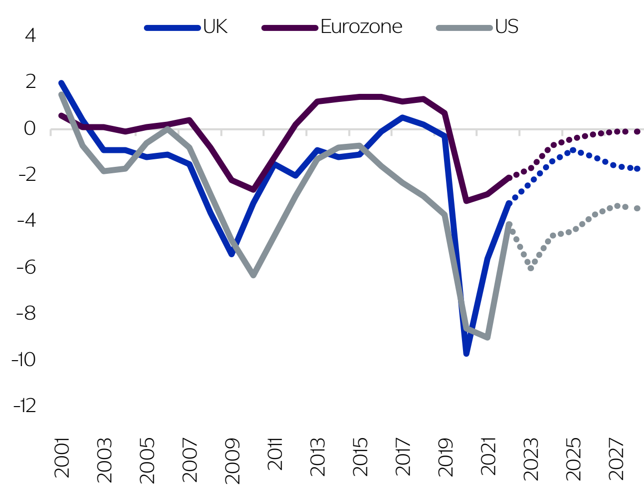
Citi Economic Surprise Index



Data as at July 31, 2023. Source: ONS, Eurostat, Bureau of Labor Statistics, Global Macro & Asset Allocation analysis.

Exhibit 4: Europe Has Not Enjoyed as Much of a Fiscal Boost, But This Means It Will Also Require Less Tightening

Cyclically Adjusted Primary Budget Balance, % Of GDP, IMF Forecasts



Data as at October 31, 2023. Source: IMF World Economic Outlook, Global Macro & Asset Allocation analysis?

That said, there are some more structural forces at work that are denting longer-term business pyschology in Europe. In addition to higher rates and higher fuel costs in a country like Germany (which over indexed to natural gas versus nuclear under former Chancellor Merkel), Europe's industrial sector is also feeling the structural slowdown that China is experiencing, as Chinese nominal GDP growth dips by two-thirds to seven percent, from 21% just a few years ago. Unfortunately, this overhang will not likely reverse course overnight. Meanwhile, NIMBY (not in my back yard) attitudes and regulations are slowing the pace of development in key European real estate markets and infrastructure development projects. Finally, unlike in 2011 (when I joined KKR, and most governments were strong majorities that could get legislation through with minimal resistance), politicians today in Europe are hamstrung by coalitions that are deeply divided on key issues such as immigration, Russia/Ukraine, taxes, and labor representation.

Importantly, Germany is not alone. Several of the traditional steady growers across the region, including the U.K. and Netherlands, will need to overcome a sluggish global economy and continued high energy and other input costs amid high inflation. At the same time, the Nordic region is still feeling the adverse effect of over-stimulating its housing market. By comparison, we see countries such as Spain and Greece, which were much maligned during the 2011 austerity campaign in Europe, actually performing better this cycle (helped by Europe's Recovery and Resilience Facility).

POINT NO. 2

Central Bank Policy

While the Bank of England will likely not tighten further, it may also not be able to cut rates too quickly, either. The exit of 55+ year-old workers from the labor force post-COVID, less dynamic immigration, and higher input costs have led to a meaningful negative supply shock with inflationary implications. So, consistent with this, Huw Pill, the Bank of England's Chief Economist, has said that UK policy rates may follow a Table Mountain path (a reference to the long flat mountain overlooking Cape Town, South Africa) pointing to a higher for longer approach, as opposed to a Matterhorn-type interest rate cycle (quick acceleration up followed by rapid rate cuts on the way down).

Meanwhile (and on a more positive note), it does feel like the ECB could turn more dovish faster than in the United States or in the United Kingdom. President Lagarde has noted that one of her key indicators that track what she calls persistent inflation is improving, and in fact has already fallen back to 2.1%. True, this measure of inflation excludes volatile components like food and energy, but this suggests we are potentially returning to a point where the ECB needs to weigh the weakening core inflation measures as much as the volatile headline measures. As such, we would not be surprised to see the ECB easing as soon as the second quarter of 2024.

Exhibit 5: One of the ECB's Favored Inflation Metrics Is Already Effectively In Line With the Two Percent Target

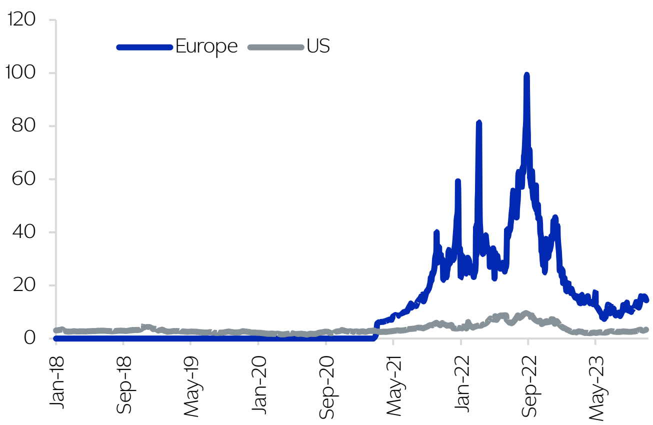
ECB: Eurozone HICP Persistent and Common Component of Inflation (PCCI), Core, %

Data as at November 8, 2023. Source: Bloomberg.

Finally, the complicated macro picture is tempering price expectations, offering more opportunities for thoughtful asset allocators to deploy into what we think will prove to be an attractive vintage for private capital.

Exhibit 6: Gas Prices in Europe Are Approximately 4x Those in the U.S.

Natural Gas Prices ($/mmbtu)



Data as at November 10, 2023. Source: Bloomberg..

POINT NO. 3

Investment Opportunities

Despite a challenging macro backdrop in Europe, we continue to find interesting ideas that are almost a 'contra play' on tougher macroeconomic challenges. Let's start with ongoing labor shortages. Upward pressure on wages is driving what we believe is a secular upswing in automation/digitalization of the corporate sector. Against this backdrop, investments in areas such as fertility and warehouse software and logistics continue to make a lot of sense to us.

Ongoing capital charge pressure at the banks also continues to create opportunities in Direct Lending. We also expect more regulatory capital trades as banks look to improve balance sheet efficiency.

Third, our ongoing 'security of everything' thesis is – unfortunately – alive and well in Europe. Companies, we believe, will seek further ways to create redundancies that make them less dependent on China. At the same time, corporations in Europe will also look for more ways to find energy efficiency/independence. Not surprisingly, this region remains a leader in the pivot towards de-carbonization.

Fourth, as we have seen with recent deal activity by our KKR Europe investment teams, the need for both corporate and government entities to de-lever and create efficiencies is providing compelling opportunities for private capital. Moreover, all of this is occuring at a time when the data suggests that, the transportation and renewables sectors continue to see large shortfalls in capital expenditures that can only be filled by private capital.

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Conclusion

The European macro and market environment remains highly complex, harking back to the 'Adult Swim Only' days of 2016. Simply stated, now is not the time to make a macro bet on a sharp recovery in Europe; it is unlikely to come through, despite what we believe will be a more dovish ECB in 2024.

However, our conversations in Europe, especially with business leaders, left us confident that there are chances to turn potential macro headwinds into opportunities. For example, we see fertility clinics as a foil to slowing demographics or supply chain software/automation as a foil to rising labor costs. There is also currently a scarcity of capital in critical areas of the financial markets (consistent with our view that now is a good time to be a lender) as well as in growth industries such as data, transportation, and renewables. Finally, there are large scale opportunities in sectors where overindebted entities — both the public and private sector — may be looking for de-leveraging partners of choice. As such, we continue to think that any asset allocators who are pausing on Europe today, are probably passing up on one of the more compelling vintages that we will see for a while.

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