Keeping Perspective

By Henry H. McVey, Aidan Corcoran and Bola Okunade

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When I last visited Aidan Corcoran and Bola Okunade in London back in May, we left the various meetings we organized there with a decidedly more cautious outlook for the global economy, Europe in particular (see our note *Thoughts From the Road*, May 2022). While we are again trimming our growth forecasts and raising our inflation outlook, our changes are now more modest than in the past. More importantly, though, to us is that the sentiment of investors, companies and markets has – without question – 'caught down' to the realities that Europe is now facing heading into the fall, leaving us in a much more balanced position to consider the trade-offs between weak fundamentals relative to cheaper prices.

Exhibit 1

For the Eurozone, We Further Cut Our Real GDP Expectation for 2023

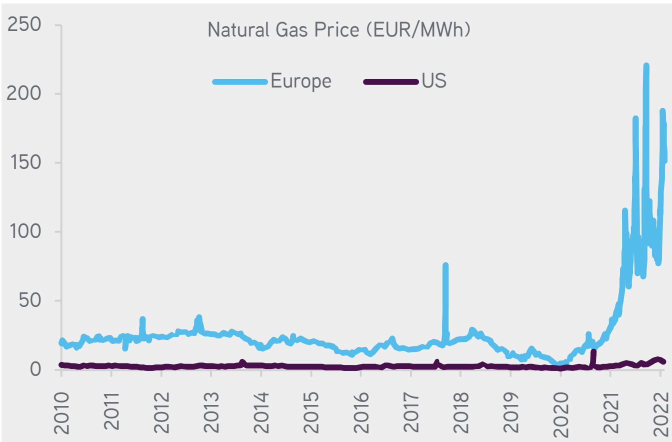
KKR GMAA Euro Area Real GDP Growth, %			
	New	Prior	Bloomberg Consensus
2022	2.3%	2.3%	2.7%
2023	0.3%	1.3%	1.3%

Data as at July 27, 2022. Source: KKR Global Macro & Asset Allocation analysis

No doubt, Europe faces a long list of headwinds (e.g., Mario Draghi's resignation, record U.K. inflation, the 'weaponization' of Nord Stream I, ECB hikes, etc.). Inflation is raging across both the U.K. and the Continent, driven by an energy crisis that likely exceeds that of the 1970s. However, the universal bearishness we encountered discounts a lot of these headwinds, which gives us confidence to now lean into dislocated opportunities. Indeed, if investing success is capitalizing on a variant perception relative to the consensus, as we believe it is, the surprise might be that Europe does not fully sink into the abyss by 2023. To be sure, we fully agree it is premature to 'call the bottom' before ISMs reach their floor (*Exhibit 4*), but I do know that sentiment today in Europe feels about as bad as it did in 2011 when I joined KKR. This is especially noteworthy, as my introduction to the firm coincided with the Greek debt crisis, when there were real questions about whether the Eurozone could hold itself together amidst material spread widening across most sovereign bonds and bank debt in Europe. Ultimately, that time period proved to be a good investing period for many investors, including KKR. Our deal teams avoided the noise and focused on long-term investment themes whose growth rates and business models ultimately overpowered a macro environment that proved to be extremely choppy for a prolonged period.

Exhibit 2

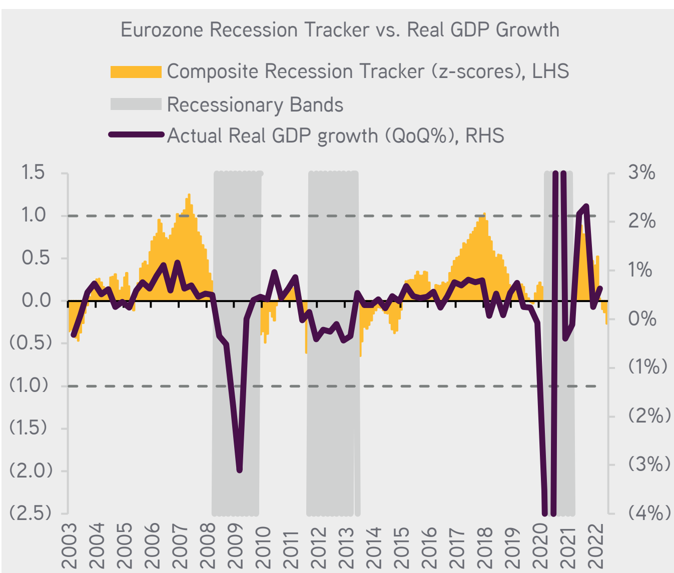
The Russian Invasion of Ukraine Has Destabilized European Gas Prices



Data as at July 22, 2022. Source: Bloomberg.

Exhibit 3

Surging Natural Gas Prices Are Further Confirming Our Recession Models' Cautious Tone

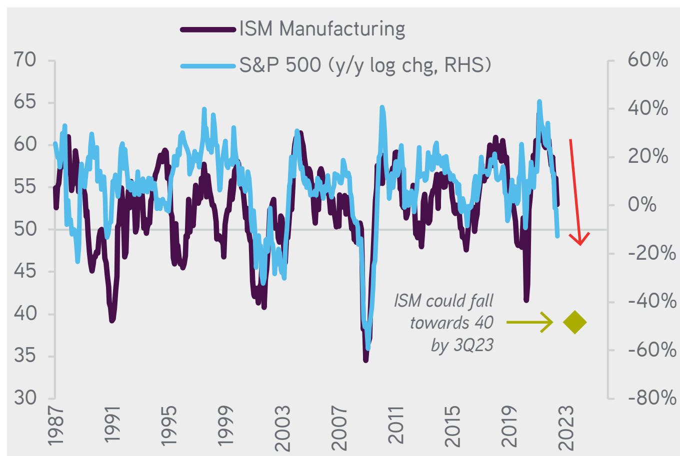


Data as at July 22, 2022. Source: KKR Global Macro & Asset Allocation analysis.

Importantly, we also know that markets bottom before earnings. One can see this in *Exhibit 5*. So, where should one look for opportunity? Credit fixed income issuance in Europe is now essentially shut down (*Exhibit 11*), a backdrop that will soon drive increased demand for private capital. Meanwhile, many stocks are down 20-30% in the public markets (and private market sellers are beginning to appreciate that the world has indeed changed). At the same time, mega themes like automation/digitalization, the security of everything, and the energy transition are all gaining, not losing, momentum. So, our call remains that now is not the time to run, but it is the time to walk (see *Walk, Don't Run*, June 2022).

Exhibit 4

We See ISM Heading Lower, Which Likely Means Earnings and Stocks Remain Challenged Until 2023



Data as at June 30, 2022. Source: BEA, Bloomberg, Haver Analytics.

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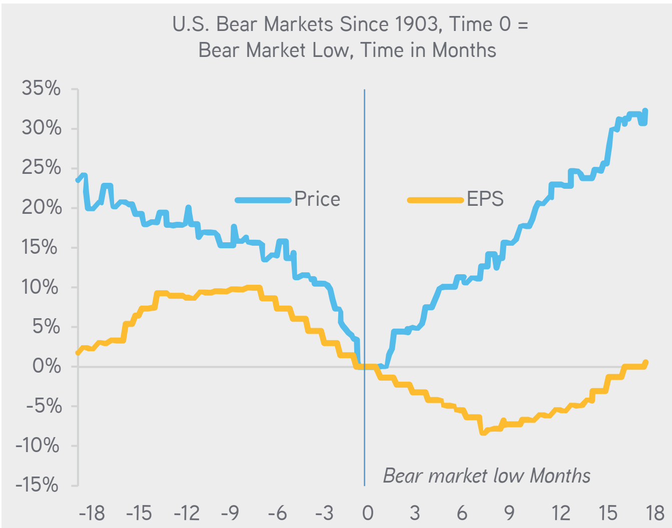
Exhibit 5

However, Let Us Not Forget That Price Recovers About 6-9 Months Before EPS Starts to Rise



Data as at July 21, 2022. Source: Robert Schiller, Goldman Sachs Global Investment Research.

Details

What are the key conclusions that we believe folks should consider in the years ahead? They are as follows:

Never let a crisis go to waste; expect Europe to lead in the global energy transition. When the sovereign debt crisis occurred a little more than a decade ago, it ultimately forced the Eurozone to become more integrated beyond being just a monetary union. Backstops were formed, banking laws grew more uniform, and fiscal outlays became more balanced across the north and south. These reforms were actually instrumental in helping the Eurozone respond to the COVID crisis in a faster and more balanced way. This integration also set the table for the recent announcement of the Transmission Protection Instrument (TPI), a mechanism that should allow the ECB to purchase unlimited amounts of country specific sovereign bonds. Indeed, ECB President Lagarde, in her recent press conference, made clear that she – like Mario Draghi before her – would do 'whatever it takes' to prevent an unfair tightening of financial conditions, especially in peripheral countries.

As we look ahead, our strong belief is that Europe's current energy crisis, which we view as the foremost clear and present danger from our trip, will likely vault the 'union' to the forefront of energy independence in the years ahead. No doubt this transition will be bumpy and – at times – brutal (i.e., rationing of supply is likely the base case if Europe has a cold winter), but it is accelerating the region's trajectory towards a carbon neutral footprint far faster than would have occurred under ordinary circumstances – and certainly faster than what we are seeing in many other parts of the world.

Exhibit 6

Europe Is Working Hard to Fill Gas Storage Ahead of the Winter Months

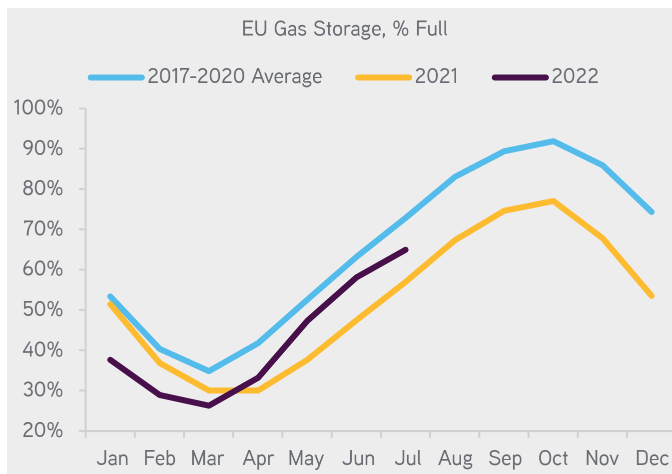


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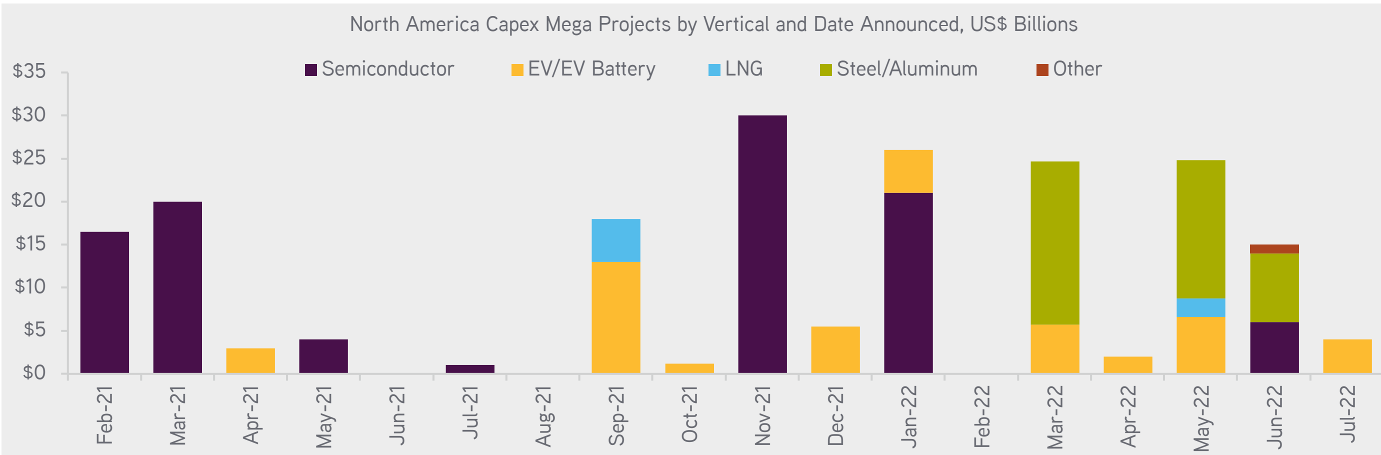
Exhibit 7

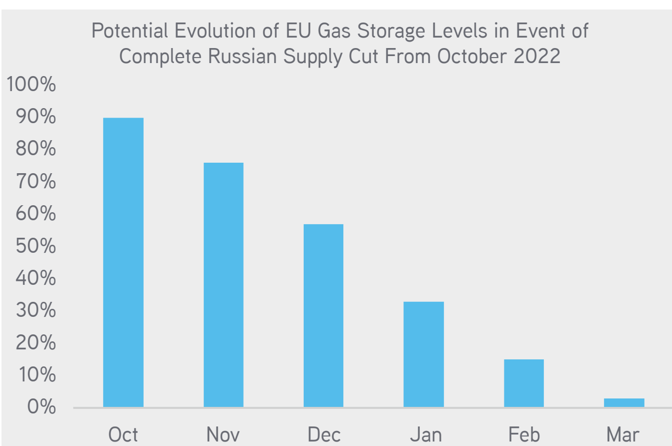
The Past Two Years Have Seen Nearly $200 Billion in 'Mega Project' Announcements in North America, Including More Than $40 Billion in Just the Last Few Months. Importantly, We See Similar Trends in Europe and Asia



Note: Data represents headline value of each project. LNG projects are listed by date of final investment decision (FID), close of financing and/or beginning of construction. Data as at July 14, 2022. Source: Melius Research.

Exhibit 8

In the Event of a Complete Shut-Off of Russian Gas, the IEA Estimates Europe Would Still Have Enough Gas to Last Thru March, Albeit Not Without Severe Disruption



Data as at July 14, 2022. Source: IEA.

From an investment standpoint, the physical damage being caused by rising temperatures and acts of war are turbo-charging our security of everything thesis.

However, it is not just the war that is driving the need to overhaul uses of energy. Record warm temperatures throughout the region are also top of mind. Forest fires in Greece, melting airport runways outside of London, and periodic power shortages/blackouts suggests to us that the focus of the ESG debate will now shift back towards the physical harm being caused by climate change versus the implementation of ESG standards (many of which have grabbed the headlines of late).

From an investment standpoint, the physical damage being caused by rising temperatures and acts of war are turbo-charging our security of everything thesis, including energy, food, water, transportation, supply chains, etc. Importantly, this trend towards resiliency is not just a European phenomenon. Rather, it is a global one, and it is leading to sustained capex spending on mega projects (*Exhibit 7*), despite slowing consumer spending.

The cost of capital has increased in Europe. Let's start with the ECB. Without question, the European Central Bank has shifted its posture. In fact, its late July announcement was the first time in 11 years that the ECB actually raised rates, and the first time since 2000 that it boosted rates by 50 basis points. Indeed, Christine Lagarde, head of the ECB, commented that now is the 'time to deliver' on bringing inflation under control. Aidan is forecasting a further 100 basis points of ECB tightening in 2022, including another 50 basis point hike expected again in September. Meanwhile, at the long-end of the curve, Aidan sees the 10-year German bund drifting all the way up to 2.0% by year-end 2023, compared to 0.96% at the moment.

Exhibit 9

Inflation Remains a Major Headwind in Europe

KKR GMAA Euro Area CPI Y/y % Changes		
	Headline	Core
1Q22	6.1%	2.65%
2Q22	8.0%	3.65%
3Q22	9.1%	4.5%
4Q22	8.6%	3.9%
1Q23	6.4%	3.4%
2Q23	4.3%	2.8%
3Q23	3.4%	2.4%
4Q23	2.5%	2.1%
Full-Year 2022	8.0%	3.7%
Full-Year 2023	4.2%	2.7%

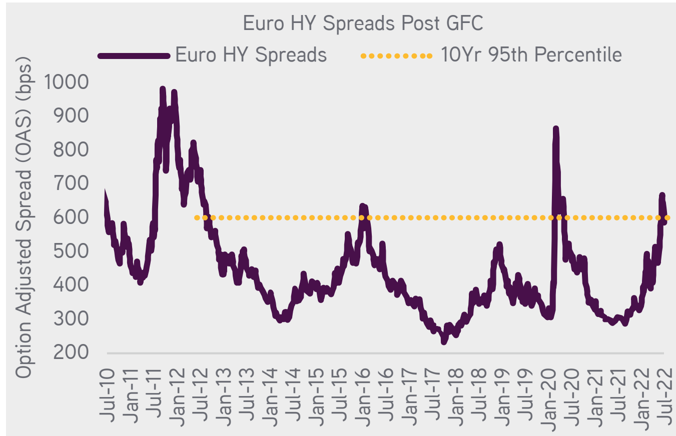
Data as at July 27, 2022. Source: KKR Global Macro & Asset Allocation analysis.

However, it is not just the risk free rate that is moving up. Spreads too have widened out. One can see this in *Exhibit 10*. Against this backdrop of rising risk free rates and spread widening, issuance has come to a screeching halt. Our base case is that debt capital markets in Europe stay shut until at least after Labor Day. If we are right, both growth companies and over-levered companies will need capital to sustain their businesses. In our view, this backdrop represents an emerging opportunity for us to pursue into the fall.

To our surprise, many of the companies with whom we spoke are actually enduring the 'storm' better than we would have imagined.

Exhibit 10

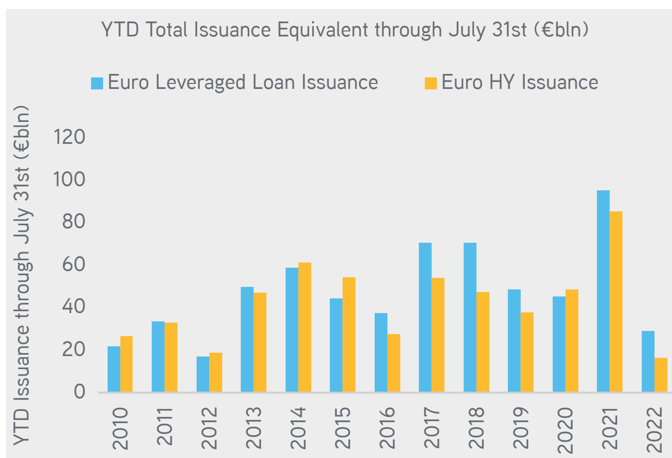
Euro HY Spreads Have Widened YTD and Are Now Approaching Previous Crisis Moments



Data as at July 21, 2022. Source: ICE, BofA, Bloomberg.

Exhibit 11

Euro Leveraged Loan and HY Issuance Is Incredibly Muted, With Low Levels Last Reached During the Euro Sovereign Debt Crisis

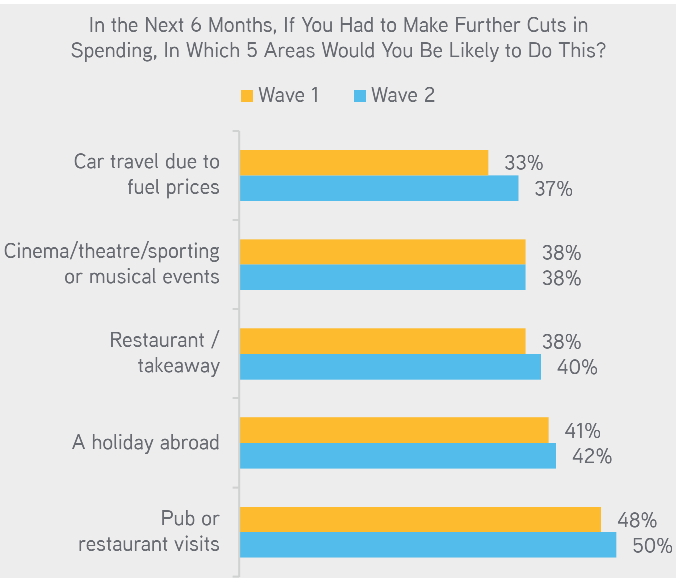


Data as at July 22, 2022. Source: Leveraged Commentary and Data (LCD).

To our surprise, many of the companies with whom we spoke are actually enduring the 'storm' better than we would have imagined. Many of these companies are services related, and many do not cater to the low end consumer, an area where we continue to see inflation eating away at both savings and annual incomes. Our key take-away is that consumers are cutting back on pubs, restaurants, and international travel. However, our visits across the corporate and macro community lead us to believe that borrowers are still paying their bills on mortgages, credit cards, and car loans. Unusually low unemployment rates, which we think will remain better than historical trends, are the key variables on which to focus, we believe, despite rising inflation eating into real incomes.

Exhibit 12

European Consumers Are Pulling Back on Discretionary Items More Than Fixed Expenses Like Rent and Car Payments, We Believe

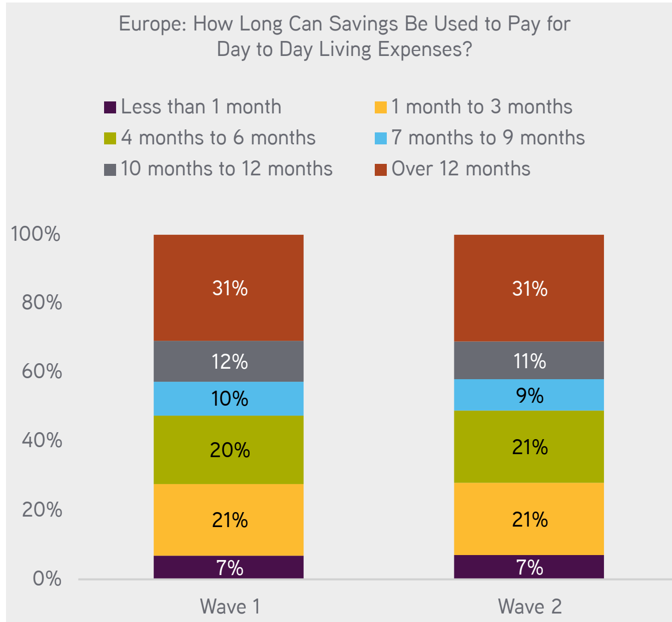


Data as at July 14, 2022. Source: AlphaWise, Morgan Stanley Research.

Looking ahead, despite weaker real wages we expect consumers to spend on vacations. There is pent up demand and a premium and value placed on 'experiences over things' in a post-pandemic world.

Exhibit 13

Employment Trends Will Be Critical, As Almost Half of Consumers Have Only Enough Savings to Sustain Their Lifestyles for Six Months or Less



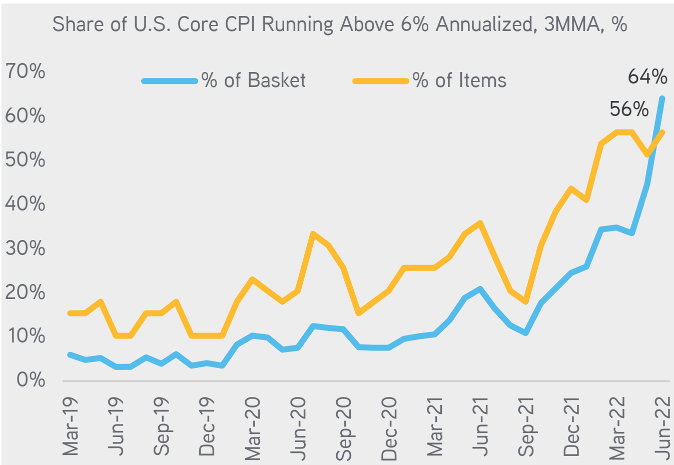
Data as at July 14, 2022. Source: AlphaWise, Morgan Stanley Research.

Looking ahead, despite weaker real wages we expect consumers to spend on vacations. There is pent up demand and a premium and value placed on 'experiences over things' in a post-pandemic world. Once consumers return from their August holidays, however, we expect a more conservative approach to savings and spending heading into the fall and winter seasons.

The biggest disparities on global viewpoints revolved around the path of slowing inflation and China housing. There was not much debate on European inflation staying sticky in the near-term. The 'math' of high natural gas prices makes it clear that Europe will likely endure real stagflation this summer and fall. Some also think, as we do, that core services inflation will stay sticky in the United States, keeping the Fed more hawkish throughout 2022. We are very sympathetic to this view, especially given the breadth of momentum in core inflation (*Exhibits 14* and *15*) as well as the reality that owner's equivalent rent could easily overshoot the Fed's more modest forecast.

Exhibit 14

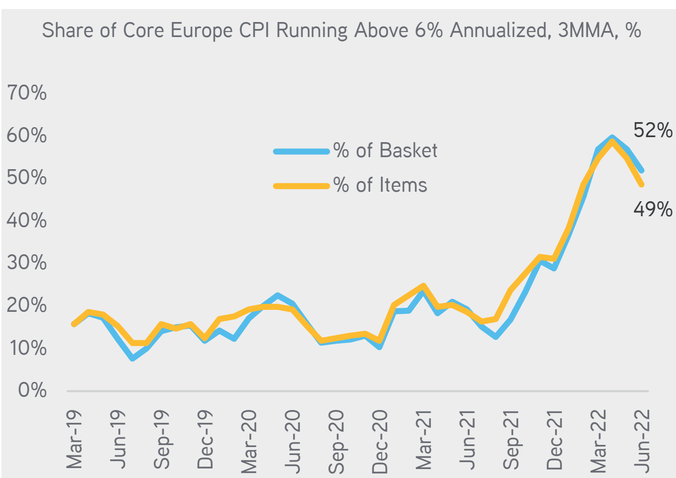
64% of the U.S. Core CPI Basket, or More Than Half the Items, Is Running Above 6% Annualized Inflation



Data as at June 30, 2022. Source: Bureau of Labor Statistics, Haver Analytics.

Exhibit 15

52% of the Eurozone Core CPI Basket Is Running Above 6% Annualized Inflation



Data as at June 30, 2022. Source: Bureau of Labor Statistics, Haver Analytics.

On the other hand, there is a growing chorus within the European macro and corporate community that believes growth is slowing so fast that central banks will soon have to pull back on their tightening campaign. Key to this thinking is that central bank tightening is right now on the cusp of blunting demand for commodities and goods, and if the chorus is right, inflation and growth will be much closer to trend by the fall.

On the China housing front (where we have the view that the property sector is now bottoming), there are many who believe that the problem is just too big and too widespread to provide any forward momentum to Chinese growth by 2023. As such, China's economy, which accounts for about one-third of global growth each year, would remain a low growth, low inflation influence.

In the scenario where growth slows faster than expected and central banks pause more quickly, an investor would want to buy long duration bonds believing that central banks would ease by 2023. On the equity side of the asset allocation ledger, an investor would want to use the same playbook as before the tightening campaign began. Specifically, he or she would want to buy duration in fixed income and overweight Technology and other high P/E Equities.

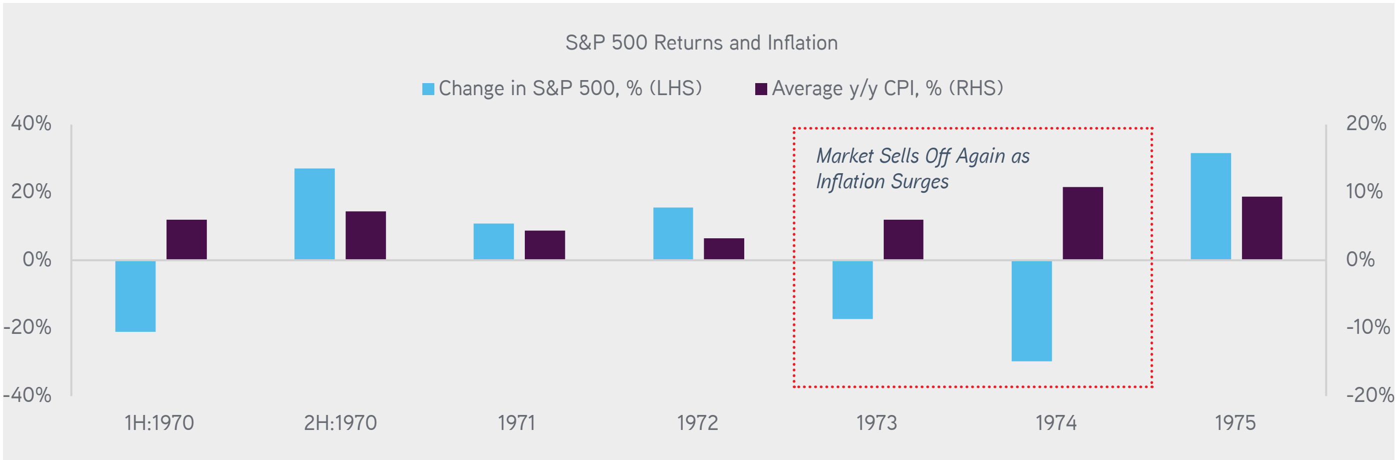
When we pull it all together, we still tilt more towards reflation than deflation, but we agree that the near-term growth trajectory and economic outlook could challenge our longer-term thesis. For starters, weaker growth may bring rates and commodity prices lower in the near-term than our forecast now suggests.

Maybe more importantly, history shows us that even inflationary periods can include periods of falling inflation, a backdrop that often produces sharp upward reversals in Equities. Just consider that in 1970, after a miserable first six months of the year, Equities went on a tear as the rate of change in inflation slowed in the back-half of 1970. Investors then piled in, driving stocks higher until inflation reared its ugly head again during the painful bear market of 1973-1974.

We have talked about the transition from a market being roiled by rising inflation expectations towards a market where inflation is negatively impacting corporate profits and consumer balance sheets. That day is now here, we believe, in both Europe and the United States.

Exhibit 16

Equities Rallied in the Second Half of 1970 – Until Inflation Came Back with a Vengeance



Data as at June 25, 2022. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

So, our base view is that this cycle will be different for several reasons. For starters, we don't see unemployment going up as fast as it typically has during other downturns, given the labor shortages we are seeing in developed markets. This backdrop could mean that consumer spending, despite record high inflation, does not stay as morbid as it did following the 2008 downturn.

Second, central bankers seem to be 'spot targeting', or raising rates to squelch what they see as runaway inflation today versus finessing their rate increases to hit a more steady state of equilibrium tomorrow. This new approach is not one we favor; it intensifies the risk that central bankers overtighten in the near-term, and as a result, over-loosen right after they overtighten, given our view that inflation will land at a higher resting heart rate this cycle.

Third, despite all these rate increases of late, financial conditions – as measured by real rates – remain quite loose relative to historical precedent. As such, we believe an asset allocator should own more types of real assets and short duration yielding securities than during the past cycle. Finally, there is a greater volume of supply side shocks, including commodities, labor, and COVID, than in the past. As a result, the volatility around growth and inflation will be higher than history would suggest. Importantly, the potential for these periodic shocks also comes at a time when central banks and politicians have added $32 trillion, or almost 38% of global GDP, to the global economy in one form or another (i.e., direct stimulus and/or balance sheet increases).

Against this backdrop we continue to favor pricing power, especially in Europe where the PPI is still running well above the CPI. We also think that collateral based cash flows will outperform, which is why we retain an overweight to Real Estate, Infrastructure, and Asset-Based Finance. Finally, we have increased our allocation to both liquid and illiquid Opportunistic Capital, so we can lean into dislocation.

What does this mean for investing? We have talked about the transition from a market being roiled by rising inflation expectations towards a market where inflation is negatively impacting corporate profits and consumer balance sheets. That day is now here, we believe, in both Europe and the United States. Second, central banks like the ECB and Fed have firmly signaled that they will champion inflation-fighting over sustaining growth. Their credibility is now on the line. Our base case calls for a slowdown, not a crash, in housing, at the same time that we are forecasting a deceleration in growth. Further, inflation, largely commodity driven, could soften a little more than we originally expected. If that happens, then investors probably do not need to keep using exit multiples lower than entry multiples. Third, despite the rate of change improving (as goods and commodity inflation ease a bit), we see services inflation remaining stickier than the consensus expects.

Conclusion

Our recent time in London reinforced our overarching macro narrative that economic growth is slowing, driven largely now by weakening corporate profits and consumer balance sheets caused by high inflation. Previously, the choppiness we have seen in the market was caused primarily by a re-assessment of inflation expectations within the bond market. Importantly, growth is slowing so much that inflation expectations are likely to come down in 2023. This background should be helpful, all else being equal.

However, our longer-term view remains that this cycle will be defined not only by the level of inflation but the volatility of inflation. This difference, while subtle, is an important one. Labor shortages, geopolitics, and excess money in the system all suggest that these drivers – the lion's share of which are supply side instances – will make this cycle different, especially relative to the low growth, low inflation period that defined the 2010-2020 cycle.

The good news, though, is that markets are now pricing in a lot of bad news. We left London with some very good ideas within the liquid debt markets, Real Estate (equity and credit), Core Infrastructure, and select growth industries including Healthcare. We also think that private market opportunities will improve as CEOs appreciate that there is no imminent rebound to growth, or to their stock price valuations.

By comparison, we remain quite cautious on the low-end consumer, and we still think that many companies are over-levered for the bumpier environment we have entered. Finally, we do not see the prices of many commodities, particularly natural gas and oil, returning to normal in the near-term, and as such, we all need to watch for companies that are overly reliant on these inputs to meet budgets and debt covenants.

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