

Walk, Don't Run

By Henry H. McVey, Aidan Corcoran and Bola Okunade



Henry H. McVey

Head of Global Macro
& Asset Allocation
henry.mcvey@kk.com

Aidan Corcoran

Managing Director,
Global Macro, Balance
Sheet and Risk
aidan.corcoran@kk.com

Bola Okunade

Associate, Global Macro,
Balance Sheet and Risk
bola.okunade@kk.com

I recently spent time in London with Aidan Corcoran and Bola Okunade. This was my second visit to the United Kingdom since COVID, and I left decidedly more cautious on the global economy, Europe and Great Britain in particular. Fueling my conservatism about growth were a series of meetings we hosted with leading macro professionals, policy makers, investors, and business executives. The consistent messaging we heard in every meeting centered on three areas: 1) the unfortunate and potentially permanent reality of Russia's invasion of Ukraine; 2) surging inflationary pressures that are now at the highest level since the days of Margaret Thatcher; and 3) waning consumer sentiment, particularly at the low end, as both savings and daily wages feel inadequate on a real basis.

In terms of 'key' thoughts from the road, Aidan, Bola, and I note the following for investors to consider:

- Growth in Europe will slow more than many think by the fall, we believe
- Consistent with this more conservative view, we are again raising our inflation forecast and bond yield targets, which continue to be materially above consensus
- At the same time, we are lowering our GDP growth forecasts to reflect tightening financial conditions against weaker consumer demand
- We soon expect corporate profits to lag nominal GDP, as margins begin to compress. This new reality will surprise many, we believe, by the fourth quarter of this year
- Low income consumers face a much tougher road ahead than the average consumer, though nine percent inflation adversely affects everyone
- Many of KKR's key structural themes are intact, or even strengthened by the current environment. The mega themes coming out of our trip are pricing power, decarbonization, and the security of *everything*

From an asset allocation perspective, we left with several observations. Credit feels cheaper than Equities, and Public Equities appear more attractive than peer-to-peer Private Equity deals, in our view. As such, we expect more public to private transactions as well as more corporate carve-outs as well as de-leveragings that will likely require capital solutions to avoid ratings downgrades. We also expect to see European champions raise capital to play offense during this heightened period of uncertainty.

Overall, we view the current backdrop quite differently than the COVID-induced dislocation that we saw in 2020. At that time, we suggested leaning quickly into the dislocation. Today, we believe a more balanced and measured approach is required. Don't get me wrong. We spent time with a variety of interesting opportunities where CEOs across Real Estate, Infrastructure, Credit, and Private Equity all need capital. Rather, what is different today is that almost everyone in the investment community is fighting headwinds from global central banks as they drain liquidity from the system in an attempt to dampen inflation as well as to cool the employment and the commodity markets. This tightening of financial conditions is also occurring against a backdrop of heightened geopolitical tensions and a tight housing supply. Said differently, we are seeing more of a supply shock versus the more traditional demand shock that creates temporary inflation. Not surprisingly, we remain of the view that we are seeing [A Different Kind of Recovery](#), one that requires an increased weighting to stories with pricing power, collateral based cash flows, and high cash flow conversion.

Details

Growth in Europe will slow – more so than many now think – by the fall, we believe. The decision to ration oil and shift away from natural gas dependence on Russia comes at an expensive price. Already, we heard stories of consumers in key areas like housing and travel and leisure shifting their behavior more conservatively. In our view, the slowdown we envision will take time, and it will likely be accompanied by negative operating leverage in the corporate sector that could surprise many investors onto the downside.

To this end, Aidan is upgrading his 2022 Euro Area inflation forecast to 7.0%, from his prior estimate of 6.7%.

This is above current consensus of 6.7%. He is also making a substantial 80 basis points upgrade to his 2023 Euro Area inflation forecast, taking his estimate to 2.9%, compared with a consensus estimate of 2.6%. Key to this forecast change is that 2023 inflation will be much *broader* in scope than 2022 inflation. This year, energy and food inflation is driving almost all of the increase. Next year, we believe breadth will increase, as almost every product company and every services company with whom we speak is actively pursuing price increases. And, given the lag in pass-through pricing that usually occurs in the corporate sector, we think these price increases will impact the economy more broadly in 2023.

Aidan is also downgrading 2022 Euro Area Real GDP growth to 2.3%, from 2.6%, which is well below current consensus of 2.7%. Our base case assumption for the European economy over the rest of the year is one of weak but positive GDP growth. However, there is a clear risk of an outright recession. Key swing factors include consumer credit trends and whether there is a sudden shut-off of Russian natural gas. Looking out to 2023, Aidan is also reducing his Euro Area Real GDP growth forecast to 2.0% from 2.1%, which is now 30 basis points below consensus.

On rates, we further upgrade our expectation of German 10-year bund yields at year-end to 1.0%, just about in line with consensus (0.95%) and up from 0.8% previously. *Where we differ materially from consensus, however, is regarding our year-end 2023 expectation, which we have at 1.80%. By comparison, the consensus forecast is just 1.15%.* As such, our forecast is now materially more hawkish than consensus. This forecast has significant implications for rate-sensitive sectors if we are correct in our analysis (and we think we are).

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Exhibit 1

KKR GMAA GDP, Inflation and Bund Forecasts

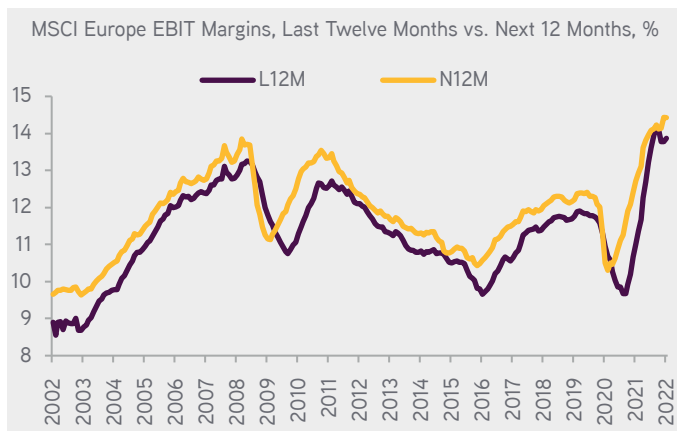
	GDP			Inflation			10-Year Bund		
	Latest	Prior	Consensus	Latest	Prior	Consensus	Latest	Prior	Consensus
2022	2.30%	2.60%	2.70%	7.00%	6.70%	6.70%	1.00%	0.80%	0.95%
2023	2.00%	2.10%	2.30%	2.90%	2.10%	2.60%	1.80%	1.75%	1.15%

Data as at May 19, 2022. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg.

We soon expect corporate profits to lag nominal GDP, as margins begin to compress, as we think the stagflationary environment is set to hit corporate profitability in the coming months. Surprisingly, market expectations of corporate profitability continue to point upward, even though margins turned in the most recent earnings season. We think there are further declines to come as we are still at an early stage in the impact of cost inflation on the economy. Every large company we spoke to on our European trip is seeking to increase prices, but almost always with a lag versus their input costs.

Exhibit 2

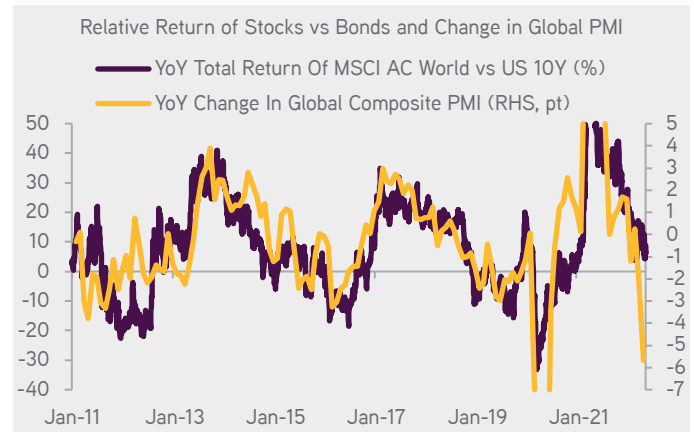
Corporate Margin Expectations Remain High, Despite a Clear Turn in Trailing Margin Data



Data as at March 31, 2022. Source: MSCI, Factset, Morgan Stanley Research.

Exhibit 3

Stocks Have Outperformed Relative to PMI and Look Vulnerable



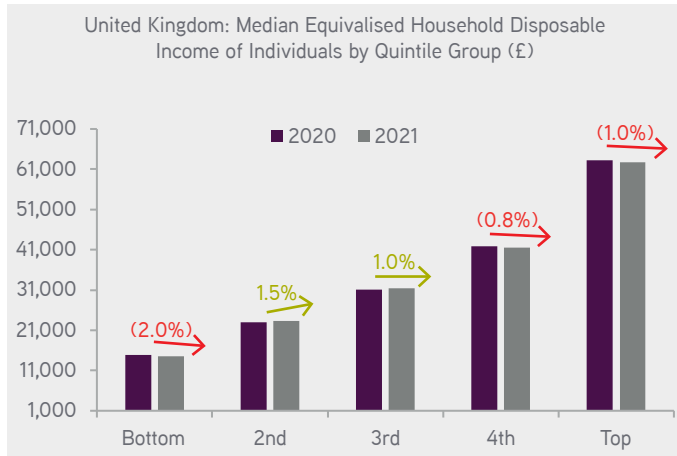
Data as at March 31, 2022. Source: MSCI, Factset, Morgan Stanley Research.

Another key takeaway was the overall health of low-income consumers. We believe the road ahead will be much tougher for them than for the average consumer, as stagflation impacts low-income consumers disproportionately. In the United Kingdom, for example, the lowest quintile group of households has already witnessed a massive decline in disposable income in 2021 relative to 2020 (*Exhibit 4*); yet, 2021 incorporated just a fraction of the cost pressures we are now witnessing in 2022. Surging energy costs (*Exhibit 5*), in particular, are wreaking havoc on consumer finances. Unfortunately, our assessment of the macro and geopolitical environment leads us to believe that this situation will worsen by the fall. Said differently, as painful as the current situation is, we are likely closer to the beginning rather than to the end of this episode of stagflation in both the United Kingdom and continental Europe.

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Exhibit 4

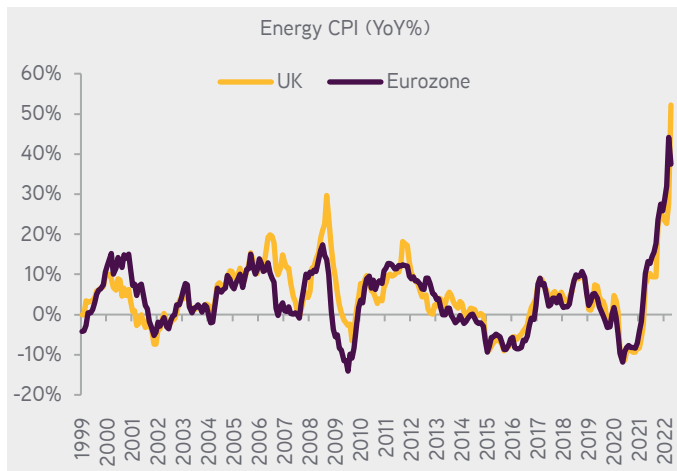
The Lowest-Income Households in the U.K. Saw Disposable Incomes Fall by the Most in 2021. We Expect This to Be a Major Issue in 2022/2023



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

Exhibit 5

Energy Inflation in the U.K. and Eurozone Have Surged to the Highest Level in Decades

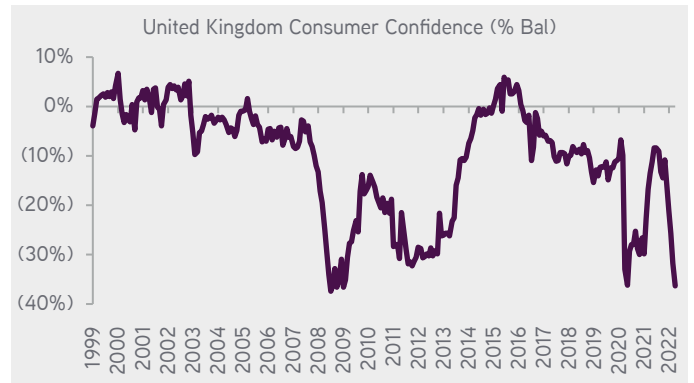


Data as at April 30, 2022. Source: ONS, Eurostat.

Europe's commitment to the energy transition is now even stronger and more urgent than prior to the Russian invasion of the Ukraine.

Exhibit 6

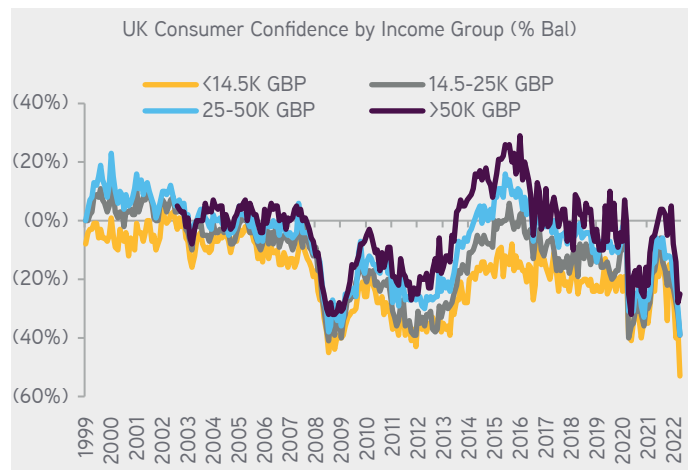
Consumer Confidence in the U.K. Has Plummeted to GFC Low...



Data as at April 30, 2022. Source: GfK.

Exhibit 7

...With Sentiment of Low-Income Households Deteriorating by the Largest Amount



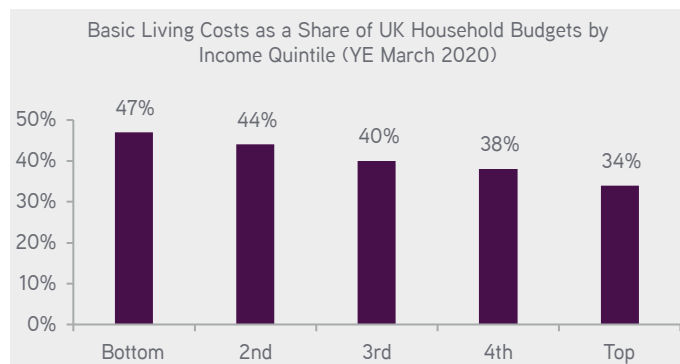
Data as at April 30, 2022. Source: GfK.

Importantly, our work shows that it is not just energy expenses. Rather, consumers in countries like the United Kingdom are seeing broad-based inflation across food, transportation, insurance, and travel. These increases are significant, particularly for low- to middle-income consumers. Even before the Russian invasion of Ukraine, basic living costs in the U.K. accounted for 47% of household budgets for the lowest income consumers versus 34% for top earners. Further compounding the issue is that there are now little savings to act as a buffer. Indeed, as

Exhibit 9 shows, the lion's share of excess savings is largely concentrated amongst high-income households.

Exhibit 8

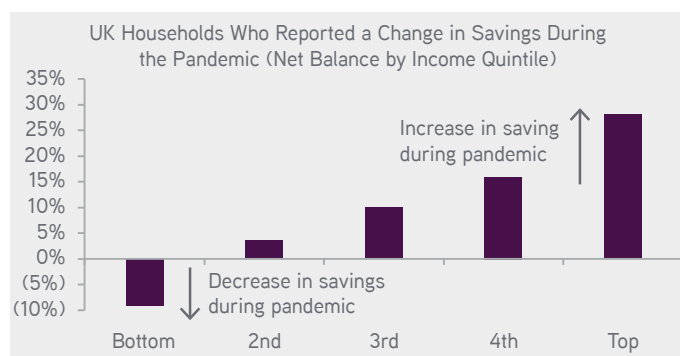
The Lower-Income Cohort Is Most Vulnerable to Rising Costs, As Basic Living Costs Make Up a Greater Portion of Household Budgets in That Cohort



Note: Basic living costs includes housing, fuel, power, food, transport. Data as at December 31, 2020. Source: ONS.

Exhibit 9

While Households Have Amassed Savings During the Pandemic, Lower-Income Households Were Unable to Increase Savings



Data as at May 15, 2022. Source: BoE.

So, our bottom line is threefold:

1. Stay cautious on cyclical risk – we are just now entering the stagflationary period in most European economies
2. Despite the weak economic outlook, we believe the ECB will maintain a meaningful and sustained upward rate-

hiking path. Opportunistic pools of capital should prepare for opportunities linked to the rate reset (listed real estate vehicles could be one of the areas where we see increasing stress, we believe)

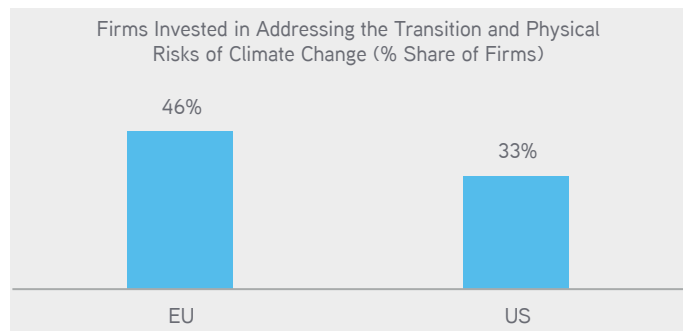
3. Certain structural themes will not only continue, but may actually strengthen in the current environment. Most notably, Europe's commitment to the energy transition is now even stronger and more urgent than prior to the Russian invasion of Ukraine. A similar case also can be made for security spending.

The mega themes coming out of our trip are pricing power, decarbonization, and security of everything. These are not new themes for us, but being on the ground in Europe, closer to the war, was a reminder that more redundancy capex is coming to bolster supply chains. On defense, Europe is pivoting to a stronger, international approach. However, one important variable that we will be watching closely is the 2024 U.S. presidential election, which could accelerate Europe's defense pivot. Meanwhile, while it feels like many in the U.S. are wavering about the speed of the energy transition, that is not what we heard in Europe. Allocators of capital are firmly committed to aggressive decarbonization; at the same time, business executives are ready to ration supplies to wean themselves from Russian inputs. Finally, as we transition from benign globalization towards one of great power competition, business leaders and their employees want greater security around major areas of the economy, including data, supply chains, and natural resources.

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Exhibit 10

European Companies Are Leading the Charge On the Energy Transition and Climate Change



Data as at August 31, 2021. Source: EIB Investment Survey.

The coalition of the willing: will it remain? We heard many executives and political experts talk about the strength of the U.S.-NATO alliance that has emerged since the Russian invasion of Ukraine. To be sure, the U.S. under President Biden appears much more connected to Europe than the U.S. under former President Trump. However, it is not clear if these bonds will hold. In particular, if the U.S. presidential election ends up in the hands of another America First president in 2024 (or if former President Trump wins again), then the current alliance between the U.S. and Europe may weaken. Further, if Trump is re-elected, then Macron will surely have the upper hand in his case for an integrated, self-reliant Europe.

From an asset allocation perspective, we left with several observations. Credit feels cheaper than Equities, and Public Equities appear more attractive than peer-to-peer Private Equity. Given that we are forecasting slowing growth, we expect to see more corporate carve-outs, more public-to-private transactions, and more flexible capital solutions (preferred, convertibles, etc.). Meanwhile, in Infrastructure we do not look for prices to correct too much, as most investors we speak to are underweight in the asset class – an asset class we believe should be overweight in portfolios. As such, sourcing and complexity will remain important features of any manager’s thoughtful deployment. Finally, within Credit, we like shorter duration mortgages and parts of High Yield in the Liquid markets, while we think that non-correlated assets (e.g., music rights, NPLs), Asset-

Based Finance, and rescue capital for growth companies are all potentially emerging opportunities to consider.

Conclusion

Overall, our narrative remains that we are transitioning from the global debate being just about rising inflation towards one of slowing growth amidst stickier than expected inflation. This storyline is more complicated because it means that central banks in the region will be tightening into declining corporate profits, a backdrop we have not seen since 2011. What we saw in the U.K. makes us believe that western economies, including the continent, face a tougher combination of rising inflation, declining real incomes, and heightened geopolitical risks. So, our basic message is a cautious one in the near term, particularly as it relates to consumer facing industries. Said differently, now is the time to walk, not run, when it comes to deployment.

However, despite the turmoil, many key structural themes are intact or even strengthened by the current environment. For example, security, decarbonization, and innovation are all areas where we see significant opportunity to invest behind the ‘signal’ while many are being swayed by the ‘noise.’ We also believe that European PE remains a compelling way to arbitrage public equity markets that are underweight innovation and overweight complexity across financial institutions, industrials, and consumer conglomerates. For opportunistic capital, we believe the coming quarters will offer good opportunities to invest in structural themes at reasonable prices. Finally, we remain bullish on European infrastructure, including data, data storage, power generation, and select parts of transportation.

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