On the Road Again...

BY HENRY H. McVEY

I recently spent time in Spain visiting with CEOs, CIOs and leading macro thinkers discussing the current state of play in the global economy. Upon arrival in Madrid, as I went through customs, I was reminded of my last international trip, one that entailed my essentially fleeing London to return to New York at the onset of the pandemic. While I will likely never travel again as much as I did pre-COVID, my Spain trip did reinforce that there is real value in face-to-face connectivity. In particular, these types of meetings can inform and improve one’s views on a variety of investments and/or thematic trends.

My big picture Thoughts from the Road are as follows:

1. **Europe’s economy is on track to recover nicely.** Despite higher fuel prices, expect the consumer to shine, including fashion purchases, cosmetics, and nesting items. If there are economic hiccups, they are likely to be supply driven.

2. **Europe has less of a wage problem than the U.S., but rising input costs are favoring price makers.** What is a price maker? They are companies that can leverage competitive advantages, including technological prowess, proprietary processes, and speed to market, to adjust prices in ways that keep pace with soaring input costs. Price makers often offer goods or services that are critical and have inflation-linked pricing embedded into long-term contract terms. In our view, we believe this cycle will be remembered for the valuation differential between price makers and price takers.

3. **China’s growth will continue to slow and the impact of its slowdown will soon bleed into Europe, including Germany.** Bigger picture, until China somehow gets better vaccines and stabilizes its housing market (something we think is several quarters off), its economy will continue to struggle — and these struggles will reverberate in Europe and globally.

4. **When we think about 10-year yields in the United States, we need to consider the 10-year yield of the German bund too.** Importantly, we left Europe still thinking yields are not poised to surge, despite break-evens moving up in recent months.

5. **Having a global but local approach in Europe is a prerequisite for success in the investment management industry, particularly when striving for truly differentiated deal sourcing.** Ongoing supply chain issues, as an example, will remain a key challenge, as this is a global phenomenon that must be managed carefully across all types of portfolios to prevent disruptions.
DETAILS: My colleague Aidan Corcoran expects growth in Europe to outpace that of the U.S. in 2022. Thereafter, top line growth comparisons will be more challenging (i.e., our rate of change thesis will play out), particularly amidst surging input costs. If there is good news for Europe, it is that the government’s handling of the labor force during the pandemic (i.e., giving government transfers to companies rather than individuals) has led to much less dislocation in the labor market. This seemingly small nuance is actually a big deal, particularly given that Europe’s economy is still largely consumer-driven.

Exhibit 1
Spain Currently Has a Manageable Number of New COVID Cases

Exhibit 2
Spain Has the Highest Share of People Vaccinated Compared to Its Key Peers

Every conversation during my trip started and ended with the risk of inflation. As everything looks expensive these days unless one believes that rates are not going up, having a strong view on inflation is the key macro variable on which to focus, we believe. Across the board, global CEOs are seeing rising input costs, and as a result, they are raising prices. However, it likely will not be enough.

The greening of the energy industry is also leading to a surge in demand in commodities that are required to fund spending in renewables. As a result, copper, aluminum, and other input costs required in the transition from ‘old economy’ energy towards renewables are likely to remain well bid. This backdrop has important implications for other industries, including our positive view on global housing.

Supply chains are of course messy, and most with whom we spoke only see improvement occurring in the second half of 2022, not the first half. On-again, off-again activity from the Asian ports, particularly China, is shifting ‘just in time’ to ‘just in case’ when it comes to inventory levels.

While all that sounds like bad news, comparisons for inflation on the goods side should start to ease by late 2022. However, services, including rental income, are likely to prove stickier.
than in prior cycles. Therefore, our basic take is that we now have a higher resting heart rate for global inflation versus the prior cycles, which supports why we have been pounding the table on Real Assets, including Infrastructure, Real Estate, and Asset-Based Finance of late. Thus, a potentially more permanent reflationaly backdrop suggests that the long-lasting spell of pessimism surrounding Eurozone inflation may now finally have been broken.

We also left Spain with the impression that this economic cycle will truly be different from the GFC. This recovery is more akin to a post-war environment than a post-financial crisis one. There is not much consumer deleveraging that needs to occur, wages are rising across most countries, and while consumer confidence on some big-ticket items like cars has waned, shoppers want to venture out, spend, and be seen. Fashion, beauty, and general consumer discretionary all feel poised to do well.

Second, the huge fiscal surge that accompanied the early stages of this recovery has not yet fully made its way through the system. In the U.S., for example, we estimate that north of $1 trillion of fiscal stimulus is still sitting in local and state coffers. In Europe, the €673 billion Recovery and Resilience Facility (RRF) is off to a good start, with most key countries having received their initial disbursements over the summer. Most importantly, the RRF is targeting those countries most in need of support, including Italy and Spain.

Third, the energy transition is actually inflationary, as expenditures essential to bolstering commodity output in key markets such as oil and copper are being diverted to pursue alternative energy sources at a time when we need lower commodity prices.

Fourth, there was no mention of austerity. Remember that Mario Draghi, as head of the European Central Bank last cycle, was talking about narrowing deficits in a post-GFC environment. Moreover, even before he came on the scene, Jean-Claude Trichet actually raised rates not once but twice to 1.5% from 1.0% in 2011.

Our conversations in Europe confirmed our belief that the ECB will remain much more dovish for much longer than the Fed and other global central bankers. We believe this is because there is less structural inflation in Europe on both an absolute and relative basis.

---

**Exhibit 3**

**Headline Inflation Has Spiked...**

![Graph showing headline inflation HICP, Y/y % from 1995 to 2021](source: Data from the Statistical Office of the European Communities, as of 01 October 2021.)

**Exhibit 4**

**...But There Is Little Evidence of Core Inflation Becoming Unhinged**

![Graph showing core inflation CPI, Y/y % from 1995 to 2021](source: Data from Statistical Office of the European Communities, as of 17 September 2021.)
This European Recovery Cycle Is About Accommodation, Not Austerity

Euro Area Fiscal Impulse–Change in Structural Fiscal Balances, %

Global Financial Crisis
Eurozone Debt Crisis

Note: Based on EC Spring Forecast. Data as at June 28, 2021.
Source: European Commission.

Fifth, while Europe is carrying more debt, it is also more competitive. Exhibit 6 shows that Spain is running a healthy current account surplus. In the aftermath of the GFC, both its banks’ capital bases and the country’s exporting competitiveness were woeful.

Spain Regained its Current Account Surplus During the Eurozone Debt Crisis and Never Looked Back

Current Account Balance (% of GDP)

Source: Data from the International Monetary Fund, as of 12 October 2021.

Unfortunately, Most of the Deleveraging Achieved Since the GFC Was Reversed During COVID-19

Domestic Debt (% of GDP)

Source: Data from Instituto Nacional de Estadística, as of 11 October 2021.

Finally, this recovery will be driven by the West, not the East. China’s growth will sputter for some time, as it looks to ‘fix’ its housing issues. Somewhat ironically, my conversations in Spain reminded me that Spanish economists have plenty of experience forecasting housing downturns, and all of them believe China will stumble more than the sell-side consensus now thinks.

In addition to inflation and China, the other big topic du jour was interest rates. Despite our conviction about a higher resting heart rate for inflation, we don’t see nominal yields surging. As our insurance survey suggested, global insurers are still overweight Cash and underweight acceptable yield. Demographics also suggest both in the U.S. as well as in countries like Spain (Exhibit 9) that income-oriented baby boomers still want yield. Further, our conversations in Europe confirmed our belief that the ECB will remain much more dovish for much longer than the Fed and other global central bankers. We believe this is because there is less structural inflation in Europe on both an absolute and relative basis. If we are right, then this backdrop means that the yield on German bunds does not increase much over the next few years. Thus, U.S. Treasuries are likely to offer good relative value, as we show in Exhibit 9, with the U.S. 10-year rarely trading 200-250 basis points above the bund.
Moreover, for those who worry that tapering in the U.S. will break the historical relationship between the treasury and the bund, we would remind folks that the Fed’s balance sheet did not contract for fully five years after it announced tapering in 2013 (i.e., tapering is not tightening).

What does all this mean for investing? We firmly expect the definition of Infrastructure to expand well beyond traditional infra to include meters, data centers, bus contracts, etc.

Meanwhile, we have more conviction in our reflation thesis, including pricing power. If we simplify the big calls during the last two decades, it was to fade China’s fixed investment boom and get long rates in the 2000-2010 period; and to buy growth stocks and get long rates (again) in the 2010-2019 period. Now we think this cycle the ‘winners’ will have a pricing moat around their franchises to protect against higher input costs, more regulation, and an increase in labor benefits. Margins, in aggregate, have likely peaked on a secular basis. Therefore, ‘winning’ in today’s environment is about determining the companies able to successfully navigate this huge tailwind becoming a headwind.

While Europe is ahead on the ‘green movement,’ we need to be eyes wide open that there could be some unintended consequences. The faster the push by government officials for expedited transitions towards carbon neutral sources, the higher the potential for a short-term economic snafu or rise in social discontent caused by surging commodity prices.

Finally, we have entered an era where every investment must be viewed through the prism of data security, monopolistic pricing, and income equality. In Europe, for example, it is clear that political coalitions will replace strong individual leaders, and as such, grounds for agreement on all sides of the debate will need to satisfy these three criteria.

Finally, we have entered an era where every investment must be viewed through the prism of data security, monopolistic pricing, and income equality.
Important Information

References to “we”, “us,” and “our” refer to Mr. McVey and/or KKR’s Global Macro and Asset Allocation team, as context requires, and not of KKR. The views expressed reflect the current views of Mr. McVey as of the date hereof and neither Mr. McVey nor KKR undertakes to advise you of any changes in the views expressed herein. Opinions or statements regarding financial market trends are based on current market conditions and are subject to change without notice. References to a target portfolio and allocations of such a portfolio refer to a hypothetical allocation of assets and not an actual portfolio. The views expressed herein and discussion of any target portfolio or allocations may not be reflected in the strategies and products that KKR offers or invests, including strategies and products to which Mr. McVey provides investment advice to or on behalf of KKR. It should not be assumed that Mr. McVey has made or will make investment recommendations in the future that are consistent with the views expressed herein, or use any or all of the techniques or methods of analysis described herein in managing client or proprietary accounts. Further, Mr. McVey may make investment recommendations and KKR and its affiliates may have positions (long or short) or engage in securities transactions that are not consistent with the information and views expressed in this document.

The views expressed in this publication are the personal views of Henry H. McVey of Kohlberg Kravis Roberts & Co. L.P. (together with its affiliates, “KKR”) and do not necessarily reflect the views of KKR itself or any investment professional at KKR. This document does not represent valuation judgments with respect to any financial instrument, issuer, security or sector that may be described or referenced herein and does not represent a formal or official view of KKR. This document is not intended to, and does not, relate specifically to any investment strategy or product that KKR offers. It is being provided merely to provide a framework to assist in the implementation of an investor’s own analysis and an investor’s own views on the topic discussed herein.

This publication has been prepared solely for informational purposes. The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this document has been developed internally and/or obtained from sources believed to be reliable; however, neither KKR nor Mr. McVey guarantees the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision.

There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Target allocations contained herein are subject to change. There is no assurance that the target allocations will be achieved, and actual allocations may be significantly different than that shown here. This publication should not be viewed as a current or past recommendation or a solicitation of an offer to buy or sell any securities or to adopt any investment strategy.

The information in this publication may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Performance of all cited indices is calculated on a total return basis with dividends reinvested. The indices do not include any expenses, fees or charges and are unmanaged and should not be considered investments.

The investment strategy and themes discussed herein may be unsuitable for investors depending on their specific investment objectives and financial situation. Please note that changes in the rate of exchange of a currency may affect the value, price or income of an investment adversely.

Neither KKR nor Mr. McVey assumes any duty to, nor undertakes to update forward looking statements. No representation or warranty, express or implied, is made or given by or on behalf of KKR, Mr. McVey or any other person as to the accuracy and completeness or fairness of the information contained in this publication and no responsibility or liability is accepted for any such information. By accepting this document, the recipient acknowledges its understanding and acceptance of the foregoing statement.

The MSCI sourced information in this document is the exclusive property of MSCI Inc. (MSCI). MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.