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2021: Another Voice

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2021: Another Voice

Back in April 2020, when we first began sharing our thoughts on the human tragedy and market implications of the global pandemic with our readers, we looked to other periods in history when resolve, resilience, and fortitude were required to simply 'Keep Calm and Carry On.' Now on the cusp of 2021, and hopefully the beginning of the end of the pandemic as vaccines and other treatments are offering hope to millions, we again pause not only to reflect on the past but to turn with more of an eye towards the future. 2021 represents a unique opportunity, a new beginning of sorts, we believe. Indeed, almost all our research at KKR tells us that we have entered a new, sustainable business cycle, and though there will inevitably be setbacks along the way, this recovery will continue to present heightened opportunities. However, all have to be willing to approach tomorrow with 'another voice' with which to view the future. Specifically, we think that global allocators will need to champion investments that not only are set to thrive in a faster nominal GDP environment than in recent years, but also synch up with our six "mega macro themes": the rise of the global millennial; the need for asset-based cash flows in diversified portfolios; beneficiaries of increased fiscal spend; domestication of global demand and supply; increased dispersions; and secular compounders/innovators.

> **For last year's words belong to last year's language. And next year's words await another voice ... What we call the beginning is often the end. And to make an end is to make a beginning.**
>
> **T.S. ELIOT**, "LITTLE GIDDING" IN FOUR QUARTETS

Introduction

T.S. Eliot wrote his poem "Little Gidding", a timely attempt to show the important interlinkages of the past with the present and the future, in 1942. World War II was raging at the time, and the devastation of human life was profound by almost any historical standard. However, despite the pessimism, there was also a twinge of hope embedded in his somber outlook that a better day could lie ahead.

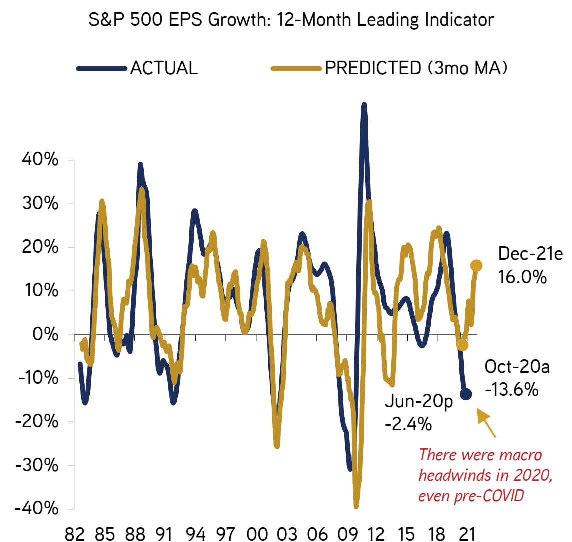
Eliot's penchant for thinking through the past, the present, and the future resonates with us today as we think about not only the ongoing devastation of COVID-19 but also the hope of what a cure might bring. It also extends beyond the human aspect and tragedy of the pandemic to what it might mean for markets. Indeed, as we look ahead to 2021, a key question for investors is whether the economy and markets – to steal a page out of Eliot's parlance – still belong to 'last year's language', which relied heavily on a small number of business verticals outperforming the broader economy (both in terms of earnings growth and stock price performance). Or, with the arrival of potential vaccines amidst a historic stimulus thrust, should we be prepared for 'another voice' in 2021?

Without question, our base view at KKR is that 2021 will be a transition year towards 'another voice,' one that is set, as Eliot suggests, to 'make a beginning.' In this new environment we are envisioning, we believe that the benefits of the vaccine, and the tailwind of stimulus initially administered in 2020 (which has led to substantial savings now available for future consumption), will begin to tangibly improve the growth trajectory of the global economy in 2021. Consistent with this view, we see a global synchronous recovery, or 'a beginning,' that fuels a sustained broadening of markets in 2021. Said differently, we see reflation without problematic inflation in the near-term.

> **Without question, our base view at KKR is that 2021 will be a transition year towards 'another voice,' one that is set, as Eliot suggests, to 'make a beginning.'**

EXHIBIT 1

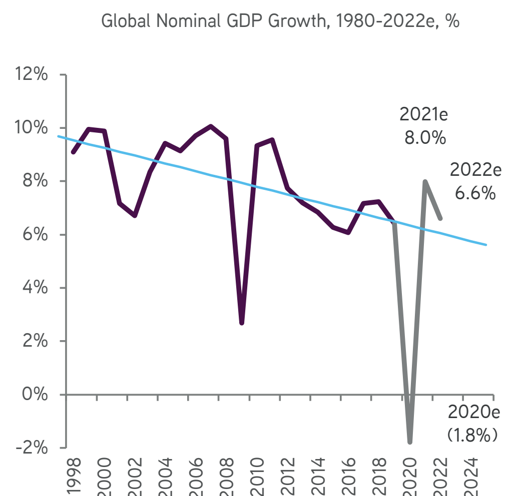
Our Earnings Growth Leading Indicator Points to a Massive Rebound in Growth in 2021, Independent from Fiscal Stimulus



The Earnings Growth Leading Indicator (EGLI) is a statistical synthesis of seven important leading indicators to S&P 500 Earnings Per Share. Henry McVey and team developed the model in early 2006. a = Actual; p = model predicted. Data as at November 30, 2020. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg.

EXHIBIT 2

Back to the Future: Growth in the 2021-2022 Period Could Feel Like the Good Old Days

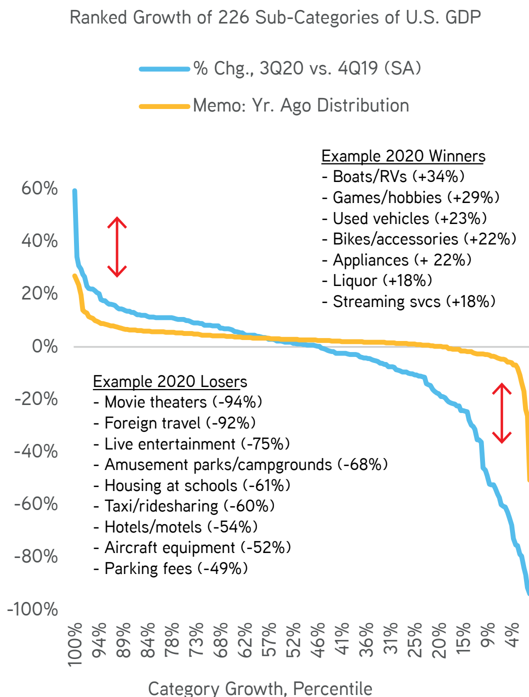


Data as at November 30, 2020. Source: BEA, Haver Analytics.

Just consider that S&P 500 consensus expectations are for companies — excluding the FAAMG[1] names — to grow 23% in 2021 and 17% in 2022; by comparison, these stocks had their earnings *decline* by 21% in 2020. At the same time, we now see structural pressure on rates to go up, not down – something we have rarely suggested in the last decade.

EXHIBIT 3

2020 Has Been a Year of Extremes on Both the Downside and the Upside. Going Forward, Mean Reversions Seem Likely

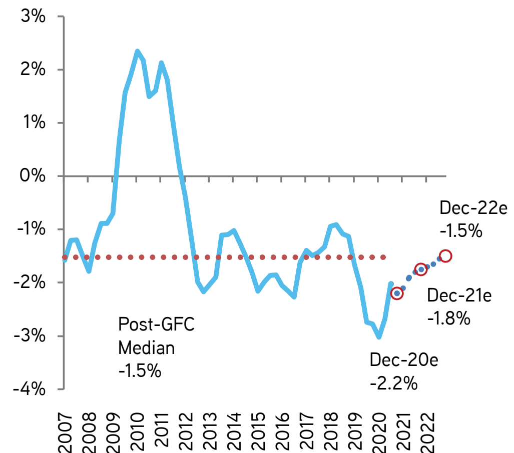


Data as at November 17, 2020. Source: BEA, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

As Federal Reserve Vice Chairman Richard Clarida noted in a speech from November, "This was the only downturn in my professional career in which disposable income actually went up in a deep recession, and a lot of that has been saved."

EXHIBIT 4

Given Our Robust Forecast for Nominal GDP Growth by the Second Half of 2021, We Think That Longer-Term Interest Rates Are Poised to Begin to Increase



e = KKR Global Macro & Asset Allocation estimates. Note: 2020-22e calculations based on 3% nominal GDP run-rate growth, in order to smooth out the pandemic dip in 2020 and rebound in 2021. Data as at November 17, 2020. Source: Bureau of Economic Analysis, Bloomberg, KKR Global Macro & Asset Allocation analysis.

In terms of the backdrop we are describing, we see several forces at work that are likely to lead to strong gains in global nominal GDP.

1. **The first is sustained government spending**, which we expect will support major initiatives in broadband, education, supply chain resilience, energy transition and climate change, health care coverage, and traditional infrastructure. Unlike the aftermath of the Global Financial Crisis (GFC), there will be no debates about austerity. There will be no rogue bankers or traders taken to task for their association with COVID-19 – only consideration of the human tragedies. As such, elected officials will feel emboldened to spend more than normal when and where they can find any agreement. Moreover, with rates so low, the return on investment required to earn an excess spread represents an extremely modest hurdle in most developed countries. Green initiatives, including energy transition and climate change, will increasingly be key areas of spend/focus across the multiple continents where KKR does business. However, we also expect reshoring initiatives to continue to influence spending on supply chains, and spending on traditional infrastructure to also contribute to faster growth by 2022.

2. **We expect a stronger than expected rebound in consumer spending once the vaccine is widely available**. We think the potential magnitude of this spending power could be underestimated, as consumers at the high end have benefitted from increased rates of savings while those at the low end have been supported by generous government transfers. As Federal Reserve

1 FAAMG refers to Facebook, Apple, Amazon, Microsoft and Google/Alphabet.

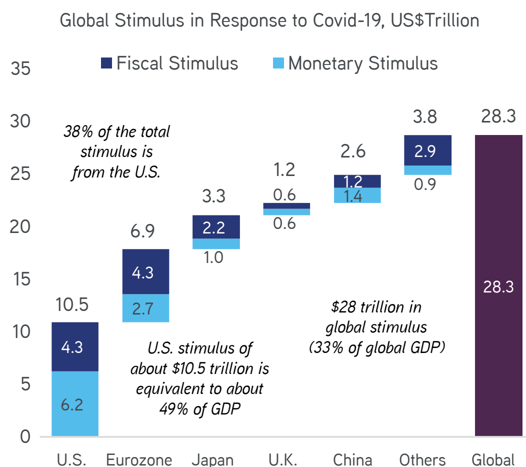
Vice Chairman Richard Clarida noted in a speech from November, "This was the only downturn in my professional career in which disposable income actually went up in a deep recession, and a lot of that has been saved." China, too, has seen its savings rate increase, which should provide additional spending firepower in 2021 and beyond. See below for further details, but we see pent-up demand being unleashed by the end of 2021.

3. **We think the Federal Reserve – with its new Average Inflation Targeting – and its global peers will remain aggressive**. As the December payroll data indicated, the percentage of Americans unemployed 27 weeks or more now represents nearly one third of all unemployed Americans; a troubling story also holds true for both Black and Latino workers in the United States. Against this backdrop, we expect the Federal Reserve to remain extremely aggressive on the bond buying front (remember the Fed is still buying at a monthly rate of $120 billion versus $80 billion under Chairman Bernanke). However, the Fed is not alone, and we expect more action from the Bank of England and the European Central Bank in 2021.

4. **The recovery in Asia has been faster than expected and will continue to expand beyond China**. Japan's stock market is telling us this already, and we see China's millennial population remaining resilient in 2021. Given China typically accounts for about one third of global growth each year, this positive momentum is quite significant. Our base view is that this near-term tailwind from a faster COVID-19 recovery will ultimately provide China with the opportunity to differentiate itself from its regional peers over the next few years.

EXHIBIT 5

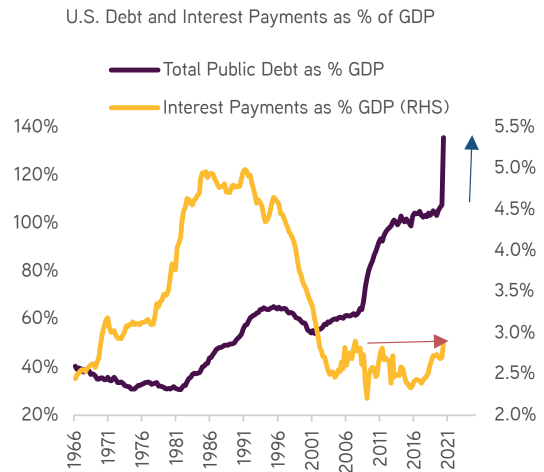
There Has Been Almost $30 Trillion in Global Stimulus, With the U.S. Leading the Charge This Cycle versus China During the GFC



Data as at December 7, 2020. Source: Cornerstone Macro.

EXHIBIT 6

So Far, the Stimulus Has Not Actually Cost That Much



Data as at September 30, 2020. Source: BEA, Haver Analytics.

Overall, this transition towards faster nominal GDP growth is hugely important. In recent years, the best thing an investor could do was do more of the same: buy more government bonds, more defensive credits, and more large capitalization growth stocks. This outcome was linked to the reality that the increase in money supply led to inflation of financial assets only – not an increase in nominal GDP. In 2021, however, we see the potential for nominal GDP to finally accelerate. One can see this in *Exhibit 2*. This insight permeates all aspects of our top-down thinking. To this end, our macro lens is telling us to enter 2021 bullish on the following themes:

- **Asset-Based Cash Flows:** We have entered a unique period where global central bankers, particularly in the United States, are doing everything in their power to stoke some inflation to accelerate growth in nominal GDP by holding nominal interest rates at record low levels. In the near-term, the importance of an above average cash flow generated by these assets, against a backdrop of heavy central bank intervention, could improve trading multiples. Longer-term, though, we think it will actually be the value of the sound collateral that backs the cash flows that further enhances performance, particularly if the investment has strong pricing power characteristics. Our bottom line: as we look ahead, we have high conviction that we are still in the early innings of a structural upward re-rating in collateral-based assets that can generate a competitive upfront yield without too much leverage.

- **Rise of the Global Millennial:** We think that we are at an inflection point for the global millennial. Starting in the U.S., we are seeing millennials, or individuals born from 1980-1994, beginning to embrace homeownership as well as to spend more on their families' needs. Already, U.S. millennials are spending at least $1.2 trillion per year, and we think that there could be upside to this number in a post-pandemic environment. Moreover, at nearly 70 million individuals (and with faster growth than most other cohorts), this change in their spending habits is an important part of the U.S. growth story. Europe too has compelling millennial trends, but the

most powerful part of the global millennial story is actually emanating from Asia. All told, there are now 822 million Asian millennials, 12 times more than in the U.S. In most Asian countries, millennials are also the cohort just now entering middle income status in such key markets as China, India, and Indonesia, which suggests important shifts in buyer behavior patterns over the next 5-15 years. As we detail below, we now look for these individuals to reshape many traditional consumer markets, particularly as it relates to financial services, healthcare, and technology.

- **Fiscal Beneficiaries, Including ESG, Amidst a Renaissance in Big Government:** In a world of low rates and high unemployment, we expect governments to spend aggressively to sustain economic growth as well as to push for higher minimum wages. We also think there will be less partisan discord over the cost of replacing crumbling and outdated infrastructure given the post-COVID focus on preparedness. Already, the U.S. has increased its budget deficit by three trillion dollars; yet, its annual interest expense has actually dropped. As part of the trend towards higher fiscal outlays, we think that almost all aspects of ESG are winners, including water cleanliness, energy transition (solar, wind, and other renewables), climate, and resiliency (e.g., grid). Also, watch for an increased focus on telelearning, telemedicine and workforce training. Importantly, when governments do take decisive action and build consensus, such as in the case of the implementation of a single suite of European regulatory standards designed to promote sustainability, or China's commitment to decarbonization, the results can be incredibly impactful. Already, the European recovery plan has upwards of 500 billion euros allocated to green initiatives. Consistent with this focus, assets in sustainable investment products in Europe are poised to reach €7.6 trillion by 2025 — a 28.8% CAGR from 2019 to 2025[2] — and as such, they would account for more than 50% of all European mutual fund assets. In the U.S., expect a less 'top down' approach; instead, look for a mix of regulation including state and local initiatives, federal and state incentives for renewables, energy efficiency (perhaps including the electric car), and corporate action to spur change. Also watch for a President-elect Biden SEC and other agencies to use disclosure to address ESG and climate risks.

- **Domestication of Global Demand and Supply:** Whether it is the push towards President-elect Biden's 'Made in America' or President Xi Jinping's concept of Dual Circulation we think we are in a period where the consumption patterns of global consumers will fundamentally change production patterns. Specifically, we believe that rising nationalistic sentiment combined with a post-COVID focus on redundant, reliable, and resilient supply chains for critical products will lead to more local bias in terms of both consumption and production (i.e., expect global capex to surprise on the upside), which has important implications for global supply chains, global trade, and capital flows. Domestically-led efforts in technology, industrials, and healthcare should all prosper, we believe. Moreover, as we detail below, the longer-term trend towards increased services versus goods will likely accelerate our thesis about domestication of global trade, we believe.

- **Embrace Dislocation and Dispersions:** Though perhaps not as extreme as in 2020, we expect 2021 to be another year of heightened volatility. This backdrop makes us bullish, as it presents global allocators of capital with opportunities to take advantage of dislocations and dispersion. Indeed, just consider that our High Yield Default monitor has blown out towards recessionary levels three times since the Global Financial Crisis; yet, we have only had one technical recession during the period, and it was a pandemic – not excess spending or overleverage – that created the downturn. Given we again expect more potential overreactions to uncertainty in 2021, we favor investment approaches that harness this type of volatility to our advantage. Moreover, given the narrow breadth of the Equity and Credit markets of late, we find that there are significant dispersions that are creating historical opportunities for active management. Details below.

> **Consistent with this focus, assets in sustainable investment products in Europe are poised to reach €7.6 trillion by 2025 — a 28.8% CAGR from 2019 to 2025 — and as such, they would account for more than 50% of all European mutual fund assets.**

- **Secular Winners:** While there is clearly a more distinct cyclical bias inherent in our portfolio for 2021, innovation is still highly relevant in the world we envision. Indeed, given all the seismic changes that have taken place in Healthcare, Security, Software, and Consumerism, we still want to be long disruptors. Also, at some point, nominal GDP will again decelerate this cycle. At the moment, we are still most enamored by the Growth part of the market across Technology, Healthcare, and the Consumer relative to earlier stage Venture investing. See below for details, but there are just fewer companies that can sustainably grow eight percent or more. As such, we see outsized gains for these companies over the next five to seven years. However, as we indicated earlier, we think that much of this growth and performance in the innovation arena will happen *outside* of the FAAMG stocks over the next five years.

What does all this mean for asset allocation? Overall, for long-term investors that do not have major near-term payout schedules, we continue to favor a portfolio that has around 40-50% in Alternatives (Growth, Buyouts, Venture Capital, etc.), 25-30% in Liquid Equities, 15% in Credit (Opportunistic and Private solutions), 10-15% in Real Assets (Infrastructure, Real Estate, etc.), and the rest in Other (Cash, Gold, Sovereigns). In regards to near-term tilts in the portfolio, our key insights are as follows:

2 Data as at October 2020. Source: *The Growth Opportunity of the Century, PwC.*

- **Continue to lighten up on sovereign debt and shorten duration, as the bull market in risk-free rates that started in 1982 is now over**. This reality will take time to play out because we likely will not have much inflation in 2021. Indeed, after a spike in the spring towards three percent, we actually forecast more modest inflationary trends in the second half of 2021 (*Exhibit 20*). Yet, given the nominal growth environment we think we are entering, now is the time for long-term investors to begin to sell-down sovereign debt portfolios as they cannot fulfill their core mandate of providing both income and diversification, we believe.

- **Increase exposure to collateral-based cash flow with income generation and pricing power, including Asset Based Finance, Infrastructure, and parts of both Real Estate Equity and Real Estate Credit**. We can't pound the table harder on this call, especially given the crosscurrents of existing low rates coupled with a surge in the global money supply. Against this backdrop, we think the downside to this investment strategy outperforming seems quite limited. Indeed, if inflation never materializes, the value of the upfront cash flow will become even more important, relative to a world of $17 trillion of negative yielding securities (many of which are on bank balance sheets). However, if inflation does surprise to the upside during the next 12-24 months, then the value of the collateral should provide an important buffer to faster nominal GDP growth. Importantly, while we are not inflation bulls, forward expectations for inflationary trends appear too low (*Exhibit 38*), in our view.

- **Sell dollars to fund other investments.** In a world where the U.S. is leading the fiscal and monetary 'race' to stimulate the economy, there has to be a release valve for all of this potential profligate spending. We think the release valve is the U.S. dollar, particularly if the Georgia Senate race tilts Democratic. An easy way to measure the potential change in the dollar's standing is to look at relative interest rate differentials, particularly in real terms. See below for details, but the United States now has real rates on par with Europe and well below most other major growth economies. It also now boasts a deficit that typically precedes sustained dollar weakness *(Exhibit 41)*. If our forecast plays out, then owning some commodities such as Copper, Platinum, and even some Gold or Oil makes sense.

Beyond increases in debt-to-GDP ratios, COVID starkly exposed the inadequacies of the health and social safety net for tens of millions around the world, as well as the deep social and racial structural inequities in many nations, particularly the U.S. These inequities must and will be fixed.

- **Buy U.S. exporters, Asian Equities, and high quality EM Local Debt (both Public and Private).** In an attempt to reinforce our view on currencies and interest rates, we have looked for other investment vehicles to capture the benefits of a falling dollar and the 'yearn for yield'. That's why we are in favor of increasing exposure to U.S. exporters with growing dividend yields, select EM Equities, and a broad range of EM local debt, including private debt. Remember that over time about one third of the total return from emerging market assets comes from the currency. As part of this allocation decision, we are also comfortable with both sovereign debt and convertible preferred securities in China, given the trend towards dual circulation (see *The Road Ahead* for full details).

- **Overweight Opportunistic Credit, dislocation funds, relative value hedge funds, and macro funds.** Rising geopolitical tensions, more natural disasters, and an increased use of leverage supports our research that there is a steady increase in the number of market sell-offs (*Exhibits 78* and *79*). So, as we look ahead, we again expect more volatility in 2021, and as a result, more oversold situations; and, within those situations, we expect more bifurcations to create opportunity for active management. Indeed, the environment we are envisioning should accrue to the advantage of portfolio managers who have long-term high conviction and understand relative value (e.g., Russell 2000 over S&P 500), coupled with deep industry expertise *and* a thoughtful top-down framework. Implicit in what we are saying is that market breadth expands in 2021, and as a result, some of the COVID 'winners' lose some of their relative momentum on a sustained catch-up trade (*Exhibit 3*).

- **Overweight Global Private Equity vehicles that effectively leverage the illiquidity premium.** As we show in *Exhibit 98*, we think that the value of the illiquidity premium is about to re-assert itself, despite near record dry powder. There are several global forces at work. First, we believe that Europe's public markets are compositionally flawed for the environment we are entering. This creates a significant opportunity for European Private Equity to outperform through sound portfolio construction, particularly as public markets in Europe are overweight Financials and multinationals at the same time they are underweight Technology/Innovation. This mismatch creates an incredibly attractive arbitrage for private equity managers to deliver outsized returns relative to the public markets, in our view. Asia also represents a major opportunity for Private Equity to potentially outperform Public Equity indices. In Indonesia, for example, there are literally no public companies in the technology space. Meanwhile, traditional financial services accounts for fully half of the total market capitalization of a country that is experiencing a significant increase in its GDP-per-capita. See below for further details, but our goal in Asia is to find vehicles that get long rising GDP-per-capita, not just growth in GDP. Finally, within the United States, we have high conviction that the performance of the Russell 2000 relative to the S&P 500 over the next five years will improve substantially (*Exhibit 50*). This backdrop, we believe, bodes well for U.S. Private Equity, particularly for managers with strong operational improvement stories.

- **Buy tail protection.** The base case looks good for risk assets in 2021, but we are currently well overbought after this autumn's

furious rally. More importantly, there are several 'black swan' events that could occur. First, we could be on the cusp of a structural increase in interest rates, particularly towards the second half of 2021. This viewpoint could be exacerbated if global consumers too aggressively spend their excess savings at the same time capital expenditures also surprise to the upside. Second, U.S.–China relations could sour faster than expected. Third, countries and companies could stumble under the weight of all the debt that they have issued in recent quarters. Finally, the dollar could weaken further than expected, given this country's large deficit and low real rates. See *Section IV*: Risks for further details on these investment considerations as well as potential hedges to consider.

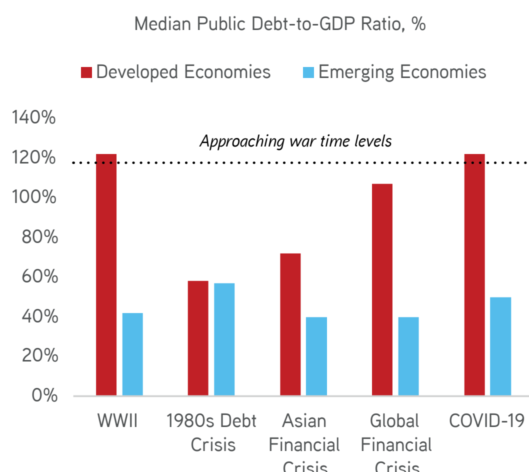
So, the punch line for the next 12-24 months is that the growth environment is going to feel quite good. Easy comparisons, more stimulus, and a snapback in consumer spending will all likely be in play. Indeed, the 'Authorities' are committed to boosting nominal GDP in the near-term, which should help power better performance in cyclical areas (note that we did not say Value segments of the market). Favorites for us now include Japan, smaller capitalization companies, and many parts of the industrial world, not just the secular growers we have been advocating for some time. That's the good news.

However, not all the news is good news. Indeed, as author Cormac McCarthy wrote in *All the Pretty Horses*, "Scars have the strange power to remind us that our past is real." In investor parlance, we should all enter 2021 with eyes wide open to the fact that ultimately there are real costs, including outsized debt burdens, associated with the policies that were required to prevent the pandemic from becoming an economic depression, particularly in the United States. Just as China had to spend much of the 2010-2020 period working off the hangover from its debt spree during the 2000s (which culminated with the country over-stimulating through a massive debt binge in 2009), the U.S. is now the country that will likely need to work through the huge stimulus thrust it put forth to combat the virus. However, it is not alone, as we show in *Exhibit 7*, many developed market countries now face debt load overhangs that could approach levels not seen since World War II. Against this backdrop, we believe that there are now heightened risks that loom across the sovereign debt and currency markets, the U.S. dollar in particular, that may serve as a catalyst for unexpected volatility in the quarters ahead.

Beyond increases in debt-to-GDP ratios, COVID starkly exposed the inadequacies of the health and social safety net for tens of millions around the world, as well as the deep social and racial structural inequities in many nations, particularly the U.S. These inequities must and will be fixed. Accordingly, global investors should also expect a more transparent redistribution of wealth and power. These initiatives could come in the form of regulation of big technology companies, higher minimum wages, and/or some form of wealth taxes. Importantly, we think these structural changes in how countries approach social inequality and income disparity are more secular, not cyclical, in nature. Although institutional distrust has also been rising over the past decade, in 2020 it exploded in many nations, particularly in the U.S. Driven in part by social media and partisan cable media, we now live in a society where facts are more likely to be disputed, information has become weaponized and even previously common sense questions like mask wearing during a pandemic become subject to ideological controversy. The U.S. ends 2020 more fractured than before, with implications for longer term governance and decision-making. Finally, investors should be aware that the current recovery cycle could be shorter in duration than the last cycle, given we are starting this cycle with above average corporate margins, more upfront fiscal coordination, and/or a faster rebound in employment (relative to the GFC).

EXHIBIT 7

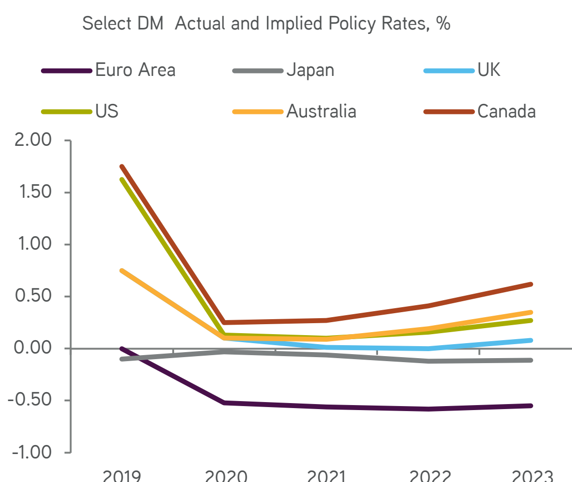
The Balance Sheets of Developed Market Economies Are Now Approaching Wartime Conditions...



Data as at October 14, 2020. Source: IMF, Goldman Sachs.

EXHIBIT 8

...Which Is Why Central Bankers Will Try to Keep Rates Low for Some Time



Data as at November 21, 2020. Source: Bloomberg, Haver Analytics.

SECTION I

Global/Regional GDP Forecasts

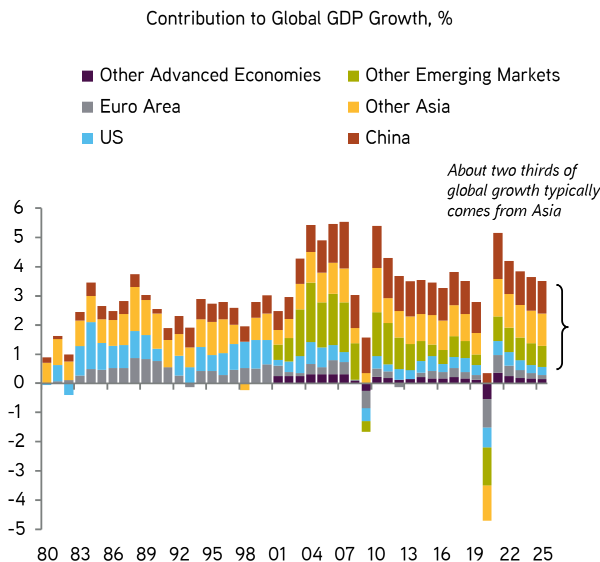
Global GDP Overview

No rebounds, no rings. Pat Riley Hall of Fame NBA Player (1 Championship) and Coach (4 Championships)

We are not sure whether there are championship rings at the end of this cycle, but our team of macroeconomic forecasters at KKR do see major rebounds across almost all economies during the next two years. Hence, we forecast growth rates ahead of consensus expectations in most regions of the world. There are several forces at work. First, we believe that Asia, driven largely by China, is recovering strongly. This reality is hugely important for the global picture, as China accounts for about one third of global growth. Coupled with China's regional peers, Asia in aggregate normally accounts for about two thirds of incremental global growth (though lower in 2021 because of the cyclical snapback in other OECD economies). One can see this in *Exhibit 9*.

EXHIBIT 9

Growth in the Global Economy Continues to be Driven by Asia

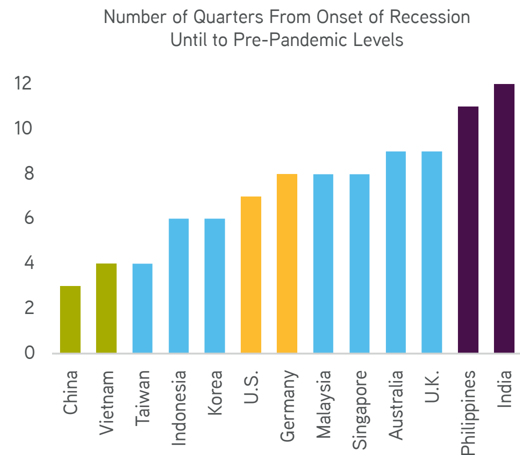


Data as at October 13, 2020. Source: IMFWEO, Haver Analytics.

> **We believe that Asia, driven largely by China, is recovering strongly. This reality is hugely important for the global picture, as China accounts for about one third of global growth.**

EXHIBIT 10

The Road to Recovery Varies Significantly Across the Globe



Data as at October 9, 2020. Source: HSBC *Long Way Home*, KKR Global Macro & Asset Allocation analysis.

Second, as we detail below, we think that the global consumer, the U.S. in particular, is actually in good shape, despite the second quarter spike in unemployment. Savings are high, jobs are coming back, and there is now pent up demand. Third, we have easy comparisons at a time when monetary stimulus is now actually just beginning to flow through the system. Remember that it usually takes 6-12 months for monetary policy to effectively find its way into the economy. So, this 2020 tailwind should help to offset some of the headwind created by a sequential slowdown in fiscal policy initiatives in 2021 versus record levels in 2020.

EXHIBIT 11

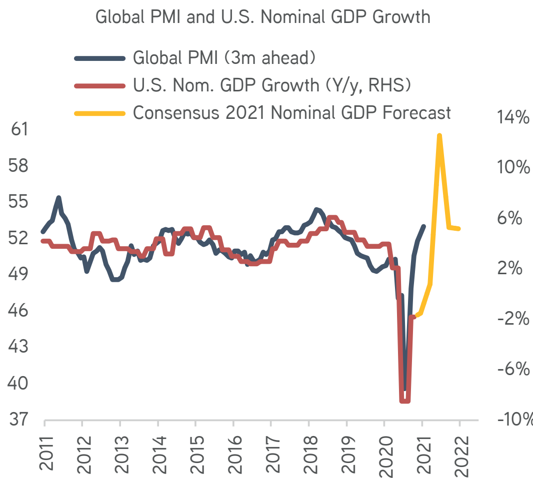
For 2021, We Are Generally Above Consensus for Growth But Below Consensus for Inflation

	2021 REAL GDP GROWTH		2021 INFLATION	
	GMAA TARGET	BLOOMBERG CONSENSUS	GMAA TARGET	BLOOMBERG CONSENSUS
U.S.	5.0%	3.8%	1.9%	1.9%
EURO AREA	5.4%	4.6%	0.9%	0.9%
CHINA	8.0%	8.1%	1.2%	1.8%
MEXICO	4.9%	3.5%	3.7%	3.8%

Data as at November 30, 2020. Source: KKR Global Macro & Asset Allocation analysis.

EXHIBIT 12

Recent Global PMI Activity Suggests an Upcoming Surge in Economic Growth

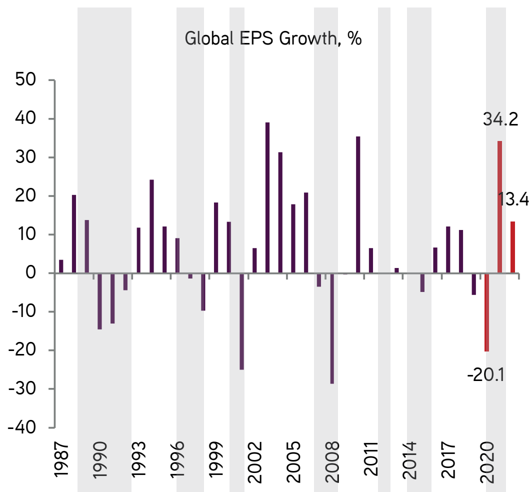


Data as at November 30, 2020. Source: Bloomberg.

Where could we be wrong? As we describe in the Risks portion of the note (*Section IV*), we are increasingly concerned about U.S – China tensions and the potential impact on the global recovery. The good news, we believe, is that the push towards domestication of supply and demand (one of our key themes in Section III) is actually going to boost investment in re-shoring initiatives as well as an increase in the consumption of local goods (i.e., dual circulation). Rates too could spike, but that seems unlikely given the insatiable demand for yield that we see from large pensions, insurance companies, and financial institutions.

EXHIBIT 13

We Expect Vigorous Growth This Recovery Cycle



Red bars equal weighted average of GS global EPS growth forecasts; Purple bars MSCI AC World. Data as at November 30, 2020. Source: Datastream, IBES, Goldman Sachs Investment Research.

Overall, we think that the next 24 months could be the fastest growth in nominal GDP and profits that we have seen in a decade. This viewpoint is central to our 'Another Voice' thesis about broadening markets that reflect much greater participation in the recovery than we have seen in years. If we are right, it suggests a massive opportunity for active managers, particularly those who traffic in asset classes already lagging before the pandemic made their performance even worse on a relative basis.

U.S.:

My colleague Dave McNellis expects strong growth in the United States in 2021. To this end, we are boosting our estimate to five percent from the four percent published in the September *Insights, The Road Ahead*. The consensus for 2021, by comparison, is 3.8%. Beyond pandemic recovery, other powerful growth tailwinds include the housing boom, wealth effects, monetary stimulus, low commodity costs, excess savings, and lean inventories. One can see this in *Exhibit 15*. In terms of sequencing and based on pandemic and vaccine forecasts, our estimates skew cautious near-term (4Q20-1Q21) and more optimistic medium-term (2Q21 onwards). To this end, we show the differential in our quarterly GDP relative to the consensus in *Exhibit 14*.

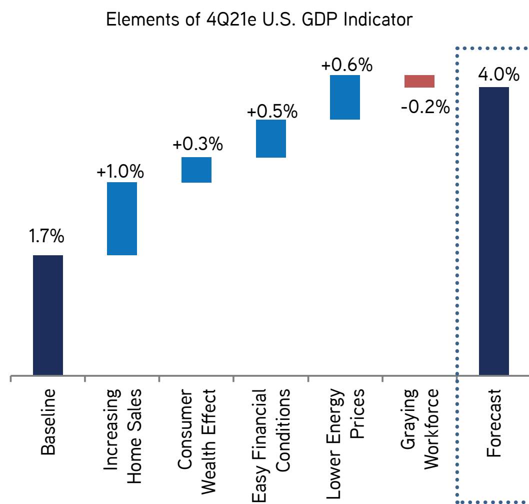
EXHIBIT 14

U.S. GDP: We See More Downside Risk in the Near Term, But Much More Upside Potential in the Medium Term

Data as at November 30, 2020. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 15

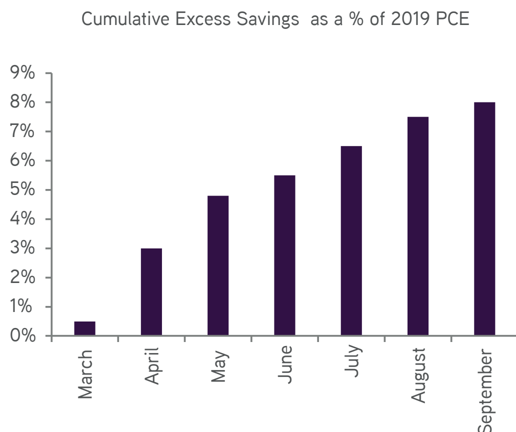
Key U.S. GDP Tailwinds Include Housing Upswing, Wealth Effects, Monetary Stimulus, and Low Commodity Costs



Data as at November 30, 2020. Source: KKR Global Macro & Asset Allocation analysis.

EXHIBIT 16

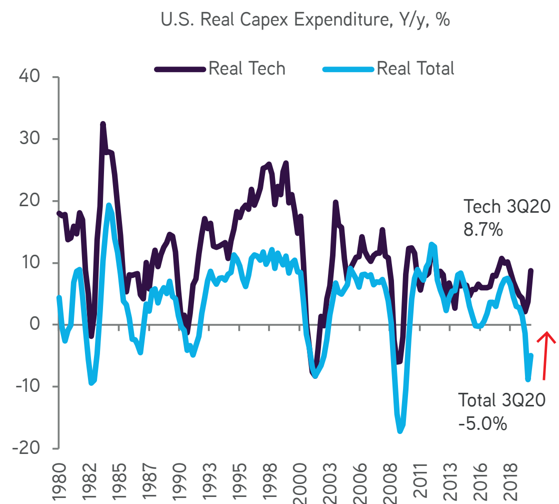
We Think That Incremental Savings by the Consumer Could Reach Upwards of $1 Trillion of Incremental Spending Capacity Over Time



Excess Savings = Savings above counterfactual level projected from February (based on realized savings growth over 2018-2019). Data as at October 31, 2020. Source: Department of Commerce, Goldman Sachs.

EXHIBIT 17

While a Shift Is Occurring in the New Economy, We Also Expect a Sharp Rebound in Non-Tech Spending During the Next 24-36 Months



Data as at September 30, 2020. Source: Cornerstone.

How should we think about the U.S. consumer, who accounts for 70% of GDP? We are steadfastly constructive, despite high unemployment rates and uncertainty around further stimulus. Key to our thinking is that, in spite of the COVID-19 recession, personal disposable income has actually grown, not shrunk, in 2020. Because personal outlays have decreased during a time of rising incomes, there has been a substantial surge in the savings rate (*Exhibit 16*). All told, we think this tailwind could translate into an estimated $500 billion to one trillion dollars in spending capacity that may not be fully accounted for by the investment community. Moreover, as we look ahead, we *do* see more stimulus. Indeed, as we show in *Exhibit 18*, one trillion dollars of further fiscal support would be enough to keep disposable income growth in positive territory during 2021. We anticipate the first $600-700 billion of that support to arrive in the near term via stimulus currently under negotiations in Congress that would extend the small business (PPP) and unemployment supplements introduced under the CARES act, among other measures. Looking into 2021, we see potential for further spending focused on pandemic recovery, including infrastructure and supply chain strengthening initiatives. Finally, a new round of stimulus checks or other income support measures, while not likely in the near term, could eventually help even further (see the two percent DPI jump in *Exhibit 18*.)

> **We are steadfastly constructive on the U.S. consumer, despite high unemployment rates and uncertainty around further stimulus.**

EXHIBIT 18

Under Most Scenarios, We Expect There Will Be Enough New Stimulus to Support Continued Expansion of Disposable Incomes in 2021

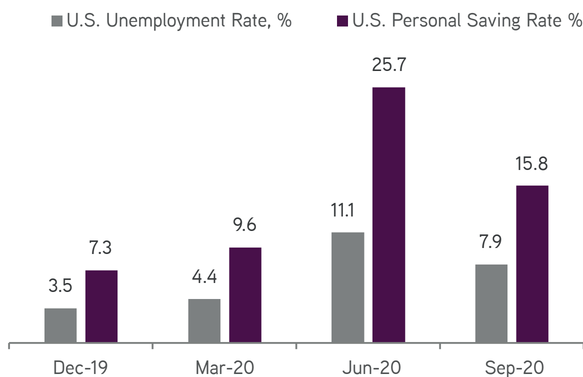
	MONTHLY AVG. DISPOSABLE PERSONAL INCOME PER HOUSEHOLD	PRIVATE SOURCES(1)	BASELINE GOV'T SOCIAL BENEFITS (INCL. AUTO STABILIZERS)	SUPPLEMENTAL PUBLIC SOURCES
	U.S. DOLLARS			
2019	11,087	8,968	2,120	0
2020E	11,428	8,341	2,421	666
BASE 2021E ($1TR. NEW STIMULUS)(2)	11,456	8,916	2,329	211
BULL 2021E ($1.3TR. INCL. CHECKS)	11,658	8,916	2,329	413
	CONTRIBUTION TO TOTAL DPI GROWTH			
2020E	3.1%	-5.7%	2.7%	6.0%
BASE 2021E ($1TR. NEW STIMULUS)(2)	0.2%	5.0%	-0.8%	-4.0%
BULL 2021E ($1.3TR. INCL. CHECKS)	2.0%	5.0%	-0.8%	-2.2%

1. Income from private sources excludes employment income funded via PPP
2. Baseline $1 Trillion stimulus assumption includes 2nd round of PPP (~$300Bn), Aid for State & Local (~$150Bn), Supplemental Unemployment insurance (~$175Bn), and ~$375Mm of public health funding and other grants and subsidies.

Note: Baseline benefits are regular government assistance programs that are already in place. Supplemental are pandemic-specific programs - mostly those introduced by the CARES act. Bull case assumes a further $300Bn for new $1,200 household stimulus checks. Data as at December 7, 2020. Source: Bureau of Economic Analysis, GS Investment Research, KKR Global Macro & Asset analysis.

EXHIBIT 19

Unlike During the GFC, U.S. Personal Savings Spiked During the Pandemic Due to the Massive Levels of Support from the U.S. Government



Data as at September 30, 2020. Source: Fed, BLS, Haver Analytics.

In terms of inflation, we would make the following two points. First, easy comparisons will flatter inflation readings in the first part of 2021. Indeed, U.S. CPI fell by fully 3.5% at an annualized rate in 2Q20, amid the first wave of pandemic lockdowns. As a result, inflation will look elevated on a year-over-year basis around mid-year 2021, given even just modest sequential improvements going forward *(Exhibit 20)*.

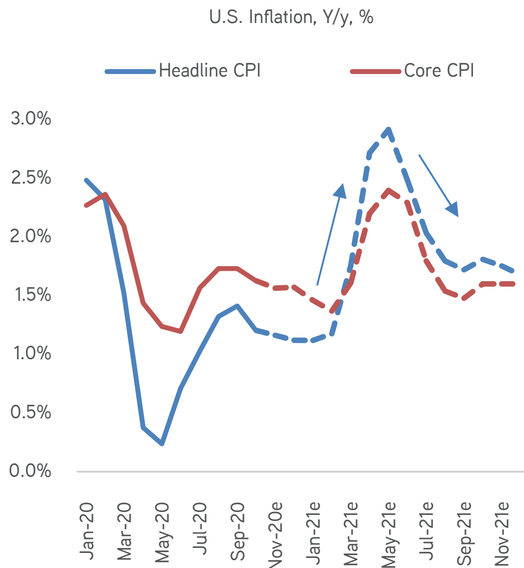
Second, **for the full year, we expect CPI to remain below two percent, anchored by restrained core inflation.** Remember, the pandemic dented pricing power in several categories holding outsized CPI weights, including apartment rentals, health care, and education. These categories have not recovered in the initial economic bounce, and in fact have come under increasing pressure in recent months *(Exhibit 21)*. Excess capacity and regulatory overhangs likely will hold back pricing power in these markets for several quarters even once the pandemic has passed.

We do not see inflation sustainably above the Fed's two percent goal until around 2024. Beyond the industry-specific issues above, we see several other drags. Most important is the still-elevated unemployment rate, which we do not see reaching inflationary sub-four percent levels until 2023 or 2024. Other macro overhangs include the elevated USD, as well as the anchoring effects of low inflation today on inflation expectations in coming years.

Ultimately, though, at some point we do think inflation trends will converge with pre-pandemic levels. As mentioned above, long-term interest rates today seem to price the deflationary aspects of the pandemic—accelerated digitalization in particular—while underemphasizing the potential reflationary aspects, including supply chain breakage, fiscal deficits, and a potential political push for higher minimum wages.

EXHIBIT 20

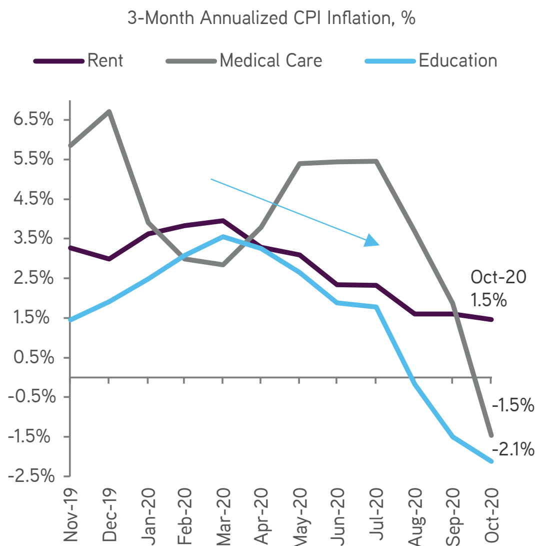
After an Initial Surge Around Mid-Year, the Rate of Inflation Should Actually Slow



Data as at November 30, 2020. Source: Bureau of Economic Analysis, Bloomberg, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 21

...But We Think that Ongoing Headwinds in Several Structurally Important Categories Will Hold Full-Year Inflation Below Two Percent



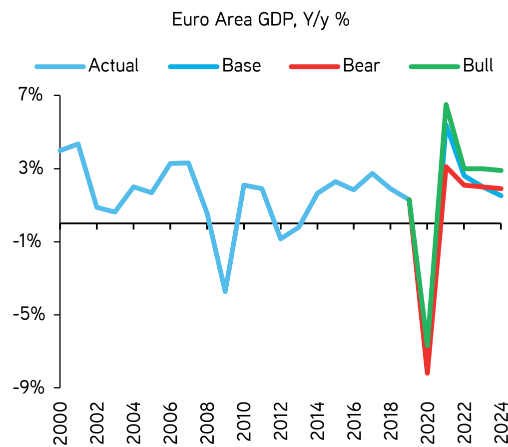
Data as at October 31, 2020. Source: Bureau of Economic Analysis, Bloomberg, KKR Global Macro & Asset Allocation analysis.

Euro Area:

My colleague Aidan Corcoran, who heads our European macro effort, remains quite constructive on GDP growth in 2021. Specifically, he is looking for growth of 5.4%, compared to -7.3% in 2020 and a consensus of 4.6% for 2021. Already, Europe experienced a stunning rebound in the third quarter of 12.6% quarter-over-quarter, bringing activity to 95.7% of the pre-virus level, before the second lockdown hit. While good for the economy, this reacceleration unfortunately drove the second wave of COVID, leading to the 4Q20 lockdowns. As such, growth in the fourth quarter is likely to be around negative three percent quarter-over-quarter, but we still do expect most countries to see positive growth in every quarter of 2021.

EXHIBIT 22

We Are Quite Constructive for Euro Area GDP in 2021...

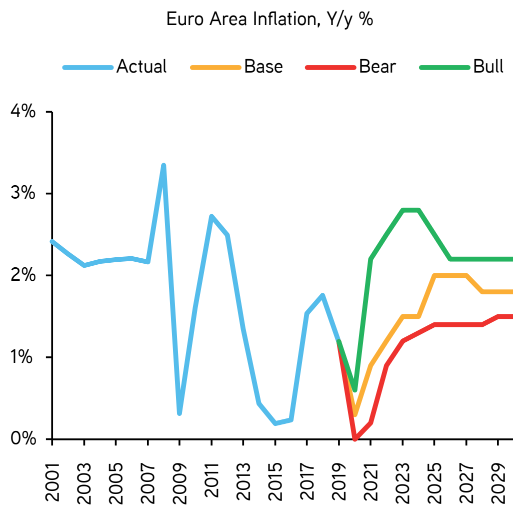


Data as at November 30, 2020. Source: KKR Global Macro and Asset Allocation estimates.

For the full year 2021, we expect U.S. CPI to remain below two percent, anchored by restrained core inflation. Remember, the pandemic dented pricing power in several categories holding outsized CPI weights, including apartment rentals, health care, and education.

EXHIBIT 23

...and Look for Inflation to Remain Quite Low for the Foreseeable Future



Data as at November 30, 2020. Source: KKR Global Macro and Asset Allocation estimates.

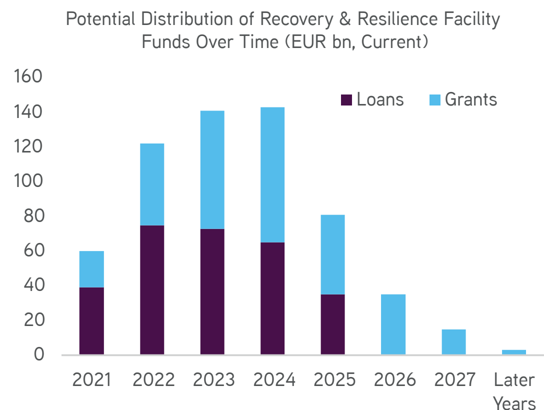
What is different this time is that the 'Authorities' in Europe have embraced fiscal stimulus versus fiscal austerity, which was their go-to move post-GFC. One can see the size, breadth, and length of both the loans and grants that will be provided going forward in *Exhibit 24*. Importantly, the periphery countries are the major beneficiaries this cycle versus a much more punitive approach towards Greece, Italy, and Spain last cycle (*Exhibit 25*).

> **What is different this time is that the 'Authorities' in Europe have embraced fiscal stimulus versus fiscal austerity, which was their go-to move post the Global Financial Crisis.**

Also, we think that the employee furlough programs in Europe have been incredibly effective. No doubt, these programs cost money, and given Europe is already quite indebted, the help of the ECB to keep rates low will be important to avoid another sovereign debt crisis. The good news is that there is plenty of liquidity; in fact, excess liquidity in the Euro Area banking system has just passed €3 trillion for the first time. On top of this, we continue to believe the ECB will maintain a strongly accommodative stance in 2021.

EXHIBIT 24

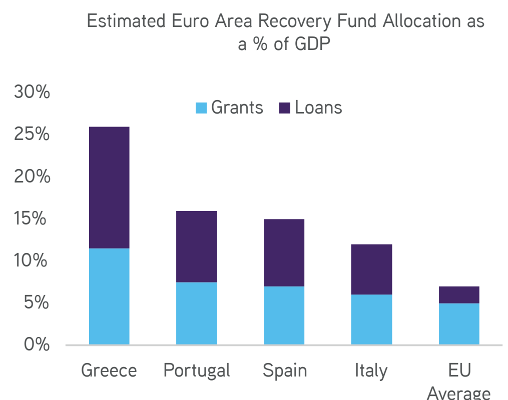
Unlike the Last Cycle, the EU Is Making a Prolonged Campaign of Support...



Data as at October 14, 2020. Source: Morgan Stanley Research.

EXHIBIT 25

...With the Periphery Being a Particularly Large Beneficiary



Data as at October 14, 2020. Source: European Commission, Morgan Stanley Research Estimates.

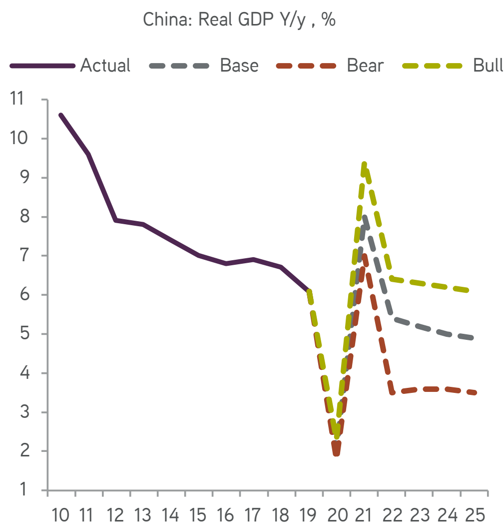
Meanwhile, on the inflation front, we also look for inflation in Europe to remain quite low for the foreseeable future. In fact, we think investors will have to wait until 2025 to see inflation sustainably reach the ECB's target. Currently, this target is 'below, but close to two percent' – an ambiguous goal which has probably contributed to Europe's disinflationary problem. We look for the target to be changed to simply two percent as early as 2021, as part of the ECB's strategic review. This change, combined with the continued exceptional monetary policy accommodation, should gradually return inflation to a healthier level of around two percent by 2025.

Asia:

My colleague Frances Lim forecasts real GDP growth to recover to eight percent in 2021 following growth of 'just' 2.1% in 2020. Key drivers of growth will evolve from infrastructure and real estate, to laggard sectors such as household spending and manufacturing investment. The recovery in the employment market should broaden out to contact-services areas as the vaccine is introduced, lifting wage growth and household spending, while reducing precautionary savings. While international travel will remain slower to recover than domestic travel, it will continue to benefit from increased consumer confidence and less safety concerns. The strong global growth recovery will improve business sentiment and manufacturing investment; however, some of this benefit could be tempered by lingering U.S.-China tensions, we believe.

EXHIBIT 26

We Expect 2021 Real GDP Growth in China to Recover to 8.0% Following Growth of 'Just' 2.1% in 2020

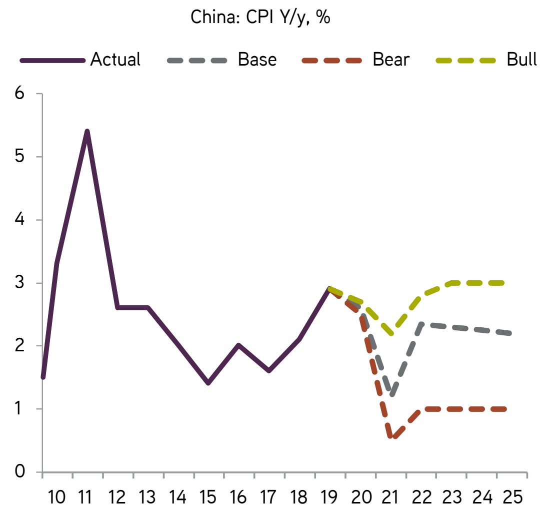


Data as at November 30, 2020. Source: China Bureau of National Statistics, KKR Global Macro & Asset Allocation analysis.

> **We forecast China Real GDP growth to recover to eight percent in 2021 following growth of 'just' 2.1% in 2020. Key drivers of growth will evolve from infrastructure and real estate to laggard sectors such as household spending and manufacturing investment.**

EXHIBIT 27

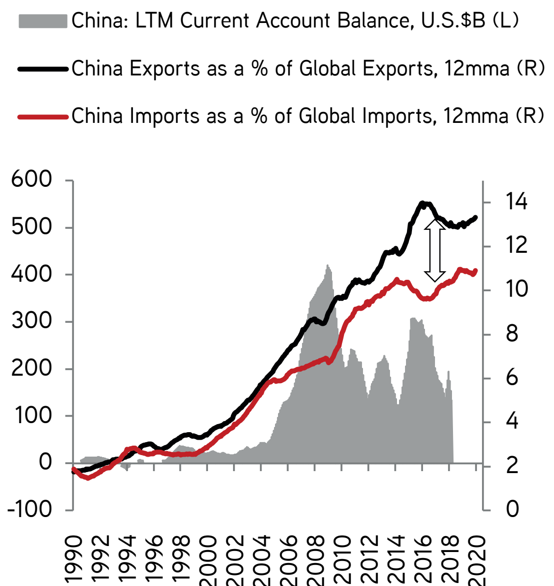
Our Scenario Planning Now Suggests More Downside Skew to Inflation in China



Data as at November 30, 2020. Source: China Bureau of National Statistics, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 28

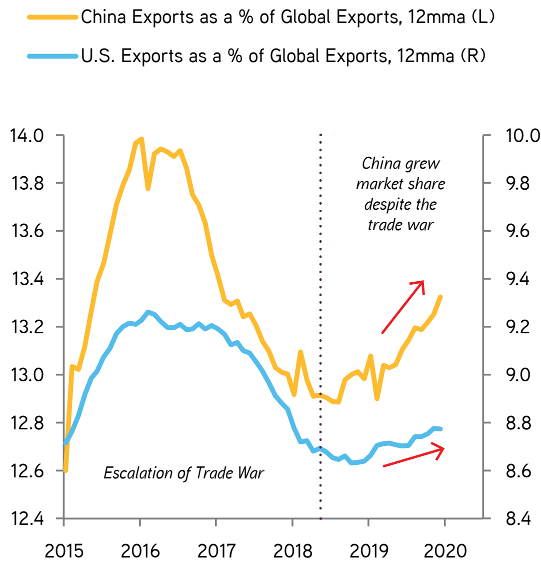
China Is Importing Less As It Turns Inward to Satisfy Demand...



Data as at December 31, 2019. Source: China Bureau of National Statistics, Haver Analytics.

EXHIBIT 29

...However, China Is Still Growing Its Export Market Share, Despite the Trade War

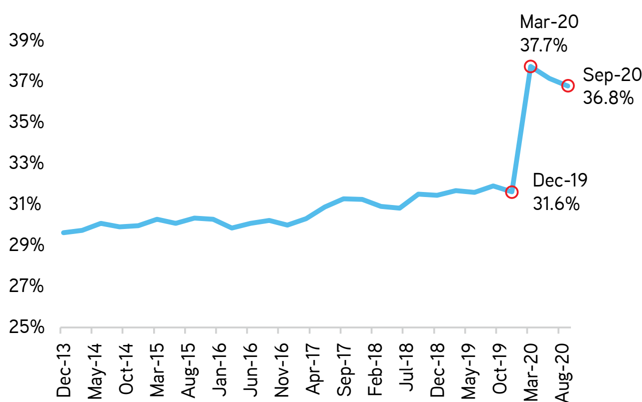


Data as at December 31, 2019. Source: China Bureau of National Statistics, Haver Analytics.

Meanwhile, though exports will remain relatively strong, imports are likely to rise on increased domestic demand. In our opinion, 2021 will be about the consumer. The good news is that, as we show in *Exhibit 30*, any reduction in the savings rate back towards normal could lead to incremental near-term spending. Importantly, trade is no longer a major driver of growth, though China does continue to take market share (*Exhibit 29*).

EXHIBIT 30

Savings Rates Have Also Increased in China. This Trend Ultimately Bodes Well for Consumption in 2021 and Beyond



Data as at September 30, 2020. Source: Haver Analytics.

Importantly, we expect less speculative spending and investment this recovery. Indeed, a key theme of the 14th Five Year Plan for 2021-2025 is quality over quantity with an emphasis on dual circulation, innovation, environmental stability, and other reforms. Also, President Xi noted that the economy could double by 2035, which implies an annualized growth of 4.7%, suggesting that slightly slower growth is now considered more desirable.

On the inflation front, we forecast headline inflation of 1.2% in China, down from 2.6% in 2020. According to Frances, the big story will be some normalization of pork prices, which surged more than 100% in 2020 on the back of the African swine flu's impact on the pig population. However, livestock levels are beginning to normalize, and as such, we expect headline CPI to enjoy much easier year-over-year comparisons in 2021. An offset, however, will be an increase in core inflation. Remember that core inflation is tightly correlated with wage growth, which jumped to 5.9% year-over-year in 3Q20 from a low of 1.2% in 1Q20. Given these dynamics, we expect core inflation to reach 1.4% in 2021, slightly above our forecast of 1.2% for headline inflation in China earlier this year.

> **Importantly, we expect less speculative spending and investment in China this recovery. Indeed, a key theme of the 14th Five Year Plan for 2021-2025 is quality over quantity, with an emphasis on dual circulation, innovation, environmental stability, and other reforms.**

Mexico:

My colleague Brian Leung expects GDP growth to be in the 4.5-5.0% range in 2021, which is quite fast by recent standards and above consensus expectations of 3.5%, but underwhelming considering the record of about nine percent year-over-year contraction this year. Limited countercyclical fiscal stimulus, relatively high interest rates, and domestic policy uncertainty, mean private consumption is likely to be subdued (especially in the context of a soft labor market) and business investment is likely to stay depressed (owing to AMLO's mixed messaging to the private sector and mid-term elections). In short, we expect Mexico to be one of the last countries in Latin America to regain its pre-pandemic level of GDP.

If there is a silver lining, it will likely be the strong U.S./global economic recovery that we are envisioning for next year. Mexico's linkages to the U.S. have already led to a strong recovery in sectors tied to the external environment (e.g., manufacturing/exports), and we see more opportunity for gains ahead. So, going forward, investors should look to identify opportunities leveraged to external demand, exports, and reshoring as opposed to domestic demand plays, we believe.

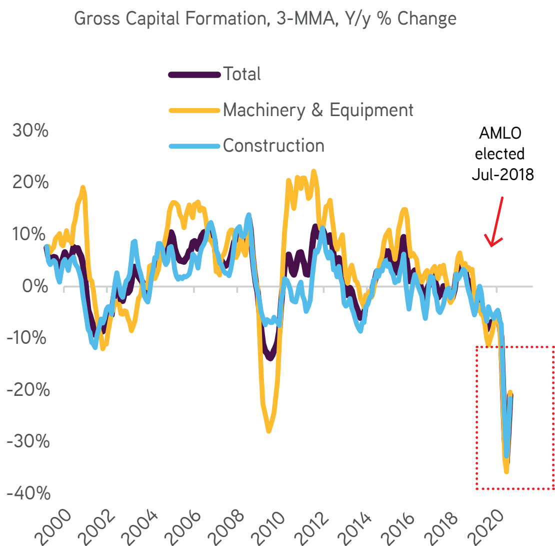
EXHIBIT 31

We Expect Mexico Real GDP to Grow 4.5-5.0% in 2021, Driven by the Strong U.S. Economic Recovery

Data as at November 30, 2020. Source: Bloomberg, Haver Analytics, Banxico, INEGI, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 32

COVID Has Accelerated the Collapse in Investment, Potentially Impairing Future Growth Prospects and Formal Job Creation in Mexico

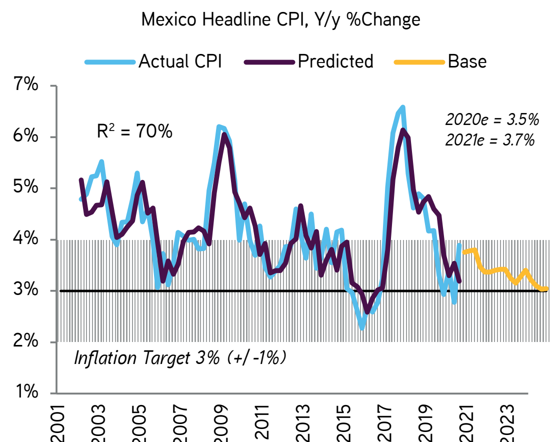


Data as at November 30, 2020. Source: Haver Analytics, INEGI.

On the inflation side, Brian expects headline CPI to average 3.7% in 2021, which is in line with consensus expectations and modestly higher than 3.5% last year. Inflation has been surprisingly sticky during the pandemic, dragged higher by merchandise inflation (mainly food) even as services remain depressed. But we see inflation pressures easing through the year given the large negative output gap, stronger peso, and fading of pandemic-related supply shocks. As such, we believe Banxico will resume its easing cycle by cutting the policy rate to 3.75% from 4.25% today. That would still represent a high carry differential relative to the U.S. thanks to an 'average inflation targeting' Federal Reserve.

EXHIBIT 33

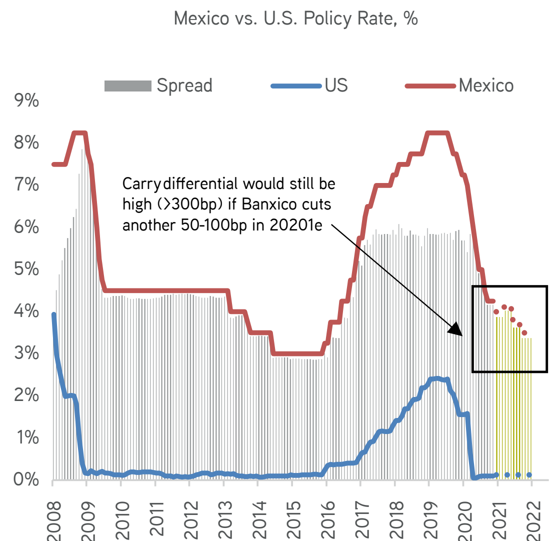
We Expect Inflation in Mexico to Average 3.7% in 2021e, Up From 3.5% This Year, But Below the 4% Central Bank Target Upper Bound



Data as at November 30, 2020. Source: Bloomberg, Haver Analytics, Banxico, INEGI, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 34

A Still-Healthy Carry Differential Suggests Banxico Can Cut Rates a Bit Further Before Jeopardizing MXN Stability



Data as at November 30, 2020. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics, Banxico, INEGI.

SECTION II

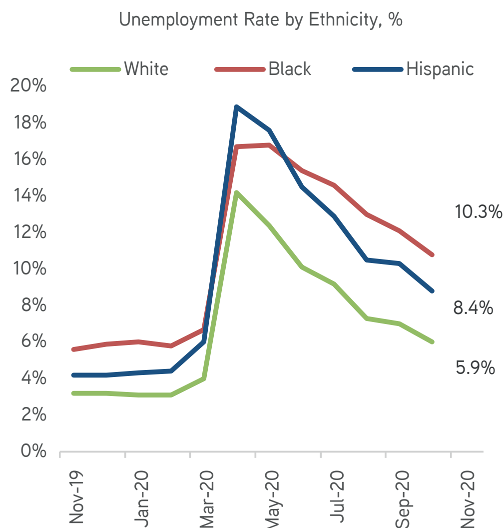
Key Macro Inputs

U.S. Interest Rates: a Year of Change Lies Ahead

We expect short-term rates to remain anchored near zero, but do think 10-year yields can drift up to 1.25% in 2021; in fact, we think this is just the beginning of a structural move upward in rates over time. We certainly expect short-term yields to remain pinned near zero in coming years, given the Fed's pre-commitment to keep rates floored until inflation is sustainably above two percent (which we view as a 2024 event, detailed below). Importantly, the Fed is laser-focused on unemployment, and the outsized burden the pandemic is exerting on women, BIPOC communities[3], and service workers, who are increasingly falling into the ranks of the long-term unemployed (*Exhibit 35* and *36*).

EXHIBIT 35

Black and Hispanic Employment Trends Still Lag That of White Employment Trends

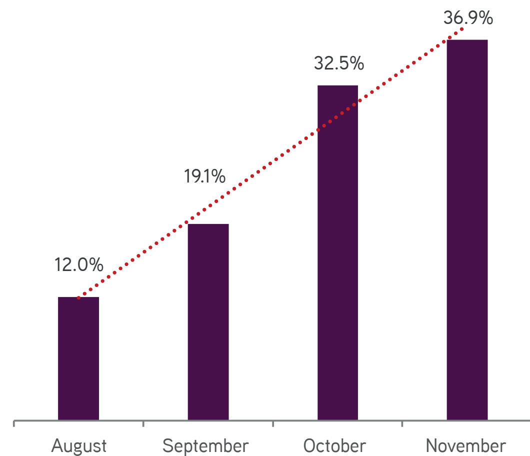


Data as at November 30, 2020. Source: Bureau of Labor Statistics, Haver Analytics.

We expect short-term rates to remain anchored near zero, but do think 10-year yields can drift up to 1.25% in 2021; in fact, we think this is just the beginning of a structural move upward in rates over time.

EXHIBIT 36

Also Worrying Is the Rising Long-Term Unemployment Picture



Data as at November 30, 2020. Source: Bureau of Labor Statistics, Haver Analytics.

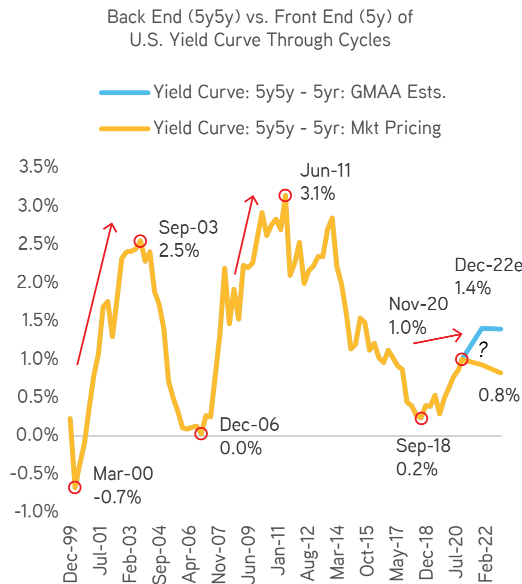
As mentioned above, however, our central insight is that the back end of the yield curve (years 5+) usually trends higher early in a new cycle, which we do not yet see reflected in today's term structure (*Exhibit 37*). To be sure, there are potential headwinds to rates moving higher. Accelerating digitalization, a heavy-handed central bank, and demographics could all act to keep rates low in the near-term. Regardless, long-term rates still appear artificially compressed in our view, and as such, we see multiple ways for them to increase. First, real yields appear too low relative both to history and expected growth trends. Second, there is no embedded term premium, which seems misguided after so much stimulus. Third, there could be cyclical inflationary forces at work, including supply chain breakage, increasing minimum wages, and larger fiscal deficits.

Bottom line: We think U.S. 10-year yields can move up to 1.25% in 2021 and onward to 1.5% in 2022. One can see this in *Exhibit 38*. At 1.5%, 10-year yields would hover about 150 basis points below our three percent long-run estimate of U.S. nominal GDP growth, which we think is an appropriate mid-cycle interest rate target. We also think that the yield curve could steepen in the future. As we show in *Exhibit 37*, we see the 5-year forward curve five years out at 1.4% relative to the current 5-year yield at 0.4%, and compared to the consensus of just 80 basis points.

3 Black, indigenous, and peoples of color.

EXHIBIT 37

We Expect More Curve Steepening Than What Is Currently Priced In



e = KKR Global Macro & Asset Allocation estimates. Data as at November 30, 2020. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 38

Pulling the Pieces Together, We Target a 10-year Yield of 1.25% in 2021 and 1.5% in 2022

	MARKET PRICING			GMAA ESTIMATES		
	10-YR YIELD	5-YR YIELD	5Y5Y FWD	10-YR YIELD	5-YR YIELD	5Y5Y FWD
NOV-20	0.85%	0.38%	1.38%	**0.85%**	0.38%	1.38%
DEC-21E	1.04%	0.60%	1.53%	**1.25%**	0.60%	2.00%
DEC-22E	1.24%	0.85%	1.68%	**1.50%**	0.85%	2.25%

e = KKR Global Macro & Asset Allocation estimates. Data as at November 30, 2020. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Currency: Weaker USD

We have a strong view that the U.S. dollar is likely to continue to depreciate relative to a wide array of currencies over the medium term. There are a number of forces at work, in our view. They include the following:

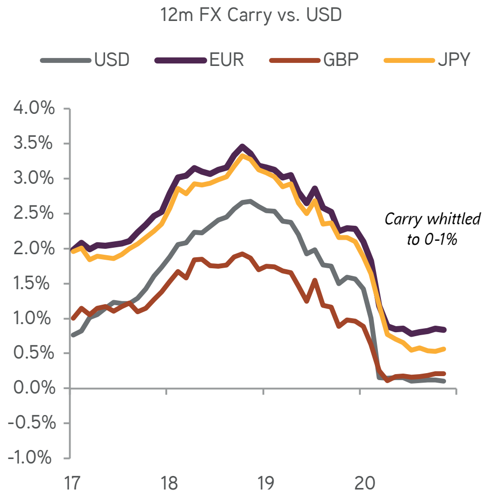
- **The dollar still appears expensive on most metrics that we track,** despite recent weakness. For example, as we show in *Exhibit 41*, the dollar appears expensive on a Real Effective Exchange Rate (REER) basis.
- **The Fed could be among the last central banks to raise rates.** The Fed has signaled that it will keep rates low for an extended period, particularly given recent trends in minority and low income employment. Indeed, unlike during the Taper Tantrum in 2013/2014 when the Federal Reserve was the first to raise rates, the U.S. central bank may be among the last to raise rates this recovery cycle, we believe.
- **Growth favors the rest of the world over the U.S.** The broader U.S. dollar index tracks the growth differential between the U.S. and IMF World real GDP growth. Looking ahead, growth favors the rest of the world versus the U.S. for the next few years.
- **Not all FX has appreciated against the USD as of yet.** So far, most of the appreciation versus the USD has been across G10 currencies. LATAM, EMEA, Africa and Asia have yet to fully participate. USD appreciation is likely to vary by country depending on growth differentials, interest rate differentials, and fund flows.
- **Fiscal and Current account deficits suggest more downside to USD.** The trade weighted U.S. dollar tracks fiscal and current accounts, both of which have deteriorated and now suggest further U.S. dollar weakness. One can see this in *Exhibit 42*.

In terms of our favored ways to implement this view, our favorite longs are JPY relative to the dollar. We like this currency pair a lot because it is working in both risk-on and risk-off markets. We also think that the significant decline in U.S. real yields relative to European real yields means that the euro is poised to outperform. Additionally, we see the British pound appreciating relative to the dollar, particularly as the worst of the BREXIT passes. AUD and CAD should also fair well, based on stronger growth and recovering commodity prices. Finally, we see China's CNY appreciating based on stronger growth as well as significant interest rate differentials relative to the United States.

The Fed has signaled that it will keep rates low for an extended period, particularly given recent trends in minority and low income employment. Indeed, unlike during the Taper Tantrum in 2013/2014 when the Federal Reserve was the first to raise rates, the U.S. central bank may be among the last to raise rates this recovery cycle, we believe.

EXHIBIT 39

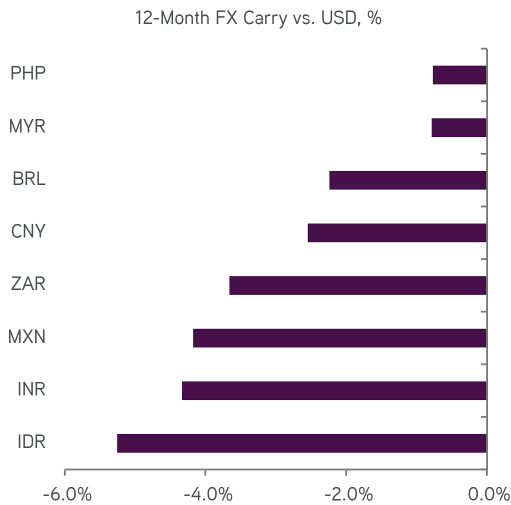
The G4 Have Lost Much of Their Carry Appeal, Which Reinforces Our Penchant for Several EM Currencies



Data as at November 30, 2020. Source: Bloomberg.

EXHIBIT 40

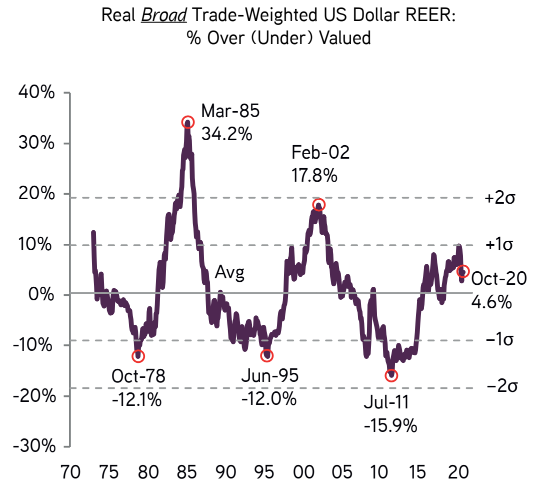
So Far, Most of the Appreciation vs. the USD Has Been Across G10 Currencies, Not in EM. We See This Changing in 2021



Data as at November 30, 2020. Source: Bloomberg.

EXHIBIT 41

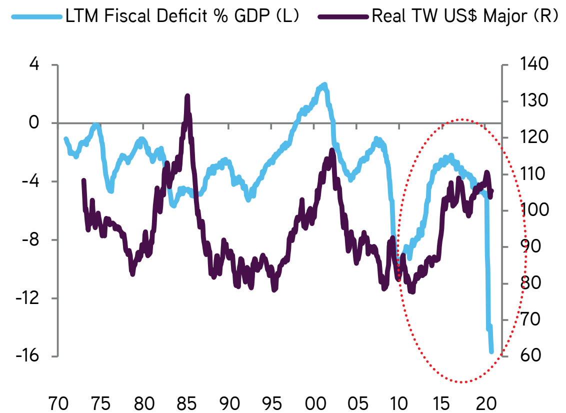
The U.S. Dollar Overvaluation Has Only Corrected Slightly, We Believe



Data as at October 31, 2020. Source: Haver Analytics, Bloomberg, KKR Global Macro & Asset Allocation estimates.

EXHIBIT 42

The U.S. Fiscal Deficit Suggests a Lot More Downside to the Dollar



Data as at October 31, 2020. Source: U.S. Treasury, Federal Reserve Board, Bureau of Economic Analysis, Haver Analytics.

The trade weighted U.S. dollar tracks fiscal and current accounts, both of which have deteriorated and now suggest further U.S. dollar weakness.

EXHIBIT 43

We Do See a Path to More Normalized Oil Supply and Demand Fundamentals in the Near Future

	KKR GMAA (Nov'20)	WTI Futures (Nov'20)	Nov'20 Forecasts GMAA vs. Futures	KKR GMAA (Dec'19)	WTI Futures (Dec'19)	Dec'19 Forecasts GMAA vs. Futures	*Change in GMAA Forecasts: Nov'20 vs. Dec'19*	*Change in Futures: Nov'20 vs. Dec'19*
2019A	57.04	57.04	0.0	57.04	57.04	0.0	*0.00*	*0.0*
2020E	37.50	38.51	-1.0	52.50	53.14	-0.6	*-15.00*	*-14.6*
2021E	47.50	42.99	4.5	47.50	52.34	-4.8	*0.00*	*-9.4*
2022E	50.00	43.84	6.2	55.00	51.29	3.7	*-5.00*	*-7.4*
2023E	52.50	43.98	8.5	60.00	51.07	8.9	*-7.50*	*-7.1*
2024E	55.00	44.27	10.7	N/A	51.29	N/A	*N/A*	*-7.0*

Data as at November 23, 2020. Forecasts represent full-year average price expectations. Source: S&P 500, KKR Global Macro & Asset Allocation analysis.

Oil: Normalization Is Still a Ways Away

While the global economic rebound has exceeded all consensus expectations of late, this backdrop is no longer the case in the oil market. Specifically, the rate of improvement in energy demand is now stalling, largely due to natural limits to activity in a pre-vaccine world. As a result, crude inventories are drawing, but it may be a struggle for the net deficit to expand beyond the approximately 1.0-1.5 million barrels per day mark that has been the norm since late July. All told, our framework points to global inventories and OPEC spare capacity needing to normalize in order for WTI oil to trade sustainably above $50. Consensus sees inventory normalization happening by 4Q21, but we are more conservative, making it a 2022 event. As we saw in the OPEC+ meeting in December, some members are anxious to return barrels to market as quickly as possible, and therefore willing to delay global inventory normalization for the cause of market share. An added complication is the potential return of Iranian production to market in 2021-22 in the event of a breakthrough in nuclear talks. We think other OPEC+ members, aware of this dynamic, will likely seek to normalize their own spare capacity as much as possible before Iran returns to market.

Our 2021 target represents a 12-13% of upside. We see several forces at work, including high-efficacy vaccines, no major tax increases, and a less confrontational approach to trade tariffs. Meanwhile, central bank policy remains supportive (the global policy rate is at historically low levels with ongoing QE), and additional fiscal stimulus is expected even if the scope/scale is narrower. So, with policy uncertainty on the wane, we expect the equity risk premium to stay benign.

Our Bottom line: We do see a path to a normalized oil supply/demand fundamentals, albeit one that takes a couple of years to play out. To this end, we lay out our forecasts below in *Exhibit 43*. As the table shows, we see oil prices hitting $55 by 2024, well above the futures market. Our above-consensus forecast could be even higher if the U.S. dollar weakens more than expected. However, as we also show, our 2024 forecast would still be below 2019's level. Said differently, our forecast is encouraging, but we fully appreciate our comparisons are coming off of near-record lows.

S&P 500 EPS and Valuation: More Upside in 2021

For 2021 we are using an S&P 500 fair value of 4,050, compared to our December 31, 2020 estimate of 3,600. As such, our 2021 target represents a 12-13% of upside. We see several forces at work, including high-efficacy vaccines, no major tax increases, and a less confrontational approach to trade tariffs. Meanwhile, central bank policy remains supportive (the global policy rate is at historically low levels with ongoing QE), and additional fiscal stimulus is expected even if the scope/scale is narrower. So, with policy uncertainty on the wane, we expect the equity risk premium to stay benign.

EXHIBIT 44

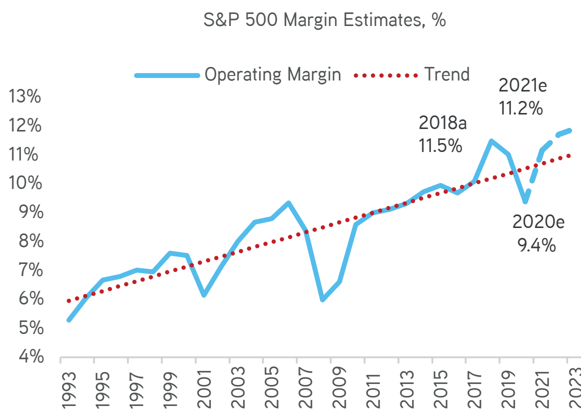
Several Important Macro Supports, Including Low Energy Prices, Recovering Inventories, and Easy Monetary Policy Support Our Strong S&P 500 EPS Forecast for 2021

	JUN'20P CONTRIBUTION	DEC'21P CONTRIBUTION	DELTA
Oil Prices	-7.1%	4.0%	11.1%
ISM PMI	-1.3%	2.8%	4.1%
Real Home Price Apprec.	1.9%	5.0%	3.0%
Trade-Weighted USD	-0.6%	0.2%	0.8%
G7 ex US Monetary Policy	-0.2%	0.4%	0.5%
Baseline Growth	5.3%	5.3%	0.0%
Credit Spreads	-0.5%	-0.5%	0.0%
Consumer Confidence	0.1%	-1.2%	-1.2%
Total	**-2.4%**	**16.0%**	**18.4%**

Note: EGLI indication for 2021 is +16%. But adding back 10-12%pt of undershoot due to the pandemic gets us to 25-30% EPS growth in 2021. Data as at November 30, 2020. Source: S&P 500, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 45

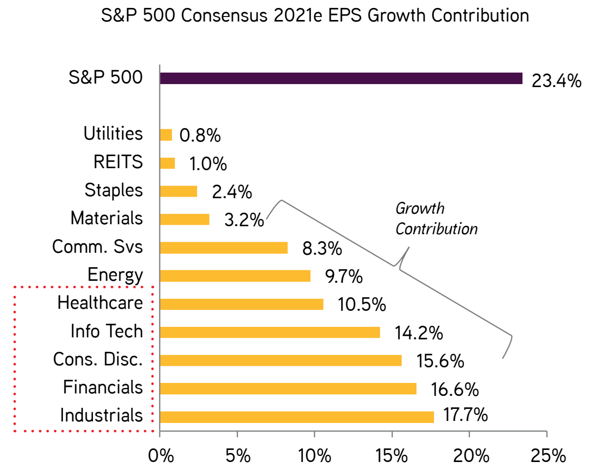
Our Earnings Forecast Implies Margins Rebound Back Above Trend in 2021e, But Below the 2018 Peak of 11.5%



Data as at November 30, 2020. Source: S&P 500, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 46

A Healthy Mix of Cyclicals, Value, and Secular Growth Sectors Are Responsible for Around 75% of 2021 EPS Growth



Data as at November 30, 2020. Source: S&P 500, KKR Global Macro & Asset Allocation analysis.

In terms of specific forecasts to support our year-end targets, we use the following assumptions: We expect the equity risk premium to stay near current levels of 5.0%, which is approximately 50 basis points lower than the post-GFC average of 5.5%, but above the lows of 4.2%. In terms of the discount rate, we assume that the 10-year U.S. Treasury yield, our proxy for the risk-free rate, rises to 1.25% from 0.90% today. While rising rates are a modest headwind to valuation, the absolute level remains approximately 100 basis points lower than the 2011-2019 average of 2.25%. All in all, our outlook suggests that earnings will drive the lion's share of equity returns in 2021, as we expect NTM P/E multiples to stay roughly flat at 21.2x.

Importantly, we think that we are in the early innings of an economic recovery that should encourage broader market participation amidst robust earnings growth. We note the following:

1. The labor market is recovering well ahead of expectations. We now forecast the unemployment rate to reach 6.2% in 2021, compared to peak level of 14.7% in April 2020 and our 6.7% in December 2020.

2. On an apples-to-apples basis, our EGLI model suggests S&P 500 earnings could rise 25-30%, reaching $174 per share in 2021e (up from $136 per share in 2020e). This estimate compares to the consensus estimate of $169/share for 2021 and our prior estimate of $170/share. The increase is powered by several important macro supports, including low energy prices, recovering inventories, housing bull market/wealth effects, and easy monetary policy.

3. Our numbers imply that operating margins rebound back above trend in 2021e to 11.2%, up from 9.4% in 2020e, but below the 2018 peak of 11.5%. Better-than-expected 2Q20 and 3Q20 earnings seasons have shown that aggressive cost cutting through the recession has allowed operating leverage to drive higher margins and earnings.

4. In terms of contribution by sector, a healthy mix of Cyclicals (Industrials, Consumer Discretionary), Value (financials) and 'Secular Growth' sectors (Technology, Healthcare) are expected to drive approximately 75% of 2021 EPS growth.

Despite our view that we are near-term overbought, the technical picture is also supportive. Indeed, the S&P 500 just registered its highest percentage of new six-month highs since the early 1990s (45%). The last two readings of this magnitude occurred just as markets were rebounding off the lows of the Tech Bubble Crash in 2003 and GFC in 2009. It is not just the S&P 500, as all-time highs are occurring in the Dow Jones Industrials, Dow Jones Transportation, Russell 2000 and Wilshire 500 – and this all comes following three years of sideways price action in most of these indicates. Meanwhile, outside of the U.S., Japanese equities (NKY) are making 29-year highs, while Sweden, Korea, New Zealand, Taiwan and the Nifty 50 are all making new all-time highs.

EXHIBIT 47

Taking into Account the Positive Vaccine News and Our Upgraded U.S. GDP Estimate, Our New Fair Value Estimate for the S&P 500 Is 4050 in 2021e

10-YR U.S. TREASURY YIELD, % \ IMPLIED EQUITY RISK PREMIUM, %	5.75%	5.50%	5.25%	5.00%	4.75%	4.50%	4.25%
2.00%	3,226	3,382	3,553	3,742	3,953	4,188	4,452
1.75%	3,312	3,473	3,649	3,844	4,060	4,302	4,575
1.50%	3,400	3,565	3,746	3,947	4,170	4,419	4,699
1.25%	3,489	3,658	3,845	4,051	4,281	4,537	4,825
1.00%	3,579	3,754	3,945	4,158	4,393	4,657	4,953
0.75%	3,671	3,850	4,048	4,266	4,508	4,779	5,084
0.50%	3,764	3,948	4,151	4,375	4,624	4,903	5,216

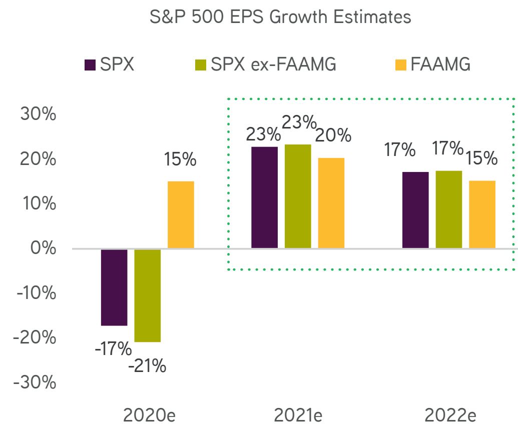
Data as at November 18, 2020. Source: S&P 500, KKR Global Macro & Asset Allocation analysis.

Underpinning our positive outlook is that the market will no longer be as dependent on the FAAMG stocks for success. In fact, FAAMG names are poised to grow 20% in 2021e while non-FAAMG stocks are expected to rise 23%, reversing a multi-year trend of FAAMG stocks outpacing the rest of the SPX in earnings per share growth.

Underpinning our positive outlook is that the market will no longer be as dependent on the FAAMG stocks for success. In fact, as we show below, FAAMG names are poised to grow 20% in 2021e while non-FAAMG stocks are expected to rise 23%, reversing a multi-year trend of FAAMG stocks outpacing the rest of the SPX in earnings per share growth.

EXHIBIT 48

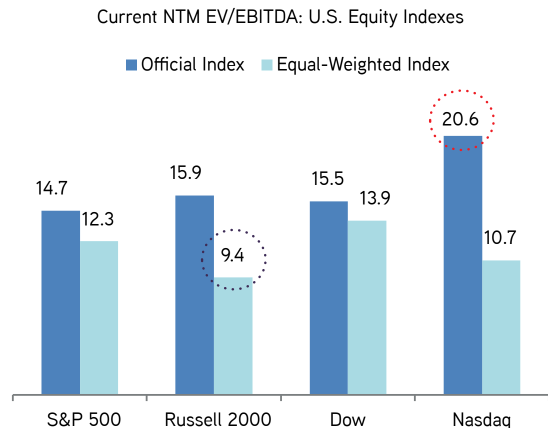
Consensus Expects S&P 500 ex-FAAMG EPS to Grow Faster than FAAMG Stocks Themselves in 2021-22



Data as at November 30, 2020. Source: S&P 500, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 49

Secular Stagnation Concerns Which Are Also Reflected in the Valuations of Secular Growth vs. Economically Sensitive Equities



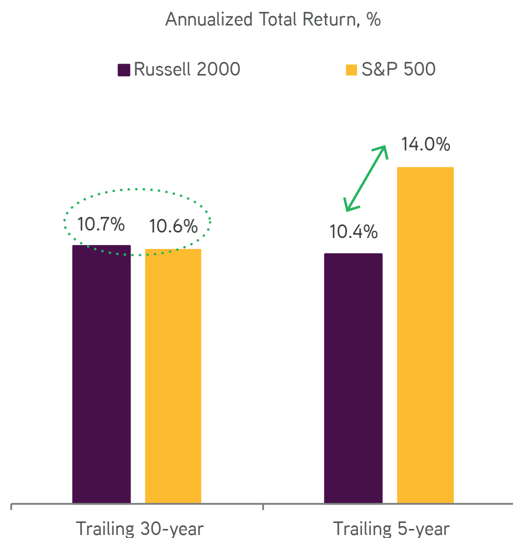
Data as at October 14, 2020. Source: KKR Global Macro & Asset Allocation analysis, S&P 500, Bloomberg, Factset.

Our Models Favor Equities and Select Parts of Credit

During the 2016-2019 period, we spent a lot of time with our clients trying to guide them on whether to overweight Credit *or* Equities. Today our message is to own both, given the positive backdrop we have laid out in this report. As such, we have been spending time of late working to see where the best relative value lies across the capital structure. At the moment (and as we described in the Equities section), we think Equities – with 12-13% potential total return – offer the most upside in absolute terms. Importantly, though, we see more structural upside in the Russell 2000, given its trailing 5-year underperformance at a time when we see market breadth extending beyond large capitalization Technology stocks in 2021. One can see the longer-term upside potential in *Exhibit 50*. We also think that, consistent with our 'yearn for yield' thesis, investors will migrate towards companies with growing dividends that appear attractive relative to the risk free rate (*Exhibit 51*).

EXHIBIT 50

There Has Been a Tremendous Bifurcation in Performance Between Small-Cap and Large-Cap Stocks. We See This Now Converging

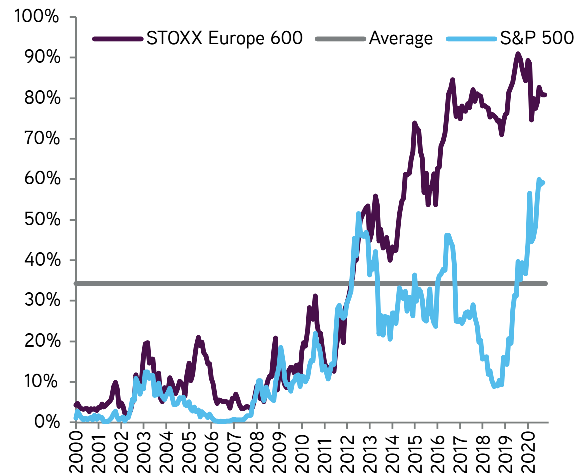


Data as at November 30, 2020. Source: Bloomberg.

Importantly, though, we see more structural upside in the Russell 2000, given its trailing 5-year underperformance at a time when we see market breadth extending beyond large capitalization Technology stocks in 2021.

EXHIBIT 51

We Still Think that Equities Look Cheap Relative to Corporate Debt



Data as at November 30, 2020. Source: Bloomberg, Datastream, FactSet, Compustat, Goldman Sachs Global Investment Research.

Meanwhile, one of our more influential macro models is suggesting that Emerging Market Equities should outperform Developed Market Equities. One can see this in *Exhibit 52*. The key change since our last update at the end of 2019 is that valuation has moved into the 'green' zone, as EM trailing P/E (20x) is now fully 10 percentage points below DM (30x). Furthermore, EM is at a 1.0x discount in price/tangible book terms, which is the most attractive we've seen since the early 2000s. Moreover, EM FX continues to look interesting in valuation terms as well, although that 'green flag' is not a new development, but rather a holdover from what we were seeing at the start of 2020.

However, there are offsets to the aforementioned positives, which supports our view to be selective within Emerging Markets. Offsetting factors to consider include operating fundamentals that appear fairly lackluster with ROEs having fallen during the pandemic relative to developed market peers. Further, across most EM countries, post-pandemic fiscal stimulus has been underwhelming, especially when compared to the developed markets. Trade tensions too will likely provide additional headwinds.

EXHIBIT 52

We Continue to Suggest Selective Engagement With Emerging Markets

	"RULE OF THE ROAD"	MAY'15	JAN'16	AUG'16	MAY'17	SEP'17	JUN'18	DEC'18	DEC'19	DEC'20
1	Buy When ROE Is Stable or Rising	↔	↔	↔	↗	↗	↗	↗	↔	↔
2	Valuation: It's Not Different This Time	↔	↗	↗	↗	↔	↔	↔	↔	↗
3	EM FX Follows EM Equities	↘	↘	↔	↔	↗	↔	↗	↗	↗
4	Commodities Correlation in EM is High	↔	↔	↔	↔	↔	↗	↔	↔	↔
5	Momentum Matters in EM Equities	↘	↘	↗	↔	↗	↔	↘	↔	↔

OVERALL

For long-term investors, we continue to recommend selective engagement with Emerging Markets. Across several measures, EM equity valuations are at the most attractive levels relative to DM since the early 2000s. EM currencies also look washed out, and may benefit over time from the U.S. Fed's reflation efforts, which we believe are USD-negative. All that said, fundamentals in many instances do not yet look compelling. Across most EMs, post-pandemic fiscal stimulus has been underwhelming relative to DMs. Ongoing global trade tensions are a further headwind for some EMs.

Data as at December 15, 2020. Source: KKR Global Macro & Asset Allocation analysis.

EXHIBIT 53

We Think That BBB CLO and BB CLO Liabilities Appear Attractive on a Risk-Adjusted Basis versus Similarly Rated Loans and Bonds as Well as Higher-Rated CLO Tranches

PAIR RELATIONSHIPS	CURRENT	MEDIAN SINCE 2014	PERCENTILE SINCE 2014	PERCENTILE SINCE 2018
Corp BB/BBB Spread Basis	153	109	72%	66%
Corp B/BB Spread Basis	148	168	34%	25%
BB Loan-Bond Yield Differential, Basis Points	2	18	40%	45%
B Loan-Bond Yield Differential, Basis Points	28	-17	87%	84%
CLO BB Yield Pickup Over HY B, Basis Points	2.36	1.57	82%	64%
CLO BB Spread Pick Over B Loans, Basis Points	225	202	64%	49%
CLO A/AA Yield Ratio	1.32X	1.25X	62%	91%
CLO BBB/A Yield Ratio	1.50X	1.32X	91%	82%
CLO BB/BBB Yield Ratio	1.94X	1.57X	95%	88%

Data as at November 30, 2020. Sources: KKR Leveraged Credit Analysis (Michelle Liu), BofAML, S&P LCD.

On the Credit side, we think a nuanced approach is now also warranted, given the size of the upward move in prices during fall 2020. To this end, we note the following relative value opportunities that we are championing at this point:

- **CLO Liabilities**, particularly BB CLO and BBB CLO, screen attractive compared to corporate High Yield and Loans of the same rating as well as compared to higher rated CLO tranches. This gap, however, is narrowing quickly. We are also finding relative value in new issue CLOs versus secondary ones.

- **We slightly favor High Yield over Loans** because of central bank support in the U.S. and EU for bonds this year, which outweighs the embedded rates risk in our view. At a more granular level, we would overweight HY B, B Loans and EU Loans. However, as rates begin to tick up in the second half of the year, we could see more of a sharp rotation into Loans.

- **CCC Bonds as well as CCC Loans** screen well on a projected risk-adjusted basis due to our 'relatively moderate' expectations for realized defaults in the coming years. If we believe that those sub-asset classes have been 'purged' this year (approximately 40% HY CCC LTM default rate), a modest allocation to HY CCC (and to CCC loans to a lesser extent) is warranted.

- **While overbought in the near-term, Private Credit offers long-term value,** in our view. As we show in *Exhibit 55*, the illiquidity premium is still healthy (greater than 150 basis points), and recent behavior during the COVID crisis justifies some allocation to private credit tailored to one's appetite for illiquid assets, particularly from a risk adjusted perspective.

EXHIBIT 54

Within High Yield, U.S. BB and U.S. B Rated Securities Potentially Show the Most Room to Run If the Economic Recovery and Fed Support Continues

Yield Comparisons

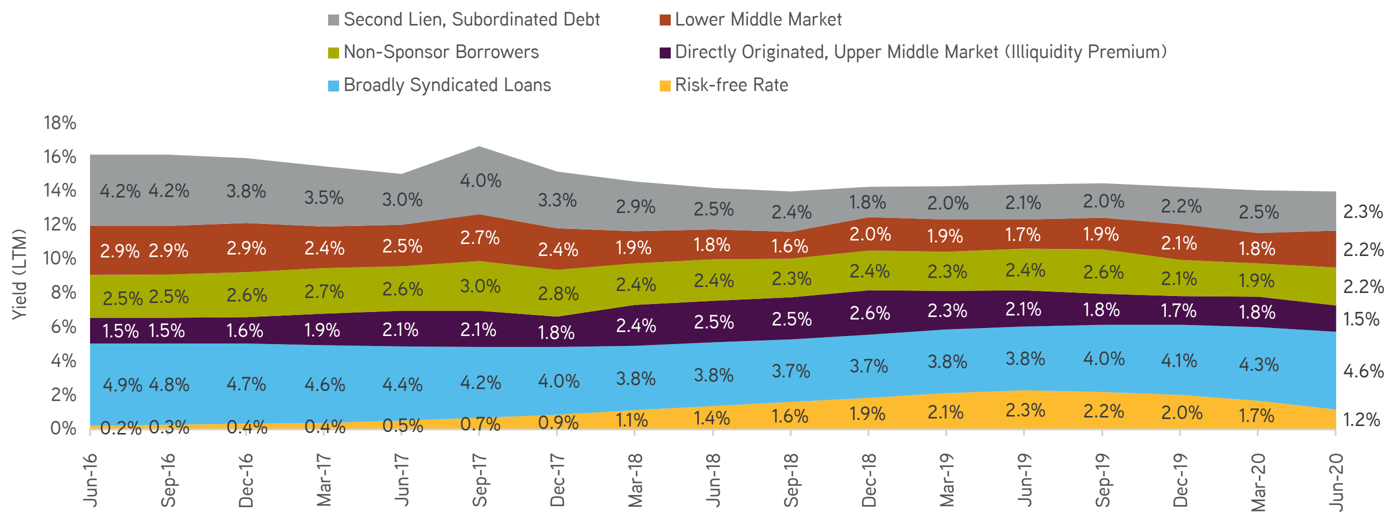
YIELDS	U.S. HIGH YIELD	U.S. BB	U.S. B	U.S. CCC	EURO HIGH YIELD	EURO BB	EURO B	EURO CCC	U.S. BBB	U.S. IG
Current	4.7%	3.5%	5.0%	9.5%	3.0%	2.1%	4.1%	9.1%	2.1%	1.8%
Since 2019 Tight	4.6%	3.4%	4.8%	9.5%	2.5%	1.6%	3.7%	7.6%	2.1%	1.8%
Since 2019 Wide	11.4%	8.9%	12.4%	20.1%	8.2%	6.3%	12.3%	17.2%	5.6%	4.7%
Tightening since Wide	59%	60%	60%	53%	63%	66%	66%	47%	61%	61%
Distance from Tights	2%	4%	4%	0%	23%	32%	12%	19%	0%	0%
1-Year Avg	6.2%	4.6%	6.5%	13.4%	4.1%	2.9%	5.8%	11.6%	3.0%	2.5%
3-Year Avg	6.3%	4.8%	6.5%	11.9%	3.6%	2.6%	5.3%	10.0%	3.7%	3.3%
5-Year Avg	6.5%	4.8%	6.6%	12.4%	3.6%	2.6%	5.0%	10.9%	3.7%	3.3%
7-Year Avg	6.4%	4.8%	6.4%	11.8%	3.7%	2.7%	5.0%	10.9%	3.7%	3.2%

Note: Yield to Worst for Bonds for Loans. Data as at November 30, 2020. Sources: BofAML, S&P LCD, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 55

We Still See Longer-Term Value in the Illiquidity Premium of Private Credit

Corporate Direct Loan Risk Premiums, June 2016 to June 2020



Data as at June 30, 2020. Source: Cliffwater 2020 Q2 Report on U.S Direct Lending, Preqin, S&P LCD, ICE Data Indices, BofAML.

SECTION III

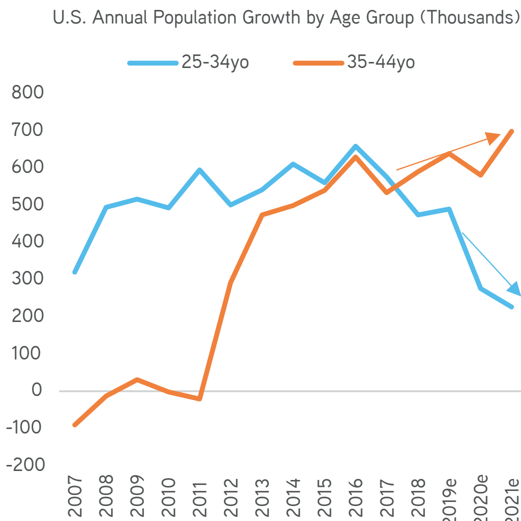
Six Key Themes

#1: Rise of the Global Millennial. In our humble opinion, we have entered an important period of investing where 'demographics have become destiny.' Driving this destiny, we believe, is the rise of the global millennial. For example, millennials, who were born between 1980-1994, are now a major force in the United States, totaling nearly 70 million, or close to 25% of the country's population. The breadth of the U.S. millennial population is also significant *(Exhibit 56)*, as it extends into important minority cohorts such as Hispanics (fully 26% of whom are millennials).

What's changed with this group to make it more exciting to investors? Our work is unequivocally showing that millennials are now of the age where they want to have families, own homes and other goods, and are more inclined to save. Interestingly, almost two thirds of millennials now favor some type of multi-channel experience in the United States versus a purely online one. This purchasing behavior is actually quite different from when this segment of the population was a decade younger — and spending was concentrated online — with a distinct focus on value offerings.

EXHIBIT 56

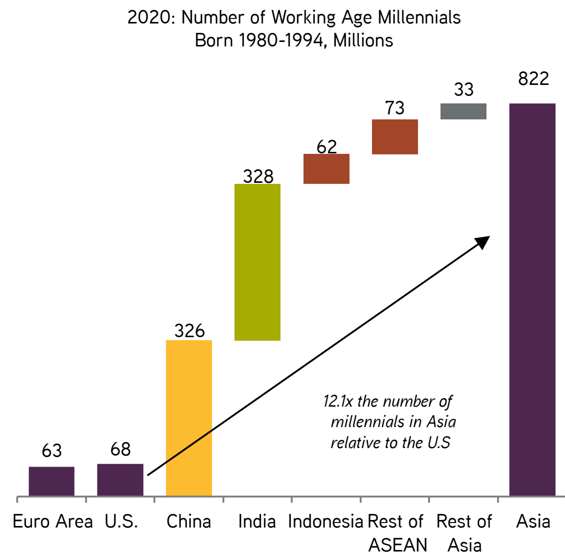
U.S. Millennials Are Now Aging Into Their Prime Household Formation and Expansion Years



Data as at September 30, 2020. Source: KKR Global Macro & Asset Allocation, Evercore/ISI, Census Bureau projections.

EXHIBIT 57

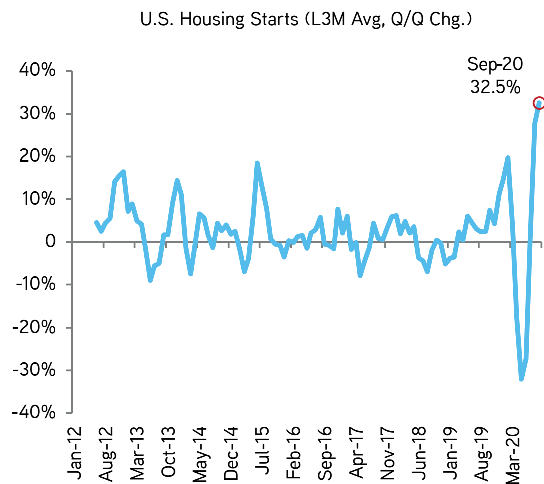
With More than 6x As Many Millennials in Asia than in U.S. and Europe Combined, the Asian Millennial Will Reshape the Global Consumer Market



Data as at October 13, 2020. Asia includes China, India, Japan, Hong Kong, Korea, and ASEAN (Indonesia, Malaysia, Philippines, Thailand, Singapore, and Vietnam). Working Age = 15-64. Source: United Nations World Population Prospects, Haver Analytics.

EXHIBIT 58

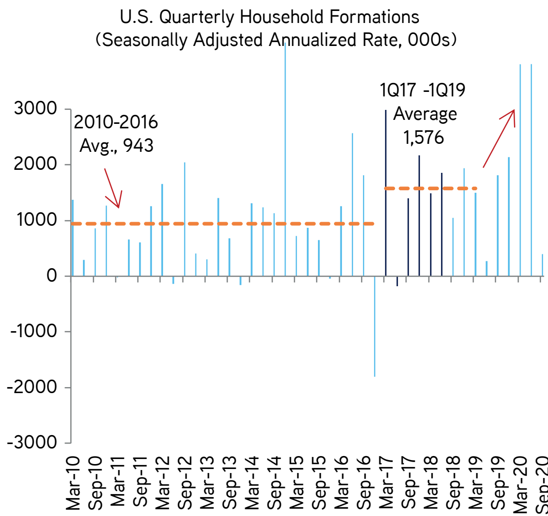
Housing Starts Are Skyrocketing in the Era of Accelerated Stimulus...



Data as at September 30, 2020. Source: Census Bureau, Haver Analytics.

EXHIBIT 59

...With Household Formations Running Well Above Previous Averages



Data as at September 30, 2020. Source: Census Bureau, Haver Analytics.

Outside the United States, *the millennial story is even more powerful, with Asia leading the charge*. As *Exhibit 57* shows, Asian millennials – given their size and growth trajectory – are incredibly important to the global consumption story. In particular, the long-term trend of Chinese millennials helping to accelerate the transition of the nation towards more of a domestically focused, services-based economy by way of increasing technological advancements is undeniable. Chinese millennials value fresher and healthier food and product alternatives than their parents, and they price comparison shop much more than their elders and many of their global peers. We link many of these traits to their tech-savvy ways – and it is not just goods purchased. Just consider that it only took Didi, China's ride hailing leader, three years to reach 50% market penetration, while Uber has yet to reach these levels after eleven years in the U.S. Meanwhile, Alipay has only taken four years to hit a penetration rate of 50%, while Apple Pay has yet to reach the 50% milestone in the United States.

We also anticipate continued demand from Chinese millennials for China to tackle air, water and soil pollution, likely creating opportunities for companies that address these issues. Importantly, though, the Chinese consumer is becoming increasingly sophisticated, which is leading to a more demanding customer who uses technology more often to drive value, selects aspirational brands over standardized ones, and comparison shops more often than in the past.

EXHIBIT 60

The Pandemic Has Accelerated Many of Our Major Investment Themes in Asia

IN A SURVEY OF 8,000 PEOPLE ACROSS SIX SOUTHEAST ASIAN COUNTRIES IN LATE APRIL/EARLY MAY	
45%	Increased online buying of groceries
42%	Bought more established brands in recent months, ensuring product reliability, trust and stability
72%	Will be more health conscious in the future, with more consumers recognizing telemedicine and digital health services
70%	Increased at-home habits, including working from home, shopping, and dining
4X	More time spent on education apps in China in March relative to all apps

Data as at June 30, 2020. Source: Bain & Co *How Covid-19 is changing Southeast Asia's consumers,* UBS Evidence Lab.

EXHIBIT 61

Asian Consumers Are Spending More Time Online Reading News, Watching Content, and Engaging in Social Media

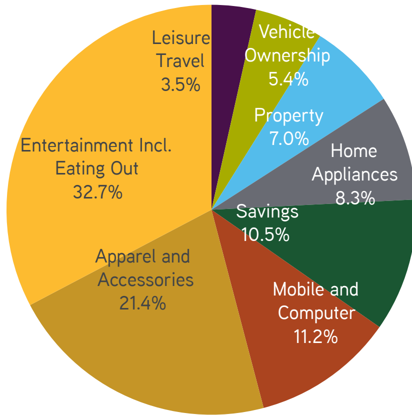
MCKINSEY CONSUMER SENTIMENT SURVEY: EXPECTED CHANGE (PLUS/MINUS) OF TIME ALLOCATION OVER THE NEXT TWO WEEKS (NET INTENT)	CHINA	INDIA	INDONESIA	JAPAN	SOUTH KOREA
Live News	3%	60%	50%	26%	48%
Video Content	-3%	59%	53%	7%	48%
Movies or Shows	-8%	57%	41%	1%	41%
Reading News Online	-1%	55%	56%	26%	46%
Social Media	2%	48%	56%	-4%	22%

Asian consumer sentiment during the COVID-19 crisis April 2020. n = 500. Net intent is calculated by subtracting the % of respondents stating they expect to decrease spend from the % of respondents stating to increase spend. Data as at April 30, 2020. Source: McKinsey Survey.

However, it is not just China. We see similar trends emerging in other parts of Asia including India and parts of Southeast Asia. To be sure, we are still digesting the economic impact of COVID-19 on the millennial population, but we believe that trends towards e-commerce, health and wellness, preventative care, and the environment still have significant momentum. Moreover, as we show in *Exhibit 63,* we think that the pandemic will further accelerate existing trends towards mobile payments.

EXHIBIT 62

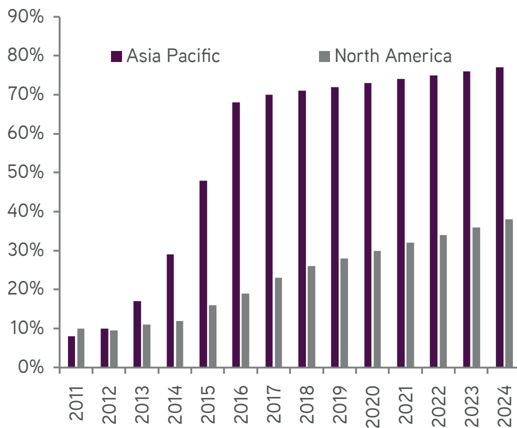
Indian Millennials Spend More than 36% of Their Incremental Income on Entertainment and Travel



Note: incremental income is money remaining after monthly essentials (rent, utilities) and education. Data as at February 2018. Source: Deloitte Database (Thomson One), *Trend-setting Millennials Redefining the Consumer story.*

EXHIBIT 63

Even Before the Pandemic, Nearly Three of Every Four e-Commerce Purchases Were Completed On Mobile Phones in Asia Pacific, Compared to Less Than One in Three in North America



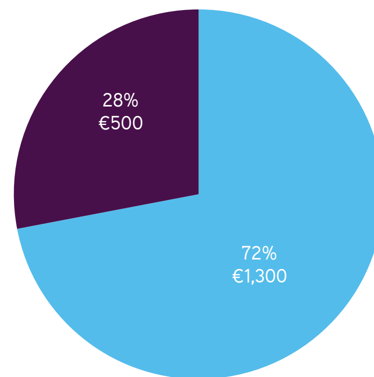
Data as at November 15, 2020. Source: Euromonitor2020, BofAML.

#2: Fiscal Beneficiaries, Including ESG, Amidst a Renaissance in Big Government. Another big macro investment theme we are pursuing is focused on beneficiaries of fiscal spending, including broadband, education (digital infrastructure in particular), the environment, and roads/infrastructure. Indeed, unlike prior exogenous shocks and the subsequent economic recoveries, austerity is not part of the current game plan in the post-COVID world. This approach makes sense to us, given 1) no one sector or individual caused the pandemic (unlike the common beliefs held post the Global Financial Crisis); 2) rates are so low that the incremental cost to spend more on fiscal initiatives is quite nominal in today's negative real rate world; and 3) the adverse effects Europe experienced from a heavy-handed austerity push during the 2011-2015 debt crisis still weighs on all politicians.

Consistent with our views, we note that Vitor Gaspar, the head of fiscal policy at the IMF, recently *acknowledged that the austerity plan implemented during the European sovereign crisis was a mistake*. He then went on to encourage more spending, giving assurances that "The [public debt] ratio in our projections stabilizes and even declines slightly towards the end of our projections which shows that COVID-19 is a one-off jump up in debt and with low interest rates, the debt dynamics stabilize."

EXHIBIT 64

Significant Funds Have Been Devoted to Climate Action in COVID-Related Stimulus...

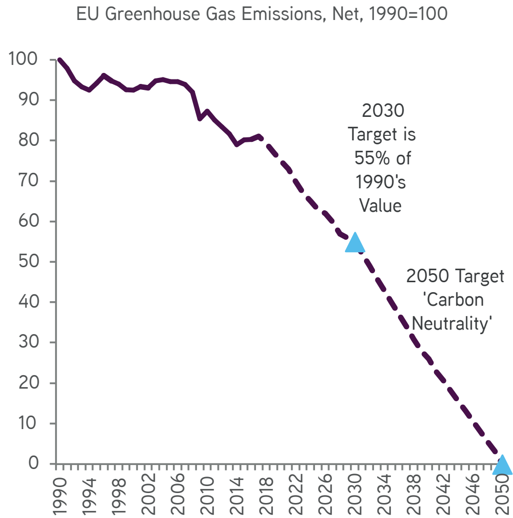


Data as at July 31, 2020. Source: Eurostat and Bloomberg NEF.

> **Even if all of President-elect Biden's proposals do not become law, given the renewed focus on deficits by Republicans, there appears to be a demonstrable bipartisan support for renewables, energy efficiency (carbon capture and storage credits), and electric vehicle credits, we believe.**

EXHIBIT 65

...Working Towards Broader 2030 and 2050 Targets



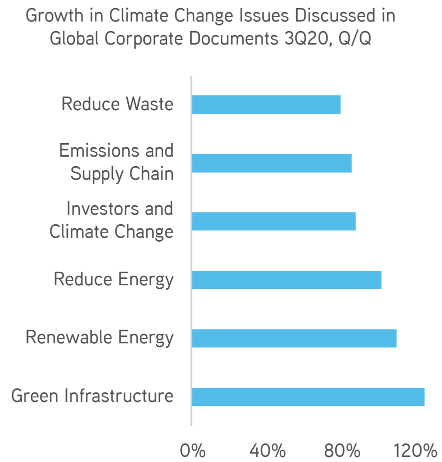
Data as at July 31, 2020. Source: Eurostat.

We expect new U.S. fiscal stimulus on the order of $1.0-1.5 trillion over the next year. Most immediately, we think Congress will work to push through pandemic relief on the order of $600-700 billion, focused on extending the unemployment and small business lending programs initiated under the CARES act, as well as providing targeted aid to 'front line' sectors such as transit systems, schools, healthcare providers, and the postal service. Looking into 2021, we see potential for further spending focused on pandemic recovery, including infrastructure and supply chain strengthening initiatives. We also expect more spending on healthcare infrastructure, and as we describe below in our domestication of supply and demand section, we believe that supply chain resiliency will become a major positive tailwind in most major economies, the United States and China in particular.

Importantly, in all three regions where KKR invests – Asia, Europe, and North America – we expect both the private and public sectors to invest aggressively behind new green initiatives. In Europe, for example, there will likely be 500 billion or more euros in spending on new climate goals. Meanwhile, China's 14th fifth year plenum was intently focused on the environment, with an historic commitment to decarbonization. Specifically, environmental innovation, particularly in areas of green and low carbon development, was touted as a key area of prioritization. Finally, in the United States, President-elect Biden is already making noise about pushing forward his 'green' agenda when he takes office on January 20th, 2021. So, even if all of his proposals do not become law, given the renewed focus on deficits by Republicans, there appears to be a demonstrable bipartisan support for renewables, energy efficiency (carbon capture and storage credits), and electric vehicle credits, we believe.

EXHIBIT 66

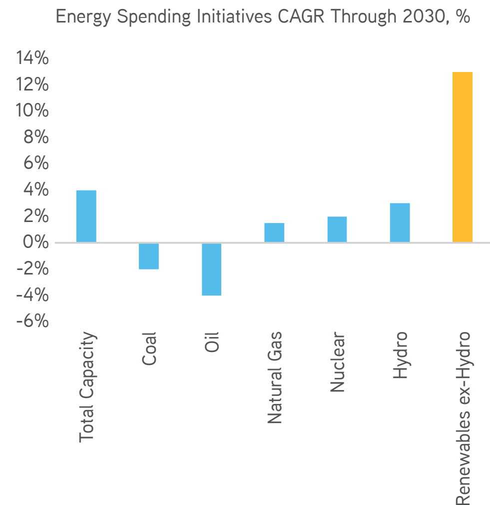
Green Infrastructure and Renewable Energy Were the Most Discussed Climate Change Issues in 3Q20, Compared to the Prior Quarter



Data as at September 30, 2020. Source: UN SDGs, Deutsche Bank, Alphawise.

EXHIBIT 67

Renewables Spending Is Poised to Lead All Energy Spending Initiatives Over the Next Decade

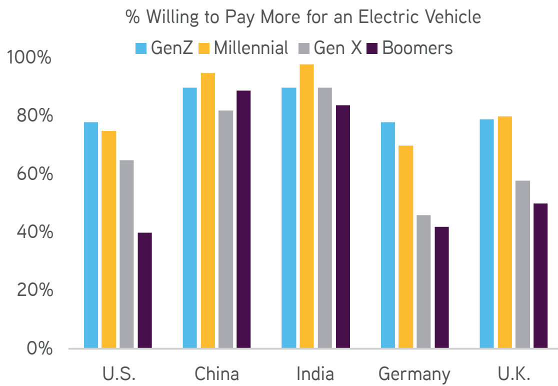


Data as at October 13, 2020. Source: IEA World Energy Outlook 2020.

Energy transitions away from 'old' energy sources like coal will be a major a focus. Remember, coal still accounts for nearly 40% of all global carbon emissions. The green wave we are forecasting will also affect supply chains. According to an analysis of third quarter 2020 corporate reporting by Deutsche Bank, the number one priority of corporates was supply chain emissions, followed by reducing energy consumption. We attribute this heightened sensitivity to both consumer and political demands for responsible climate policies. One can see this in *Exhibit 68*.

EXHIBIT 68

GenZ and Millennials Are Willing to Pay More for an Environmentally Friendly Product



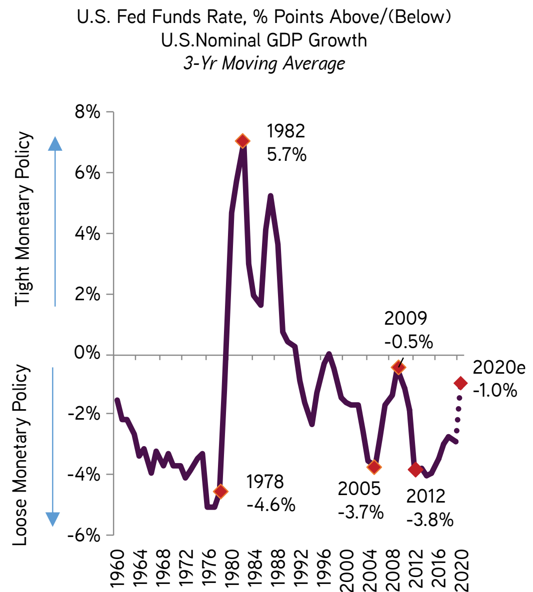
Data as at February 28, 2020. Source: AlphaWise, Morgan Stanley Research.

#3: Asset Based Cash Flow: Entering a Super Cycle. We are maximum bullish on assets linked to nominal GDP growth with upfront cash flow. Amidst heavy fiscal spending and monetary policy that essentially equates to yield curve control, historical precedent reinforces that now is the time to overweight these assets in one's portfolio. One can see this in *Exhibit 69*. To be sure, we do not see inflation surging in the near-term, but recent comments by Federal Reserve members about average inflation targeting only increase our conviction that today, not tomorrow, is the time to buy a little extra insurance. As a result, we have moved to an even more overweight position in Asset-Based Finance in Credit, Infrastructure, Logistics, and parts of Real Estate. Besides the upfront yield, the ability of these investments' collateral to appreciate alongside – or potentially even faster than – nominal GDP is compelling.

We are maximum bullish on assets linked to nominal GDP growth with upfront cash flow. Amidst heavy fiscal spending and monetary policy that essentially equates to yield curve control, historical precedent reinforces that now is the time to overweight these assets in one's portfolio.

EXHIBIT 69

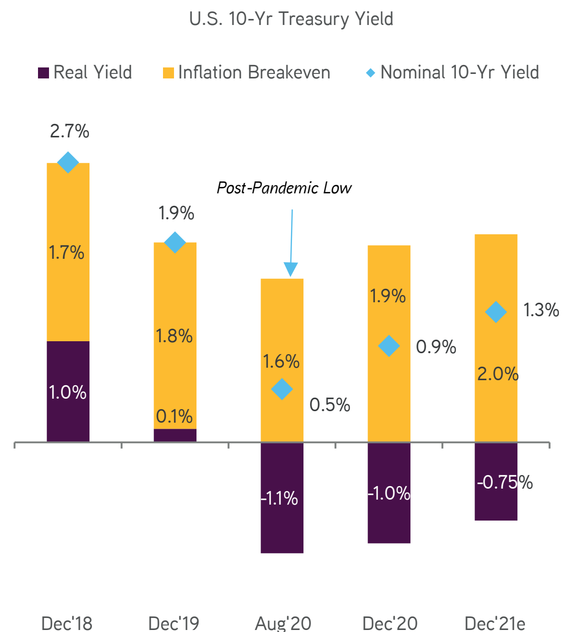
The Strategy to Reflate Is Based on Holding Nominal Interest Rates Below Nominal GDP



Data as at September 30, 2020. Source: BEA, Federal Reserve, Haver Analytics.

EXHIBIT 70

Record Stimulus by the Federal Reserve and Treasury Are Finally Lifting Inflation Expectations

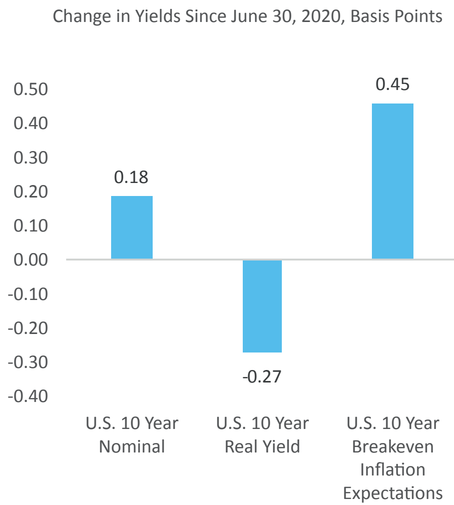


Data as at December 8, 2020. Source: Bloomberg.

In our view, there is a secular change occurring in government policy towards greater fiscal spending, and as a result, we think that CIOs will want and need more inflation protection in an era of bigger budget deficits, rising minimum wages, and broader healthcare offerings. The reality is that, as we show in *Exhibit 71*, real yields are not moving around that much. In fact, they remain deeply negative by historical standards. By comparison, inflation expectations are moving up sharply. Given this shifting dynamic, finding investments with above average GDP growth and/or pricing power becomes of paramount importance to offset any potential widening of cap rates.

EXHIBIT 71

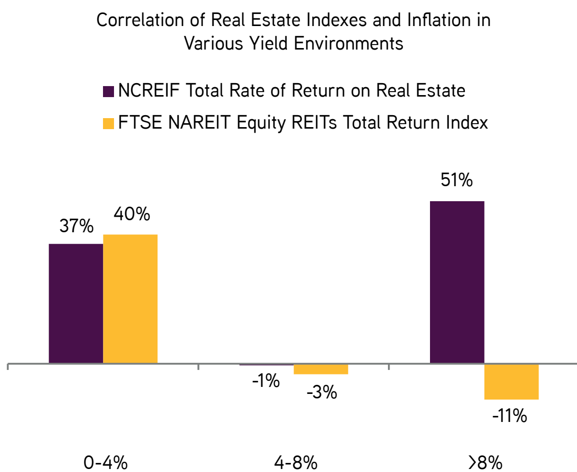
Any Upward Movement in Nominal Rates of Late Has Come From Rising Inflation Expectations, Not Real Yields



Data as at November 30, 2020. Source: Bloomberg.

EXHIBIT 72

The Inflation Hedging Power of Real Estate Is Strong, Particularly in a Low Rate Environment

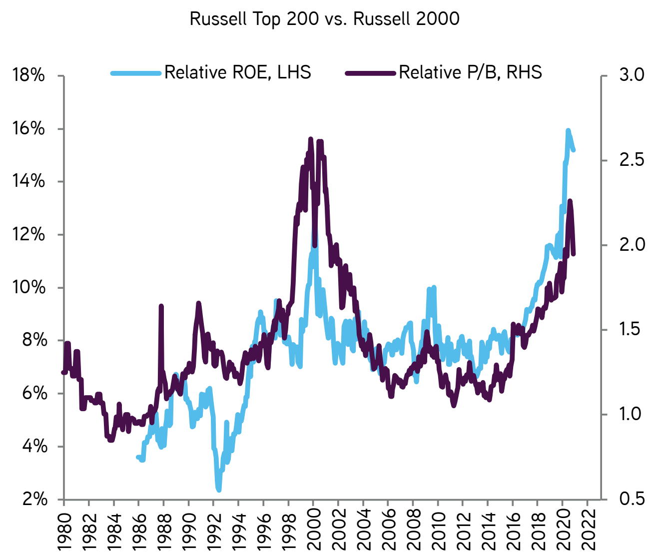


Data as at September 30, 2020. Source: Bloomberg.

#4: Lean Into Market Dislocations and Take Advantage of Wide Dispersions. As we described in our April 2019 Insights note *The Uncomfortable Truth*, we are living in an odd time characterized by low interest rates, uneven global GDP growth, and rising geopolitical tensions. Against this backdrop, we expect above average periodic dislocations across the capital markets versus a massive 'one-time' 2008-like downturn. We regard this backdrop as an *opportunity* because it confirms our strong view that assets are consistently being mispriced when investors lose faith in central bank liquidity and/or economic growth. January 2016, the fourth quarter of 2018, and March 2020 were excellent examples where nimble investors could buy high quality securities, including both Debt and Equities, at attractive prices.

EXHIBIT 73

As Profitability in the Value Segment Improves in 2021, We Expect Dispersions to Begin to Narrow

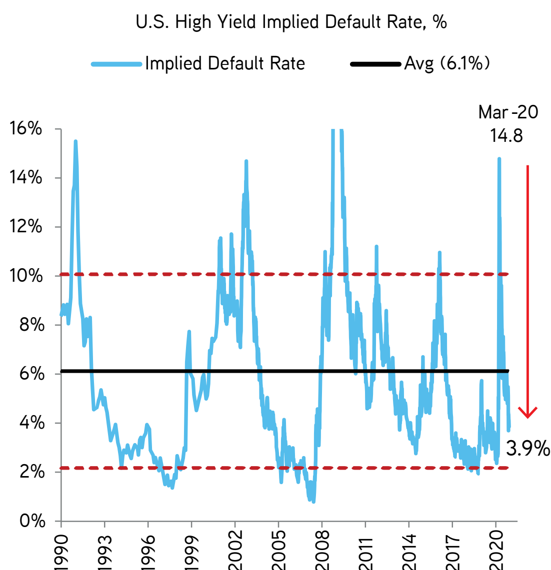


Data as at November 30, 2020. Source: Bloomberg.

Equally as important as the opportunity set that periodic dislocations provide, though, are the significant dispersions we are seeing across and within the global capital markets. To this end, we note that *Exhibit 75* serves an effective dashboard for highlighting some of these mismatches in the U.S. credit markets. In some instances, B-rated Bank Loan spreads are trading at the 61st percentile on a three-year basis; at the same time, B-rated High Yield securities are trading tight at their 13th percentile over the same period. A similar scenario is playing out in the equity markets as well.

EXHIBIT 74

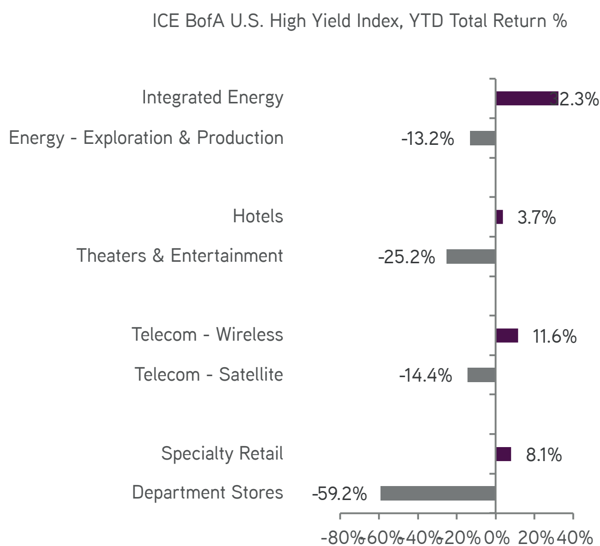
Markets Are Now Discounting That Default Rates Are Now Back Towards Extremely Benign Levels



Data as at November 30, 2020. Source: Bloomberg.

EXHIBIT 75

Dispersions Have Created Huge Opportunities for Outperformance in 2020. We See This Trend Extending into 2021

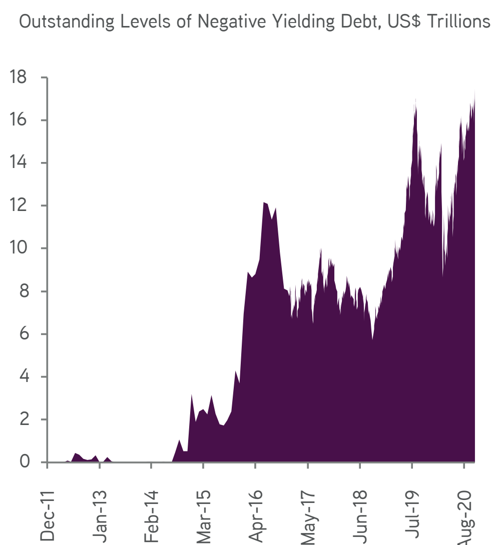


Data as at November 30, 2020. Source: BofAML-ICE, Bloomberg.

This improving backdrop means that there is a compelling ability to earn outsized returns, as 1) misunderstood credits are pulled to par; and 2) misunderstood equities are re-rated upward, as their earnings power becomes more apparent. Against this backdrop, we believe that hedge funds, adept credit pickers, and concentrated long-only strategies should perform well. Already, we have seen huge gains in the Russell 2000 and the Emerging Markets. In our view, this trend is secular, not cyclical, and it portends a structural rotation in value creation now occurring across the global capital markets.

EXHIBIT 76

Negative Interest Rates Are Here to Stay, Which Fuels Our Yearn for Yield Thesis

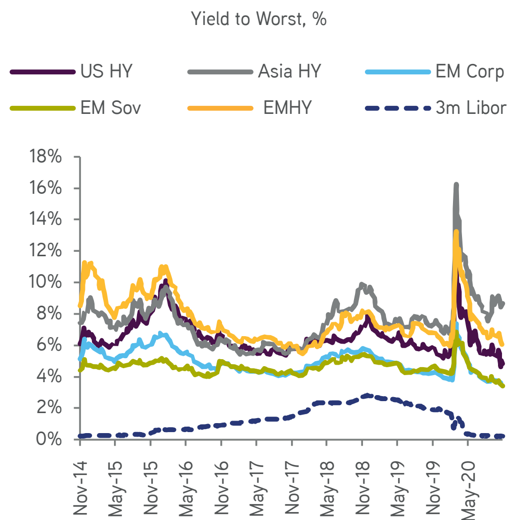


Data as at November 30, 2020. Source: Bloomberg.

This improving backdrop means that there is a compelling ability to earn outsized returns, as 1) misunderstood credits are pulled to par; and 2) misunderstood equities are re-rated upward, as their earnings power becomes more apparent.

EXHIBIT 77

Today's Low Rate Environment Likely Means a More Opportunistic Portfolio Is Required to Maximize Returns

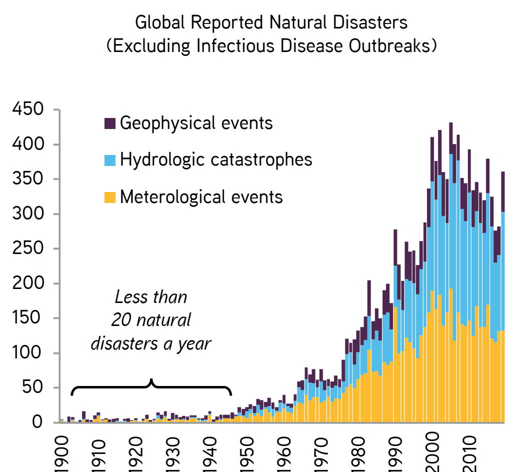


Data as at November 20, 2020. Source: Bloomberg.

In our humble opinion, we are likely to encounter more volatility in the quarters ahead – even if we do not have a major sustained drawdown like 2008. At the moment, we are playing this macro theme through our Opportunistic Credit and Distressed/Special Situations allocations, but we do believe it is constructive for Equity Hedge Fund managers again in 2021 (something we first highlighted in January 2020).

EXHIBIT 78

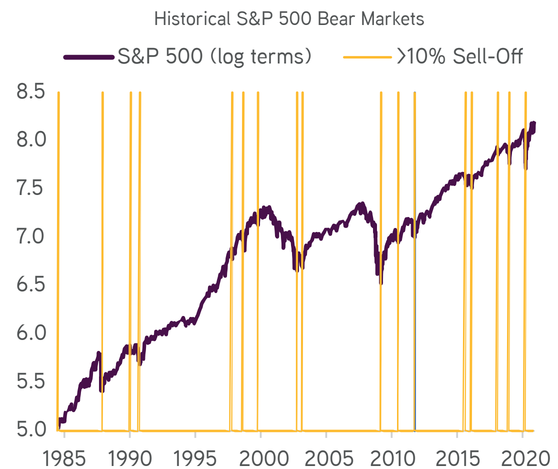
Natural Disasters Are On the Rise...



Data as at December 31, 2019. Source: EMDAT (2020): OFDA/CRED International Disaster Database, Université catholique de Louvain – Brussels – Belgium, OurWorldInData.org/natural-disasters.

EXHIBIT 79

...So Are 10% Sell-offs. In Fact, Five Have Occurred Since 2015, Compared to Two During the Prior Five Years



Data as at November 30, 2020. Source: Bloomberg.

#5: Intensifying Domestication of Global Demand and Supply. For several years, we have been writing and talking about the peak in global trade. This event – in isolation – would be significant. However, it is not just a slowdown in the velocity of price and/or volume of transportable goods. We see several other important forces at work. First, we are seeing a global shift in political policy towards more domestic consumption. In China, President Xi Jinping is encouraging this inward shift by promoting his policy of dual circulation, while the U.S. is increasingly pushing 'Made in America.' Europe too is following suit, with its focus on what EU officials call 'strategic autonomy.' 5G may be getting all the headlines these days, but our research underscores that these global initiatives to accelerate domestic consumption are extending all the way down towards encouraging companies to buy local computers, furniture, etc. It also likely means more urbanization as well as further redistribution of wealth.

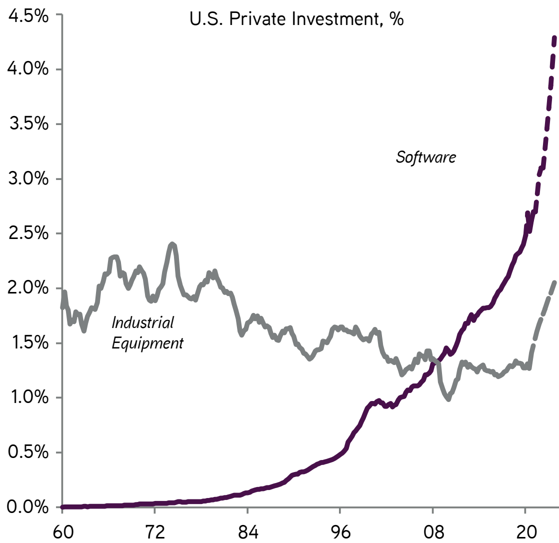
Further, while the U.S. and China are clearly center stage in terms of trade disputes, we think that other emerging countries, particularly ones with large consumption economies, will shift towards more of a domestically-focused agenda. Consistent with this view, reliability of

> **Moreover, global trade in services is also evolving from simply back office tasks such as call centers and accounting functions to consumer interfaces in areas such as healthcare, online shopping, and online services.**

supply chains for food, pharma and other critical goods is now seen as a top priority within many of the countries where KKR does business.

EXHIBIT 80

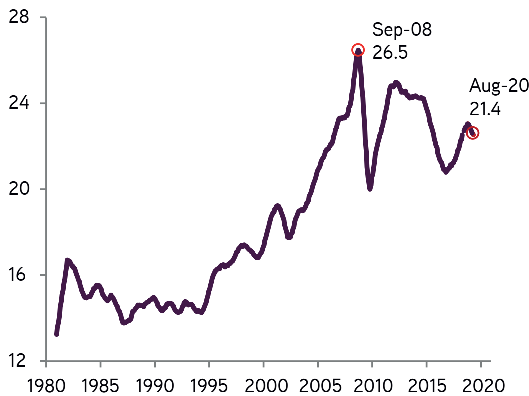
We See Both Technology and Traditional Capital Expenditures Booming in Our Macro Outlook



Note: 2021-2024 = estimates. Data as at September 30, 2020. Source: Goldman Sachs.

EXHIBIT 81

Trade as a Percentage of Global GDP Peaked in 2008

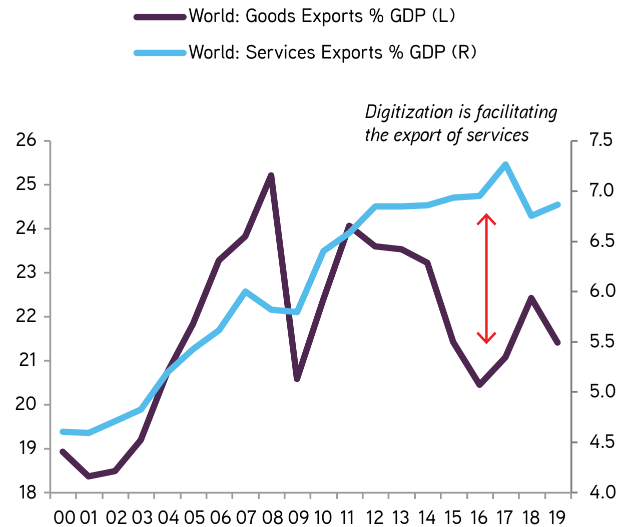


Data as at August 31, 2020. Source: Haver Analytics.

Second, my colleague Frances Lim strongly believes that the secular trend towards services over goods that we see in our macro data *(Exhibit 82)* suggests that both consumers and businesses are tending to favor domestic offerings rather than global ones. Already, many services, including professional services, are inherently local in nature. Moreover, global trade in services is also evolving from simply back office tasks such as call centers and accounting functions to consumer interfaces in areas such as healthcare, online shopping, and online services.

EXHIBIT 82

The Digitization of Globalization Is Resulting in a Shift in Trade From Goods to Services



Data as at December 31, 2019. Source: World Bank, IMF, Haver Analytics.

Third, rising national security concerns and the emergence of COVID-19 are important influences deterring investment in the traditional China supply chain. One can see this in *Exhibit 83*. Given these concerns, we have seen nearly a 1,000 basis point increase in multinational companies that are stalling or reducing investment *(Exhibit 84)*.

For several years, we have been writing and talking about the peak in global trade. This event – in isolation – would be significant. However, it is not just a slowdown in the velocity of price and/or volume of transportable goods. We see several other important forces at work.

EXHIBIT 83

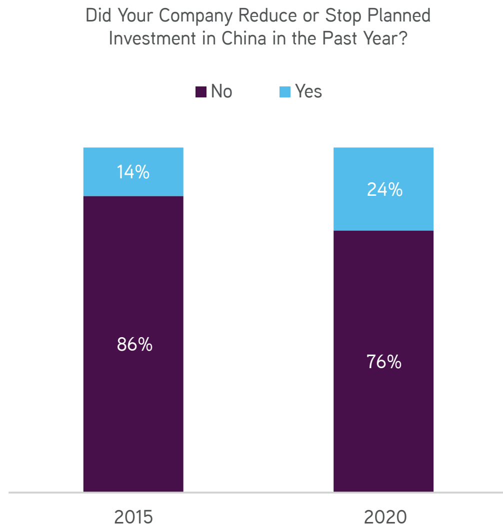
Rising Tensions Have Led to a $51 Billion Reduction in U.S. Imports of Chinese Goods

Product	U.S. Imports from China in 2019 ($bn)	China's Market Share of U.S. Imports	Change* in U.S. Import Market Share (Today vs 2017, pp)											
			China	Mexico	Canada	UK	Euro Area	Japan	Korea	India	Vietnam	Malaysia	Taiwan	Other
Computer & Elec Prod	**132.8**	**38.1%**	(7.8%)	2.4%	0.1%	0.2%	0.6%	0.1%	(0.2%)	0.2%	2.6%	0.8%	2.5%	(1.4%)
Computer Equip	53.3	51.7%	(8.7%)	7.6%	0.1%	0.2%	1.1%	0.2%	(0.1%)	0.0%	0.2%	(0.1%)	3.6%	(4.2%)
Communications Equip	54.8	58.1%	(4.1%)	(1.8%)	0.3%	0.0%	(0.2%)	0.0%	(2.4%)	0.2%	8.2%	(1.7%)	0.9%	0.4%
Audio & Video Equip	9.0	39.3%	0.1%	6.2%	(0.1%)	0.1%	0.4%	(0.7%)	0.5%	0.0%	(0.2%)	0.3%	0.4%	(7.0%)
Semiconductors	10.5	14.3%	(14.3%)	1.7%	(0.0%)	0.1%	(0.6%)	0.1%	1.3%	0.4%	1.6%	7.1%	4.3%	(1.5%)
Navigational/Measuring	4.3	8.2%	(4.7%)	(0.1%)	(0.0%)	0.2%	1.3%	(0.3%)	0.1%	0.1%	1.0%	0.2%	1.0%	1.2%
Electrical Equip	**39.7**	**34.5%**	(4.2%)	0.5%	0.0%	0.1%	0.4%	(0.3%)	0.3%	0.2%	1.4%	1.4%	0.3%	(0.1%)
Electric Lighting Equip	7.8	63.4%	(3.6%)	0.4%	1.4%	0.1%	0.5%	(0.0%)	0.0%	0.1%	0.6%	0.1%	(0.0%)	0.4%
Household Appliances	15.8	50.8%	0.4%	0.3%	0.2%	0.0%	0.2%	0.1%	(0.3%)	0.0%	(1.7%)	0.2%	(0.0%)	0.6%
Electrical Equip	5.2	16.6%	(3.2%)	2.5%	(0.2%)	0.2%	0.4%	(0.1%)	(0.4%)	0.1%	0.7%	(0.2%)	(0.0%)	0.2%
Electrical Equip/Comp	10.9	28.3%	(6.4%)	(1.7%)	(0.4%)	(0.2%)	(0.1%)	(1.9%)	1.2%	0.4%	4.1%	4.0%	0.7%	0.2%
Misc. Manuf Commod	**37.1**	**33.9%**	(0.2%)	0.9%	(0.1%)	(0.3%)	0.7%	0.1%	0.1%	(0.6%)	1.0%	0.4%	0.3%	(2.3%)
Medical Equip & Supplies	7.0	14.1%	(0.2%)	0.4%	(0.2%)	(0.4%)	0.7%	(0.5%)	(0.0%)	(0.0%)	(0.0%)	0.3%	(0.0%)	0.1%
Sporting/Athletic Goods	5.3	61.8%	(2.5%)	(0.6%)	0.4%	0.1%	0.3%	0.2%	(0.2%)	0.0%	2.0%	0.1%	3.3%	(3.1%)
Dolls, Toys, Games	13.8	86.8%	(1.8%)	(0.3%)	(0.2%)	0.2%	0.2%	0.8%	(0.0%)	0.2%	5.2%	0.3%	(0.0%)	(4.4%)
Machinery ex-Electrical	**30.2**	**17.3%**	(3.4%)	0.2%	0.1%	0.4%	0.6%	0.4%	0.1%	0.4%	0.2%	0.0%	0.3%	0.6%
Industrial Machinery	4.5	17.1%	(7.5%)	(0.4%)	0.0%	0.3%	4.1%	4.4%	(1.4%)	0.1%	0.3%	0.3%	1.5%	(1.7%)
HVAC / Fridge Equip	4.6	29.1%	(4.5%)	1.4%	0.4%	0.5%	0.1%	(0.3%)	0.1%	(0.0%)	0.6%	0.2%	0.2%	1.4%
Apparel & Access	**19.7**	**31.0%**	(3.9%)	(0.6%)	0.1%	0.0%	0.6%	0.0%	(0.0%)	0.4%	2.6%	(0.0%)	(0.0%)	0.8%
Fabricated Metal Prod	**20.0**	**30.2%**	(2.2%)	0.6%	0.2%	0.4%	(0.4%)	(0.3%)	0.2%	0.5%	0.8%	0.3%	0.2%	(0.2%)
Furniture & Fixtures	**15.1**	**45.4%**	(10.7%)	1.4%	0.6%	0.1%	1.2%	0.0%	0.0%	0.4%	8.1%	1.4%	0.6%	(3.2%)
Transportation Equip	**15.2**	**4.4%**	(0.5%)	3.0%	(1.0%)	0.9%	(0.7%)	(2.2%)	0.2%	0.3%	0.1%	0.0%	0.1%	(0.2%)
Motor Vehicle Parts	10.1	10.7%	(1.2%)	2.9%	(0.6%)	0.0%	(0.3%)	(1.8%)	0.7%	0.3%	0.2%	0.0%	0.2%	(0.4%)
Chemicals	**16.2**	**6.3%**	(2.0%)	(0.3%)	(1.5%)	(0.7%)	6.1%	0.4%	(0.5%)	(0.1%)	0.1%	(0.2%)	(0.2%)	(1.1%)
Plastics & Rubber Prod	**18.1**	**31.0%**	(1.3%)	0.1%	(1.0%)	(0.3%)	(0.2%)	(0.2%)	0.4%	0.3%	1.0%	0.2%	0.1%	0.8%
Leather & Allied Prod	**11.8**	**44.5%**	(8.4%)	(0.5%)	(0.0%)	(0.0%)	2.1%	0.0%	0.1%	0.3%	4.6%	0.0%	0.0%	1.8%
Textile Mill Prod	**22.1**	**54.0%**	0.0%	0.1%	(0.4%)	0.0%	(0.2%)	0.0%	0.1%	0.0%	0.7%	0.0%	0.0%	(0.4%)
NonMetallic Min Prod	**5.4**	**29.8%**	(4.4%)	1.4%	0.7%	(0.1%)	0.7%	0.2%	0.3%	1.3%	1.0%	0.4%	0.4%	(1.9%)
Food & Kindred Prod	**2.9**	**4.3%**	(1.9%)	0.1%	(0.7%)	(0.0%)	0.2%	0.1%	0.1%	(0.1%)	(0.0%)	0.0%	0.1%	2.2%
Agricultural Prod	**0.4**	**1.2%**	(0.4%)	4.5%	(0.2%)	(0.1%)	0.2%	0.0%	0.0%	(0.5%)	(1.1%)	0.0%	(0.0%)	(2.4%)
Other	**78.8**	**4.8%**	(0.6%)	0.4%	1.2%	0.5%	2.3%	0.3%	0.2%	0.2%	0.2%	(0.0%)	(0.0%)	(4.6%)
Total	**465.6**	**18.2%**	**(3.4%)**	**1.0%**	**(0.0%)**	**0.3%**	**1.5%**	**(0.1%)**	**0.1%**	**0.2%**	**0.7%**	**0.0%**	**0.4%**	**(0.6%)**

Methodology: The products listed rank in the top 15 of U.S. imports from China by dollar amount, cross-referenced with China's market share. Agricultural products is outside of the top 15 but added here as reference. The heat map measures the change in each country's market share of U.S. imports by product/category. Change refers to full year 2019 versus full year 2017. Source: KKR Global Macro & Asset Allocation, Haver Analytics, Census Bureaus.

EXHIBIT 84

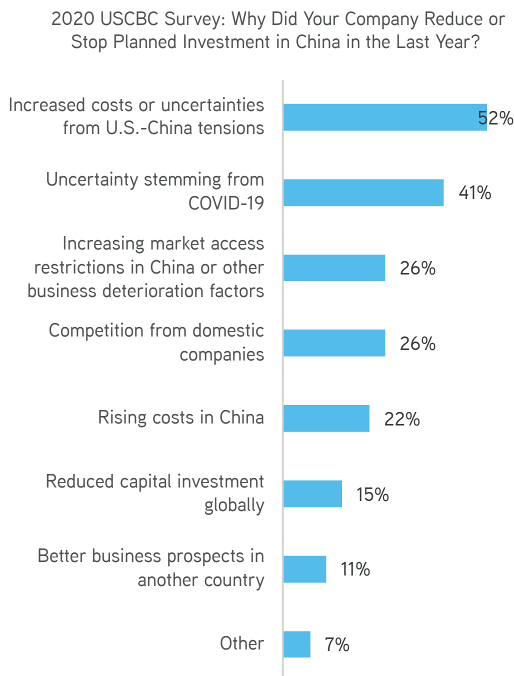
Almost 25% of Companies Surveyed Have Reduced or Stopped Planned Investment in China in the Last Year, a Historic High



Data as at June 2020. Source: U.S. China Business Council Member Survey.

EXHIBIT 85

The Top Reasons for Curtailing Investment in China Are Increased Costs or Uncertainties from U.S.-China Tensions and COVID-19



Data as at June 2020. Source: U.S. China Business Council Member Survey.

What does this all mean for investing? We see several important action items. First, we think that, as supply chains diversify, there will be important winners outside of China that warrant investor attention. Some of the key country/regional 'beneficiaries' include the broader ASEAN region, Mexico and Europe. In terms of sectors that could be impacted by supply chain diversification, Pharmaceuticals, Transportation and Equipment, Semiconductors, Automation, Computers and Electronics, Communications Equipment and Medical Devices should all be product areas on which to focus, in our view.

Second, as import substitution increases amidst more domestic demand, investors should spend more time backing local champions, including domestic supply chain winners in this new environment that we are envisioning. Commodity producers that supply the inputs to new and/or refurbished capex are also likely to thrive, particularly if our weak dollar call comes to fruition. Finally, we think that national security concerns are going to lead to an arms race on the innovation front, particularly as it relates to technology, healthcare, and cyber-security. In our view, growth investors should spend additional time and effort looking to partner with those companies that not only have the best offering but also have the backing of both public and private sectors.

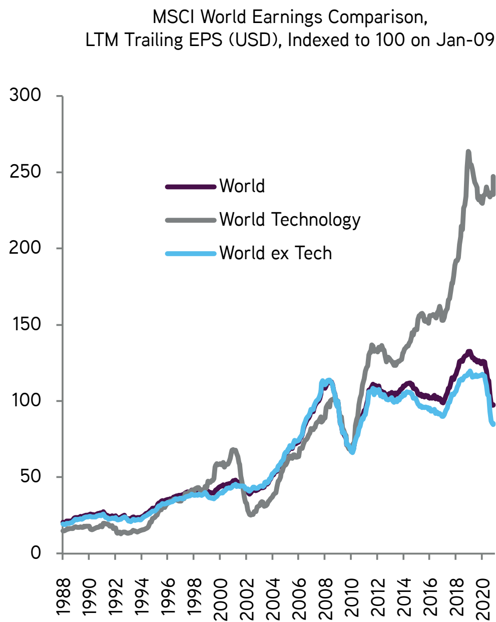
#6: Secular Compounders => Remain Long Innovation. Disruptive forces, particularly in the Technology, Healthcare, and Financial Services Technology sectors, are creating something akin to an industrial revolution that we have not seen since the 1870s. Against this backdrop of a slowing China and increasing disruption across several key industries, we have seen the percentage of companies with top-line growth of eight percent or more decline per the MSCI World Index, compared to 45% in 2000/2001.

We believe that many of these structural growers now enjoy not only a cheaper cost of capital but are increasingly benefitting from a network effect that allows them to gain greater operating leverage than their peers. In many instances during this pandemic, the economic backdrop is allowing fast-moving corporate 'winners' to take market share and to maintain pricing. As such, the outlook is quite bright, we believe, particularly in private Growth market.

Key markets like cybersecurity and value-added payment systems are obvious examples of this new world order playing out, but we also believe that this 'winner take all approach' is occurring in logistics, defense electronics, and even food and healthcare delivery platforms that we see in Asia. Importantly, though, we probably would avoid or own smaller positions in some of the high-profile growth companies that traffic in areas where anti-monopoly or anti-competitive behavior will likely be further scrutinized by elected officials in Europe and the United States during 2021.

EXHIBIT 86

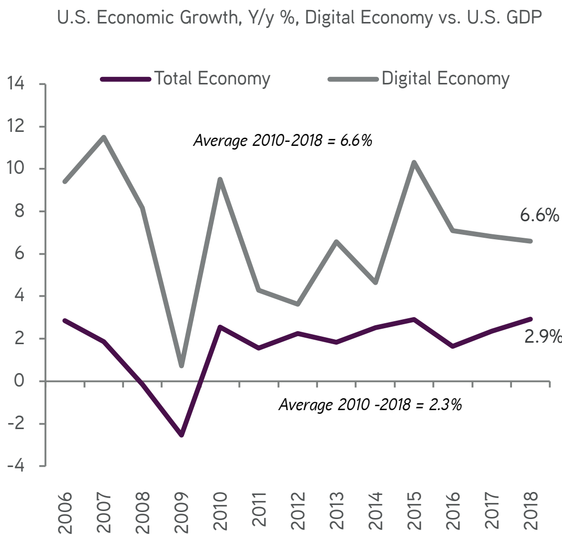
Outside of Technology, World Indices Have Not Generated Much EPS Growth Post the GFC



Data as at November 30, 2020. Source: Datastream, I/B/E/S, Goldman Sachs Global Investment Research.

EXHIBIT 87

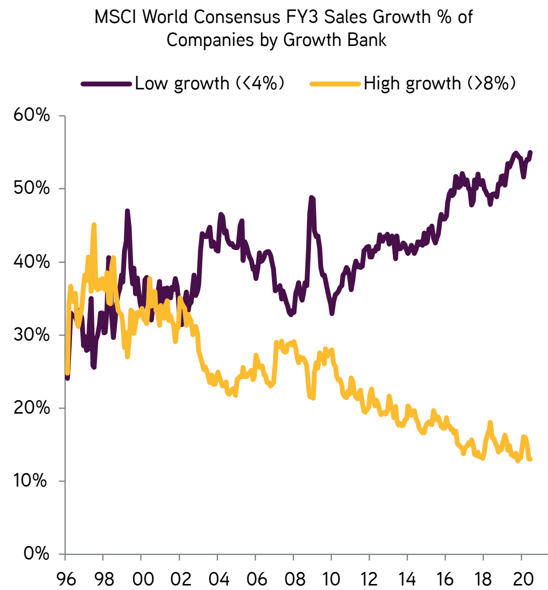
Digitalization Has Become a Key Driver of Economic Growth



Data as at August 31, 2020. Source: Bureau of Economic Analysis, Cornerstone Macro.

EXHIBIT 88

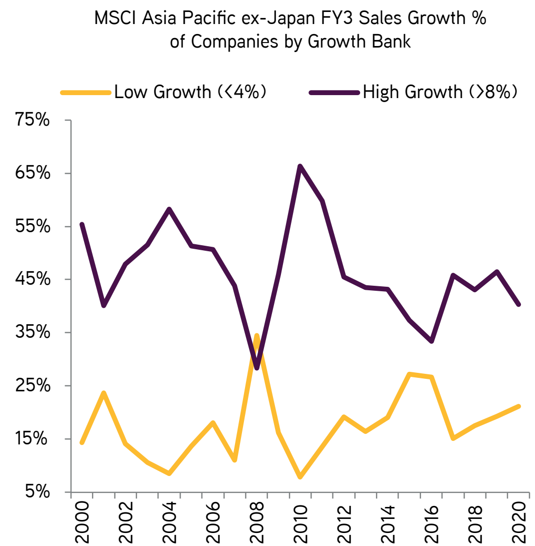
The Number of Companies That Can Structurally Grow Has Slowed...



Data as at September 30, 2020. Source: Datastream, I/B/E/S, Goldman Sachs Global Investment Research.

EXHIBIT 89

..Even in Asia



Data as at September 30, 2020. Source: Datastream, I/B/E/S, Goldman Sachs Global Investment Research.

SECTION IV

Investment Considerations/Risks

#1: Interest Rates: As *Exhibit 90* suggests, markets look expensive by almost any traditional valuation metric except one – interest rates. However, interest rates do matter, and while our view is that rates have bottomed, we do not see them at risk of moving up too quickly in the near-term.

EXHIBIT 90

The Market Looks Expensive on All Metrics Except Interest Rate Adjusted Metrics. Importantly, Though, Interest Rates Do Matter

	S&P 500 AGGREGATE INDEX	
VALUATION METRIC	CURRENT	HISTORICAL PERCENTILE
U.S. Market Cap/GDP	239%	**100%**
EV/Sales	3.0x	**100%**
EV/EBITDA	15.9x	**100%**
Forward P/E	22.3x	**96%**
Cash Flow Yield	6.1%	**93%**
Price/Book	3.9x	**92%**
Cyclically Adjusted P/E	29.0x	**91%**
Free Cash Flow Yield	3.8%	**60%**
Yield Gap vs. 10-Year UST	367 Basis Points	**37%**
Median Metric		**92%**

S&P 500 data from 1976 apart from FCF yield which is from 1990. Credit market data from 1997, equity risk premium from 2001 and government bond data from 1921. Data as at November 9, 2020. Source: Goldman Sachs.

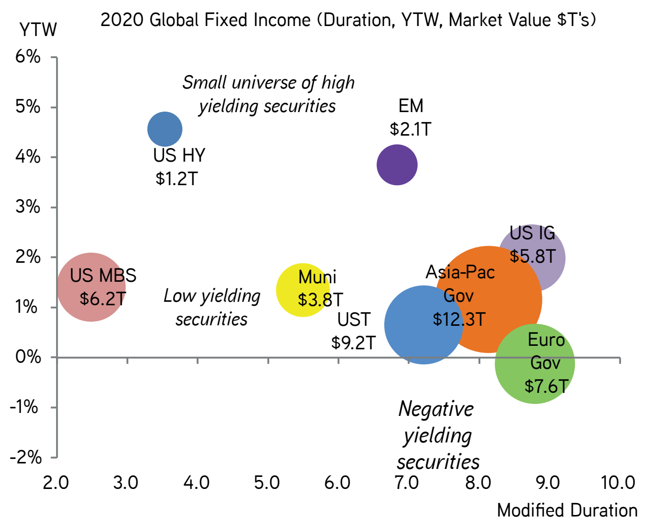
Within geopolitics, U.S.-China relations remain at the epicenter of this nervousness, according to many of KKR's clients. We don't disagree, given the blurring of lines between traditional trade, rule of law, technology, supply chains and national security.

There are several forces at work. First, the reality is that – driven by central bank buying – demand for yield from savers and the intermediaries that represent them has become almost insatiable, we believe. Moreover, the acceleration in the 'yearn for yield' is happening at a time when there are not many high quality assets meeting investors' needs. Said differently, while sovereign supply is increasing, supply of higher quality, higher yielding assets is actually in net contraction mode in many instances. Finally, we see little impulse for central banks to sell their enlarged balance sheets. In fact, we do not think it is out of the question that central banks like the Bank of England follow the ECB in its pursuit of negative deposit rates.

Our bottom line: Rates have bottomed and are headed higher on both a real and nominal basis. However, the chance of rates becoming unglued and permanently denting valuations across the debt and equity market remains quite low, in our opinion. For those who do want to hedge a material increase in rates, however, we like betting against the 5-year forward curve, selling the exchanged traded fund TLT, buying CDX against Investment Grade debt, and/or shorting U.S. dollars.

EXHIBIT 91

The Yearn for Yield Continues, Despite a Significant Risk of Principal Impairment If Rates Were to Rise



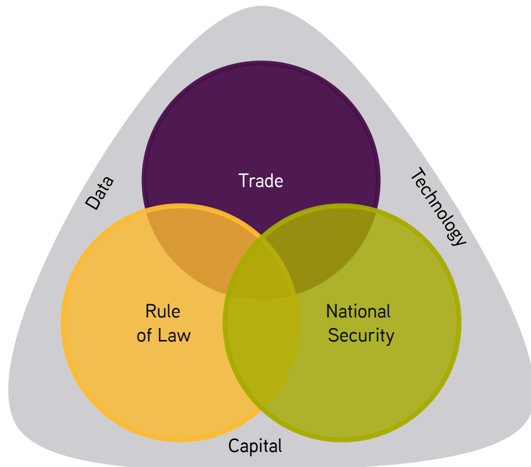
Data as at November 30, 2020. Source: BofA, Bloomberg.

#2: China: Recent client survey work done by KKR confirmed to us that investors view geopolitics as among the biggest risks in today's market. Within geopolitics, U.S.-China relations remain at the epicenter of this nervousness, according to many of KKR's clients. We don't disagree, given the blurring of lines between traditional trade, rule of law, technology, supply chains and national security (*Exhibit 92*). Yet, while we do believe that a 'new' cold war between the United States and China is unfolding, we also want to suggest that this relationship is likely to look quite different from the U.S.-Russia relationship during the 1947-1991 period. Key to our thinking is the fact that the U.S. and China are much more tied together economically than during prior periods of super-power confrontation *(Exhibit 94)*.

EXHIBIT 92

National Security Is Now Bundled With Rule of Law and Trade Negotiations

Blurring of Lines Across Trade, Rule of Law, and National Security

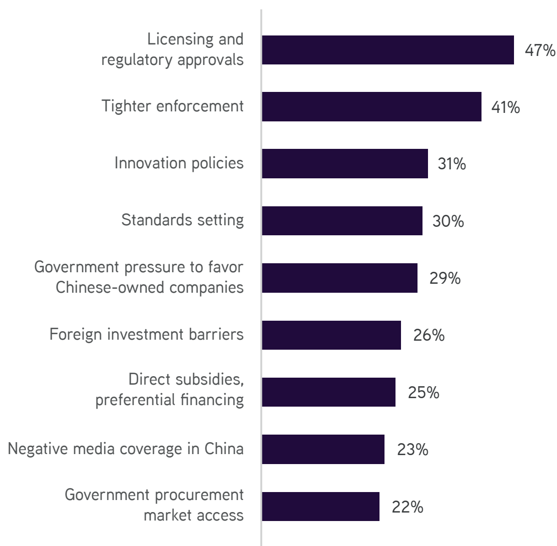


Data as October 31, 2020. Source: KKR Global Macro & Asset Allocation analysis.

EXHIBIT 93

Global Multinationals Are Having a Harder Time Navigating the Business Environment in China

What are the most important concerns of operating in China these days?

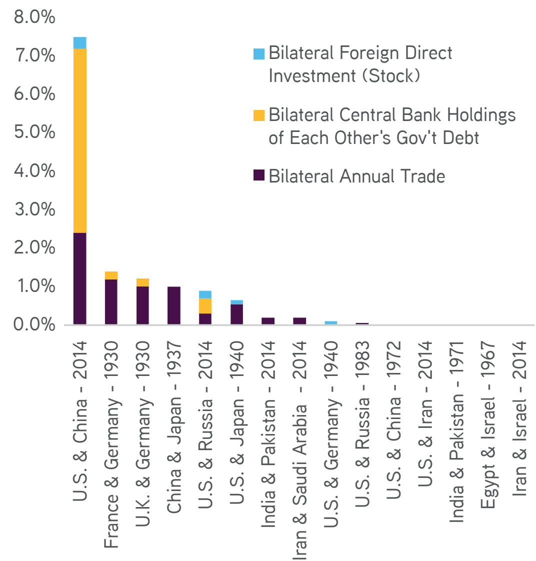


Data as at June 30, 2019. Source: U.S. China Business Council Member Survey.

EXHIBIT 94

The U.S. and China Currently Have Much Deeper Economic Linkages Than Other Actual or Potential Adversaries of the Last 100 Years

Economic Linkages of Acutal and Potential Adversaries, %

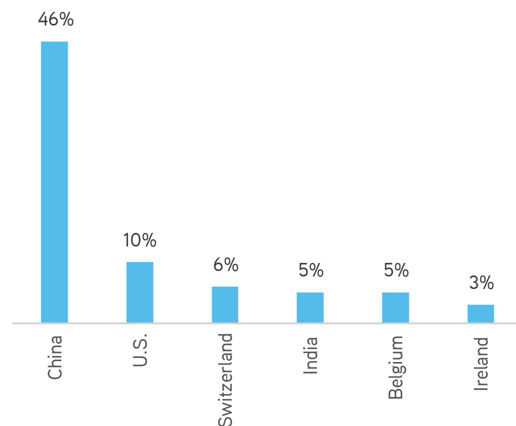


Data as at December 31, 2016. Source: JPM Asset Management, UNCTAD, World Bank, UN, U.S. Treasury, Baribieri/Keshk COW Trade data, U.S. Trade Representative Office, Setser (CFR), Bank of England, St. Louis Fed, Eichengreeen (Berkeley), Howson (Princeton), East-West Center, O'Neill (CNA), Ritschi (LSE) Accominotti (LSE), Wilkins (FIU), Villa (CEPII).

EXHIBIT 95

China's Dominant Position in Pharmaceutical Production Has Created National Security Concerns

Share of Active Pharmaceutical Ingredient Exports, 2019, %



Data as at December 31, 2019. Source: Goldman Sachs.

So, where do we go from here and how to play it? Our base view is that the U.S. will stay tough on China under a Biden administration. However, we do expect some differences. First, we believe that President-elect Biden may trade some of President Trump's tariffs for other concessions from China, perhaps on climate change. The reality is that the tariffs are unpopular in both countries, and as we noted in the China economic section (see *Exhibits 28* and *29*), President Trump's trade policies have not prevented China from actually growing its market share in exports.

Second, we think that President-elect Biden will likely pursue a 'coalition of the willing' strategy, trying to foster a better rapport across not only the public and private sectors within the United States, but between the U.S. and its global counterparts as well. Also, expect less noise from a Biden Administration than from the current Administration.

If we are right about our China worldview, the best way to hedge is to get long our intensifying Domestication theme (see *Section III*). Defensive currencies such as the yen also likely make sense. Finally, our bias remains to embrace capital structures that can withstand a more unsettled geopolitical environment than in the past.

#3: Unsettled and Severe Weakness in the U.S. Dollar: While there are clearly many benefits to an engaged Federal Reserve and Treasury, there are growing risks that investors will shun the 'greenback.' From a valuation standpoint, the dollar looks expensive across multiple metrics (*Exhibit 41*). Moreover, this valuation headwind is occurring at a time when U.S. real rates are deeply negative and U.S. deficits are at or near record levels.

Our base view is that the dollar's slide in 2021 will be gradual, but we are also hedging our bets — beyond outright selling of the currency — by owning more collateral-based cash flows, including Infrastructure, Real Estate and Asset Based Finance, including housing. We are also constructive on commodities such as Copper, Platinum, and Gold. Finally, overweighting Emerging Markets, U.S. exporters, and currencies such as the Japanese Yen all make sense to us.

> **We think that President-elect Biden will likely pursue a 'coalition of the willing' strategy, trying to foster a better rapport across not only the public and private sectors within the United States, but between the U.S. and its global counterparts as well.**

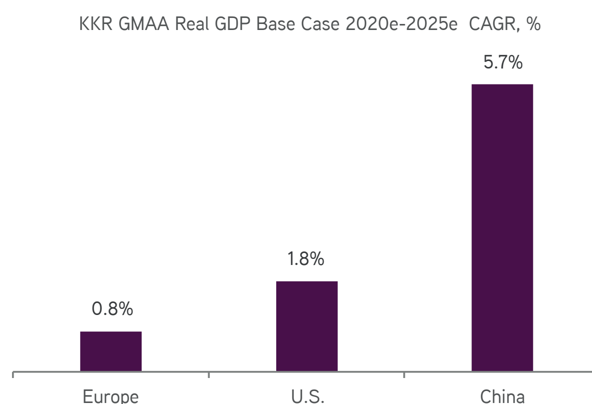
Conclusion

You are either on the bus or off the bus. Tom Wolfe

As we look ahead, both our models and our historical comparisons point towards a time 'to be on the bus' when it comes to risk appetite. To be sure, there will be setbacks along the way, including concerns about growth, stimulus, rates, and geopolitics. However, our primary message is that we are entering a new cycle, not stuck in an old one. The breadth of economic growth we expect should make its way into markets, and as such, a new 'voice' will indeed be required.

EXHIBIT 96

We Expect the Magnitude of Economic Growth to Vary Across Regions, Making Thematic Selection Critical in Our View



Data as at November 30, 2020. Source: KKR Global Macro & Asset Allocation analysis.

In our view, this new 'voice' will champion companies that thrive in a faster nominal GDP world. To this end, we favor the following mega themes:

- **The rise of the global millennial is upon us**. In the United States, the 68 million millennials are now at an age where they are buying houses, spending on their families, and shifting their consumer preferences. Moreover, in Asia there are now more than 800 million millennials; their shifting preferences at a time of huge technological change will have significant implications for all aspects of the global economy.

- **We are bullish on collateral based cash flows**. Asset-Based Finance, Infrastructure, and many parts of Real Estate should perform well in the faster nominal GDP environment we are envisioning.

- **Given record low rates and the campaign against austerity, investors should back fiscal beneficiaries, particularly as it relates to ESG.** Climate change and the transition to clean energy are clear areas of focus for many investors, but our research at KKR suggests that investors should also spend time around

emerging areas such as decarbonization, energy conservation and storage, water quality and security. We also continue to prioritize opportunities that benefit from COVID-related structural tailwinds across areas like education/work-force development, waste management, and industrial technology.

- Though COVID-19 will certainly accelerate the trend, **we think local bias preferences by both governments and corporations were already leading to shifts in the global supply chain**. Our strong belief remains to invest behind this transformation. Reshoring of property, plant, and equipment will be an attractive investment area, though the rise of local technology and services champions could be an even more fertile area for investment capital, we believe.

- **We think that more volatility and more dispersion lie ahead**. To this end, we favor flexible mandates such as Opportunistic Liquid Credit and Real Estate. Funds that also benefit from market dislocations should do well in the environment that we envision.

- Despite our desire to ride the cyclical wave in economic growth we are forecasting, **we do not believe that Growth investing behind secular winners should abate**. Our distinct preference is less for Venture Capital and more towards Growth ideas in areas such as Healthcare, Technology, and Consumer.

Why are we so bullish on our macro themes? Because our strong view is that investors will need a structured roadmap to outperform in a world where both nominal and real returns are going to be much more modest than in the past. One can see our forward expected returns in *Exhibit 97*.

There are also risks to be considered. As we have discussed, capital markets are only appropriately priced if interest rates stay low. This view is our base view, but we are surprised that risk assets have moved up so sharply of late without any real fluctuation in interest rates, particularly at the longer end of the curve.

Second, we expect more geopolitical noise between China and the United States, and to this end, we think more volatility lies ahead. We remain opportunistic about investing in China, but we do think that monitoring overall exposure levels makes more sense than in the past.

EXHIBIT 97

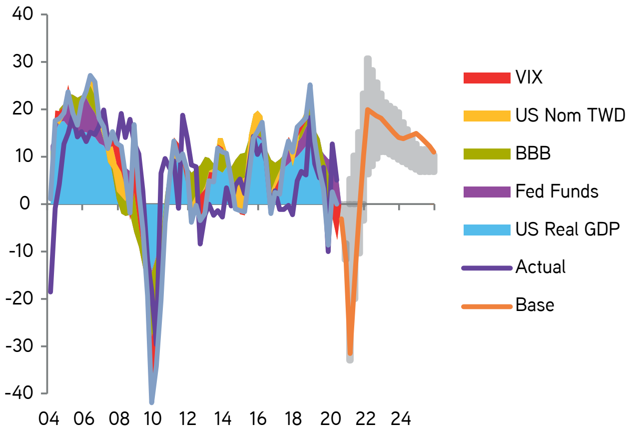
Generating Returns Using Just Stocks and Bonds Will Be Much More Challenging in the Future

RETURN ASSUMPTIONS		5-YEAR OUTLOOK BASE	5-YEAR OUTLOOK LOW GROWTH	5-YEAR OUTLOOK HIGH GROWTH	PAST 5-YRS
STOCKS		3.3%	-0.8%	8.0%	14.0%
BONDS		-1.5%	-0.5%	-3.4%	5.0%
ALLOCATION		**EXPECTED RETURNS**			
STOCKS	**BOND**	**BASE**	**BEAR**	**BULL**	**PAST 5-YRS**
0%	100%	-1.5%	-0.5%	-3.4%	4.5%
10%	90%	-1.0%	-0.5%	-2.3%	5.5%
20%	80%	-0.5%	-0.6%	-1.1%	6.4%
30%	70%	-0.1%	-0.6%	0.0%	7.4%
40%	60%	0.4%	-0.6%	1.2%	8.3%
50%	50%	0.9%	-0.6%	2.3%	9.3%
60%	40%	1.4%	-0.7%	3.4%	**10.2%**
70%	30%	1.8%	-0.7%	4.6%	11.1%
80%	20%	2.3%	-0.7%	5.7%	12.1%
90%	10%	2.8%	-0.7%	6.9%	13.0%
100%	0%	3.3%	-0.8%	8.0%	14.0%

High growth case is when inflation and interest rates rise. Low Growth case is when there is deflation risk and rates fall further or we do QE. Data as at November 20, 2020. Source: Bloomberg, Haver Analytics, Cambridge Associates, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 98

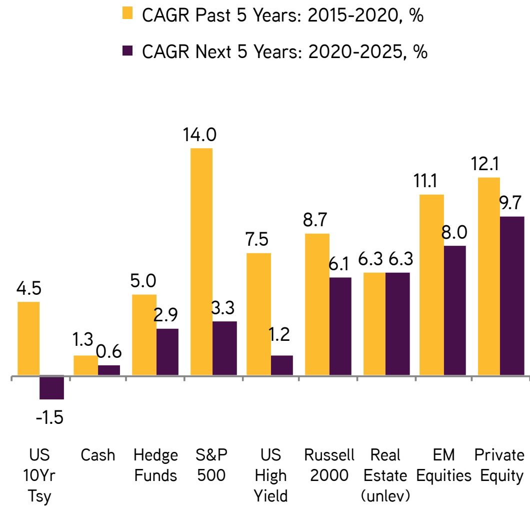
The Illiquidity Premium for Private Equity Could Rise Significantly Post the Current Relief Rally



Data as at 2Q2020. Source: Cambridge Associates, MSCI, Bloomberg, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 99

We Generally Look for Lower Returns Across Many of the Asset Classes We Forecast



Data as at November 20, 2020. Source: Bloomberg, Haver Analytics, Cambridge Associates, KKR Global Macro & Asset Allocation analysis.

Third, while we expect the U.S. dollar to weaken, the world's reserve currency must do so in an orderly fashion. Any unsettled decline in the path of the dollar would be anathema to the stability that global financial conditions are currently enjoying.

Overall, though, we think the environment for 2021 is a compelling one for the investment strategies we are pursuing. The illiquidity premium is likely to expand again, dispersions are wide within the liquid markets, and we expect inflation to lag this cycle. So, we enter 2021 confident that our 'Another Voice' thesis is just unfolding, and we see more gains ahead for those who are willing to embrace our top-down approach to macro and asset allocation.

Overall, though, we think the environment for 2021 is a compelling one for the investment strategies we are pursuing. The illiquidity premium is likely to expand again (*Exhibit 98*), dispersions are wide within the liquid markets, and we expect inflation to lag this cycle. So, we enter 2021 confident that our 'Another Voice' thesis is just unfolding, and we see more gains ahead for those who are willing to embrace our top-down approach to macro and asset allocation.

Important Information

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