

# INSIGHTS

GLOBAL MACRO TRENDS

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## The Road Ahead



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# The Road Ahead

*In recent weeks we have received a slew of requests for more insights about China's changing role in the global economy, including its relationship with the United States, as well as the Federal Reserve's 'new' shift towards average inflation targeting (AIT). Without question, both topics are important ones that reflect the increasing complexity of the current global macro environment. In our humble opinion, the U.S.-China relationship is likely to intensify further in the coming months, particularly ahead of the U.S. presidential election in November. However, given China's importance to the global economy's growth trajectory, we think there is still a significant benefit to investors who can thoughtfully deploy capital throughout Asia by leveraging an investment approach that is both local and global in nature. Meanwhile, we view the Federal Reserve's new framework as a milestone announcement. In fact, AIT is likely the biggest shift in U.S. monetary policy since the introduction of quantitative easing (QE) at the end of the Global Financial Crisis. Not surprisingly, these two weighty topics — U.S.-China relations and the Fed's recent shift in strategy — have significant long-term implications for all professionals of macro and asset allocation. Our base view at KKR is that inflation and rates stay low, and as such, we should heighten our focus on growth companies, yield, and collateral-based cash flowing stories. However, given that many central banks are now experimenting with helicopter money via direct deposits and looser inflation standards, we have also boosted our allocation to key markets such as Infrastructure, Asset-Based Finance, Gold, and parts of Real Estate.*

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**There is a road, no simple  
highway, between the dawn and  
the dark of night**

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GRATEFUL DEAD  
AMERICAN ROCK BAND

As summer winds down and autumn sets in, we typically welcome the onset of the ‘back to school’ season, which usually coincides with the end of summer vacation and the re-establishment of more formal routines. Yet, as we all know, that is not how we are going to remember the fall of 2020, given the challenges surrounding school re-openings, social distancing measures, and the troubling reality that at the end of August coronavirus cases surpassed the 25 million mark, which is more than a four-fold increase since just the beginning of June 2020.

At this point, we do take some comfort that medical professionals have learned more ways to manage the disease. That said, the overall case load in the U.S. remains quite high heading into the fall. Meanwhile, in Europe and Asia – after a fairly benign summer – cases have worryingly begun to tick up again in certain countries. Exacerbating all of this uncertainty is a fast-approaching and divisive election season in the United States and rising global tensions with China. These headwinds are offset by aggressive action by central banks, a sizeable slate of government transfer programs, and seemingly significant progress in the development of vaccines.

From our perch at KKR, we continue to balance the human tragedy associated with this disease, including sickness, death, job loss, and racial/social inequalities with our fiduciary responsibility to our limited partners to perform as investors on their behalf. This balance is certainly a complicated one, but as KKR’s founders Henry Kravis and George Roberts have been constantly telling us throughout the pandemic: If there was ever a time for us to intensify our efforts to “do well while doing good,” now is that time. To this end, we have tried to be present, engaged and to keep the channels of communication open with our investment teams, clients and our companies.

At the moment, there are two major issues that seem to dominate almost every “top down” discussion we have been having in recent weeks. They are as follows:

**1. Both real and nominal yields are collapsing amidst a significant change in Fed policy. What does this mean for risk assets as well as the U.S. dollar?** Our base view is that, unlike the aftermath of the 2008 crisis, the U.S. – not China – is the most aggressive player when it comes to stimulus. All told, we estimate that, of the total \$25 trillion in global stimulus flooding the system, the U.S. portion accounts for nearly 40%. Even with all this stimulus, the U.S. unemployment rate is still essentially on par with the Global Financial Crisis at its peak. Moreover, the burdens of unemployment are disproportionately harming low income and minority workers, which we think weighs heavily on the Fed as it thinks about its mandate. Importantly, this unsettled unemployment picture is happening at a time when there has been a landmark shift in the Fed’s focus towards a “flexible form of average inflation targeting.” As a result, real interest rates in the United States have collapsed to record low levels in absolute terms, while the relative level of real rates in the U.S. is now on par with or even below its global peers in many instances. The implications of these moves are significant, we believe. For starters, we think we are now transitioning away from a multi-year U.S. dollar bull market towards a more challenging period for the greenback. If we are right, then that backdrop could be a net positive for risk assets, particularly those linked to nominal

GDP growth and upfront cash flow. Emerging Markets as an asset class could perform better, as currency typically accounts for nearly one percent of total EM returns in the public markets. The macro landscape we envision also means that – within Equities, both Private and Public – secular cash flow compounding stories are likely to remain in high demand, and as such, we look for valuations to remain stable or potentially even to expand in today’s low rate environment. However, the more dovish environment we are describing does come with some important caveats. Specifically, Chairman Powell also made it known that the Federal Reserve will use additional tools, including less QE and more regulation of the financial services industry, to ward off any financial instability that will “impede the stability of our goals” of maximum employment and price stability. So, while the monetary backdrop is still quite favorable, this warning represents a change in tone that could – at times – weigh on risk premiums well into 2021. Further details below.

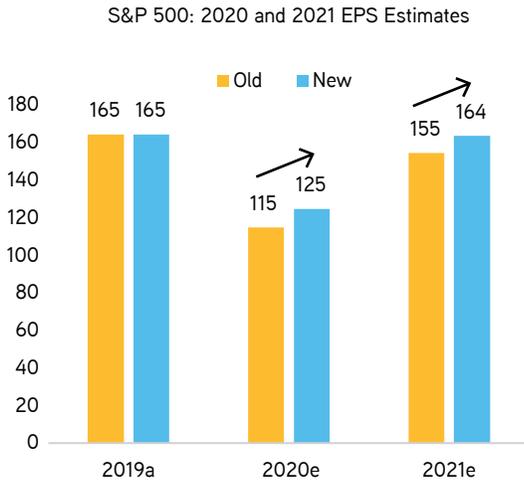
**2. Is China still an investable growth story?** Our work shows that China and its trading partners are still the ‘swing factor’ in global growth. All told, we still expect China to account for one third or more of global growth over the next few years, and when coupled with its immediate trading partners, this pact of Asian EM countries could account for nearly two thirds of incremental global growth. However, geopolitical tensions between China and the U.S. as well as other nations (Australia, India, and some in the EU) are escalating sharply, and we stick to our call that we are at a major inflection point for U.S.-China relations. To this end, we detail how we see not only well-established global supply chains beginning to alter their footprints in China but also what it means for regional growth trends. We also delve into declining future intentions by global multinationals to spend on both investment and research and development. Importantly, though, China is not sitting idle. In fact, China is responding to these changes in corporate behavior using a variety of techniques, including becoming a larger and more powerful domestic economy that relies on its own production (what President Xi Jinping calls “domestic circulation”). In the current environment China may also better leverage its higher interest rate curve (both real and nominal) to try to attract capital to support this more permanent shift towards a consumption economy. A more stable currency outlook is also helping. Our bottom line: Expect a heightened rivalry across multiple facets of the relationship, including some decoupling. However, given the absolute size of the opportunity in China, now is actually the time to think through different ways to harness China’s growth in thoughtful, risk-adjusted fashion, particularly investments that reward long-term, patient capital. Specifically, we think that further implementation of domestic circulation as a policy will lead to the rise of more domestic corporate leaders, and as a result, more – not less – corporations will look to find ways to serve this emerging consumption base.

Looking at the big picture, we continue to believe we are in a decent environment for risk assets. Liquidity remains ample, and both real and nominal yields are near record lows. Meanwhile, corporate earnings are rebounding in the near-term faster than many investors think. Consistent with these improving trends, we are raising our 2020 and 2021 earnings per share for the S&P 500 to \$125 from \$115 and to \$164 from \$155, respectively. One can see the details on

these upgrades in *Exhibits 1* and *2*. Based on these upgrades, we also lift our fair value target for the S&P 500 to 3,350-3,450 from 3,020-3,120 (*Exhibit 4*). From a GDP perspective, we too are making upward revisions. Specifically, we are lifting our 2020 forecast to negative 3.8% from negative 6.5% previously. Even with the recent surge in COVID cases during the summer, economic growth remained steadfastly resilient. That's all good news.

**EXHIBIT 1**

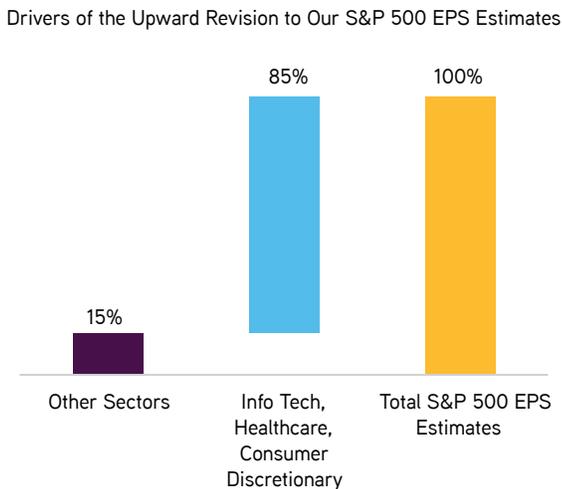
We Have Bolstered Our Earnings Estimates to Reflect Both Better Revenue Momentum and Tight Cost Controls



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

**EXHIBIT 2**

In Terms of Sectors, Technology, Healthcare and Consumer Discretionary Account for About 85% of the Upward Revisions Relative to Our June Estimates



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

**EXHIBIT 3**

Despite a V-Shaped Start to This Recovery, We Envision More of a Square Root Over Time



Data as at September 24, 2020. Source: S&P, KKR Global Macro & Asset Allocation analysis.

However, the “road” ahead will, as noted above, likely remain a bumpy one, not the “simple highway” for which many are hoping. Beyond the two topics we address in this paper — a shifting posture by the Fed as well as intensifying U.S.-China relations — there are others crosscurrents to consider, including a growing chance of a disputed election in the U.S. Meanwhile, the disruptive role that technology is playing in the global economy has never been bigger, a trend we see poised to accelerate further. There is also a record increase in debt loads, which ultimately will affect growth (*Exhibit 6*). Finally, after a historic period of oversized activity by the Federal Reserve and the U.S. Treasury relative to its global peers, it feels like the secular bull market in the U.S. dollar and its interest rate advantage may now have finally run its course. We do not make these statements lightly.

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**However, the ‘road’ ahead will, as noted above, likely remain a bumpy one, not the ‘simple highway’ for which many are hoping.**  
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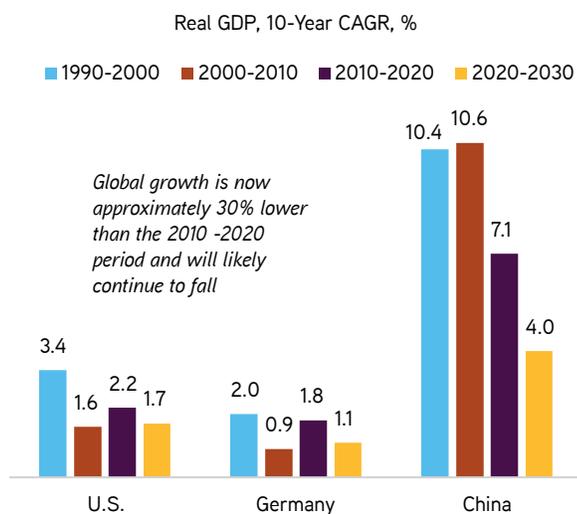
Given Higher EPS Estimates and a More Benign Risk Premium, Our Base Case Now Pegs S&P 500 Fair Value in the 3,350-3,450 Range

S&P 500 Fair Value Sensitivity Table

		Implied Equity Risk Premium (%)								
		6.25%	6.00%	5.75%	5.50%	5.25%	5.00%	4.75%	4.50%	4.25%
Trend Recovered by 2025	70%	2,655	2,780	2,916	3,066	3,232	3,416	3,622	3,853	4,116
	75%	2,691	2,817	2,955	3,108	3,276	3,463	3,672	3,907	4,173
	80%	2,726	2,854	2,995	3,149	3,320	3,510	3,722	3,960	4,231
	85%	2,762	2,892	3,034	3,191	3,364	3,557	3,772	4,014	4,288
	90%	2,797	2,929	3,074	3,232	3,408	3,603	3,822	4,067	4,346
	95%	2,833	2,966	3,113	3,274	3,452	3,650	3,872	4,121	4,403
	100%	2,868	3,004	3,152	3,316	3,496	3,697	3,922	4,175	4,461

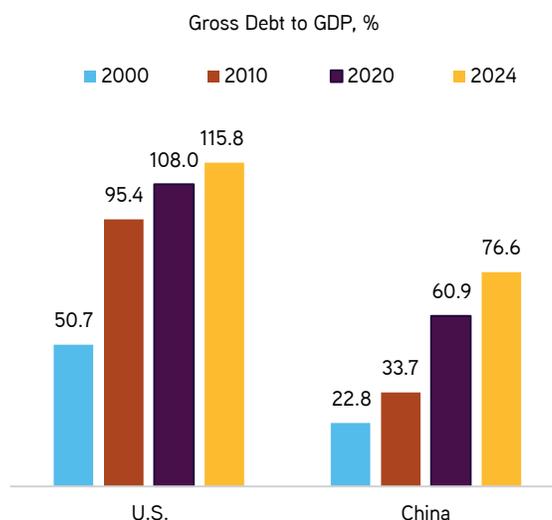
Notes: Key Assumptions – 2020e EPS growth = -24% (vs prior estimate of -30%); Long-Term Risk-Free Rate = Current 10y U.S. Treasury yield = 0.7% pull; up to 0.7% Long-Term Growth Rate = 1.2% (50bps higher than the risk-free rate to account for the new Fed regime); Cash payout (dividends and buybacks) falls to 80% (better than GFC levels of 65%) and recovers back to 90% by 2025. Key Metrics – Fair Value Estimate = (3,350-3,450); high case is around 3,900 and low case is <3000; 2021e EPS = \$164/share; P/E Multiple on 2021e EPS = 21.4-22.0x (versus prior estimate of 19.5-20.1x).

Long-Term Global Growth Will Continue to Fall...



Data as at July 30, 2018. Source: OECD, Haver Analytics.

...Particularly As Global Debt Continues to Rise



Data as at April 14, 2020. Source: IMF, Haver Analytics.

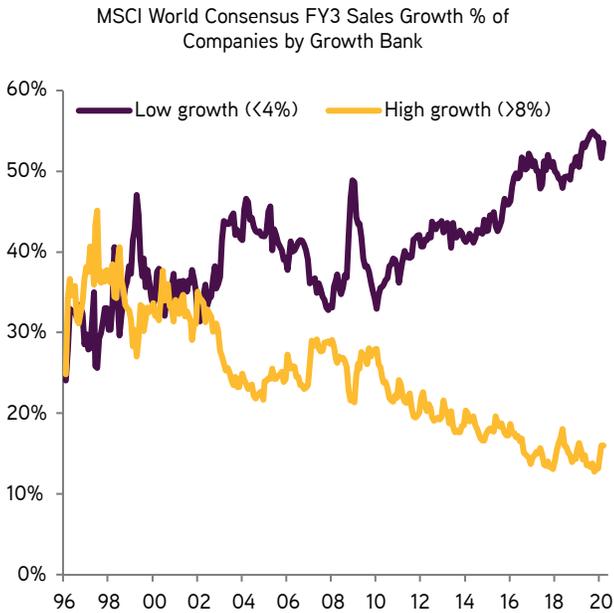
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**From our perch at KKR, we believe that CIOs will need to bring down loss rates across all products, given our more muted expectation for forward returns.**  
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Against this backdrop, we believe a thoughtful macro framework becomes even more important than in the past. From our perch at KKR, we believe that CIOs will need to bring down loss rates across all products, given our more muted expectation for forward returns (see Exhibit 44 in our recent Insights note, *The End of the Beginning*). Somewhat ironically, this requirement to bring down loss rates is occurring at a time when we think most allocators will actually need to take more risk – not less – to achieve their stated goals. Given the low cost of financing, some CIOs will pivot towards adding some leverage to boost overall returns. We are not opposed to this idea, but we strongly believe that getting the right asset allocation with the right top-down themes will become the most important differentiator over the next five years.

So, where to invest? For our nickel, we continue to advocate even more strongly for a mix that is overweight secular growth companies that can also compound their earnings, which we view as an increasingly rare achievement (*Exhibits 7 and 8*). Also, remember that real rates are now deeply negative, which increases the value of upfront cash flows that are well in excess of the current rate of inflation. From a thematic perspective within this bucket of our asset allocation, we favor e-commerce, digitalization, pet care, personal safety, and nesting.

**EXHIBIT 7**

**The Number of Companies With Sustainable Growth Continues to Wither**



Data as at August 3, 2020. Source: Datastream, I/B/E/S, Goldman Sachs Global Investment Research.

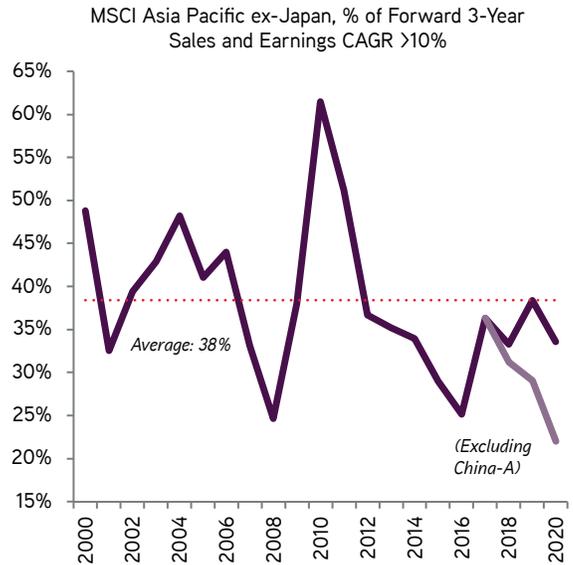
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**Recent comments by Federal Reserve members about average inflation targeting only increase our conviction that now is the time to buy a little extra insurance. As a result, we have moved to an even more overweight position in Asset-Based Finance in Credit, Infrastructure, Logistics, and parts of Real Estate.**

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**EXHIBIT 8**

**Interestingly, Even Asia – Which Boasts the Strongest Growth – Is Seeing a Decline in the Number of Its Fast Growing Companies**

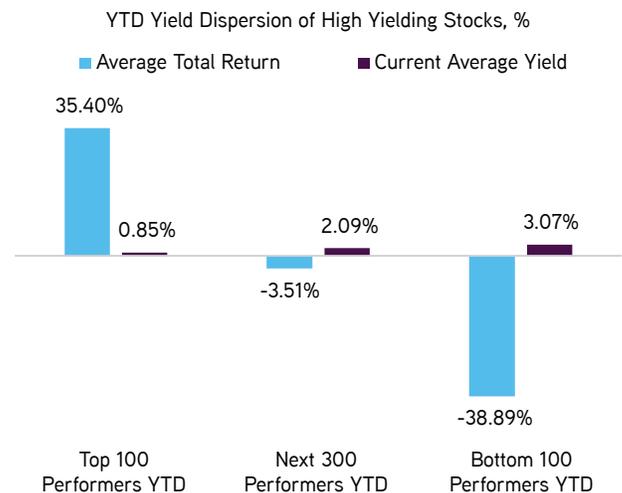


Data as at August 31, 2020. Source: Factset, MSCI, Goldman Sachs Global Investment Research.

We also favor assets linked to nominal GDP with upfront cash flow. We do not see inflation surging in the near-term, but current fiscal and monetary policies are unprecedented. Recent comments by Federal Reserve members about average inflation targeting only increase our conviction that now 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. Finally, we continue to advocate for a significant slug of non-correlated assets, including Gold.

**EXHIBIT 9**

**Equity Investors Have – Until Recently – Rewarded Growth, Not Yield, Amidst a Bifurcating Market**



Data as at August 14, 2020. Source: Barrons, Bloomberg.

Importantly, though, as *Exhibit 9* shows (and we noted earlier), being in the right verticals with the right themes likely matters more than ever. So, our goal at KKR is to continue to effectively marry our macro themes with our micro insights and to use our portfolio construction tools to deliver investment outcomes that we believe are reflective of our firm's 44-year history as not only a leading alternative investment manager, but also as a thoughtful partner to our clients.

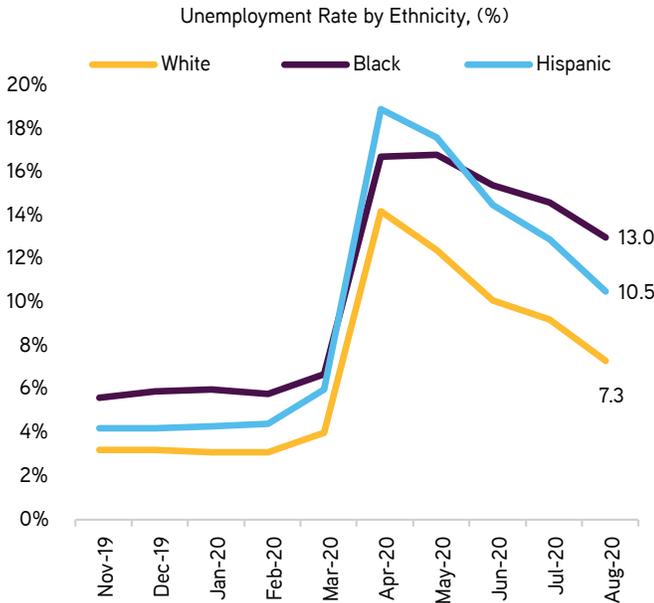
**DETAILS**

**Question #1: Real yields are collapsing. What does it mean for yields and for the dollar?**

Coming out of the July FOMC meeting, the headline was that there were no policy changes. However, that is not how we interpreted events. In particular, what was most interesting to us was Chairman Powell's press conference, where *he continued to elevate his concerns for the U.S. real economy amid the ongoing pandemic – flagging, for example, the significant backtracking in job creation for minorities since February (Exhibit 10)*. Indeed, we think that the Fed is heavily influenced by the unsavory skew of recent unemployment trends. The reality is that unemployment – even after adding back nearly 11 million jobs since March – is still running just below where it was at the peak of the Global Financial Crisis. Without question, these elevated levels of worker displacement are making a huge impression on the way the central bank governors think about policy for the foreseeable future.

**EXHIBIT 10**

**Minorities Have Experienced a Tougher Job Market During the COVID-19 Pandemic...**

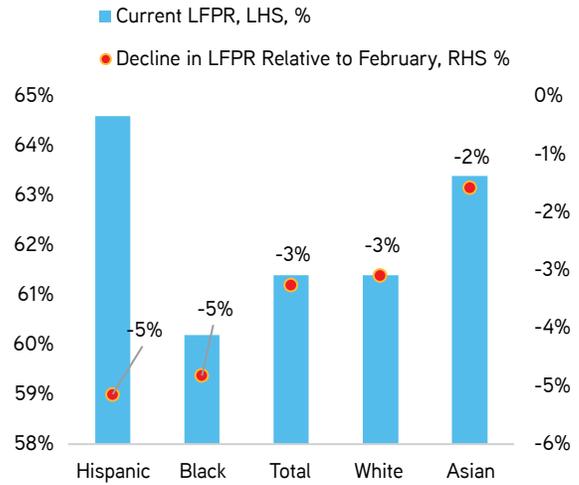


Data as at August 31, 2020. Source: Bureau of Labor Statistics, Haver Analytics.

**EXHIBIT 11**

**...Including More Dramatic Fall-Offs in Labor Participation Rates**

Labor Force Participation Rate (LFPR) vs. Pre-COVID Levels



Data as at August 7, 2020. Source: Bureau of Labor Statistics, Haver Analytics.

By comparison, Powell has consistently downplayed the substantial healing we have already seen in financial conditions, emphasizing that his prime focus is keeping credit markets open and liquid. Indeed, despite tightening credit spreads, he has been unwavering in his message that “preserving the flow of credit is essential” to minimize the damage caused by the virus. In fact, even after credit spreads had almost fully normalized to the pre-pandemic range, the July statement by the Federal Reserve announced that, “To support the flow of credit to households and businesses, over the coming months the Federal Reserve *will increase* its holdings of Treasury securities and agency residential and commercial mortgage-backed securities at least at the current pace to sustain smooth market functioning, thereby fostering effective transmission of monetary policy to broader financial conditions.”

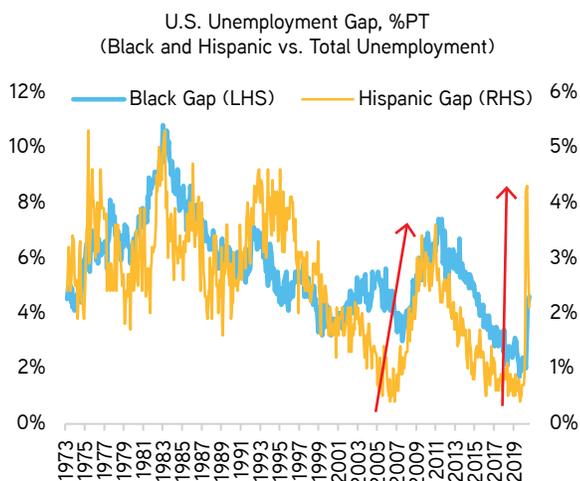
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**Without question, these elevated levels of worker displacement are making a huge impression on the way the central bank governors think about policy for the foreseeable future.**

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EXHIBIT 12

The Unemployment Rate for Black/Hispanic Americans Has Increased More Substantially Than for the Average American



Data as at August 31, 2020. Source: Bureau of Labor Statistics, Haver Analytics.

EXHIBIT 13

At the Same Time, Low Wage Workers Have Suffered More Mightily Than High Wage Workers

	Pre-COVID (Feb-20)	Trough (Apr-20)	May-20	Jun-20	Jul-20	Aug-20
Total	0%	-15%	-13%	-10%	-8%	-7.6%
Private	0%	-16%	-14%	-10%	-9%	-8.3%
High Wage (27% of total)	0%	-8%	-8%	-7%	-7%	-6.0%
Medium Wage (48% of total)	0%	-12%	-10%	-7%	-7%	-6.1%
Low Wage (25% of total)	0%	-33%	-27%	-19%	-16%	-14.7%

Data as at August 31, 2020. Source: Bureau of Labor Statistics, Haver Analytics.

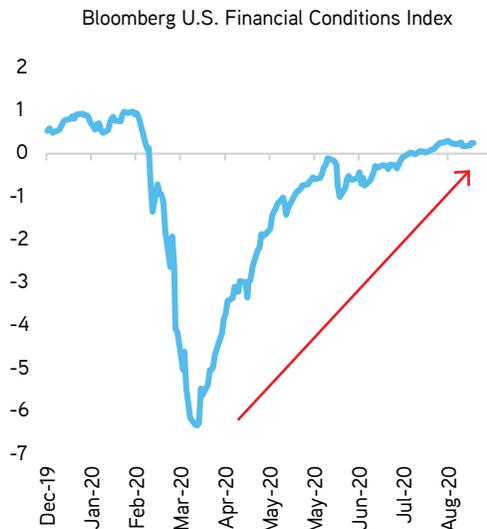
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**In fact, Powell noted that the Fed seeks to promote its employment and inflation goals while warding off any risks to financial stability (i.e., asset bubbles) ‘that impede the stability of our goals’.**

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EXHIBIT 14

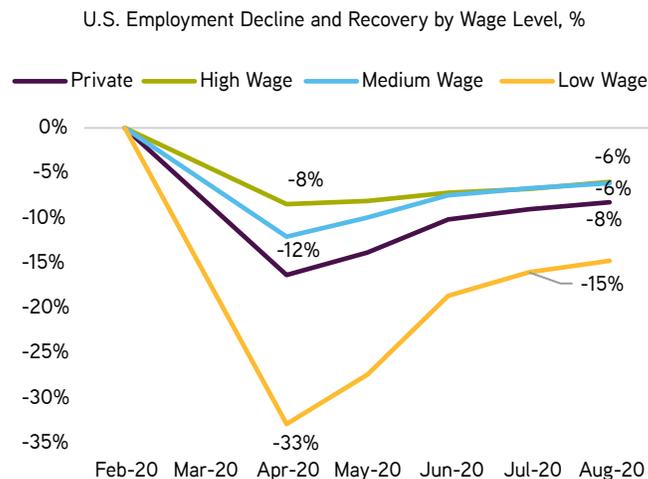
The Federal Reserve Is Winning the Day, as Financial Conditions Have Steadily Been Improving



Data as at September 3, 2020. Source: Bloomberg.

EXHIBIT 15

Employee Wages, Particularly At the Low End, Have Been Hard Hit. We Believe This Reality Is Heavily Weighing on the Federal Reserve’s Posture



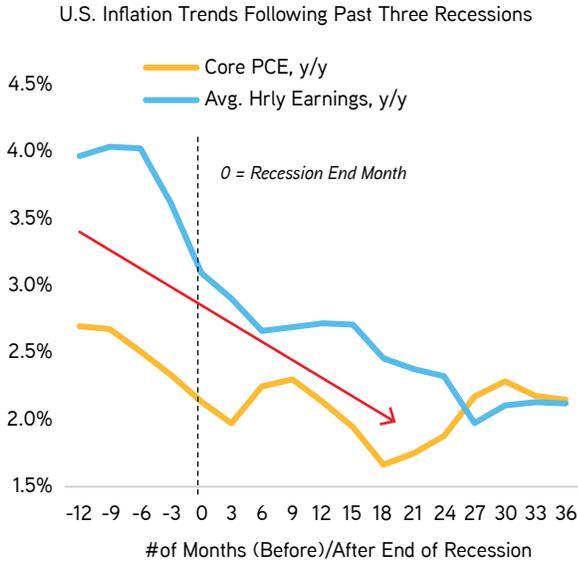
Note: High-Wage = Information Services, Utilities, Finance, Prof Services And Mining/Logging; Medium-Wage = Wholesale Trade, Construction, Manufacturing, Education/Healthcare, Transport; Low-Wage = Retail Trade, Leisure/Hospitality. Data as at August 31, 2020. Source: Bureau of Labor Statistics, Haver Analytics.

At the annual Jackson Hole summit (held virtually in 2020) in late August, the Fed – as we indicated earlier – shifted its inflation mandate towards an average goal of two percent. In our view, the lion’s share of central bank committee members now believe that inflation is so structurally low that the committee’s change “reflects [their] view that a robust job market can be sustained without causing an outbreak of inflation.” This statement is important because it reveals two things. First, it suggests that, despite the Fed’s dual mandate, it

appears to be intensifying its focus on employment relative to inflation. In fact, Powell recently stated that, “This change (in the inflation mandate) reflects our appreciation for the benefits of a strong labor market, particularly for many in low- and moderate-income communities.” Second, when it comes to future inflation trends amidst further downward pressure on wages, he certainly sees a negative skew. Recent trends support this view as inflation has only reached two percent for six months during the last 10 years, despite the U.S. reaching a generational low in its unemployment rate in 2019.

EXHIBIT 16

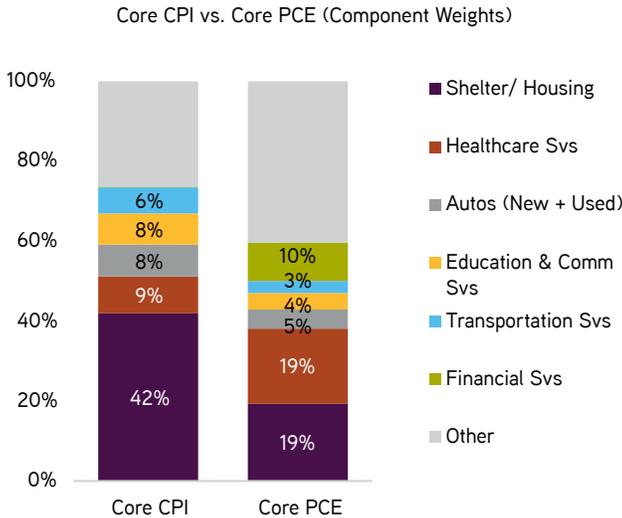
Price and Wage Inflation Typically Remains Subdued for Several Quarters Following the End of a Recession



Data as at September 11, 2020. Source: BEA, Haver Analytics.

EXHIBIT 17

The Fed Is Going to Have to Work Hard to Create Inflation, Given Many of Its Largest Components Are Facing Downward Price Pressure



Data as at July 31, 2020. Source: BEA, BLS, Haver Analytics.

Another important consideration is what the market is discounting. As we show in *Exhibit 23*, the rates market is actually embedding potentially negative fed funds in coming quarters. This set-up is significant because it means that Chairman Powell must remain extremely dovish just to prevent a ‘taper tantrum’ situation from unfolding, we believe.

The Fed then held what we view as a ‘watershed’ meeting on September 15th, 2020. At this meeting it officially pivoted to an average inflation targeting framework and committed to formally maintaining rates at the zero lower bound until inflation rises above two percent with solid labor market trends. We believe that there are six main conclusions for investors to digest. They are as follows:

- 1. A robust new pre-commitment on rates.** While we knew the Fed would pivot to a framework targeting two percent inflation on average, the new development was that the FOMC made an explicit, robust commitment to hold rates at zero “until inflation has risen to two percent and is on track to moderately exceed two percent for some time.” Importantly, though, employment trends – more so than inflation – will drive its willingness to raise rates. Under its new policy, the Fed would not have raised rates in either 2015 or 2016.
- 2. From here, the focus is on the economy over markets...** The Fed is now pre-committed on rates, but it has no such pre-commitment on QE or macro prudential regulation. In fact, Powell noted that the Fed seeks to promote its employment and inflation goals while warding off any risks to financial stability (i.e., asset bubbles) “that impede the stability of our goals.” Put differently, the Fed’s new framework seems to be about mashing the accelerator on the economy via rates, while maintaining the option of tapping the brakes on markets via macro prudential regulation (bank oversight, stress tests, leveraged lending guidelines, etc.) and QE scaling. This approach is new, and we believe it represents growing caution about retail trading activity, particularly in high growth sectors like Technology.
- 3. ...With a particular emphasis on social equity and income inequality.** Chairman Powell noted the FOMC’s concern that the pandemic has disproportionately harmed women, BIPOC communities<sup>1</sup>, and service workers. Addressing inequality has historically been more the bailiwick of elected officials than central bankers, but COVID has reminded all Americans of the structural racial inequities in our society. This awakening is just and good, and, the Fed’s focus on these issues helps explain the strong measures it is taking to promote job and wage growth.
- 4. The Phillips Curve is out. Disinflation is in.** Chairman Powell noted that “low unemployment is not necessarily a policy concern unless it leads to unwanted increases in inflation.” He also acknowledged that we are in a “new normal” wherein “rates are near the effective lower bound even in goods times.” Bottom line: In essence, we think the Fed has now divorced itself from the traditional Phillips Curve, and is placing a particular new emphasis on the disinflationary forces exerted by technology and demographics.

1 Black, Indigenous and people of color.

5. **The Fed assumes more fiscal support is coming...** While stopping short of making any specific fiscal policy prescriptions, Powell did assert that “fiscal support has been essential in the good progress we see so far” in the economy. He also noted that “most private forecasters assume there will be substantial additional fiscal support,” which we view as his way of telling us this is the Fed’s assumption too.

6. **...Helping to support a continued strong recovery.** See *Exhibit 18* below for details, but the Fed revised up its assumptions for GDP, employment, and inflation across the board. It now sees U.S. GDP at -3.7% in 2020 versus its forecast of -6.5% back in June. We agree that the opening phases of the recovery have been quite strong, and as we indicated earlier (*Exhibit 3*), we too have boosted our GDP forecasts for 2020.

**EXHIBIT 18**

**The Fed’s New Economic Projections Reflect Better Growth and Lower Unemployment in 2020**

FOMC Summary of Economic Projections, Including Changes Relative to Prior Forecast Update in June 2020

	2020e	2021e	2022e	2023e	Long-Run
<b>Central Tendency of Economic Projections</b>					
<b>Real GDP Growth</b>	-3.7%	4.0%	3.0%	2.5%	1.9%
<i>June meeting</i>	-6.5%	5.0%	3.5%	N/A	1.8%
<i>Memo: Bbg Consensus</i>	-4.5%	3.7%	2.8%	N/A	N/A
<b>Unemp. Rate</b>	7.6%	5.5%	4.6%	4.0%	4.1%
<i>June meeting</i>	9.3%	6.5%	5.5%	N/A	4.1%
<i>Memo: Bbg Consensus</i>	8.5%	6.9%	5.6%	N/A	N/A
<b>PCE Inflation</b>	1.2%	1.7%	1.8%	2.0%	2.0%
<i>June meeting</i>	0.8%	1.6%	1.7%	N/A	2.0%
<i>Memo: Bbg Consensus</i>	1.1%	1.7%	1.9%	N/A	N/A
<b>Core PCE Inflation</b>	1.5%	1.7%	1.8%	2.0%	N/A
<i>June meeting</i>	1.0%	1.5%	1.7%	N/A	N/A
<i>Memo: Bbg Consensus</i>	1.3%	1.5%	1.7%	N/A	N/A
<b>Year-End Fed Funds Forecast</b>					
<b>September meeting</b>	0.125%	0.125%	0.125%	0.125%	2.500%
<i>June meeting</i>	0.125%	0.125%	0.125%	N/A	2.500%
<i>Memo: FF Futures</i>	0.08%	0.03%	0.01%	0.01%	1.13%
<i>Memo: GMAA</i>	0.05%	0.05%	0.125%	0.125%	1.5%

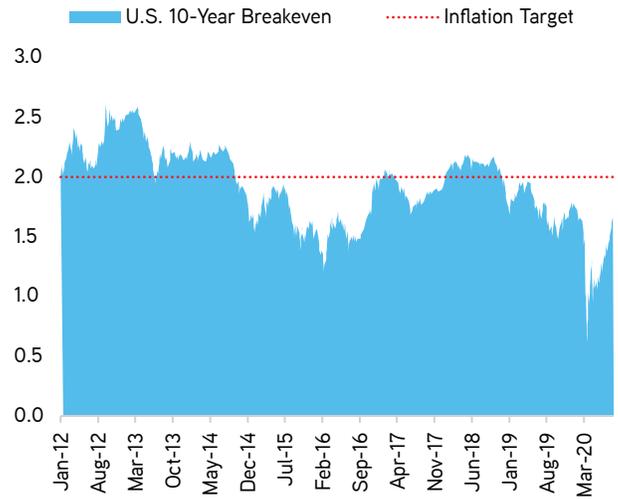
Data as at September 16, 2020. Source: FOMC, Bloomberg, KKR Global Macro & Asset Allocation analysis.

As we look ahead towards the winter, we still expect an extension of the current regime of declining U.S. real yields amid pinned nominal rates and rising inflation expectations. Importantly, 10-year inflation expectations have recovered significantly to 1.77%, but current levels still remain below the Fed’s stated two percent goal. As such, we now see further scope for break-evens to grind higher and real rates to grind lower after the Fed fleshes out in a credible manner how it will implement flexible average inflation targeting (FAIT).

**EXHIBIT 19**

**The Federal Reserve Is Using Average Inflation Targeting as a Way to Try to Bolster Inflation Expectations Back Towards More Normal Levels**

Inflation Expectations Compared to Fed’s Target, %

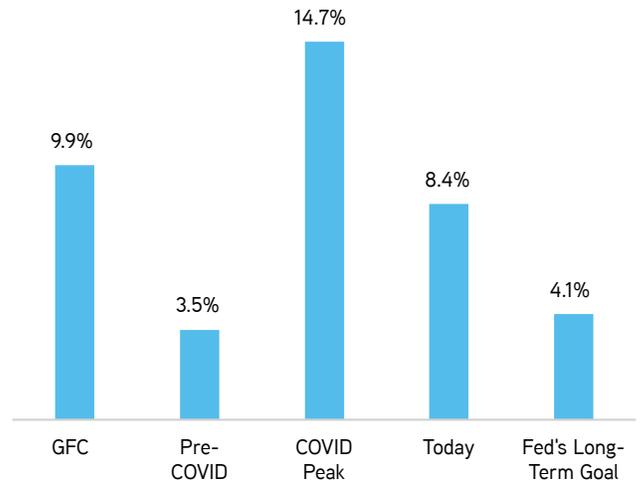


Data as at September 3, 2020. Source: Bloomberg.

**EXHIBIT 20**

**While the Unemployment Rate Has Improved, It Is Still at Very Concerning Levels for the Federal Reserve**

Unemployment Rate Comparison, %

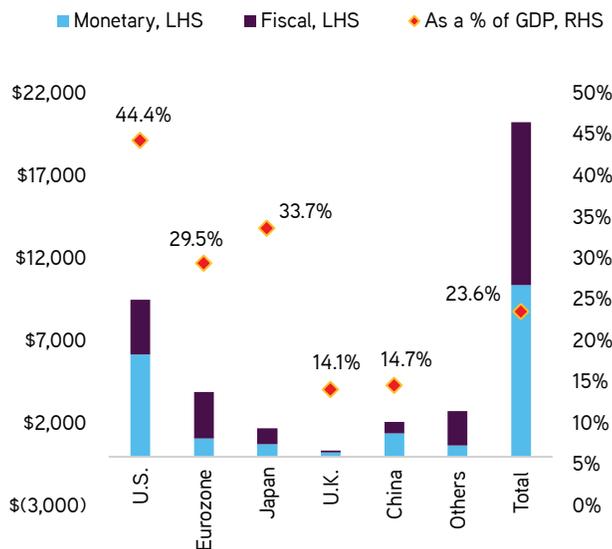


Data as at September 3, 2020. Source: Bloomberg.

EXHIBIT 21

The Amount of Global Stimulus Has Been Breathtaking, But We Actually Believe There Is Likely More to Come

Global Monetary and Fiscal Stimulus to Fight COVID-19, February thru May 2020, US\$ Billions and % of GDP

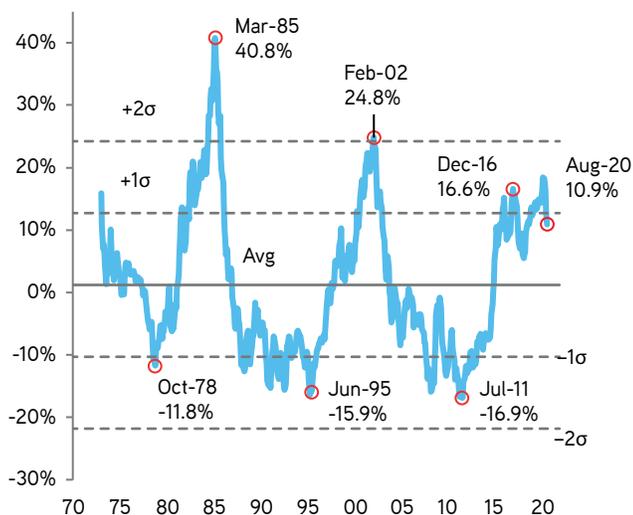


Data as at July 31, 2020. Source: Cornerstone Macro.

EXHIBIT 22

Given Its Currently High Valuation Amidst Record Stimulus, We Think That the Dollar Could Be Poised to Finally Fall

Real Major Trade-Weighted U.S. Dollar REER: % Over (Under) Valued



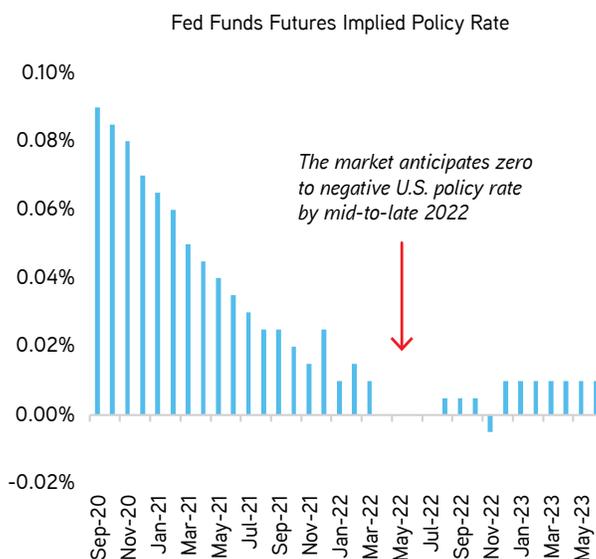
Data as at August 31, 2020. Source: Federal Reserve Board, JP Morgan, Bank of England, OECD, IMF, World Bank, Bank for International Settlements, Haver Analytics, Bloomberg.

What does all this policy rhetoric mean for asset allocation on a go-forward basis? For starters, it means monetary policy in the United States will remain significantly accommodative for quite some time. As part of this worldview, we think that U.S. dollar assets will depreciate more so on a relative basis than they have during the past 5-10 years. In particular, such negative U.S. real rates are supportive for the euro to increase to at least 1.25 relative to the dollar. We also see the potential for many emerging market currencies to gain ground versus the dollar as well. To this end, my colleague Frances Lim has done some interesting work to show that, despite significant debt loads in China, U.S. debt loads have increased even more. All told, the U.S. has spent 44% of its GDP to try to temper the adverse effects of the coronavirus. Against this backdrop, we believe that the Chinese renminbi seems well poised to appreciate against the U.S. dollar, which could bring a major change in the attitude of global investors.

Meanwhile, within Private Credit, we think that investors should be aggressive around sourcing hard asset-based investments with upfront cash flows (e.g., Asset-Based Finance). We are currently seeing a compelling opportunity set for providing solutions via housing platforms where there are supply-demand imbalances pressuring both home prices and rents, or lending against the embedded value of an asset (EV) with favorable coupons. Along those same lines, we also like asset classes that tend to pay relatively higher excess coupons for which there are sound underwriting disciplines and fundamentally driven borrower behavior. One such example includes auto loans, for which the backdrop of personal mobility and independence is a near term tailwind; we also like that, if underwritten properly, there is significant asset value in many autos that can serve as collateral, particularly when the auto is viewed as a personal safety item for the driver (e.g., a commuter).

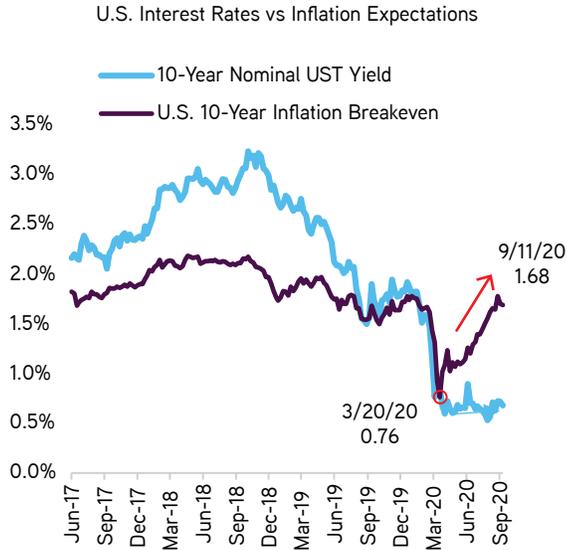
EXHIBIT 23

The Market Anticipates Steadfast Dovishness From the Fed, Which Means Powell Essentially Must Remain Dovish to Avoid a Taper Tantrum



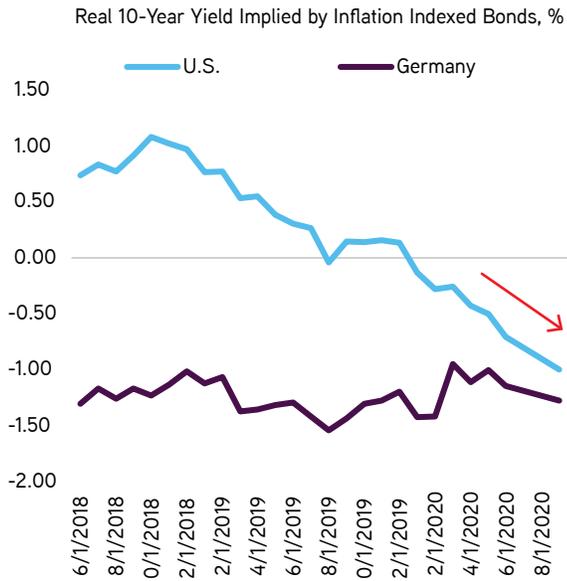
Data as at September 11, 2020. Source: Bloomberg.

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



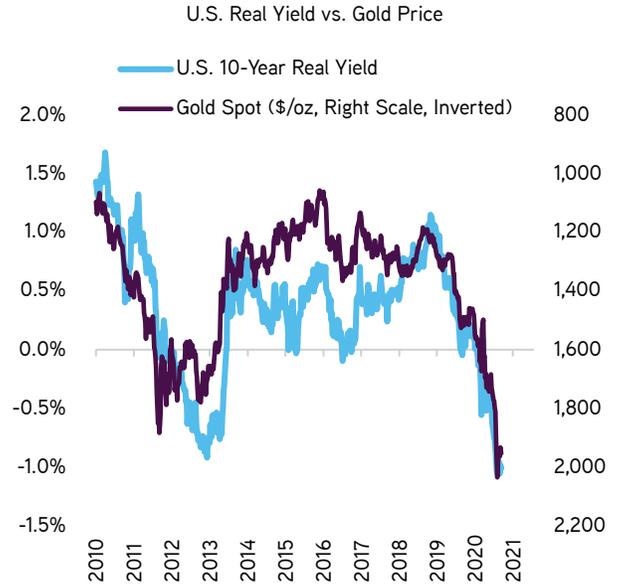
Data as at September 11, 2020. Source: Bloomberg.

U.S. Real Rates Have Crashed Into Negative Territory, Converging With European Levels



Data as at September 11, 2020. Source: Bloomberg.

Gold Prices Have Reacted Positively to the Decline in Real Rates



Data as at September 11, 2020. Source: Bloomberg.

The environment we envision also means that Infrastructure should do well. Coupled with rapidly aging populations that are not confident that they will have enough money to retire, the desire for income producing investments should only increase in our view. We believe these trends are secular, not cyclical, and will likely continue to positively affect valuations of “growth-oriented” yielding securities or investments, including global infrastructure. Last mile build-out in optical fiber has been a significant overweight for us, but we are also seeing a growing number of infrastructure opportunities emerge from over-levered corporates. At the moment, Europe and Asia have been the most active areas, but we do also expect the U.S. to participate in our deconglomeratization thesis. As *Exhibit 28* shows, our work suggests this transition towards more simplicity in corporate structures generally leads to a significant increase in value.

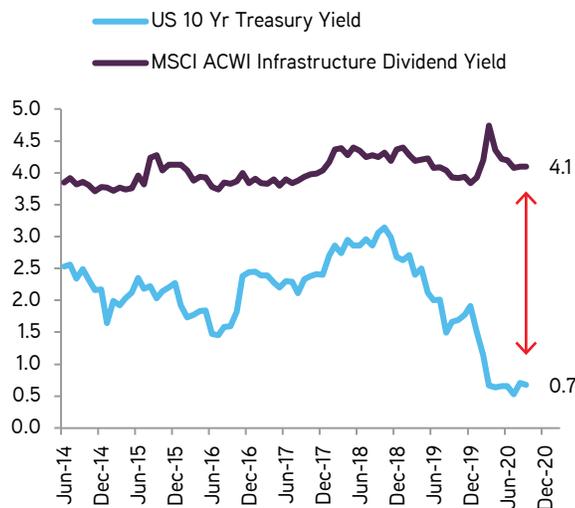
“

**We also believe that collateral-based, private investments like Infrastructure, Real Estate Credit, and Asset-Based Finance will likely be re-rated upward in the coming quarters if we are correct about the intentions of the Federal Reserve.**

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EXHIBIT 27

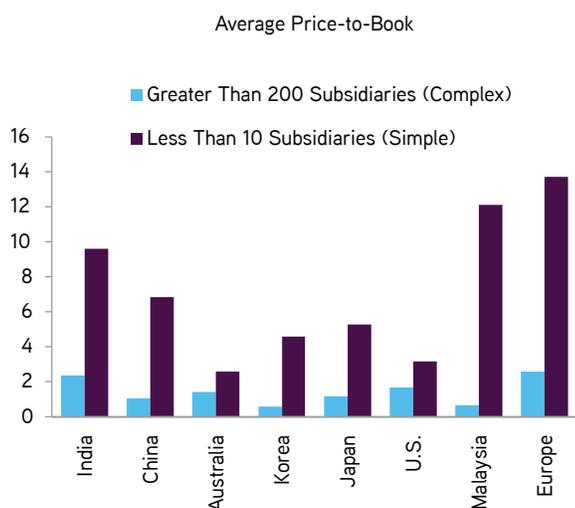
Infrastructure Yields Have Remained Relatively Stable, While Bond Yields Have Collapsed



Data as at September 1, 2020. Source: MSCI, Bloomberg.

EXHIBIT 28

A Simple Corporate Structure Typically Holds a Higher Valuation Than a Complex One



Data as at August 6, 2019. Source: MSCI, Factset Global, KKR Global Macro & Asset Allocation analysis.

On the traditional equity side of the portfolio (and despite the cyclical rebound we are forecasting), the current structural global GDP slowdown is having a profound impact on the ability of companies to grow. All told, the percentage of companies in the MSCI All Country World that are poised to grow eight percent or more has fallen sharply to 16% in 2020 from 45% during the 2000-2001 period (Exhibit 7). So, our view is to find companies that have established cash flowing business models with identified economies of scale that will result in material improvements in cash flow and book value as these businesses grow in size. We also think that these companies should have clearly defined sources of support for those cash flows, including access to growing end markets, clear ability to scale in

production or distribution, brand loyalty, and defensible margins. This underscores our view that owning some secular growth in the portfolio has become of paramount importance. In terms of where to invest behind our favorable outlook on secular growth stories, we currently favor several regional themes over global ones, including business services, logistics, digitalization, payments, and automation.

Our bottom line: Led by outsized U.S. monetary policy that is more flexible in nature and a surge in fiscal stimulus, we are at an inflection point in the global capital markets, one that requires a rethinking of traditional asset allocation. Beyond the more restricted role that government bonds can play in a diversified portfolio (see our recent Insights note, *The End of the Beginning*), we are using this piece to strengthen our view that the recent decline in the U.S. dollar will emerge as a more permanent feature during this recovery. Just consider that real yields in the U.S. are now on par with Europe – which makes the euro more competitive – while nominal yields greatly favor China’s currency (see below Exhibit 46). Consistent with this view, we are also suggesting that weightings to European and Asian Private Equity likely need to trend higher. We also believe that collateral-based, private investments like Infrastructure, Real Estate Credit, and Asset-Based Finance will likely be re-rated upward in the coming quarters if we are correct about the intentions of the Federal Reserve.

However, the Fed’s revelation that it will monitor financial stability means that the background will be less of a one-way trade in favor of risk assets. In particular, the Fed is now starting to publicly remind everyone that monetary policy is intended to ‘fix’ the economy, not continually bolster financial asset prices. Hence, it has made the decision to flag ‘financial stability’ more aggressively in its mandate. Walking this line as a committee will not be easy. Indeed, we view the dissension in September by Fed governor Robert S. Kaplan as an important signal for the investment community to watch. Were more Fed governors to adopt his viewpoint, it could quickly reduce some of the excess froth that now appears to be building up in some of the more speculative parts of the debt and equity markets.

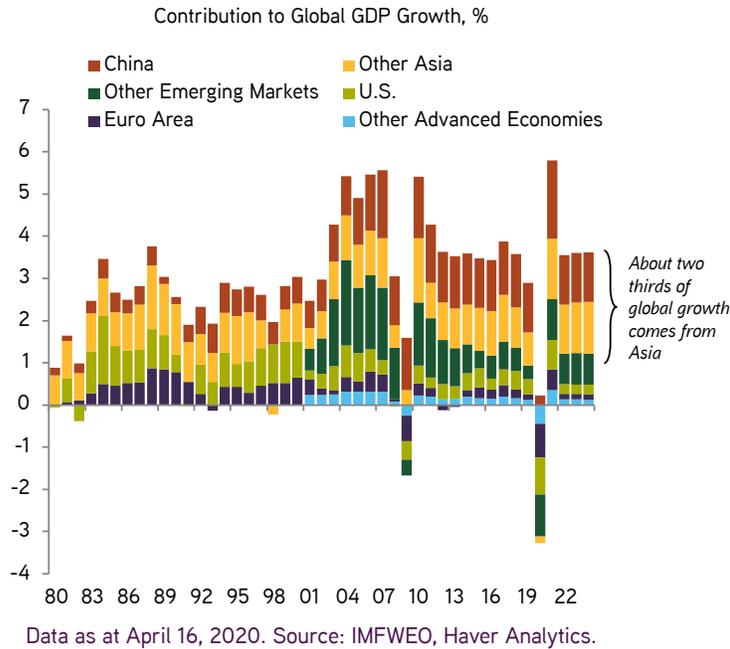
Question #2: Is China Still an Investable Growth Story?

In recent weeks, investor’s interest in Asia, China in particular, has – not surprisingly – surged. This heightened level of inquiry makes sense to us, given ongoing technology disputes, noise around the South China Sea area, and a continued ‘blame game’ around the onset of the coronavirus. Given this backdrop, we thought it might make sense to discuss our current thinking on several major trends in China, including areas where we still have high conviction and areas where our thoughts might have changed or become more conservative.

In terms of what has not changed in our outlook, there are several long-term trends to embrace, we believe. First, we still expect China to remain the dominant force in global growth, even in the slow growth ‘world’ we envision. One can see that China alone makes up about one third of global growth; with its immediate trading partners across the emerging markets that proportion climbs to almost 75% (Exhibit 29). That part of the story has not changed.

EXHIBIT 29

Growth in the Global Economy Continues to be Driven by the Emerging Markets



for its burgeoning consumer market and domestic businesses. However, as we show in *Exhibit 31*, this transition actually began to take place immediately and steadfastly after 2007, the exact point when China realized it needed – for both economic and national security reasons – to pivot away from an export-driven model that was largely dependent on the U.S. consumer.

Fast forward to today, and exports as a percent of GDP are now just 17%, compared to nearly 36% in 2007. Moreover, the type of exports has shifted, as China has boosted the proportion linked to higher value-added products (read *China 2025*) to nearly 60% from around 44% in 2008 (*Exhibit 32*). In our view, the coronavirus as well as the recent trade spats will only reinforce China’s commitment to this initiative.

EXHIBIT 31

Importantly, Trade Is Becoming a Smaller Part of China’s Economy

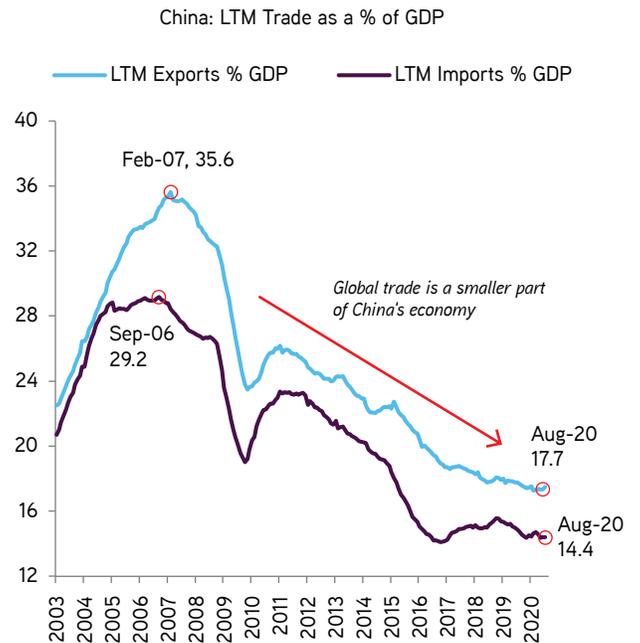
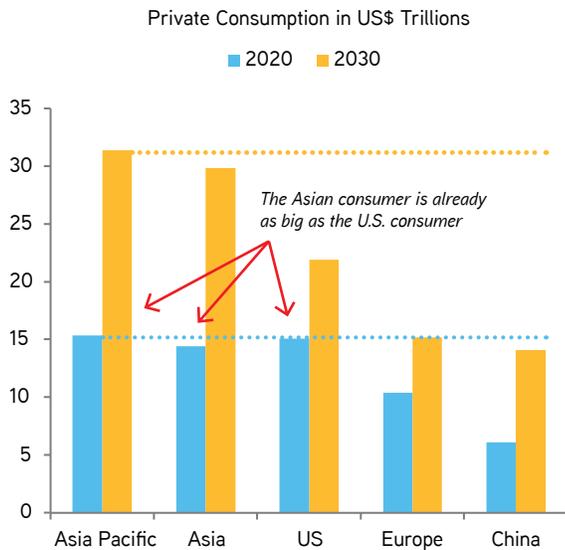


EXHIBIT 30

Asia Will Further Dominate Global Consumption Trends by 2030



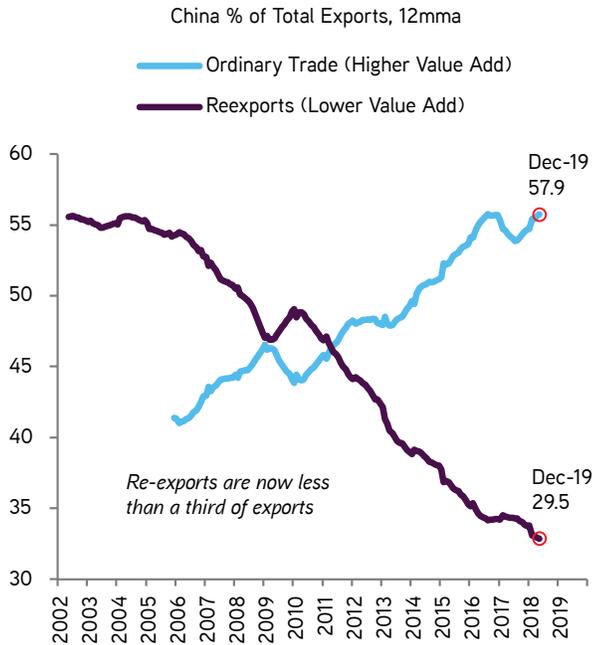
We also believe that China remains steadfastly committed to aggressively internalizing its economy. Of late, President Xi Jinping has been promoting his new ‘dual circulation’ strategy, which emphasizes domestic manufacturing and services for the domestic consumption economy. In other words, the country is pivoting from one focused on international trade/exports to one that is focused on self-sufficiency

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**In other words, China is pivoting from a country focused on international trade/exports to one that is focused on self-sufficiency for its burgeoning consumer market and domestic businesses.**

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Chinese Exports Continue to Rebalance Towards Higher Value Added Goods

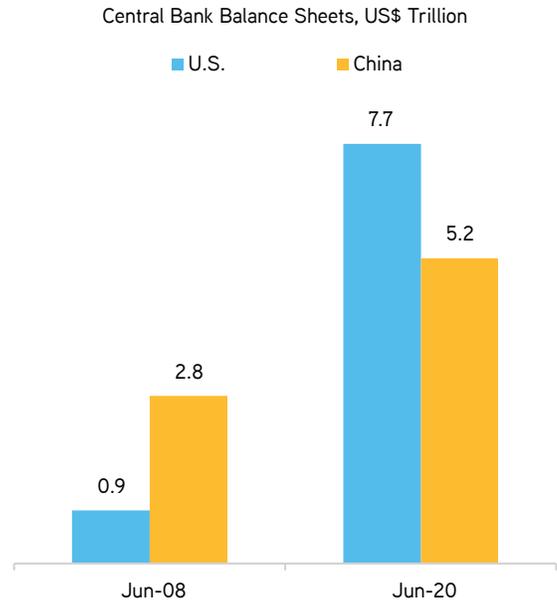


Data as at December 31, 2019. Source: China Customs, Haver Analytics.

Importantly, we see more running room ahead, particularly given the huge size of China’s middle class. One can see this in *Exhibit 30*. As part of this growth, we expect the trends towards digitalization, e-commerce, fintech, and online experiences to accelerate. Moreover, we think the collective arrival of the Internet of Things (IOT), Artificial Intelligence (AI), and 5G (5th Generation Connectivity) mark a pivotal point that will reshape the global economy. Indeed, while many hoped that the AOL-Time Warner merger would herald in the Internet age in 2000, it was missing the processing speed, swaths of data, and mature algorithms to fuel AI. Today, however, we believe 5G, AI and IOT will revolutionize every industry. We now have massive amounts of data, a technologically skilled workforce, high tech communications infrastructure, and high speed processing power. As a result, 5G will remain a key battleground, and as such, China’s ability to differentiate itself during its rollout/adoption could be significant to the country’s overall growth and competitive positioning in the global economy.

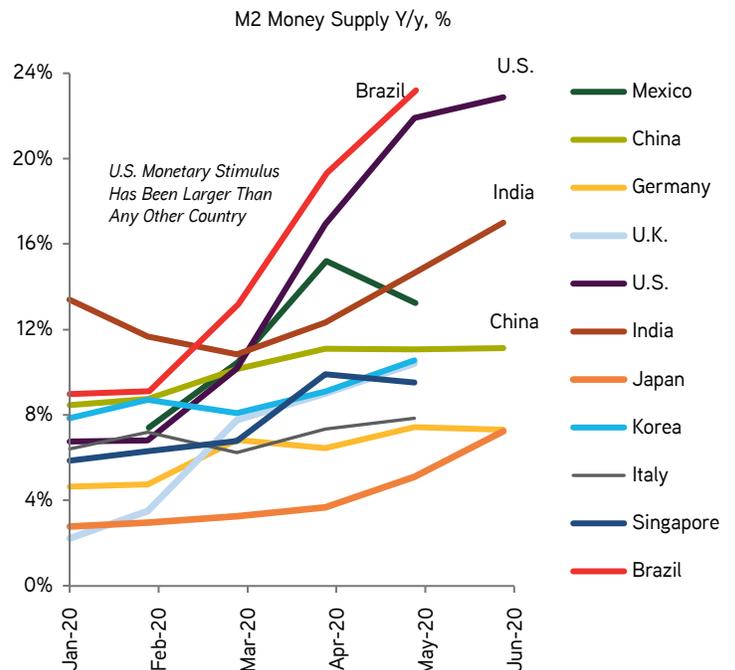
On the other hand, there are several important influences that have changed direction in recent months. The first is China’s role in the global liquidity picture, and then its response to the coronavirus in particular. Specifically, whereas China used record amounts of stimulus essentially to reinvigorate the entire global economy in 2008, this cycle, it has been the United States leading the charge in terms of throwing the greatest amount of liquidity at the problem. One can see this in *Exhibit 33*.

In 2008, China Led the Way. Today, However, the U.S. Is the Most Stimulative



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

U.S. Money Supply Is Surging Relative to Other Countries That We Track



Data as at July 27, 2020. Source: Haver Analytics.

Heightened geopolitical tensions are also changing the way China and its trading partners think about their role in the global supply chain. Importantly, we do not believe that the current geopolitical frictions centered in the Indo-Pacific region are an anomaly – the

product of the particular personalities presently in power or election year dynamics in the U.S., although the latter is certainly exacerbating certain trends. Rather, we see great-power competition – not only between China and the United States, but between China and other major powers – as an enduring, transformational force on the international stage, akin to globalization, that is likely to play out for the foreseeable future.

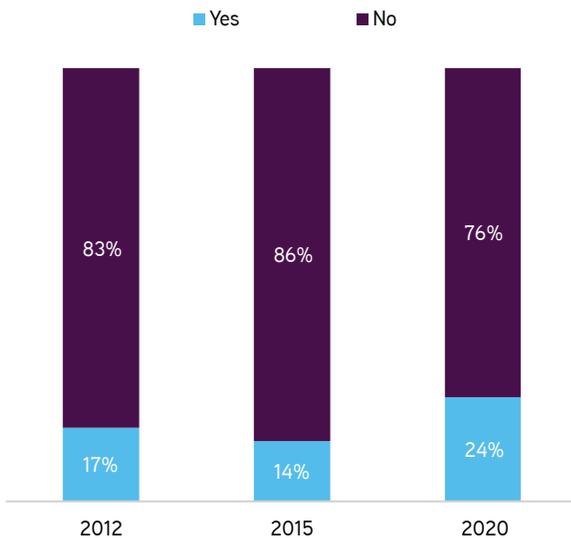
Without question, this transformational shift will definitely impact supply chains. To this end, we recently spent time analyzing some excellent work done by the U.S.-China Business Council as well as comparing best practices across our nearly 200 portfolio companies. As we show in *Exhibit 35*, the punchline is that many companies are slowing down their investment in China. Some of this shift in sentiment is linked to heightened geopolitical tensions, while some of it stems from the aftermath of COVID-19. As we show in *Exhibit 38*, research and development too has fallen dramatically.

Interestingly, though, our conversations with many CEOs operating in China suggest that there is an important bifurcation occurring. Specifically, management teams who believe that their companies have built competitive advantage – either by product or by process – are actually ramping up their investments in China to try to capture more of the market. The goal, we believe, is to extend their lead over local players in such a way that they build a competitive, sustainable moat around their businesses. This viewpoint is significant, as large U.S. multinationals have \$900 billion in assets and more than \$500 billion in book value now located in China, according to a recent report by the *Economist*. By contrast, smaller and more marginal players, particularly those who today face a more formidable local competition, are now pulling back more aggressively than in the past.

**EXHIBIT 35**

**Almost 25% of U.S. Multinationals Surveyed Have Reduced Or Stopped Planned Investment in China in the Last Year, A Historic High for This Survey**

2020 USCBC Survey: Did Your Company Reduce or Stop Planned Investment in China in the Past Year?

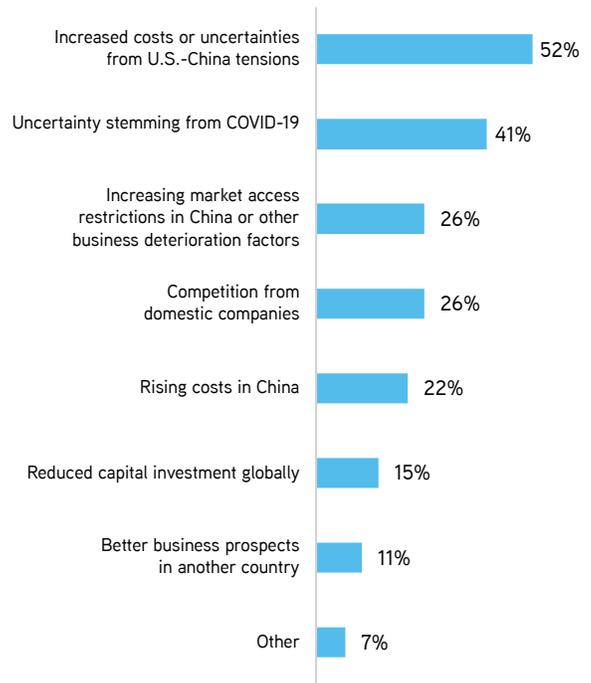


Data as at June 2020. Source: U.S. China Business Council Member Survey.

**EXHIBIT 36**

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

2020 USCBC Survey: Why Did Your Company Reduce or Stop Planned Investment in China in the Last Year?



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

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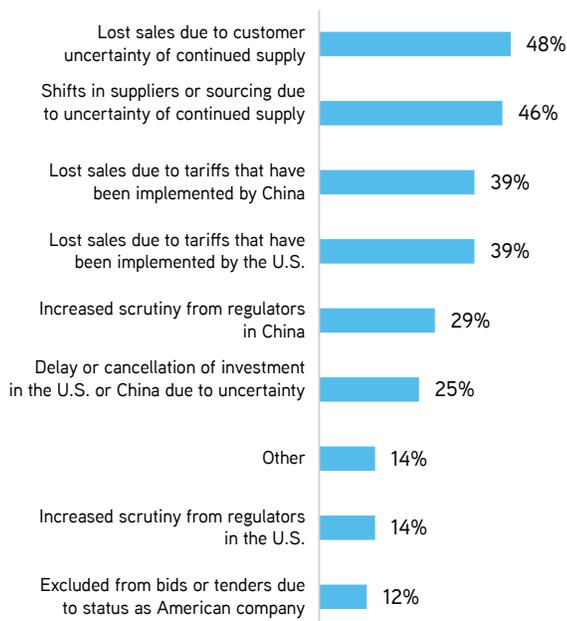
**Rather, we see great-power competition – not only between China and the United States, but between China and other major powers – as an enduring, transformational force on the international stage, akin to globalization, that is likely to play out for the foreseeable future.**

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EXHIBIT 37

Besides Trade Tensions and COVID Uncertainty, Businesses Are Facing Increased Competition from Domestic Companies and Market Access Restrictions

Impact of U.S.-China Trade Tensions on Business, %

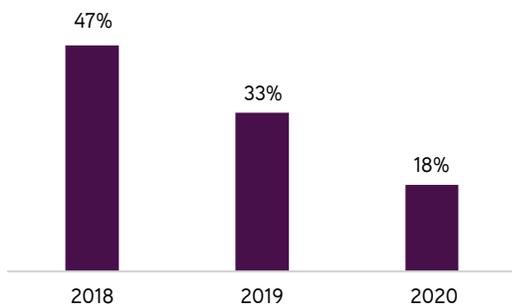


Data as at June 2020. Source: U.S. China Business Council Member Survey.

EXHIBIT 38

Data Flow Restrictions and Export Control Policies in China Are Likely Impacting R&D Spending

2020 USCBC Survey: Increase in Investment in China Directed to Research & Development Spending, %



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

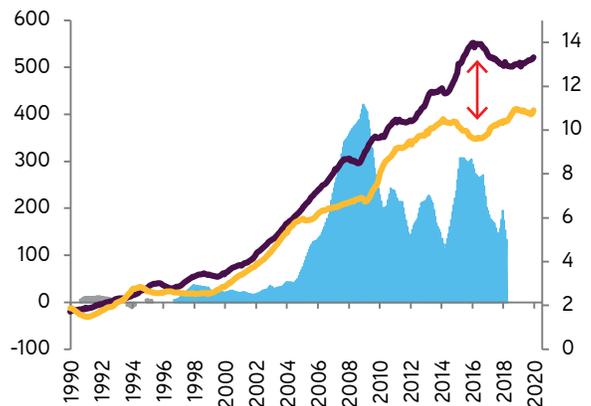
We also do not ascribe to the bearish view that all supply chains will exit China immediately. There are several influences to consider. First, our contacts on the ground inform us that local Chinese officials are working very hard to create an attractive environment in which U.S. multinationals can continue to operate. Consistent with this view, we are increasingly hearing of more approvals, particularly in financial services, for foreign operators to own majority stakes in China.

Second, because China has such a strong and proficient infrastructure, it is hard to replicate the 'supply chain pods' that exist inside China elsewhere. As such, while some capacity is either re-shoring or moving to other low costs countries like Thailand, the majority of those we polled in our informal survey are keeping more than 70% of their production in China for the foreseeable future. This reality is one of the main reasons we are not surprised that China has continued to gain market share in the export market. One can see this in *Exhibit 39*.

EXHIBIT 39

China Is Importing Less Goods and Services, as It Makes Its Economy More Self-Sufficient...

China: LTM Current Account Balance, U.S.\$B (L)  
 China Exports as a % of Global Exports, 12mma (R)  
 China Imports as a % of Global Imports, 12mma (R)



Data as at July 2020. Source: China Bureau of National Statistics, Haver Analytics.

"

**We also do not ascribe to the bearish view that all supply chains will exit China immediately. First, our contacts on the ground inform us that local Chinese officials are working very hard to create an attractive environment in which U.S. multinationals can continue to operate. Second, because China has such a strong and proficient infrastructure, it is hard to replicate the 'supply chain pods' that exist inside China elsewhere.**

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...All While Growing Export Market Share Despite the Trade War



Data as at July 2020. Source: China Bureau of National Statistics, Haver Analytics.

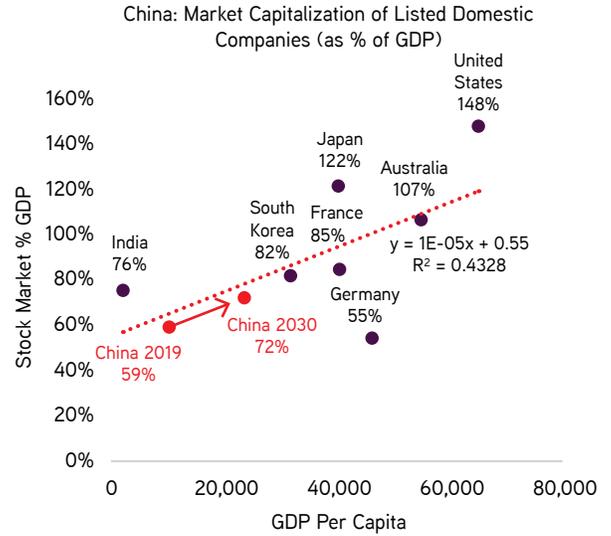
From a strategic standpoint, China is also changing the way it thinks about its capital markets. Remember that as it continues its transition from a fixed investment economy to a services and consumption based one, China will almost inevitably run a current account deficit. If it does, it will need to fund that 'hole' in its current account with positive flows into its capital account. To do this, it must either attract foreign direct investment and/or portfolio flows. Our 'gut' instinct is that China will do both.

“

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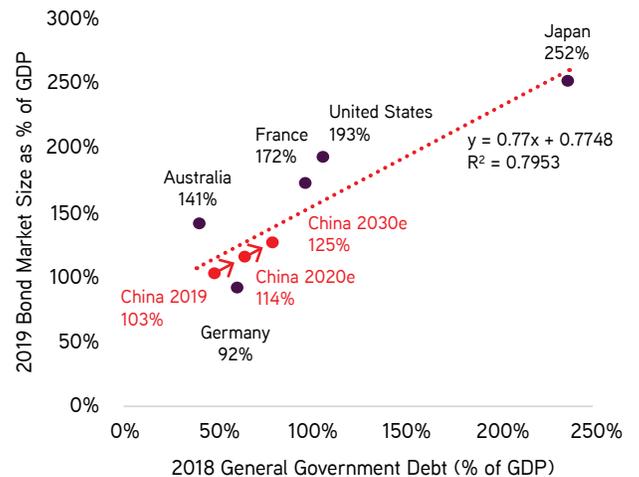
China's Stock Market Should Grow Faster, As the Country Begins to Attract More Foreign Capital



Note: The size of stock market refers to the total market capitalization of domestic listed companies. Data as at September 23, 2020. Source: World bank global financial development database, BIS, KKR Global Macro & Asset Allocation analysis.

China's Bond Market Should Deepen Further, As It Transitions Towards a More Mature Consumption Economy

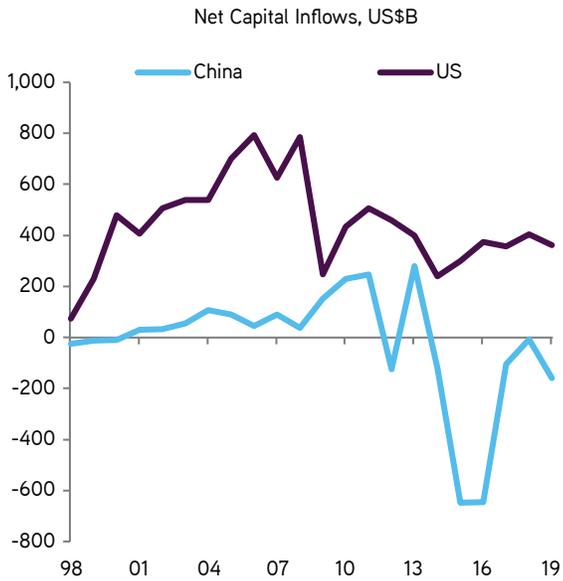
China: Total Debt Securities by Residence of Issuer (as % of GDP)



Note: The size of bond market refers to total securities outstanding including domestic and international. Data as at September 23, 2020. Source: World bank global financial development database, BIS, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 43

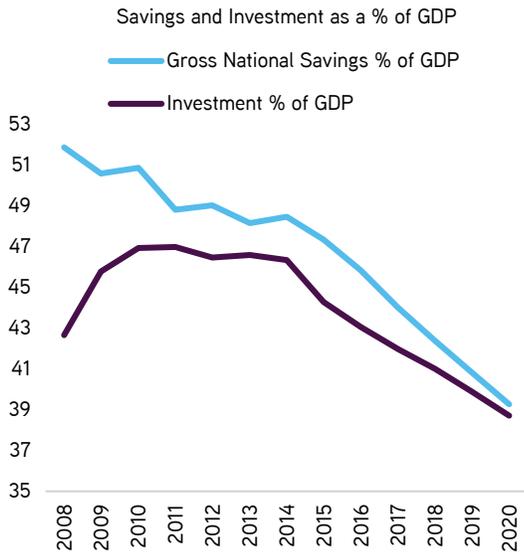
Going Forward, China Will Likely Need Upwards of Several Hundred Billion in Net Capital Inflows Annually to Finance the Current Account Deficit



Data as at June 30, 2020. Source: State Administration of Foreign Exchange, Haver Analytics.

EXHIBIT 44

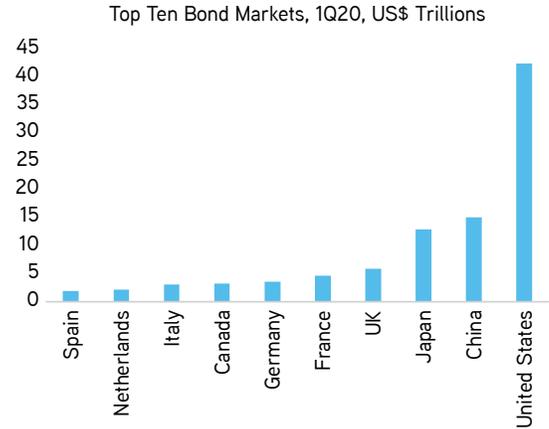
A Declining Savings Rate Will No Longer Support Increased Investment. As Such, Our Base View Is That China Will Need to Import Substantial Amounts of Foreign Capital Over Time



Data as at October 7, 2019. Source: IMF, Haver Analytics.

EXHIBIT 45

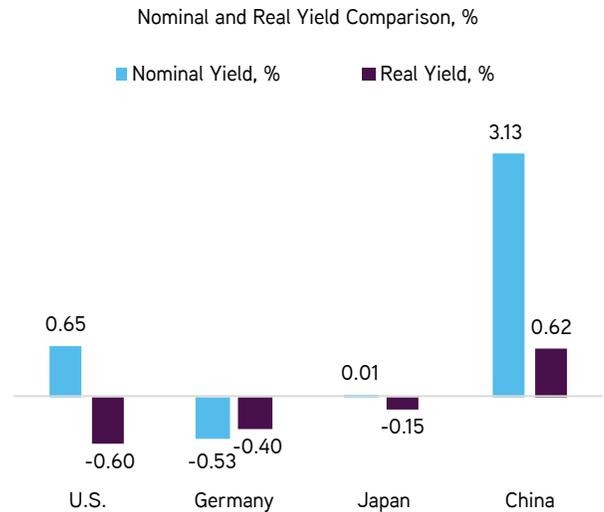
The U.S. Bond Market Is the Biggest, But China's Higher Yields Give It the Opportunity to Grow Its Market Share...



Data as at March 31, 2020. Source: BIS, Haver Analytics.

EXHIBIT 46

...Particularly When Developed Market Bond Yields, the U.S. in Particular, Now Offer Very Little Return to Investors



Data as at September 24, 2020. Source: Bloomberg.

Key to our thinking is that the U.S. and China are redefining their policies around a variety of different issues, including economic ties, ideology/human rights, national security, and law enforcement.

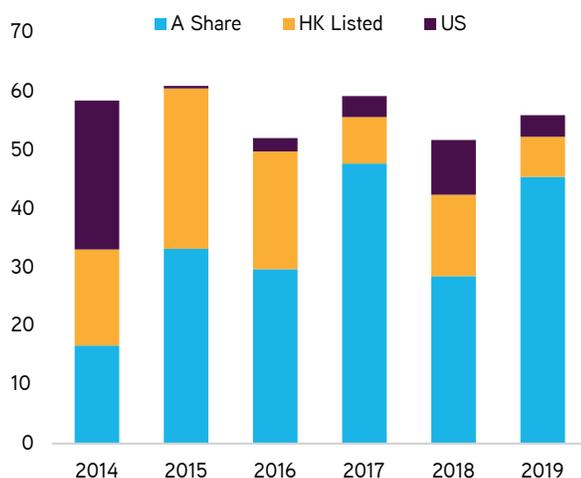
Importantly, with the size of the capital markets being quite small relative to size of GDP, there could be significant room for growth if China were to catch-up in relative size with some of its developed market peers. While China's banking system as a share of GDP of 292% is much larger than that of the U.S. (119%), its bond market is much smaller. Specifically, China's bond market is now just 114% of GDP, compared to 193% in the United States, 252% in Japan, and 92% in Germany. In our view, herein lies the opportunity, we believe, particularly given China has so much higher real and nominal rates (*Exhibit 46*). If we are right, China will work hard to ensure that its bond market, which can be supported by more foreign capital, can replace its bank lending market as a primary source of funding growth and pricing risk. The key, of course, will be assuring investors that their capital will not get stuck in China, an issue of concern for many global investors with whom we speak.

On the equity side of the Chinese capital markets, we are also optimistic about China's ability to import foreign capital. Already, since 2019, China's A-share representation in the MSCI Emerging Markets Index has quadrupled from five percent to 20%. Yet, even with this sizeable increase, the size of China's capital markets is still comparatively much smaller than its peers. All told, its stock market capitalization stands at 59% of GDP, which is much lower than that of the U.S. at 148% of GDP, Japan at 122% of GDP, and Australia at 107% of GDP (*Exhibit 41*). Moreover, as *Exhibit 47* shows, recent new issue activity has remained extremely robust, despite rising geopolitical tensions, a trend we expect to continue.

#### EXHIBIT 47

While the U.S. Is Still an Important IPO Market for Chinese Companies, More Are Now Raising Capital in Local Markets

Funds Raised by Chinese Companies via IPO, US\$ Billions



Data as at June 19, 2020. Source: CEIC, Morgan Stanley.

#### EXHIBIT 48

U.S. Delisting Activity Is Not Affecting Chinese Companies Ability to Raise Capital, As Many Have Pivoted Back to Asia

Number of Chinese Firms Delisting in the U.S. and Relisting in Asia	
2011	9
2012-2014	40
2016	22
2017	13
2018	1
2019	8
<b>Total</b>	<b>93</b>

Data as at June 11, 2020. Source: Citigroup.

So, in sum, while Frances Lim and I think we are at an important inflection point for U.S.-China relations, many of the current trends that led to this inflection point have been bubbling up for a decade or more. In terms of key areas of focus, our top belief is that investors should expect China to continue to internalize its economy. A consumption economy lifts millions out of poverty, which helps to ease social unrest. A consumption economy also makes China less dependent on others, including the United States. "Domestic circulation," or the intent to source more parts locally, will also drive more innovation as well as growth in new Chinese industries. However, as consumption becomes more important, so too will the ability to attract foreign capital. In our view, understanding the nuances of this transition will be a critical one for all global investors.

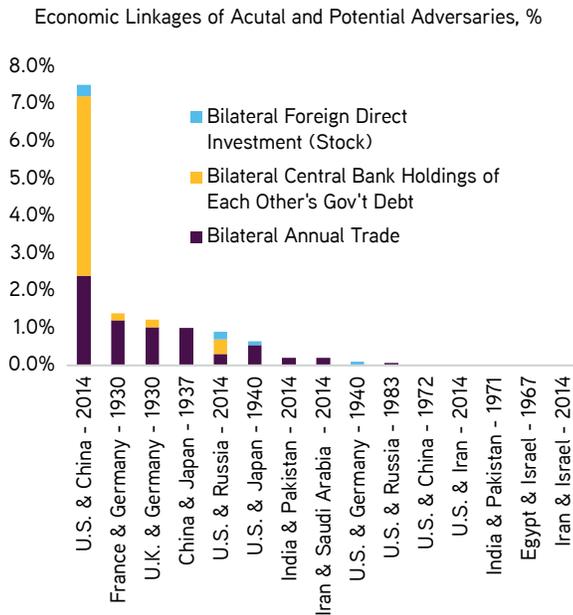
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**A consumption economy also makes China less dependent on others, including the United States. 'Domestic circulation,' or the intent to source more parts locally, will also drive more innovation as well as growth in new Chinese industries. However, as consumption becomes more important, so too will the ability to attract foreign capital.**

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EXHIBIT 49

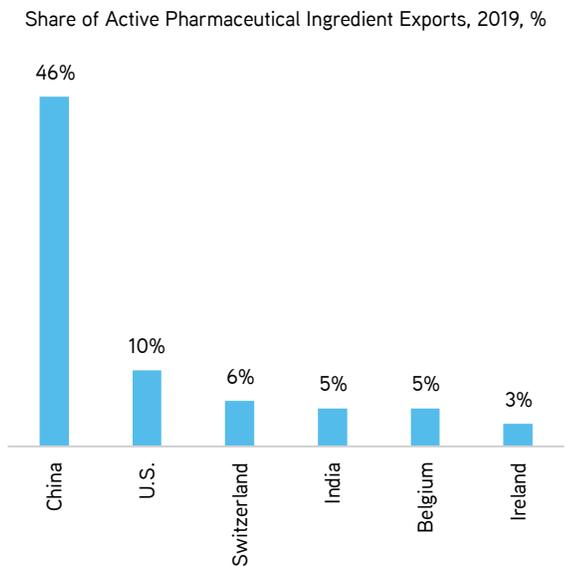
The U.S. and China Currently Have Much Deeper Economic Linkages Than Other Actual or Potential Adversaries of the Last 100 Years



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, Eichengreen (Berkeley), Howson (Princeton), East-West Center, O'Neill (CNA), Ritschi (LSE) Accominotti (LSE), Wilkins (FIU), Villa (CEPII).

EXHIBIT 50

However, the Focus May Become Supply Chains As National Security Issues

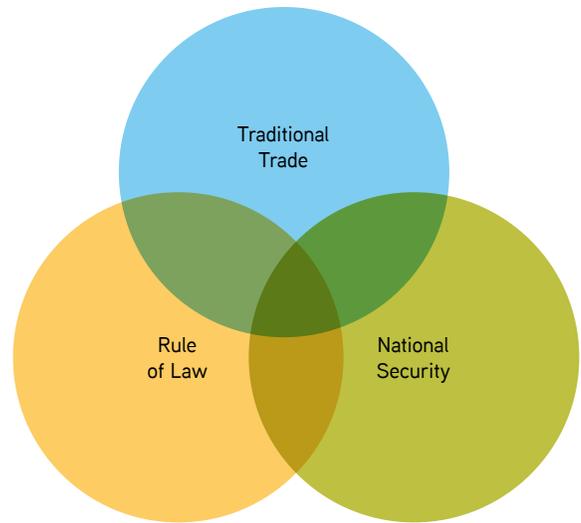


Data as at December 31, 2019. Source: Goldman Sachs.

Nonetheless, there will likely be a higher risk premium associated with investing in China. In particular, tensions around economic prowess, national security, human rights, and ideology likely mean that investors will need to approach China with a more nuanced lens, one that requires both local and global perspectives. For example, as we show in *Exhibit 50*, China's dominant position in the production of active pharmaceutical ingredients is already being questioned by national security experts in Europe and the United States. Parts of supply chains too as noted earlier may be rethought.

EXHIBIT 51

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



Data as at May 29, 2019. Source: KKR Global Macro & Asset Allocation analysis.

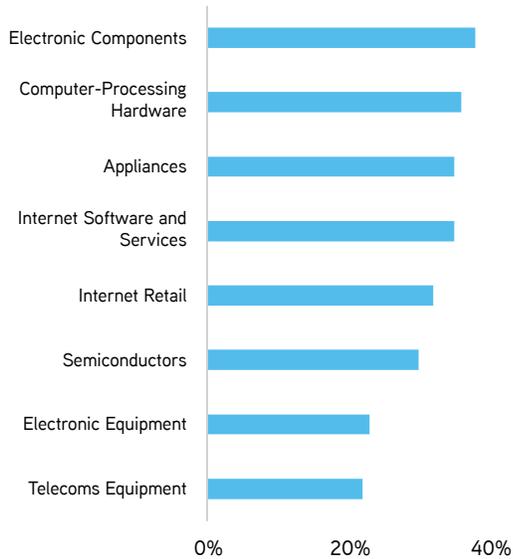
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As we mentioned at the outset of this *Insights* note, the path forward for China could be a rocky one, but there is a lot we can learn from where China has been in order to invest behind where it will be going in the future. Indeed, as Confucius said, “study the past if you would define the future.” In our humble opinion, after traveling to China for nearly three decades, never have these words of wisdom been truer.

**EXHIBIT 52**

**All Global Technology Companies, Including Ones in the U.S., Rely On the Chinese Market for Growth**

Global Technology Sector Revenue Exposure to China, %



Data as at July 31, 2020. Source: Deutsche Bank, The Economist.

**Conclusion**

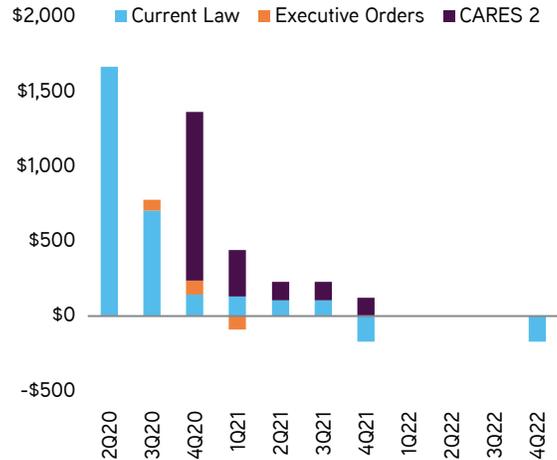
As we head into the fall, we feel confident about the upside potential for our global investors if we can correctly marry our macro themes with the micro opportunities that our investment teams continue to uncover. However, as we detail in this piece, understanding the long-term implications of the change in Fed policy and also in the U.S.-China relationship is paramount to that success. Importantly, similar to the introduction of QE as an inflection point in monetary policy during and after the GFC, we view the Fed’s new inflation framework as another important milestone.

Our base view is that inflation and rates will remain low. So, from an asset allocation perspective, investors should increase their focus on growth companies, yield, and collateral based cash flowing stories. However, given that many central banks are now experimenting with helicopter money via direct deposits and looser inflation standards, CIOs should likely have more inflation-based protection in the mix. By comparison, given how deeply negative real interest rates are, the penalty for owning cash has gone up. As a result, periodic dislocations in the credit markets should be consistently bought, particularly at the short end of the curve. Finally, while the backdrop is still a good one for risk assets, the Fed’s intensifying focus on financial stability should serve as an important warning shot that more volatility and less consistent gains lie ahead.

**EXHIBIT 53**

**Fed Policy Must Balance Long-Term Unemployment Concerns With Short-Term Stimulus Trends Linked to COV-19**

New Fiscal Stimulus per Quarter Under Various Scenarios, US\$ Billions

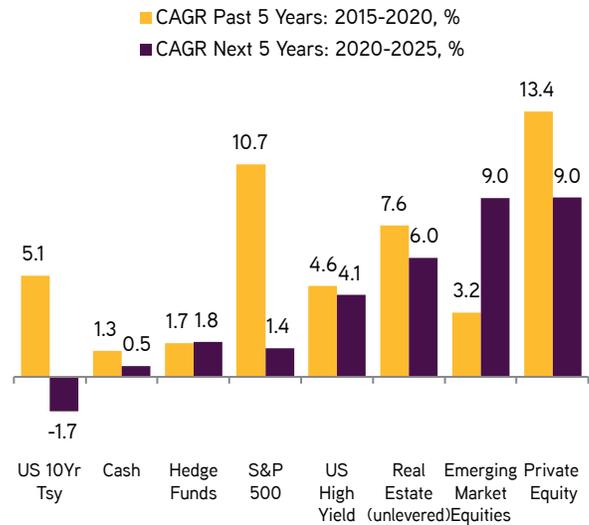


Data as at August 28, 2020. Source: Cornerstone Macro.

**EXHIBIT 54**

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

Expected Returns by Asset Class, %



Data as at June 30, 2020. Source: Bloomberg, Haver Analytics, Cambridge Associates, KKR Global Macro & Asset Allocation analysis.

On the China front, we expect heightened tensions to continue. Key to our thinking is that the U.S. and China are redefining their policies around a variety of different issues, including economic ties, ideology/human rights, national security, and law enforcement. Because there are so many differing constituents with separate agendas involved in the debate, the probability of near-term harmony is low. Largely, this is why we have dedicated so much of our research effort to better understand China's long-term plan and what it means for the global economy and capital markets.

Overall, we view the current environment as an attractive one for investors who can translate their thematic macro work into actionable micro themes. The key, as we have described in all our recent post-COVID *Insights* pieces including this one, is to focus capital deployment on areas, including sectors and themes, where there is not only above average GDP growth but also the ability to translate the revenues into high cash flow returns. Without these disciplines, we believe that the ability to earn outsized returns during the next five to seven years is now much more limited (*Exhibit 54*).

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**Our base view is that inflation and rates will remain low. So, from an asset allocation perspective, investors should increase their focus on growth companies, yield, and collateral based cash flowing stories. However, given that many central banks are now experimenting with helicopter money via direct deposits and looser inflation standards, CIOs should likely have more inflation-based protection in the mix. By comparison, given how deeply negative real interest rates are, the penalty for owning cash has gone up. As a result, periodic dislocations in the credit markets should be consistently bought, particularly at the short end of the curve.**

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