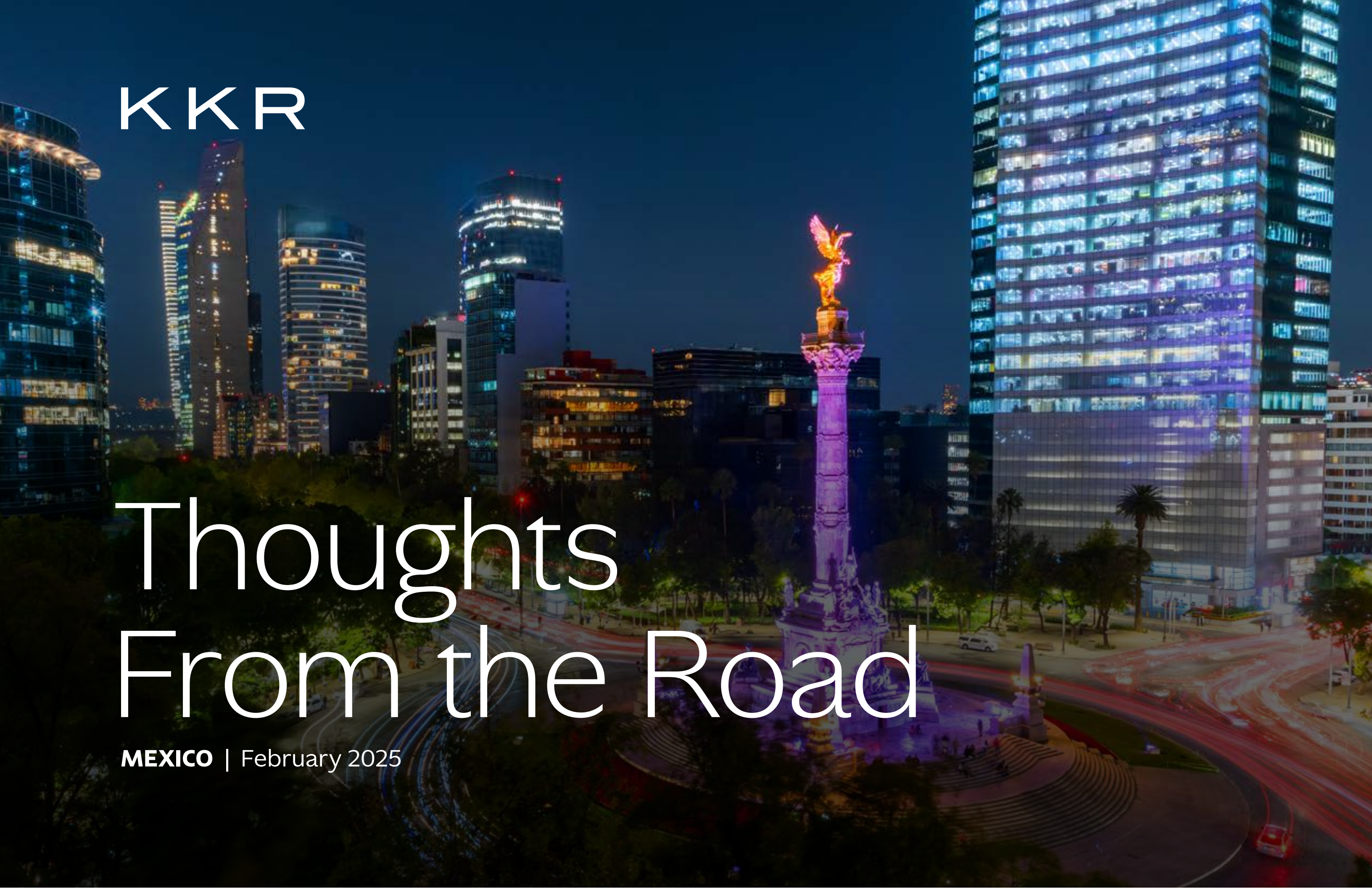

Thoughts From the Road

MEXICO | February 2025

Brian Leung and I recently made a quick trip to Mexico City, alongside our colleagues Gio Onate and Nicolas Mira, to get an update on how the United States' largest trading partner is performing at a time of heightened uncertainty. During our visit we met with CEOs, clients, sell-side representatives, members of the media, and individuals close to the central bank. While we did spend time discussing macro, most of our meetings in Mexico left us with a distinct sense of 'déjà vu' in terms of what we have been seeing not just in Mexico but also in many other parts of the world. Our experience in Mexico suggests to us that we are all part of a larger narrative about how the global economy and markets will operate in the *Regime Change* we have been discussing for quite some time. See below for full details, but we left Mexico City with seven key takeaways.

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1

Without question, we are all still living in an asynchronous global recovery. Despite its being the United States's largest trading partner and its neighbor, Mexico – similar to many of its global peers – is actually not reaping rewards from the strength of the U.S. economy. In fact, Mexico's economy may actually stall during the next few years, as it is hindered by restrictive monetary conditions (real ex-ante short rates are at 5.6%, compared to zero to two percent for most of the rest of the developed world), negative private investment due to judicial reforms and tariff uncertainty, fiscal consolidation, and a slowing – albeit still solid – consumer.

2

As we saw in Mexico, uncertainty is now slowing global growth. The global euphoria that surged post-President Trump's election around deregulation and M&A has clearly cooled, we believe. As we detail below, uncertainty about U.S. domestic policy as well as trade policies is having a near-term chilling effect across many global economies. In Mexico, for example, the central bank is clearly seeing this deceleration, as evidenced by its recent commentary that the balance of risks to activity "remains skewed to the downside."

3

The Mexican peso is an important reminder that trade wars do not occur in a vacuum. In both Mexico and China, local currency depreciation is already acting as a major offset to many of the competitive advantages the U.S. government is targeting from implementing tariffs.

4

But are these trade wars really about trade, especially in Mexico? Our take at KKR, which our visit to Mexico City confirmed, is that the U.S. is actually embroiled in a multi-faceted negotiation across geographies that involves security, drug trafficking, border issues, and economic questions. Trade policy is one negotiating tool the U.S. and other nations are using. No doubt, trade is important, but we think that some market pundits lobbing in views from afar may be missing the real narrative. We also think it is worth flagging that in 2025, the best performing markets are actually the ones that face tariffs, a reflection on how bad current sentiment is towards Mexico, China, and Europe these days (see *Exhibit 11*).

5

Mexico's absolute yields on its debt are an important reminder that Credit has become a competitive asset class for global investors. The post-COVID world has ushered in a *Regime Change* with a 'higher resting rate' for inflation. With overnight rates at 9.5% (and inflation less than four percent), we think Mexico's high absolute yield on its government and corporate debt highlights the attractiveness of Credit for global allocators. We like the front end of the curve in Mexico, and we also believe there will be opportunities for Private Credit lenders to lend in Mexico, especially through such areas as Asset-Based Finance.

6

The need for private sector capital to offset burgeoning government deficits will continue to increase around the world, including in Mexico. Another shift in the global landscape post-COVID is that governments across the globe are now over-leveraged, necessitating private sector involvement to fund new initiatives, particularly around fixed investment. On the Infrastructure front, there is certainly opportunity in Mexico for power generation and Natural Gas Storage. It remains early days, but the administration would also like to increase the renewable energy mix to 45% by 2030, from around 25% today, which should mean solar/wind buildout opportunities in the north and south, respectively. However, recent changes to the judicial system, security, and rule of law concerns may weigh on economic activity and likely mean that higher risk premiums must be assigned to any deal.

7

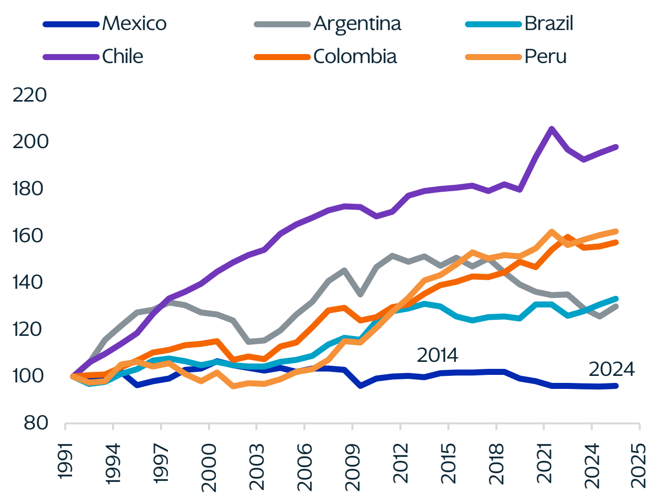
The ongoing blurring of economics and national security. Similar to what we have seen in China, India, and Japan, Mexican authorities are also changing their retirement savings laws to encourage greater investment in the local economy. All told, the AFOREs (national savings plans) can now allocate 30% to Alternative investments (up from 20% previously), with a view to boosting the mix of local private investments over time. The bigger picture conclusion, we believe, is that deglobalization is impacting much more than just supply chains as politicians around the world look for ways to drive down their cost of capital to ensure that their economies remain competitive in a rivalrous world.

Details

A nation again in transition. I have spent a lot of time in Mexico through the years, especially since Enrique Peña Nieto's tenure as president, and the 'on the ground' narrative is again different in 2025. Indeed, the story has changed from one of structural reforms under President Nieto's leadership to a more populist bent under AMLO. Today, though, Mexico appears somewhere in the middle of those two regimes, but the local consensus remains that the populist agenda is still winning the day in aggregate. Recently-elected President Claudia Sheinbaum appears deeply focused on crime reduction – an area of universal focus, given significant slippage in safety in recent years. Moreover, concerns about new judicial reforms, which require nearly every judge to be elected, are an important offset for many in the business community. Meanwhile, despite compelling demographics (the average age in Mexico is about 29), half of the economy is still informal, helping to keep a lid on productivity.

Exhibit 1: Structural Headwinds to Mexican Productivity Still Include High Levels of Labor Informality, Low Educational Attainment, Limited Access to Finance, and Insufficient Infrastructure

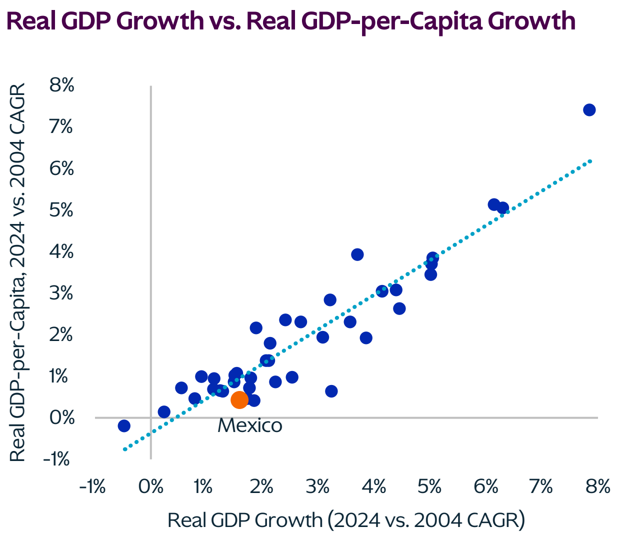
Labor Productivity (Output per Worker) (1991 = 100, Constant 2017 US$ in PPP)



Data as at December 31, 2024. Source: ILO, Haver Analytics.

Similar to what we have seen in China, India, and Japan, Mexican authorities are also changing their retirement savings laws to encourage greater investment in the local economy.

Exhibit 2: Over the Last 20 Years, Mexico's Real GDP-per-Capita Growth (0.4%) Has Continued to Lag Real GDP Growth (1.6%), On Average

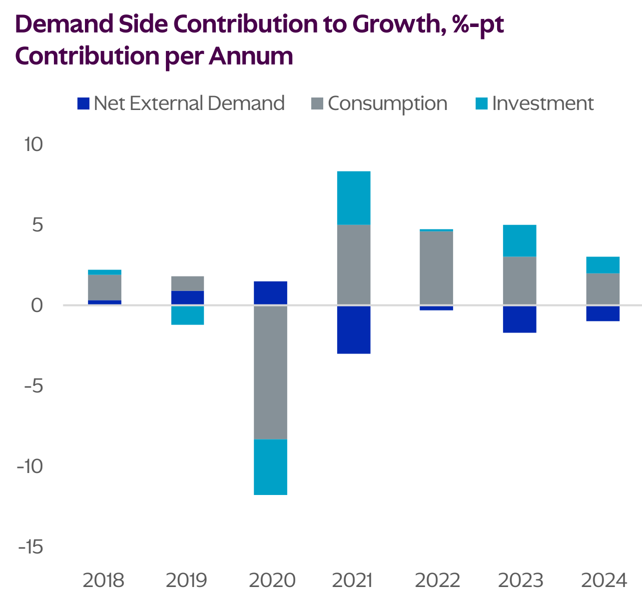


Data as at October 22, 2024. Source: IMF, World Bank.

For near-term market watchers, the Mexican economy is slowing quickly, and it is not just caused by anxiety around Trump administration policies. Record near-shoring capex in 2023 is now running below trend, while public sector investments are waning too, as President Sheinbaum tries to reduce the country's budget deficit to 3.5% from six percent. All told, we think that growth could be less than one percent in 2025, driven by fiscal consolidation, slower foreign direct investment, and weaker business confidence owing to the judicial reforms and tariff uncertainty.

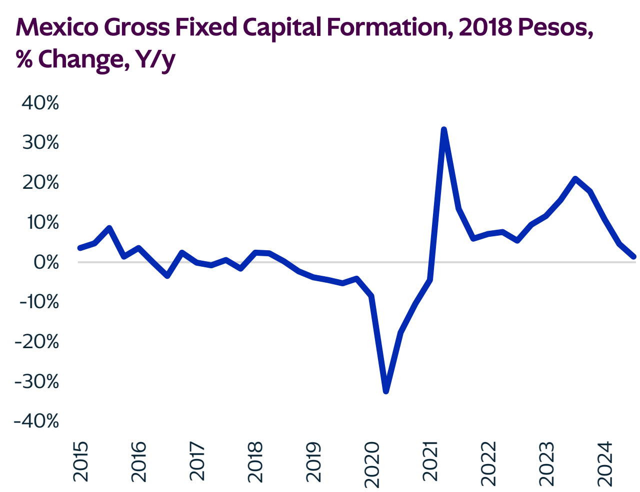
All told, we think that growth could be less than one percent in 2025, driven by fiscal consolidation, slower foreign direct investment, and weaker business confidence owing to the judicial reforms and tariff uncertainty.

Exhibit 3: Private Consumption Has Underpinned Mexico's GDP Growth Since COVID. However, in 2025 Consumer Spending Is Likely to Slow at the Same Time as Investment Cools



Data as at December 31, 2024. Source: INEGI, JPM.

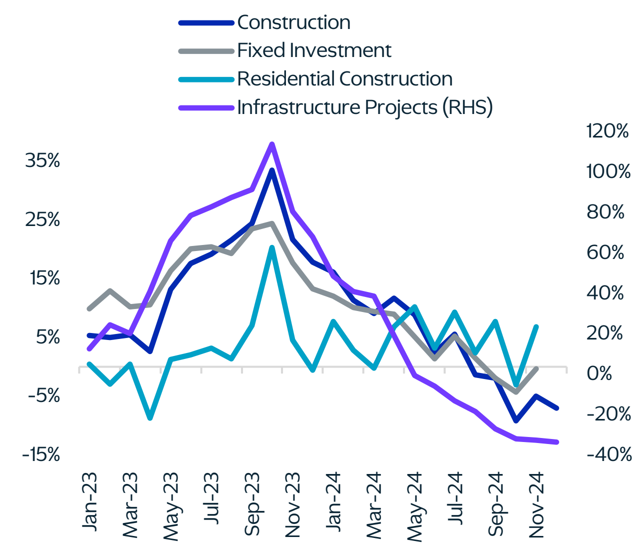
Exhibit 4: Post-COVID Pent Up Investment Demand, Especially Around Reshoring, Has Faded



Data as at December 18, 2024. Source: INEGI.

Exhibit 5: Construction and Fixed Investment Have Declined Meaningfully Since 2023, a Backdrop That Is Weighing on Growth and Sentiment

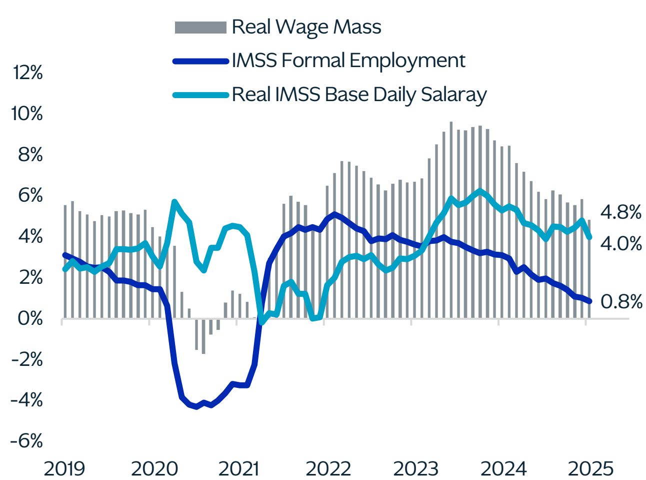
Construction and Fixed Investment, Y/y % Chg



Data as at December 31, 2024. Source: INEGI, Haver Analytics.

Exhibit 6: Formal Employment Growth Is Softening and Real Wage Mass Is Also Decelerating

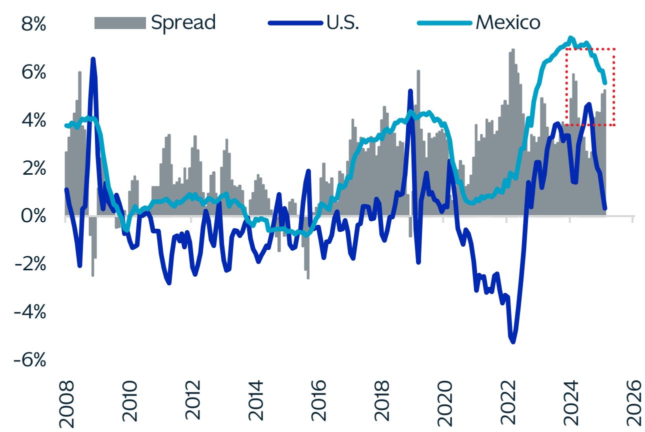
Mexico Real Wage Mass, Y/y % Chg



Data as at January 31, 2025. Source: INEGI, IMSS, Haver Analytics.

Exhibit 7: The Real Interest Rate Differential Between Mexico and the U.S. Remains >500 Basis Points, Which Suggests Ample Room for Further Rate Cuts In Mexico Even If the Fed Stays On Hold Until 2H25

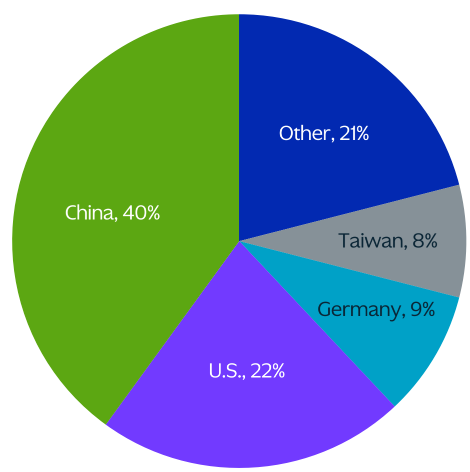
Mexico vs. U.S. Real Ex-Ante Policy Rate, %



Data as at February 21, 2025. Source: Bloomberg.

Exhibit 8: China Accounted for Fully 40% of the Industrial Real Estate Investment Projects in Mexico From 2019 to 2023

Industrial Real Estate Projects in Mexico, % of Total, 2019-23



Data as at December 31, 2023. Source: JPM, CBRE.

Against this backdrop, rates feel extremely restrictive at 9.5% for overnight rates (and 5.6% for real ex-ante rates). For reference, the real neutral rate for Mexico should be closer to 1.8%-3.6%, we believe. To us, more interest rate cuts are likely coming, and as such, we like the front end of the curve for fixed income investors. Key to our thinking is that a negative output gap, headline inflation back within the central bank target range of two to four percent, and limited evidence of FX passthrough to tradable goods inflation, should allow Banxico to cut rates down to the 8.0-8.25% range (to less restrictive territory), even if the Fed is on hold until the second half of the year. As it relates to tariffs, Banxico actually believes that, while the impact on growth is unambiguously negative, the impact on inflation is less clear cut as higher imported inflation from a weaker peso would be mitigated by growing economic slack. Importantly, Banxico and most forecasters we spoke with believe that the FX passthrough to inflation is low today at around three percent due to anchored inflation expectations and the negative output gap. Said differently, a 10% depreciation in the peso would only translate into an incremental 30 basis points of headline inflation, all else being equal.

Most market participants with whom we interacted during our visit expect that tariff tensions in Mexico will be resolved fairly quickly through a greater focus by President Sheinbaum on border security, drug trafficking, immigration, and Chinese investment in Mexico *(Exhibit 8)*. We at KKR are likely more cautious given our view that President Trump will impose some level of lasting tariffs versus the local consensus view that the 'status quo' will hold. As such, we believe that the consensus is underestimating the tail risk that President Trump isn't simply negotiating for non-trade concessions, but that he genuinely plans to use tariffs both to bring in revenue and to re-industrialize the U.S.'s domestic manufacturing base. As one can see in *Exhibit 9*, we believe that non-China tariffs, including those of Mexico, will increase to 7.7% from 2.7%. However, where we are more in line with the consensus we heard in Mexico City is that President Trump is setting up to renegotiate the United States-Mexico-Canada Agreement on more favorable terms to the U.S. before its 'due date' in 2026.

We spent a lot of time on the Mexican peso. For those who have not been paying attention, the Mexican peso has actually depreciated about 15% since last summer and closer to 25% since last spring. Said differently, the U.S. would actually need to implement some form of tariffs just to break even.

Even so, a permanent 25% tariff on all Mexican exports to the U.S. would be very damaging to Mexico's economy, as Mexico exported approximately $500 billion worth of goods to the U.S. over the last twelve months (accounting for fully 83% of Mexico's total exports and 28% of GDP). The actual GDP impact will hinge on the extent of tariff passthrough to export prices, the degree of currency offset, and potential retaliation by the Mexican government.

Exhibit 9: More So Than the Consensus, We Believe That President Trump Will Use a Tiering System Again to Implement Tariffs

List	Coverage	Amount ($bn)	Current Tariff	Incremental Tariff	Possible Final Tariff	Legal Authority
China	List 1/2	40	25%	60%	85%	IEEPA /Sec. 301
	List 3	120	25%	35%	60%	
	List 4a	90	7.5%	10%	17.5%	
	List 4b	200	0%	10%	10%	
Select Global Import Tariff (Mexico, Germany)	Broad Coverage	2,650	2.7%	5%	7.7%	Combination of 122, 201, 232, IEEPA
Total			3.8%	**7.3%**	11.2%	

Goldman Sachs Research estimate of how much was actually tariffed which is lower than initial announced amount. Data as at February 11, 2025.
Source: Goldman Sachs, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Here is our math, which we show in *Exhibit 10*. We estimate that for every one percent increase in export prices, non-oil exports decrease by approximately 0.6%. However, every one percent of peso depreciation improves non-oil exports by around 0.3% after 12 months. Our base case is that the 25% tariff on Mexico will not be enacted on any sustained basis, but we do think it is reasonable to assume the average tariff rate on Mexican goods could rise to around five percent from the ultra-low level of about 0.3% today (perhaps with some carveouts for highly traded goods). In short, if we assume a 50-60% passthrough of tariffs to export prices, an incremental five percent peso depreciation would largely preserve Mexican export competitiveness and offset the drag from higher tariffs.

Exhibit 10: We Estimate 50-60% Passthrough to Export Prices If Tariffs On Mexico Increase to Five Percent from Less Than One Percent Today. A Weaker Currency Helps, But It Is Not a 1:1 Relationship

Potential Impact on Mexico GDP Growth

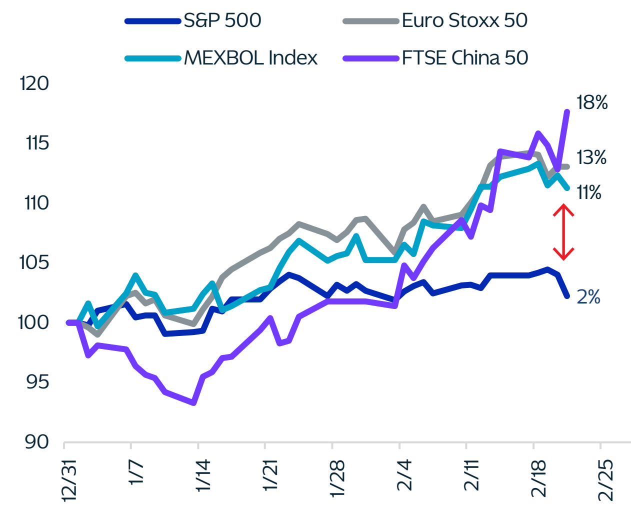
USD/MXN Level After Tariffs			Level of Tariff Pass-Through to Export Prices					
			100%	75%	60%	50%	33%	25%
	0%	20.4	-1.0%	-0.7%	-0.6%	-0.5%	-0.3%	-0.2%
	-2%	20.8	-0.8%	-0.5%	-0.4%	-0.3%	-0.1%	-0.1%
	-5%	21.5	-0.5%	-0.2%	-0.1%	0.0%	0.2%	0.2%
	-8%	22.1	-0.2%	0.0%	0.2%	0.3%	0.4%	0.5%
	-10%	22.7	0.1%	0.3%	0.4%	0.5%	0.7%	0.8%
	-13%	23.3	0.4%	0.6%	0.7%	0.8%	1.0%	1.1%
	-15%	24.0	0.7%	0.9%	1.1%	1.2%	1.3%	1.4%

Every one percent rise in export prices decreases exports by ˜0.6%. Every 1% of MXN depreciation increases non-oil exports by ˜0.3% after 12 months. Data as at February 21, 2025. Source: Bloomberg, INEGI, BNP Paribas, KKR Global Macro & Asset Allocation analysis.

Ironically, the countries that are most under attack from President Trump are having great stock market performance this year, a reflection that a lot of negative news may already be priced in *(Exhibit 11)*. No doubt, U.S. outperformance is leading to better outcomes for the U.S. economy, and it has also led to better outcomes for investors in the S&P 500 for the past two years. However, in 2025, the best performing markets are actually the ones President Trump wants to tariff. The reality, we believe, is that market participants 'pre-traded' President Trump's victory in 2024 (both buying the U.S. and selling Mexico, China, and Europe). As such, anything that is 'less bad' in these countries is likely to lead to stronger than expected market performance in 2025, we believe.

Exhibit 11: Non-U.S. Stocks (e.g., China, Europe, Mexico) Have Handily Outperformed the S&P 500 Year-to-Date

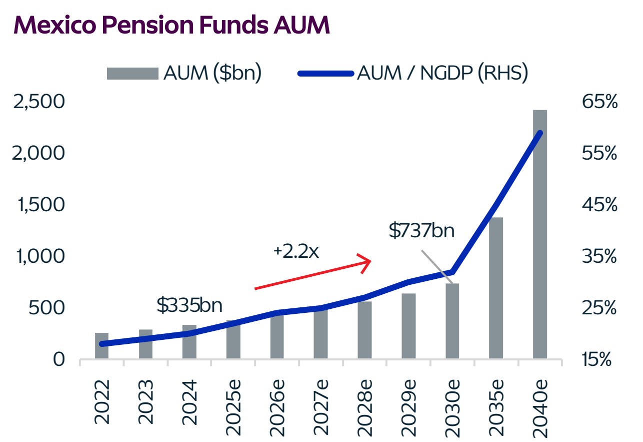
2025 YTD Price Performance, %, USD Terms



Data as at February 21, 2025. Source: Bloomberg.

Similar to other countries I have visited recently, Mexico too is ramping up the proportion of domestic savings that must go into local investments. We see these initiatives as a way to drive down a country's cost of capital in an increasingly charged geopolitical environment as well as a way to pay for infrastructure investment that indebted governments can no longer fund. In the case of Mexico, for example, the AFOREs, which manage pensions on behalf of Mexican employees, are likely to increase the proportion of private investments that must be locally invested (which is at 10% today). At the same time, there is now greater oversight of how that capital is being allocated within Mexico. As we discussed in our Mid-Year Outlook, retirement security is an area that is at the forefront of the blurring of the lines globally between national security and economic security. President Macron, for example, identified that Europe is challenged by not having an integrated financial system. He estimated that €300 billion of flows were going to U.S. Treasuries, helping fuel U.S., rather than European, innovation and growth. This vocal viewpoint aligns with what is happening in Mexico, as many political leaders want to lower their cost of capital and reduce dependence on foreign flows.

Exhibit 12: AFOREs Are Growing Faster Than Expected. Moreover, as They Grow, They Are Allocating More Capital Towards Domestic Investments

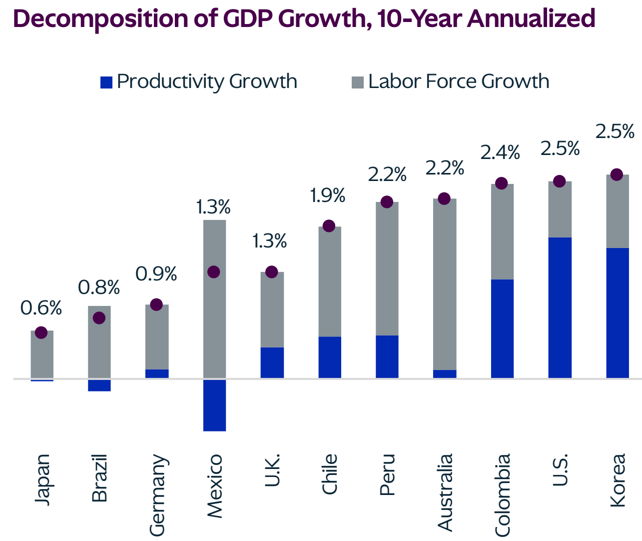


AUM converted from MXN to USD at prevailing exchange rate of 20.4. Data as at February 21, 2025. Source: Comisión Nacional del Sistema de Ahorro para el Retiro, SHCP, Santander.

While Mexico has favorable demographics, it lacks productivity. We see several headwinds that the country must address. For starters, the education system has retreated since President Enrique Peña Nieto's reforms in 2013, and the country now ranks last among 35 OECD countries. Meanwhile, although during this trip we discussed some fintech ideas, we think there is not enough of a 'technology first' mindset in the Mexican corporate sector. Finally, with roughly 50% of the economy still informal, there are not enough entrepreneurial ventures in the real economy to boost economic productivity.

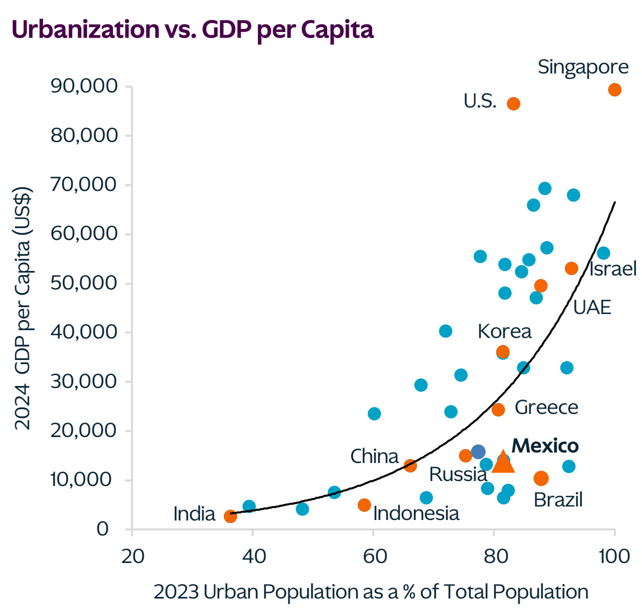
Most market participants with whom we interacted during our visit expect that tariff tensions in Mexico will be resolved fairly quickly through a greater focus by President Sheinbaum on border security, drug trafficking, immigration, and Chinese investment in Mexico.

Exhibit 13: Lack of Productivity Is a Drag on GDP Growth



Data as at October 22, 2024. Source IMF, World Bank.

Exhibit 14: Mexico's GDP-per-Capita Growth Has Not Caught Up With Its Urbanization Rate



Data as at October 22, 2024. Source IMF, World Bank.

Conclusion

As I've met with CEOs, investors, and executives across China, India, Europe and Japan over the last six months, the same themes have emerged: concerns about global economic recovery, the blurring of economics and national security, the impacts of inflation as well as monetary policy, and Trump administration policies.

So, while our recent trip to Mexico City had its own unique features, the conversations around the opportunities and challenges faced by companies and investors were actually strikingly familiar, like déjà vu. In particular, we note the following:

1. **The asynchronous global recovery shows no signs of abating.** Even though Mexico is the U.S.'s largest trading partner, it's not really benefiting from the strength of the U.S. economy. We think tight monetary conditions (with real short rates at 5.6%), a dip in private investment due to judicial reforms and tariff uncertainties, plus fiscal tightening and a slowing, though still solid, consumer base, will likely hinder growth in Mexico. The peso serves as a reminder that trade wars have broader implications—depreciation in local currencies, as in Mexico and China, can offset any competitive edge from tariffs.

2. **Our visit confirmed that the U.S. isn't in a straightforward trade war with Mexico.** Instead, it's a complex situation involving security, drug trafficking, and border issues. Trade matters, of course, but some market observers might be missing the bigger picture, we believe.

3. **Mexico's absolute debt yields reinforce how Credit has become a competitive asset class for global allocators, particularly in the post-COVID 'higher resting rate' for inflation environment.** This trend makes Mexico's debt quite appealing, especially at the front end of the curve. We are bullish on the opportunities for lending in Mexico in asset classes such as Asset-Based Finance.

4. **The need for private sector capital is going to keep rising**. In the post-COVID landscape, governments are getting over-leveraged, so private sector involvement is crucial for funding new initiatives, particularly in fixed investment. Mexico has some real opportunities in Infrastructure, especially in power generation and Natural Gas Storage. The government aims to boost the renewable energy mix to 45% by 2030 (up from around 25% today), which could open doors for solar and wind projects in the north and south. However, a word of caution: recent judicial changes may mean factoring in higher risk premiums for any deals.

5. **The ongoing blurring of economics and national security continues.** Just like in China, India, and Japan, Mexican authorities are shifting retirement savings laws to boost local investment. Now, AFOREs can allocate 30% to Alternative investments, up from 20% previously, with a view to boosting the mix of local private investments over time. Overall, it's clear that deglobalization is affecting more than just supply chains, as politicians worldwide seek ways to lower their cost of capital and keep their economies competitive.

What all of this suggests to us is that we are all part of a larger narrative about how the global economy and markets will operate in this *Regime Change* we have been forecasting. Rates are likely not going back to zero the way they did prior to and during COVID, inflation could prove stickier this cycle, and geopolitics and the current energy transition will both likely remain 'messy', we believe. If there is good news for KKR, it is that our global footprint allows us to connect the dots as well as use our experience and expertise to help navigate uncertainty, something we have done now for nearly 50 years.

So, while the promise of what Alternatives can deliver for investors remains compelling, investing behind the right themes with the right capital structures at the right time has become more important, given the aforementioned crosscurrents. To this end, we think that CIOs will need to migrate more towards an 'all weather approach' to constructing portfolios that excel in the environment we are envisioning. Against this backdrop, we remain constructive on *Productivity Enhancers,* the transition of business models from *Capital Heavy to Capital Light, the Security of Everything,* and *Collateral-Based Cash Flows.*

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