Outlook for 2017: Paradigm Shift
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Outlook for 2017: Paradigm Shift

We view Donald Trump’s ascendancy to the Presidency of the U.S. as confirmation of a political and economic paradigm shift that started with Brexit but is likely to continue for the foreseeable future, including elections across Europe in 2017. Consistent with this view, we believe that there are four major potentially secular changes that all investment professionals must consider: fiscal stimulus over monetary, domestic agendas over global ones, deregulation over reregulation, and a broadening of outsized volatility from the currency markets to include global interest rate markets. The good news is that many of our highest conviction investment themes for 2016, including the ongoing slowdown in global trade, had already begun to capture this sea change in macro and geopolitical trends. At the same time, however, in certain areas our macro preferences have evolved of late in response to the “new” reality that we now live in. As such, we have used this outlook piece to challenge conventional investment wisdom, and in some instances, “adjust our sails.”

In terms of asset allocation preferences for 2017, we are still probably most excited by what we see in Private Credit on a risk-adjusted basis. We also believe that Real Assets, particularly those with yield and growth, can prosper in the macro backdrop that we envision. Meanwhile, we are now balanced in our outlook on Equities versus Credit, but in both asset classes, we continue to suggest selling Simplicity and buying Complexity. Overall, though, we do not lose sight of the fact that we are undergoing a paradigm shift, and often these types of regime changes do not always transition smoothly. As a result, we maintain our long-held approach of seeking to monetize aggressively the periodic dislocations that inevitably occur in a world of increasing geopolitical uncertainty and macro instability.

“
I can’t change the direction of the wind, but I can adjust my sails to always reach my destination
”

JIMMY DEAN
AMERICAN COUNTRY MUSIC SINGER, TELEVISION HOST, ACTOR, AND BUSINESSMAN
When we titled our January 2016 Outlook piece Adult Swim Only, our original intent was to signal that it would be a bumpy year, likely driven by slowing global trade, less supportive monetary policy, volatile currencies, and rising populism. To be sure, we did not predict a record $13 trillion in negative yielding securities, Brexit, President-elect Trump, and most importantly, a Chicago Cubs’ victory in game seven of the World Series. But here we are.

As we look ahead into 2017, we think that we are at a major inflection point across the global capital markets. Specifically, we view Donald Trump’s ascendency to the Presidency of the United States of America as confirmation of a political and economic paradigm shift that started with Brexit but is likely to continue for the foreseeable future, including elections across Europe in 2017.

**EXHIBIT 1**

The Two Countries with Notable Populist Movements of Late Have Had the Best Growth. However, Dispersion of Income Has Created Major Issues

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Importantly, though, we strongly believe that the seeds of today’s discontent actually were planted in 2001, driven by China’s outsized commitment to fixed investment after it joined the WTO as well as rapid adoption of the Internet (and the subsequent transparency/disruption it has created). One can see the exponential, simultaneous increase in both China’s fixed investment relative to its labor ratio and global Internet adoption in Exhibit 2, both of which materially accelerated the significant displacement of the traditional DM labor force. Thereafter, central banks began to overcompensate for this structural downturn in wage inflation by inflating prices of financial assets, with the explosive surge in monetary stimulus that occurred in the aftermath of the Great Financial Crisis only exacerbating this trend (Exhibit 4).

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Since China Entered the WTO in 2001, DM Labor Has Been Adversely Affected by Rapid Technological Change and Heavy Fixed Investment in China

**EXHIBIT 2**


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Post the Great Financial Crisis, Volatility Spikes Have Become the Norm

**EXHIBIT 3**

Global QE Has Not Been Enough to Stimulate a Sustained Increase in Growth, and as Such, We See More Fiscal Stimulus Ahead

Inspired by the aforementioned catalysts, we have entered into what my KKR colleague Ken Mehlman describes as a “political bull market.” From 2008-2015, this “political bull market” took the form of more regulation, higher taxes, and heightened industry scrutiny. Many governments also promoted fiscal austerity, multilateral trade and aggressive monetary stimulus. However, last year’s U.K. Brexit vote and U.S. election of President Donald Trump likely presage a new chapter in this bull market story. Specifically, many nations are definitely now viewing trade and foreign investment from a more nationalist perspective, fiscal austerity is being replaced by stimulus via lower taxes and infrastructure spend, while key industries such as the Energy and Financial Services sectors are likely to be deregulated.

This populism is also the result of longer term structural changes to the corporate and job environment: 15 years of secular stagnation where corporate profits, not necessarily wages, were championed; multiple industrial revolutions that disrupted key industries and transformed millions of workers from secure employment in one area to more tenuous project work across multiple careers; the Internet empowering critics of any and all institutions; demographic changes replacing an aging Baby Boom population with a very different workforce of Millennials. The underlying populist impulse that empowered this “political bull market” is unlikely to abate, we believe, and as such, it means that industries and companies remain subject to public distrust and political pressure.

Somewhat ironically, both the U.S. and the U.K. – the two countries now leading the charge on political change in the developed markets – have actually delivered decent GDP growth relative to their peers in recent years (Exhibit 1). However, in absolute terms, it has been subpar compared to history and it has been wildly lopsided in terms of income dispersion. Not surprisingly, working citizens around the globe, particularly in the developed markets, are now tired of paying for a financial crisis that they feel they did not create and of the effects of extreme monetary policy (i.e., it is harder to increase savings with low/negative rates); they want less fiscal austerity and less traditional political rhetoric. They also want growth in real incomes and benefits for their families, including education, healthcare, and retirement savings.

All these influences have coalesced to create what we believe is a paradigm shift across the global capital markets. Accordingly, investors will need to – as the opening quote suggests – “adjust our sails.” In particular, we strongly believe that investors should now expect to operate in a global macro environment where four important trends are either reversing or shifting materially relative to the past. They are as follows:

- Fiscal policies are now favored over monetary ones to stimulate growth
- Deregulation over reregulation
- Domestic agendas take precedence over global ones
- Heightened volatility spills over from the currency markets to the interest rate markets

Consistent with this view, we think that the macroeconomic backdrop will likely be shifting from a disinflationary, slower growth environment towards a reflationary-directed one with less onerous near-term banking regulation and fiscal targets. Importantly, our paradigm shift “call” is not just a U.S.-centric lens from which to view the world; rather, it is a global one. We note that the Producer Price Index (PPI) in China – which will account for one-third of total global growth in 2017 – has turned positive after 54 months of being negative. Moreover, our recent visit to China in December leads us to believe that the government may actually be running a fiscal deficit north of 10%, well above the reported “federal” figure of three percent.

In our view, this shift towards more reflationary policies by many growth-starved countries around the world is still largely an aspirational one, offset in many instances by slowing trade, poor demographics, weak productivity, and heavy debt burdens. As such, we think that the cross-currents of near-term reflationary stimulus juxtaposed against the aforementioned structural macro headwinds likely mean more volatility lies ahead for investors again in 2017. In particular, we expect to see elevated and sustained volatility extend beyond the currency markets to include – among other things – global interest rates markets in 2017.

EXHIBIT 4
Global QE Has Not Been Enough to Stimulate a Sustained Increase in Growth, and as Such, We See More Fiscal Stimulus Ahead

![Central Bank Balance Sheet as a % of GDP](image)


While fiscal stimulus will help to boost U.S. growth, many of our indicators are still flashing later cycle.
Global QE Has Promoted a Sustained Increase in FX Market Volatility

**Currency Volatility (CVIX)**

- Elevated FX vol
- Avg Since 2012

**U.S. 10Yr Treasury Volatility (TYVIX)**

- Recent increase in bond vol
- Avg Since 2012

**U.S. Equity Volatility (VIX)**

- Extremely low equity vol
- Avg Since 2012

Data as at December 31, 2016. Source: Bloomberg.

While we did not explicitly forecast either Brexit or a Trump presidency, we do take some comfort in our investment process, as many of our highest conviction investment themes in the second half of 2016 had already begun to capture this sea change in macro and geopolitical sentiment. See Section II for full details, but we now actually have higher conviction about the following six macro themes that we have been espousing for some time:

- **We still strongly believe that long-term rates achieved their lows immediately after Brexit, suggesting that stocks and bonds may not be as positively correlated in the future**
- **The gap between Simplicity and Complexity is too wide and will likely reverse in the coming quarters**
- **We remain cautious on global trade, favoring instead more domestic-oriented stories, particularly in EM**
- **The U.S. dollar remains in a bull market, in our view**
- **We think Private Equity outperforms Public Equity at this point in the cycle**
- **Our long-standing view to buy Yield and Growth in the Real Asset space dovetails quite nicely with the environment we envision**

That said, not all the recent news has been totally in sync with the way we have been thinking about the world. Indeed, we would be remiss in this outlook if we did not also spend time on areas where our original investment thesis may need to be revisited at some point in 2017 – or at least tweaked to better accommodate the new world reality that we now live in. See Section III for full details, but we acknowledge the following areas where our macro outlook has evolved of late:

- **The U.S. economic cycle may now last longer than we thought during our 2016 mid-year update**
- **Emerging markets may have a bumpier bottoming process than in our original base case**
- **Reregulation of financial intermediaries will likely wane, and as such, certain opportunities in Private Credit may now be more measured**
- **We do not see interest rates surging too high in the near-term, but the existing technical bid for bonds could be waning by 2018**
- **Our desire to favor Liquid Credit over Public Equities seems less compelling than in the past; we now think that the returns profiles will be more similar and have positioned our 2017 portfolio accordingly**

In terms of our asset allocation framework, we are maintaining several long-held asset class preferences but shifting other ones to accommodate to the new world order in which we must now invest. What has not changed, however, is our desire to again seek to aggressively monetize the inevitable periodic dislocations that occur in a world of heightened political uncertainty and macro instability. See the full paper for details of how we are translating our macro views into specific asset allocation suggestions, but our key action-items for 2017 are as follows:

1. **Given the large move in interest rates of late, we are taking some profits from our target asset allocation and actually tactically trimming our macro team’s massive 17% underweight to longer-duration government bonds to “just” a 14% underweight.** We now allocate six percent to government bonds, compared to a benchmark of 20%, but an increase from three percent previously. Our target for the 10-year Treasury at year-
end 2017 is now 2.75%, up from 2.25% previously, but long-term rates have already moved 120 basis points since their low of 1.36% on July 8, 2016. As such, they are now actually not that far from what we view as near-term fair value. We also believe that current real 10-year rates of around 50-70 basis points are at the top end of their near-term range, and they could actually decline in the first half of 2017. If we are wrong and global bond yields do surge higher in the near-term, then German bunds, not U.S. Treasuries, appear most at risk, especially on a local currency basis, in our opinion. Importantly, though, please do not confuse our cyclical conservatism on the level of bond yields with our longer-term outlook that 10-year rates bottomed after Britain’s decision to exit the European Union. Consistent with this view, we believe that we recently entered an important regime change, with *many governments now targeting reflation via fiscal impulses versus simply more monetary stimulus*. In our view, this shift in focus is a big deal because it means that stocks and bonds may no longer be as positively correlated in the future.

2. Relative to January 2016, Liquid Credit no longer appears like a bargain. Just consider that our measure of the market-implied default rate for High Yield has dipped all the way to 0.9%, down sharply from 7.8% last January and now on par with levels not seen since 2006/2007. Subordination risk across High Yield is also a concern. Meanwhile, spreads within the High Grade segment of the market appear rich in both absolute and relative terms. As such, a high conviction call for us remains our overweight position in Opportunistic Credit. To fund this five percent, non-benchmark position in Actively Managed Opportunistic Credit, we now hold sizeable underweights in our pure-play High Grade and pure-play High Yield allocations. While we have a more guarded stance towards Liquid Credit in 2017, our current targets do not mean that there will not be periods of significant upside opportunity across Credit in 2017. In fact, as *Exhibit 3* shows, volatility shocks, which typically lead to periodic dislocations in the credit markets, have become the norm this cycle, a trend we expect to continue. Consistent with this top-down view, we want to allocate capital to products and styles in 2017 that positively correlate in the future.

3. We prefer global performing Private Credit, which remains one of our most outsized non-benchmark overweight allocations. Similar to last year, we are still finding a lot of opportunity in the performing side of the Private Credit Markets across the U.S., Europe, and even Asia. *In fact, performing Private Credit, particularly at the large end of the market, remains our highest conviction risk adjusted return idea again in 2017*. All told, we maintain a robust 13% allocation to the asset class versus a benchmark of zero, though we are making some product tweaks within this segment of the market. Specifically, in 2017 we are dropping our Global Direct Lending allocation to 800 basis points from 1000 basis points last year. With the proceeds, we top up our Asset-Based Lending/Mezzanine exposure, boosting this allocation to 500 basis points from 300 basis points in 2016. See below for details, but we like the return profiles on the increasing number of opportunities that we are seeing in this segment of the market. Also, given that so much of the activity is currently being sourced out of Europe, we believe that it will be less susceptible to deregulation headline risk in 2017. Overall, though, as we detail below in Section III, we are going to watch this area of the market throughout 2017 to ensure that a shifting regulatory landscape does not squeeze the healthy illiquidity premium we still see in both the Direct Lending and Asset-Based Lending markets.

4. Within our Other Alternatives bucket, we are reducing Distressed/Special Situation to two percent from five percent, and we are using the proceeds to add to our global Private Equity allocation. Given the excessive amount of Quantitative Easing now flowing through the system, the traditional distressed cycle – which usually occurs when nominal credit growth is running above nominal GDP growth for too long – has not unfolded properly this cycle. As such, we have lowered our Distressed/Special Situation allocation to two percent, down from five percent in 2016. Meanwhile, we have moved to an overweight position in Private Equity, increasing our Private Equity bet by 300 basis points in 2017 to 800 basis points versus a benchmark of 500 basis points. As we detail below in Section II, Private Equity generally tends to notably outperform Public Equities in a more modest return environment, which is what we are forecasting. Also, we believe Private Equity likely affords us a better opportunity to execute on our *Buy Complexity, Sell Simplicity* thesis, versus buying a broad index. Within global PE, we are most encouraged by what we see in Japan (*Exhibit 68*). Finally, we believe that global PE will outperform Distressed/Special Situation at this point in the cycle, or until at least global QE initiatives slow further.

"We expect some of the current volatility in the currency markets to first bleed into the interest rate market in 2017 and then ultimately find its way into the equity markets, particularly as QE subsides further in the U.S."
5. As part of our decision to neutralize our outsized Credit over Equity call from 2016, we have moved to equal-weight from underweight in our Public Equity allocation bucket. Within Public Equities, however, our biggest overweight relative to benchmark in 2017 is now Japan; previously, it had been the United States. In terms of specifics, we now hold a seven percentage point position in Japan, compared to a benchmark and prior weighting of five percent. We reduce our U.S. weighting to 21%, compared to 22% previously and a benchmark of 20%. See Section I for details, but we forecast 11% earnings growth for the S&P 500, largely offset by a seven percent multiple contraction in essentially our base case scenario. Separately, we remain underweight non-Japan Asia, given our conservative view on Chinese public equities, and we are underweight Latin America. In Latin America, President-elect Trump’s policies could be troublesome for Mexico’s heavy dependence on exports. Also, we think China will slow its torrid pace of stimulus, which likely dents commodity earnings in places like Brazil. This viewpoint on Chinese policy will also weigh on certain European commodity stocks, which represent about 14% of the Eurostoxx 600 Index in total, but we do think that financials could perform admirably in Europe on a cyclical basis. As such, we remain equal-weight Europe.

6. We maintain our overweight to Real Assets with yield and growth, but we are short Gold in 2017. In the paradigm shift environment we are espousing, we believe Yield and Growth investments, particularly those that can compound their cash flows, could outperform. At the moment, we think that opportunistic real estate, midstream assets, certain MLPs and “last mile” infrastructure projects all make sense. Importantly, our research also shows that Real Assets tend to outperform in a modestly increasing inflation expectations environment. On the other hand, we believe that rising global rates could dent the effectiveness of Gold, and similar to our view in 2014 and 2015, we are again short Gold for 2017. Separately, while we are not outright short metallurgical coal, we do believe that prices have appreciated too far too fast, and as such, could experience a notable correction at some point in 2017.

7. Within Currencies, we believe that the USD will remain well bid, particularly against the Chinese renminbi, the Turkish lira, and the Korean won. Beyond potentially bigger deficits, our research shows that repatriation of overseas capital is U.S. dollar bullish. In 2005, for example, the dollar actually surged a full 13% on the heels of rate increases and repatriation incentives. Sound familiar? There is also the potential that more detailed discussions surrounding border tax adjustability lead to a spike in the USD during 2017. Regardless, our bigger picture conclusion is that we think that the current volatility in the currency market is too outsized relative to other parts of the global capital markets. In the near term we believe volatility will likely shift from currencies to the rate markets in 2017 and then ultimately towards credit and equities over time. We also believe that further U.S. dollar increases may potentially be more financially restrictive than the consensus now thinks; hence, we are using only two rate hikes in 2017, compared to a consensus forecast of three.

8. We are slightly overweight Cash to start 2017. We enter 2017 with a three percent Cash position compared to the benchmark of two percent. Similar to last year, we expect more volatility along the way. As such, we think continuing to build a little extra dry powder makes sense, particularly given our heavy weighting towards alternatives.

As we detail below, we see mid-to-high single digit returns for most liquid asset classes if our thesis unfolds as planned, though we are more optimistic that – almost irrespective of the environment – the ongoing rotation away from simplicity towards attractively priced complex assets could add another 300-500 basis points of alpha in 2017. Within the illiquid markets, we see more upside in terms of absolute returns, but we do think that we need greater sustained volatility to put meaningful amounts of capital to work in 2017.

Of course, no one has a crystal ball, and there are always important risks against which one should consider hedging. There is certainly a lot for investors to digest these days when one considers that five of the eight Fed governors could change over the next 12-18 months (including the Chair), five of the seven members of China’s Standing Committee could be replaced by next fall, there are multiple elections in Europe, we’re still sorting through the political and cultural implications of Brexit and we still don’t have a lot of clarity around how the U.S. is going to pay for the proposed large tax cuts and infrastructure proposals.

See Section IV below for details on how we are thinking about hedges, but our latest visit to Beijing definitely left us feeling that China’s currency could continue to sell off more than expected, particularly given higher U.S. rates amidst excessive credit creation relative to nominal GDP in China. Importantly, these pressures could occur when traditional trade practices are challenged on a global basis. Separately, global bond yields could back up further than we currently expect based just on technical repositioning. This risk is worth watching, we believe, as too many investors still appear too long duration at this point in the cycle, in our view. Finally, we are concerned about credit deterioration in certain fixed income markets, including the auto loan market in the U.S.

What is really needed to boost long-term growth is an investment-led surge in productivity, something that we think is hard for any politician to manufacture overnight.
Looking at the big picture, for the first time in years investors may now be paying for more potential cyclical upside in terms of GDP and EPS growth if fiscal stimulus and reflationary forces do – in fact – grab hold. In particular, President-elect Trump seems poised to attack two key overhangs, tax complexity and over-regulation, that appear to have stymied both innovation and productivity in recent years. That’s the good news, and it is likely to flow through to both business and consumer confidence in 2017.

The downside, however, is that – almost irrespective of where we are in the cycle – declining demographics and large debt overhangs, particularly in China, are more structural in nature. What is really needed to boost long-term growth is an investment-led surge in productivity, something that we think is hard for any politician to manufac-
So, our bottom line is that there is still potential for good money to be made in 2017 as bull markets end with bangs, not whimpers (Exhibit 8). However, as we detail below, our top-down framework does not actually suggest huge theoretical upside to most asset classes at this point in the cycle, and as such, we have focused more on arbitrages where we either think investor expectations are offside and/or the regulatory environment still puts capital at a premium. In particular, our highest conviction idea remains that the ongoing rotation away from Simplicity (e.g., equity bond proxies) towards Complexity will continue, especially if we are right about a cyclical bottoming in commodities after a 50-85% decline across the complex.

Section I: Global Macro Basics

In the following section we update several key top-down metrics, including targets for GDP growth, rates, earnings, oil, and expected returns.

GDP and Inflation

Given that we have a global footprint both at KKR and within the Global Macro & Asset Allocation team, we have the benefit of being able to provide an integrated view on the global economy. See below for details by region, but our punch line is that, even though policy makers are trying to boost growth, structural headwinds are likely to prevent any notable, sustained reacceleration in global GDP growth relative to current 2017 consensus expectations.

EXHIBIT 8

Bull Markets End With Bangs, Not Whimpers

Average Daily Performance Index of S&P 500 Before and After Market Peaks

Data as at November 22, 2016. Source: BofAML U.S. Equity & Quant Strategy, Bloomberg, S&P.

EXHIBIT 9

President-Elect Trump May Boost U.S. Growth, but EM Countries Are Supposed to Account for More Than Three-Quarters of Total Global Growth

2017 Real Global GDP Growth, %

China Other Emerging Markets US Other World

China alone makes up 33% of growth in 2017

Other Emerging Markets make up another 46% of growth in 2017

US makes up 10%

Data as at October 5, 2016. Source: IMFWEO, Haver Analytics.

EXHIBIT 10

Brazil Is the One Country Where We Are Well Below Consensus Growth Forecasts

2017 Growth & Inflation Base Case Estimates

<table>
<thead>
<tr>
<th></th>
<th>GMAA Target Real GDP Growth</th>
<th>Bloomberg Consensus Real GDP Growth</th>
<th>KKR GMAA Target Inflation</th>
<th>Bloomberg Consensus Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>2.25%</td>
<td>2.2%</td>
<td>2.2%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Euro Area</td>
<td>1.4%</td>
<td>1.4%</td>
<td>1.4%</td>
<td>1.3%</td>
</tr>
<tr>
<td>China</td>
<td>6.5%</td>
<td>6.5%</td>
<td>2.3%</td>
<td>2.2%</td>
</tr>
<tr>
<td>Brazil</td>
<td>0.0%</td>
<td>0.8%</td>
<td>6.0%</td>
<td>5.1%</td>
</tr>
</tbody>
</table>

GDP = Gross Domestic Product. Bloomberg consensus estimates as at December 31, 2016. Source: KKR Global Macro & Asset Allocation analysis of various factors that contribute meaningfully to these forecasts.

European Outlook My colleague Aidan Corcoran is looking for a mid-cycle slowdown in Eurozone GDP growth, downshifting to 1.4% in 2017, compared to 1.6% in 2016. Importantly, we are looking for some notable softness around the middle of 2017, with GDP growth touching one percent year-over-year around summer time. There are four key influences that shape our 2017 outlook. The first is that the return of energy inflation (i.e., crude oil prices are up 111% in EUR terms since their low on January 20, 2016) will eat into household spending power, which is already struggling to grow. In fact, the year-on-year increase in Eurozone compensation per employee has averaged just 1.2% over the past six quarters in nominal EUR terms. This fall-off in buying power represents a critical weakness.

1 Data as at December 31, 2016. Source: Bloomberg.
in a world where global trade is challenged, making the domestic consumer trends all the more important.

EXHIBIT 11

We Look For Trade to Make a Negative Growth Contribution vs. Trend in Mid-2017, While Investment May Provide a Drag Throughout the Full Year

EXHIBIT 12

We Look for Eurozone Inflation to be at a Five-Year High of 1.4% in 2017, Driven by Services and a Reversal of Energy Deflation

Second, we think heightened political uncertainty will continue to take its toll on investment, which we think is key to restimulating productivity in 2017 and beyond (Exhibit 11). One needs to look no further than France. Indeed, even if France does avoid the extreme right candidate, Marine Le Pen, and elects the current favorite, Francois Fillon, as president, it could still be messy. Fillon’s ascendency will still likely usher in a period of austerity and labor reform in France, both initiatives that could spark protests and disruption. The European companies we have spoken to are understandably nervous ahead of the French elections — not to mention Brexit, elections in Germany and the Netherlands — and we believe that this nervousness could impact fixed investment next year.

Third, while we look for trade to be a positive driver in 1Q17 — thanks in part to a dovish European Central Bank keeping the euro under pressure — we do expect some payback around mid-2017 as base effects kick in and the euro year-over-year change could turn less supportive.

Finally, while game-changing fiscal initiatives in Europe appear unlikely, we do think governments will loosen the reins a little in response to the growing populist threat. Defense spending in particular is likely to benefit. However, the limited fiscal stimulus we expect will not be enough to counteract populism, which we think remains a major investment theme in the coming years.

United States Outlook In terms of the U.S., my colleague Dave McNelis has changed our cycle call following Donald J. Trump’s surprise victory. Specifically, we have pushed back our recession forecast to 2019 from 2018. Key to our thinking is that – in the near term – President-elect Trump is likely to both cut taxes and increase investment, the potential benefits of which one can see in Exhibit 13. As a result, we have boosted both our growth and inflation forecasts during the 2017 and 2018 periods. One can see these changes in Exhibit 16.

"We expect more opportunity for private infrastructure projects in the next three-to seven-years; the reality is that governments can’t afford to pay for much of the infrastructure that is now so desperately needed."
EXHIBIT 13

U.S. Fiscal Stimulus Will Likely Be a Tailwind to Growth in 2018, Which Was Not in Our Original Call

<table>
<thead>
<tr>
<th>2018e Incremental Fiscal Stimulus</th>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Element</strong></td>
<td><strong>Fiscal Impulse</strong></td>
<td><strong>Note: Multiplier</strong></td>
<td><strong>GDP Contribution</strong></td>
</tr>
<tr>
<td>Individual income taxes similar to G.W. Bush-era regime²</td>
<td>0.40%</td>
<td>0.4</td>
<td>0.14%</td>
</tr>
<tr>
<td>Five percent reduction in effective corporate tax rate³</td>
<td>0.15%</td>
<td>0.3</td>
<td>0.05%</td>
</tr>
<tr>
<td>Additional $50 billion per year of infrastructure spending⁴</td>
<td>0.25%</td>
<td>1.4</td>
<td>0.36%</td>
</tr>
<tr>
<td>$10 billion increase in Federal ‘discretionary’ spending⁵</td>
<td>0.05%</td>
<td>1.5</td>
<td>0.08%</td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td></td>
<td></td>
<td>0.6%</td>
</tr>
</tbody>
</table>

e = KKR Global Macro & Asset Allocation (GMAA) estimate as of November 14, 2017. (1) Fiscal multipliers as per Moody’s Analytics estimates as of 1Q12. (2) KKR GMAA estimate of fiscal headwind from the roll-off of G.W. Bush-era tax rates at the time of the 2013 ‘Fiscal Cliff’ was -0.40% of GDP. (3) KKR GMAA estimate assumes a 10%pct reduction in the 35% headline rate, which equates to a 5%pct reduction in the 26% headline rate, as per BEA data. (4) As per Trump transition website, which refers to an infrastructure investment target of $550bn. We assume this is implemented over ~10 years. (5) As per GS analysis (“Economic Implications of the Trump Agenda”), which assumes $40bn reversal of defense ‘sequester’, offset by $30bn reduction to other discretionary spending.

In terms of specifics, we are raising our 2017 U.S. GDP forecast to 2.25%, which is a 25 basis point upgrade from 2.0% previously, and slightly above the current consensus of 2.2%. Key factors influencing our thinking include a) the improvement in U.S. credit conditions in recent months, both in terms of liquid market spreads and in terms of banks’ willingness to lend; b) the recent improvement in U.S. investment and trade growth – which has been evident both in the 3Q16 GDP report and in recent PMI survey data; and c) the fact that oil in the current ~$50 dollar range appears to be in something of a sweet spot that is high enough to alleviate some of the financial stress on producers, but low enough to promote a mild continued “oil dividend” in consumer spending.

Interestingly, our statistical GDP indicator is actually pointing to 2017e growth of potentially 2.5% (Exhibit 14), so our fundamental forecast of 2.25% does incorporate a modest haircut to our quant indicator. We make this haircut due to some cross currents we see that are not fully captured by the model, including the post-election jump in economic policy uncertainty as well as the tightening of financial conditions represented by the recent dollar rally.

EXHIBIT 14

Our U.S. GDP Leading Indicator Points to a Moderate Growth Recovery in 2017...

<table>
<thead>
<tr>
<th>U.S. Real GDP Y/y Leading Indicator</th>
<th>Actual</th>
<th>Model Predicted</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>R-squared = 74%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leading indicator now points to modest uplift to mid-2% growth versus recent mid-1% growth</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a = Actual, e = Estimated. Our GDP leading indicator is a combination of eight macro inputs that in combination we think have significant explanatory power regarding the U.S. growth outlook. Data as at December 31, 2016. Source: Bureau of Economic Analysis, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 15

...Supported by Lower Oil, Rising Home Sales, Recovering Household Wealth and Improving Credit Conditions

<table>
<thead>
<tr>
<th>Elements of 4Q17e GDP Leading Indicator</th>
<th>Baseline</th>
<th>Lower Oil Px</th>
<th>Rising Home Sales</th>
<th>Recovering Household Wealth</th>
<th>Other Factors</th>
<th>Restraint to Credit Conditions</th>
<th>Growing Workforce</th>
<th>Forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improved from -1.8% headwind as of June 2016</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2.6%</td>
<td>0.3%</td>
<td>0.2%</td>
<td>0.1%</td>
<td>0.2%</td>
<td>-0.8%</td>
<td>-0.1%</td>
<td>2.5%</td>
</tr>
</tbody>
</table>

e = Estimated. Our GDP leading indicator is a combination of eight macro inputs that in combination we think have significant explanatory power regarding the U.S. growth outlook. Data as at December 31, 2016. Source: Bureau of Economic Analysis, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

While our base case forecasts have improved, we want to emphasize that the range of potential economic outcomes has widened considerably as a result of Mr. Trump’s election. We have incorporated this into our forecast in Exhibit 16 by raising the magnitude of potential growth under a bull case in which meaningful government stimulus and fewer regulatory hurdles unleash a virtuous cycle of confidence and investment. We have also, however, increased the severity of a
potential recession under our bear case, in which the administration significantly ratchets up trade tensions, but delivers little net fiscal stimulus.

Chinese Outlook For China, my colleague Frances Lim is forecasting real GDP growth of 6.5%, which is 20 basis points below her revised 6.7% 2016 target and in line with the Bloomberg consensus of 6.5% for 2017. Implicit in our forecast is that China’s housing and auto sectors will slow as 2016’s highly stimulative policy measures now mean tougher comparisons and heavier oversight. While growth of “just” 6.5% GDP for 2017 could set off alarm bells with some investors, the 20 basis point reduction in real growth that we are forecasting is actually in line with the 20-40 basis points decline over the past two years.

Moreover, in nominal terms, near-term growth appears to have bottomed, which is a big deal for business operators that have been operating in a negative PPI and a low CPI environment for quite some time. Specifically, we now think that inflation will rise to 2.3% in 2017 from an average of 2.0% in 2016. In terms of what would give inflation a boost in 2017, we believe the reduction of excess capacity, strong property prices — hence rent inflation, and a weaker currency will cause inflation to rise. On the other hand, we think the 2016 rally in commodity prices, coal and steel in particular, was induced by domestic supply side measures that are now being rolled back. As commodity prices fall in response to the increased supply, it will likely have a deflationary impact on commodity-related sectors.

Brazilian Outlook We are forecasting flat or zero percent real GDP growth for Brazil in 2017, compared to a contraction of 3.3% in 2016 and a consensus forecast of 0.8% for 2017. Make no mistake, Brazil is recovering from one of its worst recessions ever, but we continue to see a “U-shaped” recovery. In our view, Brazil will finally exit its three-to-four year recession sometime in the second half of 2017, but growth for the full year will struggle to be positive and be back-end loaded at best. With universal expectations for positive GDP growth, we feel the first half might disappoint the optimists, especially as China pulls back its stimulus, as discussed above. To note, this Brazilian recession has already lasted 10 quarters, leading to a steep decline of 10.3% in per capita GDP during this period. As such, we think the potential for a V-shaped recovery is quite low. Consistent with this view (and despite a recent surge in business and consumer confidence), unemployment continues to increase while wages contract, which is deteriorating the wage mass and keeping consumption trends sharply negative. One can see this in Exhibits 17 and 18, respectively.

### Exhibits

#### Exhibit 16
We Are Extending Our Cycle Base Case by One Year and Raising Our Inflation Outlook for 2018-19e. Importantly, however, the spread of potential outcomes has widened.

<table>
<thead>
<tr>
<th></th>
<th>Base Case</th>
<th>Bull Case</th>
<th>Bear Case</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>New</td>
<td>Prior</td>
<td>New</td>
</tr>
<tr>
<td>2015a</td>
<td>2.60%</td>
<td>2.38%</td>
<td>2.60%</td>
</tr>
<tr>
<td>2016e</td>
<td>1.60%</td>
<td>1.50%</td>
<td>1.75%</td>
</tr>
<tr>
<td>2017e</td>
<td><strong>2.25%</strong></td>
<td>2.00%</td>
<td>2.75%</td>
</tr>
<tr>
<td>2018e</td>
<td>2.00%</td>
<td><strong>0.00%</strong></td>
<td><strong>3.00%</strong></td>
</tr>
<tr>
<td>2019e</td>
<td>0.00%</td>
<td>2.00%</td>
<td>2.50%</td>
</tr>
<tr>
<td>2020e</td>
<td>2.00%</td>
<td>2.00%</td>
<td>2.25%</td>
</tr>
<tr>
<td>2021e</td>
<td>2.00%</td>
<td>2.00%</td>
<td>2.00%</td>
</tr>
</tbody>
</table>


#### Exhibit 17
Unemployment Continues to Increase in Brazil at the Same Time Wages Are Contracting

<table>
<thead>
<tr>
<th></th>
<th>Labor Market Deterioration</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Y/y % Chg. (RHS)</td>
</tr>
<tr>
<td></td>
<td>4%</td>
</tr>
<tr>
<td></td>
<td>3%</td>
</tr>
<tr>
<td></td>
<td>2%</td>
</tr>
<tr>
<td></td>
<td>1%</td>
</tr>
<tr>
<td></td>
<td>-1%</td>
</tr>
<tr>
<td></td>
<td>-2%</td>
</tr>
</tbody>
</table>

*Data as at October 31, 2016. Source: Banco Central do Brasil, Ministério do Trabalho e Emprego, Haver Analytics.*
These Trends Are Shrinking the Wage Mass and Keeping Consumption Trends Sharply Negative

![Graph: Brazil: Real Wage Mass Growth, Y/y %]

Data as at October 31, 2016. Source: Banco Central do Brasil, Ministério do Trabalho e Emprego, Haver Analytics.

Meanwhile, on the inflation front, we note that the IPCA-15 CPI index has now dropped over 300 basis points in the last nine months, and it could potentially fall to the top end of the central bank’s inflation target (6.5%) within a few months, which has not happened since 2014. Without question, the recent decline in inflation trends has been encouraging; however, as we look ahead, we only see a path for inflation to fall to just 6.0% in 2017, versus a consensus of 5.1%. One can see this in Exhibit 19. If we are right, then it means that expectations for large cuts to the Selic rate in 2017 may disappoint investors. Indeed, we think that the median estimate for 2017, which embeds an additional 325 basis points of cuts to 10.5% by year-end 2017e, is too aggressive. We also do not yet see concrete evidence that President Michel Temer’s new administration is serious about pushing for more significant fiscal contraction, with recent events showing signs of backsliding on budget reform goals. If we are right, then we think that both bond and equity investors could be disappointed.

"We continue to advocate solid exposure across risk assets, with a particular focus on idiosyncratic opportunities that benefit from either dislocations and/or existing regulatory arbitrages."

We Believe Inflation in Brazil Will Fall, but Not as Much as the Market Believes, Due to Currency Weakness, Higher Taxes and Wages

![Graph: IPCA National CPI, Y/y, %]

Blue line equals actual CPI. Data as at September 30, 2016. Source: Instituto Brasileiro de Geografia e Estatística, Haver Analytics.

The Weaker BRL from 2015 Helped to Kick Start a Recovery in Manufacturing and Exports, Which Has Helped to Close the Current Account Deficit

![Graph: Brazil Industrial Production, Y/y%]

Data as at October 31, 2016. Source: Instituto Brasileiro de Geografia e Estatística, Haver Analytics.

The Brazilian real was among the best performing currencies in 2016, up 21% on a spot basis and up 33% on a total return basis. Given persistently high inflation and slow growth, we anticipate a gradual weakening of the BRL back towards 4.00 versus its year-end level of 3.27. At current levels, the real is no longer cheap compared to its long-term average real effective exchange rate (REER).
In addition, given the recent deterioration in industrial production and employment, we feel the currency needs to reverse the 2016 gains so the export sector can remain competitive and stabilize the economy. To be sure, this depreciation will help to boost exports, but it will ultimately limit the amount of monetary easing from the Central Bank, which will likely continue to hurt both credit creation and private consumption. This strength in the U.S. dollar / weakness in the Brazilian real is further evidence for why we do not think inflation will ultimately drop to where the current consensus is forecasting.

Our Interest Rate Forecast Suggests Rates Back Up to 2.75% in 2017 and a Cycle Peak of 3.25%; However, There Is No Change to Our 2017 Fed Call for Two Hikes

As we mentioned earlier, we recently boosted our 2017 forecast for U.S. 10-year rates to 2.75% from 2.25%, but we maintain our forecast that the Federal Reserve lifts short-term rates “just” two times in 2017 versus the Fed’s current forecast of three times. Here’s our thinking on both:

Fed Funds Forecast: We have not changed our base forecast that the Fed implements two 25 basis point rate hikes in 2017, which takes the mid-point Fed Funds target rate to 1.125% by year-end. A key factor that makes us confident that the Fed will be in motion in 2017 is that unemployment is nearing or at the government’s estimate of NAIRU, or the natural rate of unemployment. The proximity of the unemployment rate to NAIRU is important because, as we show, in Exhibit 24, the rate of core inflation has risen fully in four of the past five times that unemployment dipped below NAIRU by a median increase of 25 basis points. Consistent with this view, we are also seeing solid wage growth, with December 2016’s average hourly earnings climbing a full 2.9% year-over-year, the highest level in seven years.

As we detail in Exhibit 21, our overall Fed forecast continues to tread a middle ground between the Fed and market expectations, with our base case for 2017 close to the current market consensus but below the three hikes outlined in the Fed’s December “dots plot.” Our thinking is that, while we do expect the U.S. economy and unemployment rate both to improve in 2017, we also believe there will be significant market volatility and economic uncertainty over fiscal policy as well as continued upward pressure on the U.S. dollar. Ultimately, we believe these influences restrain Fed hikes to just 50 basis points. Our outlook for 2018, however, is more hawkish relative to our 2017 assumptions. Specifically, we assume three Fed hikes in 2018, driven by our expectations that 1) the bulk of U.S. fiscal stimulus will hit in 2018; 2) even tighter labor markets in the U.S. drive stronger wage growth in 2018 compared to 2017.

A stronger dollar could also likely coincide with higher rates, which may pressure yields not only in the U.S. but also in Europe and Japan. We do not see the dollar’s move getting extreme in our base case, but there are multiple scenarios where it could move beyond its fair value in 2017.
Unemployment Seems Poised to Dip Below Its Natural Rate (“NAIRU”)...

Historically, this has been accompanied by accelerating core inflation...

Change in Rate of Core CPI Inflation Rate From Quarter Before Unemployment Fell Below NAIRU

Core CPI is currently running around 2.15% y/y, so a 25 basis point acceleration would push it to approximately 2.4% y/y by 4Q17.

We do not see interest rates surging too high in the near-term, but the existing technical bid for bonds could be waning by 2018.

U.S. 10-Year Yield Forecast: Our U.S. 10-year yield forecast of 2.75% incorporates our views on both inflation break-evens and on TIPS real rates. Looking at inflation break-evens, we think they may be headed towards 2.25% from 1.97% as of year-end 2016 and what we believe was a cycle low of 1.20% in February of 2016. Our forecast appears consistent with what we are seeing from forward-looking inflation indicators such as the ECRI Future Inflation Gauge (Exhibit 25). However, we just don’t see a massive upward adjustment in overall inflation, particularly if the dollar continues to appreciate in 2017.

Turning towards real 10-year rates, we think they could rise to about 50 basis points, which would be around the high end of the range in recent years. This level would also represent a meaningful increase versus the trend in 2016, when real rates dipped below zero at times. That said, while we do think rates are headed higher, we continue to temper our U.S. forecast to reflect the significant global pressures on bond yields, particularly from Europe and Japan. In particular, as we illustrate in Exhibit 26, the spread between U.S. and German rates is extremely elevated relative to the differential in inflation rates between the two countries, which is comparatively modest at less than one percent. Said differently, if there is something that does not make sense in the global bond markets in 2017, it will likely emanate out of Europe, or even Japan.

The Inflation Indicators We Are Watching Suggest That Inflation Break-evens Could Continue Rising Towards About 2.25% From 1.97% as of 12/31/16
Our Year-End 2017 U.S. 10-Year Yield Target Moves to 2.75% from 2.25% Previously. This Level Would Be at the High End of What We Think Is a Reasonable Spread to European Rates

Spread Between U.S. and Germany 10-Year Yield and CPI


Earning and Target Multiple Analysis Suggests Modest Upside to Equities

After three years of flat to negative earnings growth, we finally look for S&P 500 earnings per share to reaccelerate in 2017 to $132.00 from $118.70, which represents about 11.2% growth. That’s good news, and it is consistent with our decision to maintain our overweight to U.S. Equities again in 2017. The potentially bad news is that the consensus forecast of $133.40, which implies a 12.3% growth rate, may need to be marked down further, in our view. Our more conservative viewpoint on 2017 earnings growth comes from our more cautious outlook in two areas relative to the consensus: 1) we are of the mindset that significant margin expansion seems unlikely at this point; and 2) the high degree of embedded operating leverage also seems too optimistic, in our view. The consensus forecast for revenue growth (ex-Energy) of 4.2% is expected to springboard into plus 9.1% earnings growth. That’s a huge bet 90 months into an economic cycle. Were this sizeable improvement to actually occur, it would be the exact opposite of what the S&P 500 experienced in 2016 (negative operating leverage), and it would also be above the actual margin expansion achieved in 2013, 2014 and 2015.

Beyond the margin expansion market-to-market that we are making, we think that there are four “extraordinary” items that also need to be considered in concert with more traditional earnings forecasting techniques for 2017. They are as follows:

- **U.S. Dollar**: The DXY is currently up 5.1% versus its 2016 average, if it holds these levels. We estimate that for every one percent move in the DXY, S&P 500 earnings are reduced by 0.40%. As a result, we expect a pass through of at least negative $2.85, or two percent, to 2017 earnings, with upside risk towards being more of a deterrent to S&P 500 EPS.

- **Taxation**: Based on our work, we think that a 10% cut in the statutory tax rate, from 35% down to 25%, would equate to a roughly six percent drop in the “effective” tax rate (from 28% to 22%). Key to our thinking is that roughly 60% of S&P earnings are taxed at statutory rates, while the implied offshore rate for the other 40% is a more modest 17.5%. So, each one percent drop in the effective rate increases S&P 500 earnings by $1.50/share or 1.3%, leading us to forecast that a 10% cut in statutory tax rates (six percent effective) would increase S&P 500 earnings by a sizeable $9.00/share or 7.6%. We then cut this number by 50% for 2017 to align with our assumption that Trump’s program is implemented on July 1, 2017.

- **U.S. Financials Earnings**: Financials earnings are estimated to grow 11.9% Y/y in 2017, compared to 0.6% growth in 2016. Given higher absolute rates, steeper yield curves, and the potential for less regulation, we think that the consensus forecast could still be too low. As such, we have added 500 basis points of incremental growth to the consensus forecast, which boosts the sector’s earnings by $1.20 to $25.10, compared to consensus forecast of $23.90 in 2017.

- **Buybacks**: Share count has decreased by an average of one percent over the past five years, after netting buybacks and issuance. In 2017, we expect share buybacks to boost EPS an additional 2.3% over notional earnings. Our forecast assumes we get a slightly higher rate of buybacks than recent years, given the potential cash flow boost from repatriation and lower taxes, as well as the lower regulatory burden on select financials, such as regional banks. This rate of EPS accretion from buybacks would be more similar to what we saw in the 2005-2007 period.

Given this potential disconnect, we have elected to forecast “baseline” 2017 EPS growth of 6.5% (including both Energy and non-Energy sectors), essentially in line with revenues. In our opinion, 6.5% nominal revenue growth represents a healthy growth rate that one might see in an environment of improving nominal GDP; however, it assumes that the margin improvement we are seeing in beaten-down sectors is largely offset by some of the more mature trends we are seeing in consumer, healthcare, and technology at this point in the cycle.
Putting all the aforementioned factors together, we see a path for a base-line 2017 EPS growth of 6.5% “organic” that increases to 11.2% after adjusting for “extraordinary” items. One can see this in Exhibits 27 and 28, respectively.

**EXHIBIT 27**

Our Earnings Outlook Is Contingent on a Likely Change in Policies...

<table>
<thead>
<tr>
<th>S&amp;P 500 EPS Scenarios</th>
<th>U.S.$ / share</th>
<th>Y/y %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current consensus 2016E EPS</td>
<td>$118.74</td>
<td></td>
</tr>
<tr>
<td>'17 revenue growth</td>
<td>6.5%</td>
<td></td>
</tr>
<tr>
<td>'17 earnings growth</td>
<td>6.5%</td>
<td></td>
</tr>
<tr>
<td>GMAA 2017E baseline EPS</td>
<td>$126.46</td>
<td>6.5%</td>
</tr>
<tr>
<td>Adj. for Trump tax cuts</td>
<td>$4.50</td>
<td>3.8%</td>
</tr>
<tr>
<td>Adj. for stronger US dollar</td>
<td>$(2.85)</td>
<td>-2.4%</td>
</tr>
<tr>
<td>Adj. for higher financial contribution</td>
<td>$1.20</td>
<td>1.0%</td>
</tr>
<tr>
<td>Adj. for buybacks</td>
<td>$2.70</td>
<td>2.3%</td>
</tr>
<tr>
<td>Pro-forma GMAA 2017E EPS</td>
<td>$132.00</td>
<td>11.2%</td>
</tr>
</tbody>
</table>

Data as at December 8, 2016. Source: KKR Global Macro & Asset Allocation analysis.

**EXHIBIT 28**

We Look for 2017 EPS to Reach $132 in 2017 After Factoring in All the Various Considerations

In terms of valuation, we think that the S&P 500 can trade around a 17-18x P/E multiple, down seven percent to the midpoint of 17.5x from a level of 18.8x at year-end 2016. If we are right, then our framework implies a range of approximately 2200 to 2400 for the S&P 500 (Exhibits 30 and 31).

There are three important inputs that drive our thinking around multiples. First, we think the contribution to earnings in 2017 from lower multiple sectors is now much more significant than in the past. One can see this in Exhibit 29. All told, 44% of total earnings growth in 2017 comes from Energy and Financials. Second, we think that higher rates and more uncertainty surrounding policy will stifle any additional multiple expansion this cycle. From what we can tell, it currently feels like we are being more conservative than the consensus about the proper discount rate that we should now use for valuing long duration assets, equities in particular. Third, one-time tax cuts are generally not multiple enhancing events, particularly if it leads to tighter monetary conditions and/or a stronger dollar.

"We now think that the intensifying regulatory changes in financial services, particularly in the U.S., could abate under a Trump administration."

Data as at December 8, 2016. Source: Morgan Stanley.
We Think the S&P 500 Can Trade Around a 17-18x P/E Multiple…

EXHIBIT 30

We Think the S&P 500 Can Trade Around a 17-18x P/E Multiple…

<table>
<thead>
<tr>
<th>EPS</th>
<th>16.0</th>
<th>16.5</th>
<th>17.0</th>
<th>17.5</th>
<th>18.0</th>
<th>18.5</th>
<th>19.0</th>
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<tbody>
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<td>2,091</td>
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<td>2,214</td>
<td>2,276</td>
<td>2,337</td>
</tr>
<tr>
<td>125</td>
<td>2,000</td>
<td>2,063</td>
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<td>2,538</td>
<td>2,609</td>
<td>2,679</td>
</tr>
</tbody>
</table>

Data as at December 8, 2016. Source: KKR Global Macro & Asset Allocation analysis.

EXHIBIT 31

…Which Implies a Low to High Single Digit Return, Including Dividends

<table>
<thead>
<tr>
<th>EPS y/y</th>
<th>16.0</th>
<th>16.5</th>
<th>17.0</th>
<th>17.5</th>
<th>18.0</th>
<th>18.5</th>
<th>19.0</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.6%</td>
<td>-10.8%</td>
<td>-8.0%</td>
<td>-5.3%</td>
<td>-2.6%</td>
<td>0.1%</td>
<td>2.8%</td>
<td>5.5%</td>
</tr>
<tr>
<td>5.3%</td>
<td>-9.3%</td>
<td>-6.6%</td>
<td>-3.8%</td>
<td>-1.1%</td>
<td>1.7%</td>
<td>4.4%</td>
<td>7.2%</td>
</tr>
<tr>
<td>7.0%</td>
<td>-7.9%</td>
<td>-5.1%</td>
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</tr>
<tr>
<td>8.7%</td>
<td>-6.5%</td>
<td>-3.7%</td>
<td>-0.8%</td>
<td>2.0%</td>
<td>4.9%</td>
<td>7.7%</td>
<td>10.6%</td>
</tr>
<tr>
<td>10.4%</td>
<td>-5.1%</td>
<td>-2.2%</td>
<td>0.7%</td>
<td>3.6%</td>
<td>6.5%</td>
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<td>12.2%</td>
</tr>
<tr>
<td>12.0%</td>
<td>-3.7%</td>
<td>-0.8%</td>
<td>2.2%</td>
<td>5.1%</td>
<td>8.0%</td>
<td>11.0%</td>
<td>13.9%</td>
</tr>
<tr>
<td>13.7%</td>
<td>-2.3%</td>
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<td>9.6%</td>
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<td>11.2%</td>
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<td>17.1%</td>
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<tr>
<td>18.8%</td>
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<td>11.3%</td>
<td>14.4%</td>
<td>17.5%</td>
<td>20.6%</td>
</tr>
</tbody>
</table>

EXHIBIT 32

Oil Outlook: We Are Still Using $60-$75 as our 2016 Base Case

As most folks know, OPEC recently delivered on the production target cut it first announced back in late September. Importantly, this OPEC action should help to finally force global oil production into a net deficit relative to demand. The global production surplus has come down significantly in recent quarters, but as Exhibit 32 illustrates, it had been difficult to see the market moving into a material deficit as long as OPEC continued to increase production. As we have emphasized since our 2016 Outlook note a year ago, oil bear markets tend to bottom out coincident with production moving into deficit (Exhibit 33).

If we are right on our earnings and valuation forecasts, then the S&P 500 could provide a total return of around four-to seven-percent, with two percent of that return coming from the dividend. In our view, this return would be competitive with credit instruments such as High Yield and Levered Loans, but is still likely to lag Private Equity and Private Credit at this point in the cycle. It is also subject to downside risk if the new administration does not advance its tax reduction agenda by mid-2017 or trade tensions flare up at any point during the year.

EXHIBIT 33

The OPEC Cut Could Send Global Oil Production Into Deficit Relative to Demand in 1Q17 for the First Time Since the Beginning of 2014

Global Oil Production Surplus/(Deficit), % of Global Demand

Historically, Oil Bear Markets Have Almost Always Ended When Production Finally Moved Into Deficit Relative to Demand

As we look ahead, we do think OPEC’s actions will help place a floor under oil prices, but we are also cognizant that global oil inventories remain profoundly glutted, which means markets will likely need time to fully normalize. Looking at the details, Exhibit 34 illustrates that in most cases, oil inventories are above-trend by approximately 1.15 billion barrels, which equates to a 23% surplus relative to the pre-4Q14 norm. If global production runs into deficit by ~ one percent (as Exhibit 32 suggests could be the trajectory), we estimate inventories would take approximately three years to normalize. Put another way, we think it could still be a matter of years until oil prices move up to levels that would incentivize significant shale re-investment.

Many of our models suggest more limited upside to asset class returns than in the recent past. Accordingly, we continue to favor a strategy that takes advantage of idiosyncratic opportunities, particularly those that enjoy better pricing during periods of market dislocations as well as those that harness complexity to their benefit.
We Believe Oil Can Hit $60-75 Within Five Years

<table>
<thead>
<tr>
<th>Target Range</th>
<th>'16-21e Oil Demand Growth</th>
<th>Rationale</th>
<th>Approx. Probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base Case</td>
<td>$60-75</td>
<td>1.0%</td>
<td>50%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The market clears at USD 60-75/bbl in the long-term as supply-demand balances through moderate LT demand growth and continued shale oil supply growth. Assumes OPEC maintains market share above 40%, but eventually resumes modulating production to keep prices in check.</td>
<td></td>
</tr>
<tr>
<td>Bear Case</td>
<td>$40-50</td>
<td>0.2%</td>
<td>30%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Driven by weak demand, prices fall to the lower end of the shale marginal cost curve, which itself is pressured by cost deflation</td>
<td></td>
</tr>
<tr>
<td>Bull Case</td>
<td>$80-100</td>
<td>1.5%</td>
<td>20%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Demand is sufficient to allow OPEC to resume defending price rather than market share, which sends oil back to the pre-4Q14 pricing regime</td>
<td></td>
</tr>
</tbody>
</table>


Our Long-Term Expected Returns Are More Modest Than in Recent Years

While we believe that our macro themes can help deliver differentiated relative performance, we must also acknowledge that at this point in the cycle we have entered an environment of lower absolute returns for many asset classes. This outlook makes sense to us, given that we are now starting with higher equity valuations and lower bond yields versus history.

However, this insight is not necessarily “new” news to most folks. Indeed, as one can see in Exhibits 37 and 38, respectively, returns have been actually trending down since 2000 in absolute terms, largely consistent with a 41% decline in nominal GDP (and interest rates) over the same period. Our work suggests that declining labor force growth and productivity, both of which still remain challenged, have negatively impacted global GDP’s recent growth trajectory.

We also believe that Real Assets, particularly those with yield and growth, can prosper in the macro backdrop that we envision.
In terms of where we are headed on the return front, we note the following. First, as we show in Exhibit 38, we assume that the S&P 500 returns 4.5% annually over the next five years, down from 12.6% in the prior five years. Multiple contraction and margin contraction are the major drivers of the downward pressure we are forecasting. Meanwhile, in terms of bonds, we forecast a 10-year Treasury return of 1.3%, comprised of a gross 2.4% yield from the current yield or coupon minus 1.1% linked to the bond price decline from the 10-year yield rising to 3.0% by 2021.

Within hedge funds we anticipate some rebound in overall performance. All told, the percentage of underlying managers with positive alpha, which had historically been 55%, had fallen to a low of just 40% in 2016. However, we expect the trend towards deregulation as well as the trend towards fiscal spending over monetary stimulus to favor some of the value securities currently owned by the hedge fund community. In addition, our research shows that hedge funds tend to do better when volatility picks up.

Given these aforementioned trends, we now look for hedge fund alpha to reach about 155 basis points per year, above the historical norm of 80 basis points, but notably above performance in recent years. Meanwhile, given our modest overall view for nominal returns, we only expect the beta component to return 280 basis points. So, when we pull it all together (i.e., beta of 280 basis points plus 155 basis points of alpha) we expect hedge funds to return roughly 4.4%, on an annualized basis over the next five years.

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2 Data as at July 31, 2016. Source: KKR Global Macro & Asset Allocation analysis.

3 Ibid 2.
generally what happened this cycle too. We also note that, while high frequency funds have arbitraged most of the inefficiencies in the liquid markets, private markets are – by definition – less efficient. There are also more opportunities to use time arbitrage to one’s advantage, particularly in a world where investment styles and techniques seem to come in and out of favor more quickly. Finally, there is often better alignment of management, shareholders, and the board towards the ultimate goal of value creation.

### Section II: Six High-Conviction Themes/Trends

In the following section we describe in detail where we feel most confident about six macro themes:

#### #1: We think that long-term rates have achieved their lows this cycle, which implies steeper global yield curves and lower correlation between stocks and bonds.

Consistent with President-elect Trump’s pro-growth agenda, we believe that the long end of the interest rate curve is structurally bottoming in the United States. Outside of the U.S., there are also two important changes that also need to be considered as one thinks about the direction and steepness of global interest rates in the coming quarters. First, our recent trip to China in December confirmed that the country’s PPI has bottomed after 54 months of deflation. This upward trajectory in the world’s largest manufacturing economy is a big deal, as it underscores our belief that reflation is occurring not only in the U.S. but also in Asia. As one can see in Exhibit 43, the Chinese government is actually supporting growth with fiscal spending that is potentially the largest we have seen on record in both absolute and relative terms. Specifically, according to the investment bank Goldman Sachs, total “augmented” spending, which includes both official and non-official spending, is now running north of 10%, compared to less than four percent before the Great Financial Crisis.

### Exhibit 43

China Is Now Running a Deficit of Between 11-13% of Its GDP Because of Heavy Central and Regional Government Spending

EXHIBIT 44

PPI Is an Important Driver of Nominal GDP Growth in China

Second, central banks in both Japan and Europe are now signaling that they want to steepen the yield curve by putting pressure on the long-end of the curve versus the previous ideology of focusing more heavily on negative short-end rates. This change, which we think is a major turning point in monetary policy, underscores our long held belief that corporations and individuals would view negative rates as a catalyst to actually save more, not spend more as the “Authorities” had originally hoped.

EXHIBIT 45

Rates Have Increased Sharply; We See More Limited Upside in the Near-Term

If we are right about this shift in fixed income, then asset allocators must take note of what we believe is a fundamental regime change relative to where we have been. Specifically, we think that stocks and bonds will move away from being so positively correlated, which could adversely affect the performance of many “hot” long duration, multi-asset class investment vehicles, including risk parity.

Consistent with this view, we still suggest a substantial underweight position in government bonds (six percent versus a benchmark of 20%; see Exhibit 6 for details), particularly those of longer duration. We also believe that global financial stocks, which have been chronic underperformers in recent years, could continue to stage a significant multi-year rally.

EXHIBIT 46

Yield Curves Are Finally Steeping Again

The Increase in Yields Post the U.S. Election Has Been Quite Different Than During the Taper Tantrum


Data as at December 31, 2016. Source: Bloomberg.

Data as at December 31, 2016. Source: Bloomberg.

Data as at November 10, 2016. Source: Bloomberg.
After a QE-driven Surge in Correlations, We Now Expect Some Moderation in the Relationship Between Stocks and Bonds

Stocks and bonds became increasingly correlated during the era of aggressive QE...

...a trend which may now be rolling over following the U.S. elections

In recent weeks markets clearly have begun to correct these excesses, but we think there remains a healthy valuation arbitrage between complexity and simplicity that still needs to narrow. On the one hand, a lot of companies that have missed or have lumpy earnings still seem to be trading well below their intrinsic values. As a result, we think that – with some value-added restructuring, market repositioning, and/or “tuck-in” acquisitions – there is still a significant opportunity today to dramatically boost the value that public shareholders will pay for a company across a variety of sectors.

On the other hand, it also feels to us that investors have overpaid for earnings visibility and/or yield in many instances. As a result, we still believe opportunities exist across the corporate and real asset sectors to carve out and monetize distinct earnings streams that are trading at what we believe are premium valuations relative to their long-term intrinsic value.

#2: We think that the gap between Simplicity and Complexity is still too wide and will likely reverse in the coming quarters. From our vantage point, it appeared that – prior to the U.S. election – investors were fully convinced that we were going to remain in a slow growth, low inflation environment. As a result, markets became increasingly bifurcated between companies with earnings visibility and those without it. Indeed, it felt very similar to what we saw during the 1999/2000 period, when too much money was chasing “hot” technology and telecommunications stocks at the expense of value-oriented cyclical exposures.

In recent weeks markets clearly have begun to correct these excesses, but we think there remains a healthy valuation arbitrage between complexity and simplicity that still needs to narrow. On the one hand, a lot of companies that have missed or have lumpy earnings still seem to be trading well below their intrinsic values. As a result, we think that – with some value-added restructuring, market repositioning, and/or “tuck-in” acquisitions – there is still a significant opportunity today to dramatically boost the value that public shareholders will pay for a company across a variety of sectors.

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Defensive Stocks in Europe Still Look Quite Expensive in a Reflationary Environment

U.S. Value Is Now Just Outperforming Growth for the First Time in Over Two Years, Helped by Strength in Banks and Insurance

Consistent with this view, we are bullish “value” stocks and domestically focused names, particularly in the United States (Exhibit 50). Europe too still appears to be a fertile environment for differentiated security selection and given the wide disparity in valuations, we expect European value-oriented securities to outperform too. 2017 could also be a good year for credit selection, though the gap between simplicity and complexity seems less attractive in Credit than Equities after the most recent bout of spread tightening. Finally, we think that Private Equity should be able to unearth some interesting opportunities. Right now we see the deconglomeratization in places like Japan and Europe as potentially the most interesting way to harness this theme.
#3: We remain cautious on global trade, favoring more domestic-oriented stories. While many investors are focused on President-elect Trump’s agenda, we actually believe that China has emerged as ground zero for this important shift in global trade priorities. Beyond the country’s ongoing shift from fixed investment towards consumption, there are two other traded-related macro headwinds to consider:

- An increasing amount of China’s fixed investment is being diverted towards projects like renewables, subways, and sewers, all of which have a less robust multiplier effect than general construction.

- The government is increasingly pushing a variety of industries to drive more insourcing, which ultimately means less demand for intermediate goods from China’s trading partners.

Given these two changes, we were not surprised to uncover that imports of machinery and equipment, which used to account for nearly half of China’s total imports as recently as 2002, have fallen to approximately 35% of total imports by 2016. As we show in Exhibit 52, China’s growing in-house industrial proficiency has clearly come at the expense of major industrial equipment providers located in Japan, Korea, Taiwan, Germany, and Sweden, many of which have traditionally relied on strong Chinese demand to boost their own exports.

We remain constructive on large domestic-oriented EM stories that are less reliant on global trade.
China Is Insourcing More of the Products It Consumes, Autos in Particular

In our view, this shift in China’s approach towards manufacturing more of its own equipment as well as its desire to move up the global food chain in high-end exports is secular, not cyclical. If we are right, then we think that there are two important, long-term investment implications. First, global trade as a percentage of GDP should remain more muted than in the past. Already, we note that global exports as a percentage of GDP actually peaked in 2008 at 26% and now total around 21%, a percentage we expect to fall into the high teens during the next five years. Against this backdrop, we remain cautious on shipping as well as many parts of the global logistics supply chain. We also think that insourcing could dent traffic both in Latin America and Asia, particularly if President-elect Trump and President Xi Jinping execute on their vision to improve the opportunity set for their countries’ domestic labor forces.

In nominal terms, near-term growth appears to have bottomed in China, which is a big deal for business operators that have been operating in a negative PPI and a low CPI environment for quite some time.
There Have Been Many Factors Driving the Slowdown in Global Trade

2011-2015 Contribution to Slowdown in Trade

- China, 23.5%
- Trade Liberalization, 6.9%
- Global Value Chains, 10.9%
- Import Adjusted Demand (IAD), 58.8%

Data as at December 31, 2016. Source: UBS EM Cross Asset Strategy No trigger for a blow up, no ideas for growth – managing a ship adrift, OECD input-output tables, Haver Analytics, Fraser Institute.

Globalization Has Ebbed and Flowed Over Time. We Now Think We Are in a Period of Slowing Growth

Global Trade Volumes and Real GDP Growth, %

- Exports Growth
- GDP Growth
- World Exports to GDP (rhs)

Data as at December 31, 2016. Source: UBS EM Cross Asset Strategy No trigger for a blow up, no ideas for growth – managing a ship adrift, OECD input-output tables, Haver Analytics, Fraser Institute.

Second, we think that the global flows are likely to be less dynamic than in the past. Already, foreign direct investment (FDI) as a percentage of GDP has been flat to down since the Great Recession. In many instances, developed market multinationals have lost confidence in the ability to earn excess returns in difficult markets like Brazil and China. Also, there is growing risk to being global, particularly if material expressions of the populism politics and political dissatisfaction continue to bubble up.

Trade Elasticity to Industrial Production Has Been Falling Across Both DM and EM Economies in Recent Years

Data as at December 31, 2015. Source CPB World Monitor, Haver Analytics, UBS.

In Addition to the U.S., We Believe Investors Will Seek Out Large EM Consumption Stories in the Coming Years


We think that the macroeconomic backdrop will likely be shifting from a disinflationary, slower growth environment towards a reflationary-directed one with less onerous near-term banking regulation and fiscal targets.
Services, Which Often Require Less Tradable Goods, Are Becoming More Influential in Driving Rising Consumption Growth

<table>
<thead>
<tr>
<th>Source of Consumption Growth, % of Growth</th>
<th>Population Growth</th>
<th>Per Capita Consumption Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970-85</td>
<td>45%</td>
<td>55%</td>
</tr>
<tr>
<td>1985-2000</td>
<td>47%</td>
<td>53%</td>
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<tr>
<td>2000-15</td>
<td>58%</td>
<td>42%</td>
</tr>
<tr>
<td>2015-30</td>
<td>75%</td>
<td>25%</td>
</tr>
</tbody>
</table>


In terms of allocation opportunities in a slowing global trade environment, we would focus on economies where domestic consumption as a percentage of GDP is large and growing. Not surprisingly, we favor our overweight position to the United States, particularly domestic-focused names that can benefit from lower taxes and higher consumer confidence. Outside of the U.S., we think Indonesia and India will likely be two beneficiaries. Consumption as a percentage of GDP is high in both economies, the demographics are favorable, and we continue to see ongoing improvements in GDP per capita. One can see this in Exhibit 60.

By comparison, we remain wary of increasing exposures to global transportation plays, certain trade finance receivables, and traditional beneficiaries of China’s fixed investment build-out. Our bigger picture thought is rising tensions surrounding trade balances could expand well beyond U.S.-Mexico and U.S.-China to include intermediate goods producers such as Vietnam and Korea. If we are right, we must all be vigilant not to invest blindly in companies and/or industries that could garner political attention on key issues such as labor laws, outsourcing, and/or environmental damages.

#4: The U.S. dollar remains in a bull market. Higher rates, more stimulus, and more lending all suggest that the dollar is set to rise again in 2017. As we mentioned earlier, embedded in our outlook is our view that the Federal Reserve boosts rates by two times in 2017 and three more in 2018. We also like the USD as a hedge against border tax deductibility gaining any momentum in Washington, D.C. Were the U.S. to impose an import tax penalty and an export tax benefit of equal amounts, then our research shows that the dollar would normalize the market by moving higher to offset any tax initiative. Finally, our research also suggests that repatriation of foreign profit acts as a notable stimulus. Indeed, in 2005, the U.S. dollar actually appreciated a full 13% after President Bush approved a one-time repatriation.

History Suggests That Foreign Earnings Repatriation Tends to Be USD Bullish

Our bigger picture view on the global currency markets is that we see increasing currency volatility, which – as of now – is being largely ignored by the equity and credit markets. Indeed, as we show in Exhibits 64 and 65, the UK and Japan are well below the 10-year average in terms of the ratio of equity volatility to FX volatility. From what we can tell, all the volatility linked to QE appears – to date – to be manifesting itself in the global currency markets, not the global equity markets. We see two important conclusions on which to focus. First, we think that current Sharpe ratios for most institutional
investors are unsustainably low. Second, we think that the current situation is untenable. Specifically, we expect some of the current volatility in the currency markets to first bleed into the interest rate market in 2017 and then ultimately find its way into the equity markets, particularly as QE subsides further in the U.S.

EXHIBIT 64
All the Volatility from QE Appears to Be in the Currency Markets, Not the Global Equity Markets...

![Great Britain Currency vs. Equity Volatility](chart1.png)

Data as at December 31, 2016. Source: Bloomberg.

EXHIBIT 65
...and We Expect This Trend to Reverse, Particularly as QE Subsides Further in the U.S.

![Japan Currency vs. Equity Volatility](chart2.png)

Data as at December 31, 2016. Source: Bloomberg.

**#5: Private Equity over Public Equity at this point in the cycle.** We are now overweight Private Equity relative to Public Equity. As one can see in Exhibit 66, what we found is that low return environments for Public Equities have actually historically been decent environ-

ments for Private Equity. From what we can tell, it seems single-digit return environments for Public Equities tend to be markets where fundamentals are good enough to support deleveraging and operational improvements, but not so good that it is difficult for PE to keep pace with public alternatives. Also, we believe that buyout opportunities tend to increase as the forward-looking total return in public equities decreases.

EXHIBIT 66
Private Equity Typically Outperforms in Lower Return Environments

![U.S. Private Equity Average Relative Returns in Various Market Environments](chart3.png)

The Outperformance of Private Equity Relative to Public Equity Generally Grows as Equity Markets Soften

![Quarterly Amount Private Equity Outperforms Public Equity](chart4.png)

Valuations Appear Quite Attractive in Japan, Particularly If We are Right on the Operational Turnaround Opportunity

At the moment, we are most constructive on what we are seeing in Japan, because it is a direct play on our Complexity thesis. While Abenomics is not necessarily boosting GDP, it is having a material impact on parts of the corporate sector. In particular, there is now a tremendous opportunity for Private Equity firms to acquire and grow non-core subsidiaries from some of the largest and most complex Japanese conglomerates. In Europe, dislocation and political change are forcing corporate executives to rethink their footprints, a trend we view constructively. Meanwhile, in the U.S. we are more measured in our outlook, focusing more on operational improvement stories versus traditional growth opportunities.

#6: More fiscal stimulus supports our overweight Real Assets with Yield and Growth. As we indicated at the outset of this 2017 Outlook piece, we are overweight Real Assets, Real Estate and Energy/Infrastructure in particular. If we are right that we get a little more inflation in 2017, then the value of these areas should increase in importance to the investment community. Implicit in what we are saying, however, that long-term interest rates, as measured by the 10-year Treasury, do not sell off materially (Exhibits 69 and 70). Also, consistent with the rhetoric that we have heard from both U.S. and British leaders, we expect more opportunity for private infrastructure projects in the next three- to seven-years. The reality is that governments can’t afford to pay for much of the infrastructure that is now so desperately needed.

We are constructive on what we are seeing in Japan because it is a direct play on our Complexity thesis.
For public investors, we would just note that we believe MLPs still look attractive to us, particularly if our previously mentioned forecasts for oil and interest rates are accurate. As we mentioned earlier, we do not see interest rates surprising too much to the upside in 2017, which should make the large yield in the MLP sector appear appealing to many investors. Probably more important, though, is that MLPs look quite attractive, in our opinion, relative to the “Simple” assets such as slow-growing utilities, which one can see in Exhibits 71 and 72.

### Section III: Challenging Our Conventional Wisdom

In the following section we detail where recent macro events are inspiring us to potentially rethink our approach to certain key macro trends and/or portfolio positioning.

#1: While fiscal stimulus will help to boost U.S. growth, many of our indicators are still flashing later cycle. Calling turns in any economic cycle is hard, but – with President-elect Trump’s stimulus slated to benefit U.S. GDP in 2018 – we believe that it is prudent to change the outlook for the duration and trajectory of the economic cycle in the U.S. (Exhibit 16). So, we have done that by extending the cycle until 2019 from 2018. As we also mentioned above, we think that President-elect Trump’s stimulus could add 60 basis points or so to economic growth in 2018, with a stronger impact from spending than tax cuts in the near term.

Consistent with these increases, we think that the new administration could further boost both corporate and consumer confidence in the near term, while we think that the potentially negative impact from a more protectionist bent could take longer to play out. Whatever happens in the near term, there are several reasons not to believe that President-elect Trump can extend the cycle indefinitely. First, we see little evidence that tax cuts actually prolong the cycle. In fact, my colleague David McNellis recently completed a study that showed fiscal stimulus is rarely a cycle extender. One can see this in Exhibit 73.

Second, several of our U.S. indicators, including household balance sheets as a percentage of GDP, the gap between services and manufacturing jobs, and absolute level of corporate margins, all would suggest that there are important, cyclical mean-reverting forces worth considering. As we show in Exhibits 74 and 75, many of these relationships are now at levels consistent with a historical peak in markets and/or economic activity.

We are undergoing a political and economic paradigm shift that started with Brexit but is likely to continue for the foreseeable future. Often these types of regime changes do not always transition smoothly.
History Shows That Fiscal Stimulus Is Rarely a Significant Cycle-Extender

<table>
<thead>
<tr>
<th>Tax Cut</th>
<th>Signature Measure</th>
<th>Qtr. Signed</th>
<th>Start of Next 20%+ Bear Market</th>
<th>Start of Next Recession</th>
<th># of Qtrs. Until Next Bear Mkt.</th>
<th># of Qtrs. Until Next Recession</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue Act of 1964 (&quot;Kennedy Tax Cut&quot;)</td>
<td>Individual income tax rates were cut across the board by approximately 20%. (e.g., top marginal rate to 70% from 91%).</td>
<td>1Q64</td>
<td>1Q66</td>
<td>1Q70</td>
<td>8</td>
<td>24</td>
</tr>
<tr>
<td>Economic Recovery Tax Act of 1981 (&quot;First Reagan Tax Cut&quot;)</td>
<td>Across-the-board cut in individual tax rates over three years. (Top marginal rate fell to 50% from 70% and bottom rate fell to 11% from 14%).</td>
<td>3Q81</td>
<td>3Q81</td>
<td>4Q81</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Tax Reform Act of 1986 (&quot;Second Reagan Tax Cut&quot;)</td>
<td>The top tax rate for individuals was lowered from 50% to 28% while the bottom rate was raised from 11% to 15%.</td>
<td>4Q86</td>
<td>3Q87</td>
<td>4Q90</td>
<td>3</td>
<td>16</td>
</tr>
<tr>
<td>Economic Growth and Tax Relief Reconciliation Act of 2001 (&quot;Bush Tax Cut&quot;)</td>
<td>Across-the-board cut in individual tax rates over five years, which was eventually accelerated to two years. (Top marginal rate fell to 35% from 39.6% and bottom rate fell to 10% from 15%).</td>
<td>2Q01</td>
<td>2Q01</td>
<td>2Q01</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>


Third, expansions just do not last forever. As Exhibit 76 shows, we are already 90 months into the current one, and our new base case is that we do not have a recession until 2019, which implies a recovery of 114 months. To put this in context, only the 1991-2001 recovery will be longer than what we are predicting in our base.

Finally, there are still a lot of unknowns that could dent global growth. For example, border tax deductibility, which focuses on where items are bought, not produced, could actually impair growth in the near term, slow investment, and/or spike the U.S. dollar. Separately, removal of interest deductibility for businesses is being floated as an offset to lower corporate tax rates. In our humble opinion, market participants have not really spent much time digesting these potentially significant changes, and as such, the risk of a downside economic surprise over the next 24 months should not be dismissed.
EXHIBIT 76

We Are a Solid 90 Months Into the Current Economic Expansion …

Duration of U.S. Economic Expansions (Months)

<table>
<thead>
<tr>
<th>Economic Expansion Period</th>
<th>Months</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 2009 Current (Dec 2016)</td>
<td>90</td>
</tr>
<tr>
<td>November 2001 - December 2007</td>
<td>73</td>
</tr>
<tr>
<td>March 1991 - March 2001</td>
<td>12</td>
</tr>
<tr>
<td>November 1982 - July 1990</td>
<td>36</td>
</tr>
<tr>
<td>July 1980 - July 1981</td>
<td>58</td>
</tr>
<tr>
<td>March 1975 - January 1980</td>
<td>37</td>
</tr>
<tr>
<td>November 1970 - November 1973</td>
<td>45</td>
</tr>
<tr>
<td>February 1963 - December 1969</td>
<td>39</td>
</tr>
<tr>
<td>April 1958 - April 1960</td>
<td>80</td>
</tr>
<tr>
<td>May 1954 - August 1957</td>
<td>50</td>
</tr>
<tr>
<td>October 1949 - July 1953</td>
<td>27</td>
</tr>
<tr>
<td>October 1945 - November 1946</td>
<td>22</td>
</tr>
<tr>
<td>June 1938 - February 1945</td>
<td>10</td>
</tr>
<tr>
<td>March 1933 - May 1937</td>
<td>12</td>
</tr>
<tr>
<td>November 1927 - August 1929</td>
<td>19</td>
</tr>
<tr>
<td>July 1924 - October 1926</td>
<td>6</td>
</tr>
<tr>
<td>July 1921 - May 1923</td>
<td>44</td>
</tr>
<tr>
<td>March 1919 - January 1920</td>
<td>33</td>
</tr>
<tr>
<td>December 1914 - August 1918</td>
<td>21</td>
</tr>
<tr>
<td>January 1912 - January 1913</td>
<td>21</td>
</tr>
<tr>
<td>June 1908 - January 1910</td>
<td>21</td>
</tr>
<tr>
<td>August 1904 - May 1907</td>
<td>21</td>
</tr>
<tr>
<td>December 1900 - September 1902</td>
<td>21</td>
</tr>
</tbody>
</table>

Performance on a monthly basis, peak to trough. Data as at December 31, 2016. Source: Bloomberg.

EXHIBIT 77

...And Wages Are on the Upswing, Which Usually Does Not Bode Well for Margins

EXHIBIT 78

To Date, U.S. Markets Have Endured a Highly Unusual Rate Cycle, Enjoying Significant Multiple Expansion

<table>
<thead>
<tr>
<th>First Hike</th>
<th>Last Hike</th>
<th># of Months</th>
<th>LTM P/E Start</th>
<th>LTM P/E End</th>
<th>LTM P/E % Chg</th>
<th>LTM P/E % Annz’d</th>
<th>SPX % Chg</th>
<th>SPX % Annz’d</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Nov-54</td>
<td>Oct-57</td>
<td>35</td>
<td>12.6</td>
<td>11.9</td>
<td>-5.0%</td>
<td>-1.7%</td>
<td>19.9%</td>
<td>6.4%</td>
</tr>
<tr>
<td>2 Jul-58</td>
<td>Nov-59</td>
<td>16</td>
<td>16.2</td>
<td>17.1</td>
<td>5.7%</td>
<td>4.3%</td>
<td>23.5%</td>
<td>17.2%</td>
</tr>
<tr>
<td>3 Jul-61</td>
<td>Nov-66</td>
<td>64</td>
<td>22.0</td>
<td>14.5</td>
<td>-33.9%</td>
<td>-7.5%</td>
<td>20.5%</td>
<td>3.6%</td>
</tr>
<tr>
<td>4 Oct-67</td>
<td>Aug-69</td>
<td>22</td>
<td>17.7</td>
<td>16.3</td>
<td>-8.0%</td>
<td>-4.5%</td>
<td>1.7%</td>
<td>0.9%</td>
</tr>
<tr>
<td>5 Feb-71</td>
<td>Aug-71</td>
<td>6</td>
<td>18.5</td>
<td>18.1</td>
<td>-2.1%</td>
<td>-4.2%</td>
<td>2.4%</td>
<td>4.8%</td>
</tr>
<tr>
<td>6 Feb-72</td>
<td>Aug-73</td>
<td>18</td>
<td>18.2</td>
<td>13.8</td>
<td>-24.2%</td>
<td>-16.8%</td>
<td>-2.2%</td>
<td>-1.5%</td>
</tr>
<tr>
<td>7 Feb-74</td>
<td>May-74</td>
<td>3</td>
<td>11.6</td>
<td>10.1</td>
<td>-12.9%</td>
<td>-42.3%</td>
<td>-9.3%</td>
<td>-32.3%</td>
</tr>
<tr>
<td>8 Nov-76</td>
<td>Mar-80</td>
<td>40</td>
<td>10.4</td>
<td>6.7</td>
<td>-36.2%</td>
<td>-12.6%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>9 Jul-80</td>
<td>May-81</td>
<td>10</td>
<td>8.2</td>
<td>9.0</td>
<td>9.4%</td>
<td>11.4%</td>
<td>9.0%</td>
<td>10.9%</td>
</tr>
<tr>
<td>10 Apr-83</td>
<td>Aug-84</td>
<td>16</td>
<td>13.0</td>
<td>10.0</td>
<td>-23.4%</td>
<td>-18.1%</td>
<td>1.4%</td>
<td>1.0%</td>
</tr>
<tr>
<td>11 Nov-86</td>
<td>May-89</td>
<td>30</td>
<td>15.3</td>
<td>12.6</td>
<td>-17.6%</td>
<td>-7.5%</td>
<td>30.3%</td>
<td>11.2%</td>
</tr>
<tr>
<td>12 Jan-94</td>
<td>Feb-95</td>
<td>13</td>
<td>17.7</td>
<td>14.9</td>
<td>-15.9%</td>
<td>-14.8%</td>
<td>1.2%</td>
<td>1.1%</td>
</tr>
<tr>
<td>13 May-99</td>
<td>May-00</td>
<td>12</td>
<td>28.1</td>
<td>25.8</td>
<td>-8.3%</td>
<td>-8.3%</td>
<td>9.1%</td>
<td>9.1%</td>
</tr>
<tr>
<td>14 May-04</td>
<td>Jun-06</td>
<td>25</td>
<td>18.4</td>
<td>15.5</td>
<td>-15.7%</td>
<td>-7.9%</td>
<td>13.3%</td>
<td>6.2%</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td></td>
<td><strong>22</strong></td>
<td><strong>16.3</strong></td>
<td><strong>14.0</strong></td>
<td><strong>-13.4%</strong></td>
<td><strong>-9.3%</strong></td>
<td><strong>8.6%</strong></td>
<td><strong>2.8%</strong></td>
</tr>
<tr>
<td><strong>Median</strong></td>
<td></td>
<td><strong>17</strong></td>
<td><strong>16.9</strong></td>
<td><strong>14.2</strong></td>
<td><strong>-14.3%</strong></td>
<td><strong>-7.7%</strong></td>
<td><strong>5.7%</strong></td>
<td><strong>4.2%</strong></td>
</tr>
</tbody>
</table>

Our bottom line: Now is not the time to aggressively risk up one’s portfolio. Rather, we continue to advocate solid exposure across risk assets, with a particular focus on idiosyncratic opportunities that benefit from either dislocations and/or existing regulatory arbitrages. We also like margin improvement opportunities and/or industry consolidation plays. We believe Value should outperform Growth in Public Equities, while we think that Levered Loans should perform notably better than High Grade Credit and some of the overbought commodity-linked parts of High Yield.

#2: We think that Emerging Markets will now have a bumpier bottoming process. Higher real rates, smaller deficits, less institutional sponsorship, and more stable currencies all lead us to believe that Emerging Markets as an asset class are bottoming after 75 months of underperformance. This viewpoint is consistent with what we laid out in our October 2016 Insights Asia: Pivot Required.

However, what’s new since the publication of the note is that we now expect an even stronger dollar — compliments of repatriation, more fiscal stimulus, and a potentially more hawkish Fed. We also expect heightened investor concerns surrounding global trade under a Trump presidency. Without question, both a stronger dollar and a more protectionist bent would hurt low-end manufacturers, many of whom are domiciled within emerging markets.

No doubt, these are important influences to consider, but our EM dashboard, which we show in Exhibit 79, continues to suggest that many of these concerns are now largely “in the price.” Indeed, of the five indicators that we track as part of our dashboard, all five are now either neutral or positive.

Moreover, there are two important changes in the macro landscape that suggest – even if a bottom takes longer to form – a 2013 taper tantrum-like event is highly unlikely. First, the overall health of EM countries is in much better shape today, particularly relative to the famed “taper tantrum.” One can see in Exhibits 80 and 81, respectively, that real rates are higher and deficits are now much lower today than in 2013.

Second, given that Trump may focus more on a domestic agenda, China is likely to use the U.S.’ decision to abandon the Transatlantic Trade Partnership (TPP) to increase its presence in the region, including greater trade connectivity through the China led Regional Comprehensive Economic Partnership (RCEP). This “pivot” by China could actually increase near-term activity in many parts of EM, particularly across Asia.

### EXHIBIT 79
Emerging Markets Are Getting Progressively More Interesting, but Selectivity Is Still Required

<table>
<thead>
<tr>
<th>“Rule of the Road”</th>
<th>May’15</th>
<th>Jan’16</th>
<th>Current Signal</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Buy When ROE Is Stable or Rising</td>
<td>↔</td>
<td>↔</td>
<td>↔</td>
<td>Slowing nominal GDP growth has been a headwind to operating leverage and asset turns; however, this could be turning in 2017</td>
</tr>
<tr>
<td>2 Valuation: It’s Not Different This Time</td>
<td>↔</td>
<td>↑</td>
<td>↑</td>
<td>Relative valuation has finally moved into the “strike zone” where EM has historically troughed relative to DM</td>
</tr>
<tr>
<td>3 EM FX Follows EM Equities</td>
<td>↓</td>
<td>↓</td>
<td>↔</td>
<td>Many EM currencies are down 20-40%+ versus the dollar, but we think FX likely remains a headwind for USD or other hard currency denominated investors</td>
</tr>
<tr>
<td>4 Commodities Correlation in EM is High</td>
<td>↔</td>
<td>↔</td>
<td>↔</td>
<td>The GSCI index has stabilized at low levels, but we do not anticipate material upside until oil inventories start a convincing decline. OPEC action may help, but will not decisively rebalance the market near-term</td>
</tr>
<tr>
<td>5 Momentum Matters in EM Equities</td>
<td>↓</td>
<td>↓</td>
<td>↑</td>
<td>EM relative momentum vs. DM turned positive on a year-over-year basis in September for the first time since early 2011. Historically, changes in EM momentum have been sustained over multi-year cycles</td>
</tr>
<tr>
<td>Overall</td>
<td></td>
<td></td>
<td></td>
<td>Early-stage recovery is starting to unfold</td>
</tr>
</tbody>
</table>

Unlike in 2013, Real Yields Are Now Higher in EM...

**EXHIBIT 80**

![Chart showing change in real yields between current vs. April 2013 (Taper Tantrum), data as of December 31, 2016. Source: Bloomberg.]

Data as at December 31, 2016. Source: Bloomberg.

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...While Current Account Positions Are Stronger

**EXHIBIT 81**

![Chart showing change in current account as a % of GDP 3Q16 vs 2Q13, data as of September 30, 2016. Source: IMFWEEO, Haver Analytics.]

Data as at September 30, 2016. Source: IMFWEEO, Haver Analytics.

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**EXHIBIT 82**

EM Equities Have Moved in Long and Relatively Stable Cycles Relative to DM

![Chart showing relative total return, MSCI EM/DM, data as at December 31, 2016. Source: MSCI, Bloomberg, KKR Global Macro & Asset Allocation analysis.]


Our bottom line: We still think that EM is in the process of bottoming, but it will likely be bumpier than in the past. As a result, an investor likely now needs to be more tactical than previously because a sustained V-shape recovery in EM is highly unlikely. Key to our thinking is that not only is the multiplier on China’s fixed investment now shrinking but also the overall part of the economy that is directly linked to fixed investment is also contracting. Also, global trade is still slowing, and any further discord between the United States and China will certainly not help revive this area of the global economy.

Given this backdrop, near term we remain focused on three areas within EM. First, we remain constructive on large domestic-oriented EM stories that are less reliant on global trade. Over the longer-term, we favor India and Indonesia. Second, through both Public and Private Equities, we see significant opportunity to align with companies that are using acquisitions and/or joint ventures to grow their businesses outside of their core markets. Key industries on which we are focused include travel, healthcare, and technology. Third, our conversations with banking and private sector executives in China and India both confirm our view that more and more global conglomerates will likely be divesting non-core businesses, which we view as an emerging opportunity for global PE players, particularly across Asia.

#3: We now think that the intensifying regulatory changes in financial services, particularly in the U.S., could abate under a Trump administration. Will this be a negative for Private Credit? Since we joined KKR in 2011, our travels across Europe, the U.S., and parts of Asia led us to consistently witness a trend towards traditional financial services companies becoming more “utility-like” in approach. While we think that there were several influences, the move towards low-to-negative rates by central banks as well as the desire by governments for significantly heightened regulation were probably the most important.
Apparently, we were not alone, as President-elect Donald Trump now thinks that deregulation has dramatically altered the flow of credit, and he wants change. Maybe more important, though, is that many of his supporters, including some that are following him to Washington, want to repeal Dodd-Frank.

So, where do we go from here? Our base case is that there will be some important alterations to the competitive landscape. Specifically, we now look for an SEC that fines individuals more regularly than companies. This statement is not to be taken lightly, as banks paid out nearly 15% of their equity just in reporting fines since the Great Financial Crisis (Exhibit 83). Second, we think that the Fed-appointed banking supervisor is likely to be more markets friendly. Coupled with an SEC that we think will be more concerned about liquidity, we believe that there will be looser interpretations of the Volker rule on a go-forward basis. Third, we expect the limit for Systemically Important Financial Institution (SIFI) to get lifted from $50 billion in assets towards $250 billion in assets.

Here is what we don’t think will change, however. First, we do not believe that aggressive leverage is coming back into the system. At the peak, universal banks and investment banks were levered 30:1; our base view is that leverage remains modest in the 10-12x range. Second, we think that regulators will still encourage complexity to trade off market towards private credit solutions with more diversification benefits. Third, we think that the trend towards sponsors just wanting certainty of capital will favor customized solutions where private credit players can speak for the entire deal. Finally, we expect little change in the asset-based lending market, as the lion’s share of that current deal origination is now occurring in Europe.

**EXHIBIT 83**

Seven Years of Fines Have Taken a Heavy Toll on the Top 10 Global Banks, Wiping Out the Equivalent of 14% of Equity Capital; We Think This Could Soon Change

Despite the threat of future regulatory changes, the illiquidity premium still feels appealing.
In terms of allocation opportunities, we remain quite constructive on the larger deals in Private Credit. Ironically, having more capital in this part of the market allows a select number of firms to dictate pricing, particularly during periods of market dislocations. On the other hand, we are increasingly concerned that the small end of the private credit market is becoming saturated by too many players chasing too few deals with too little differentiation.

Separately, we are increasingly constructive on Asset-Based Private Lending, particularly in Europe (which is likely to be much less impacted by any bank regulatory changes under consideration). Also, it is probably worth noting that, in a world where the German bund yields less than one percent, we think that the opportunity to earn low double digit returns with some collateral against the loan remains quite attractive, in our view.

#4: We do not see interest rates surging too high in the near-term, but the existing technical bid could be waning by 2018. Given the trend towards increased fiscal spending and domestic priorities over monetary tools and global linkages, we have boosted our 2017 10-year interest rate outlook. Implicit in our increase is both an uptick in real rates and inflation. However, we do not envision a 1994-type market where bond yields become unglued amidst faster than expected Fed rate increases. For starters, we do not see significant wage inflation nor do we believe that the Fed needs to play “catch up” on inflation expectations. In addition, as we outline in Exhibit 87 we think that the technical bid for sovereign debt remains particularly strong through 2017. Indeed, whereas the G4 was increasing net available bonds by over $1.1 trillion in 2011, current estimates – according to the investment bank Morgan Stanley – are for net issuance to be negative $426 billion in 2017. That’s good news for the long-end of the curve.
The potentially bad news – and an area of the market we are watching closely – is that net issuance is expected to increase to positive $604 billion in 2018 after net shrinkage in supply in both 2015 and 2016. This shift could be a big deal because many investors have become accustomed to a robust technical bid, which has kept yields lower than expected in recent years.

So, as we look ahead, our base view is that long rates remain controlled in 2017. Hence, our decision to cover 300 basis points of our significant underweight to Government Bonds in our target asset allocation. However, if President-elect Trump’s fiscal plan is greater than expected and/or global central bank QE, particularly in Europe, is not enough to help offset the increase in issuance that we forecast for 2018, we may need to bump up our target yields for interest rates in 2H17 and beyond.

#5: Buying Liquid Credit relative to Equities is no longer as obvious. When we rolled out our 2016 outlook piece, we argued strongly that Credit was much more attractively priced than Public Equities. As we show in Exhibit 89, the implied default rate for High Yield was 7.8% in January 2016, essentially approaching levels in line with prior recessions. Today, by comparison, our model shows an implied default rate of 0.9%, which feels fairly skinny to us.

We maintain our long-held approach of seeking to aggressively monetize the periodic dislocations that inevitably occur in a world of increasing geopolitical uncertainty and macro instability.
High Yield and Levered Loans Look Too Tight Relative to Other Risky Credits

<table>
<thead>
<tr>
<th>Comparable Spread Products, Basis Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>CLO A</td>
</tr>
<tr>
<td>240 260 315</td>
</tr>
<tr>
<td>CLO BBB</td>
</tr>
<tr>
<td>400 425 500</td>
</tr>
<tr>
<td>CMBX 8 BBB-</td>
</tr>
<tr>
<td>504 573 635</td>
</tr>
<tr>
<td>CMBX 8 BB</td>
</tr>
<tr>
<td>877 1,013 1,057</td>
</tr>
<tr>
<td>High Yield</td>
</tr>
<tr>
<td>476 479 658</td>
</tr>
<tr>
<td>Leveraged Loan</td>
</tr>
<tr>
<td>460 460 531</td>
</tr>
</tbody>
</table>

Data as at December 12, 2016. Source: Morgan Stanley Research.

Levered Loans Now Look Rich Relative to the Risk-Free Rate

<table>
<thead>
<tr>
<th>Relative Total Return U.S. Leveraged Loan vs. U.S. Treasury</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Leveraged Loan / U.S. Treasury</td>
</tr>
<tr>
<td>Trend</td>
</tr>
<tr>
<td>+1stdev</td>
</tr>
<tr>
<td>+2stdev</td>
</tr>
</tbody>
</table>

Data as at December 2016. Note: US leveraged loan = SPBDAL Index; U.S. Treasury = G0Q0 Index. Source: BofA Merrill Lynch Global Research, Bloomberg.

Given these aforementioned return assumptions, our base case is that Credit will not be the asset class it was in 2016, and as such, a more balanced approach to Equities and Credit is now likely warranted. Within these two asset classes, however, we do expect some notable differentiation. Specifically, within Equities, we expect Value stocks to handily outperform, with Financials and Energy as our most favored sectors. We also think parts of Healthcare look quite compelling for long-term investors.

Meanwhile, in Credit we expect Levered Loans to outperform High Grade Credit and other longer duration fixed income instruments. Maybe more important, though, given our view that volatility is likely to remain high in 2017, is that we expect Opportunistic Credit to again deliver outsized results. From our vantage point, we think that there is still enough dispersion for thoughtful credit managers to provide returns well in excess of their benchmark in 2017 by digging through the “rubble” in High Yield and Levered Loans. One can see the magnitude of the existing dispersion in Exhibit 93. Parts of the CMBX market also look interesting to us (Exhibit 91).

There Still Seems to Be Value in the Spicier Part of the Credit Market...

<table>
<thead>
<tr>
<th>Discount/Premium as % Above/Below Long-term Median, U.S. Bonds and Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds                      Loans</td>
</tr>
<tr>
<td>Cheap relative to long-term median</td>
</tr>
<tr>
<td>78.5%                      41.8%</td>
</tr>
</tbody>
</table>
| 3.7%                       


We are growing increasingly concerned that – at some point – credit deterioration in any sector, auto-related markets in particular, could turn out to be worse than the consensus is now expecting.
Section IV: Risks/Hedging

Similar to prior years, we have taken time to identify several potential risks that we are watching as well as to provide potential hedging to protect against these risks if they do come to fruition. They are as follows:

Short an equally-weighted basket of Korean won, Turkish lira, and the one-year forward on the Chinese yuan (all relative to the USD): As we have highlighted multiple times in this year’s outlook piece, owning more dollars seems like potentially the most efficient way to solve for many of the tail risks that could adversely affect today’s jubilant market conditions. Without question, our latest visit to Beijing in December 2016 left us feeling even more strongly that China’s currency could continue to sell off more than expected, particularly given higher U.S. rates amidst excessive credit creation relative to nominal GDP in China. At the moment, the one-year forward in the offshore CNH market is priced for 3.5% to 4.0% depreciation versus the U.S. dollar in 2017. However, we expect a move of two to three times that level, given the current pace of capital flight and the recent rates at which the country has burned through reserves trying to maintain an orderly depreciation.

We also think that mounting pressure on the Chinese renminbi could promote further weakening of EM currencies that are exposed to global trade (e.g., Korean won) and/or global capital flows to EM (e.g., Turkish lira). The Turkish lira is one of the few “high carry” shorts that we think can still depreciate further than forwards (which are pricing in more than a seven percent decline for 2017). All told, the average depreciation versus the U.S. dollar has been 15% for the last three years, and we now view the political and economic environment as being in no better shape than previous years. Meanwhile in Korea, exposure to a weakening won is positive carry, given interest rate differentials with the U.S. Given our view of an extremely competitive Asian export environment, we see the Korean won heading lower in 2017.

Buy credit protection at current levels as a low-carry way to gain exposure to a potential default cycle in the U.S., driven by excess lending in U.S. Investment Grade Credit, particularly auto-related.

As we discussed earlier, we have abandoned our Credit over Equity call, which was one of our key messages in 2016. Risk-free rates are now on the rise, while the entry point in terms of spread per unit of leverage is now considerably less attractive than it was last January. As such, we are growing increasingly concerned that – at some point – credit deterioration in many sectors, auto-related markets in particular, could turn out to be worse than the consensus is now expecting. According to the Federal Reserve Bank of New York, subprime auto originations are running at just under $50 billion per quarter on a trailing 12-month basis, which is approaching the record pace of subprime auto-lending we saw during the 2005-2006 period. Importantly, this robust growth in subprime originations is happening at a time when delinquencies in auto loans are increasing and used car prices (which proxy for recovery values) are decreasing.

There are several ways to hedge this risk, but we like investment grade CDX as a hedging vehicle at current levels. Investment grade CDX is trading at just 68 basis points (Exhibit 95), approaching the level of all time tights in Investment Grade Credit last seen during the spring of 2014. We view buying protection at this level as a low-carry way to get exposure to a potential credit cycle driven by the excess lending in subprime auto over the last four years. In fact, U.S. Investment Grade Credit has exposure to the U.S. auto OEMs, credit card issuers and banks, all which should experience direct stress if subprime auto causes a repricing of credit in 2017.

We Want to Gain Exposure to a Potential Credit Cycle, Including the Excess Lending in Subprime Auto During the Last Four Years
Potential play on a basket of U.S. branded consumer staples equities. We believe an elegant way to take advantage of our “sell simplicity” theme is to capitalize on the downside potential of a basket of four large cap branded consumer stocks which has seen substantial inflows from a combination of yield seeking and “min vol” ETF investors. All told, these four names trade with an average P/E valuation of 22.8x and average EV to EBITDA of 14.2x – both measures being more than one standard deviation rich to long-term levels. Moreover, the average dividend yield across the four names is 2.6%, which is well below our 2017 - 2019 forecast for the U.S. 10-year Treasury. If we are right and these stocks do correct more meaningfully in 2017, we believe that the downside could be significant. One can see in Exhibit 96 how far these stocks are currently trading above trend, even after the most recent mini-correction.

EXHIBIT 96
Branded Consumer Products Are an Elegant Way to Take Advantage of Our Sell Simplicity Theme

Branded Equal-weight Consumer Basket P/E Ratio

<table>
<thead>
<tr>
<th>P/E</th>
<th>LT avg.</th>
<th>+/- 1 SD</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td></td>
<td></td>
</tr>
<tr>
<td>14</td>
<td></td>
<td></td>
</tr>
<tr>
<td>16</td>
<td></td>
<td></td>
</tr>
<tr>
<td>18</td>
<td></td>
<td></td>
</tr>
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Data as at December 28, 2016. Source: Bloomberg.

Section V: Conclusion
As we look ahead towards 2017’s investment opportunities, we are most excited by what we see in Private Credit. Despite the threat of future regulatory changes, the illiquidity premium still feels appealing, a feature we do not expect to shift in the near to medium term. Moreover, in a world awash in liquidity, Private Credit is one of the few markets in which we transact where demand still seems to be handily outstripping supply, particularly at the high end of the market. Also, if we are right that volatility extends beyond the currency market to the interest rate market the way we think it will in 2017, then there should be ample opportunity to lean in when the cost of capital has increased for financial sponsors, corporations, and project-based financiers.

We also believe that Real Assets, particularly those with yield and growth, can prosper in the macro backdrop that we envision. Savers still need yield, and the uptick in inflation that we are forecasting should allow Real Assets to regain some pricing power. Separately, we are now balanced in our outlook of Equities versus Credit, but in both asset classes, we continue to suggest selling Simplicity and buying Complexity.

Overall, though, we do not lose sight of the fact that we are undergoing a paradigm shift, and often these types of regime changes do not always transition smoothly. In particular, it appears that we are adding stimulus to the U.S. economy exactly when its labor markets have tightened. Also, while we have been pointing out globalization’s shortcomings for years, we are not sure that swinging wildly in the opposite direction is the cure for what ails global growth.

Finally, there are a lot of policy initiatives, particularly in the United States, where we have limited visibility on how they will play out. Interest deductibility and border tax adjustments are two potential “hot spots” on which to stay focused. Meanwhile, 2016 policy stimulus in China was likely much more potent than the consensus now appreciates, and as such, we will need to study closely how President Xi Jinping deals with slowing economic trends heading into a highly important political landscape in October 2017 (i.e., five of the seven members of China’s Standing Committee could be replaced).

We also do not want to ignore some of the structural issues. At its core, global growth is still being bogged down by poor demographics, heavy debt loads, and excess capacity, none of which can be quickly overcome by lower corporate taxes and deregulation of industry. Said differently, a lot of cyclical stimulus would be required to overcome some of the headwinds that have defined the secular stagnation that the global economy has witnessed in recent years.

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**EXHIBIT 97**

Geopolitical Tensions Are Causing Many to Question Key Issues Like Immigration

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**EXHIBIT 98**

Population Growth Is Concentrated in Frontier Markets, While Many Developed Markets Are Now Expected to Shrink

**EXHIBIT 99**

Productivity Has Been Falling Around the Globe...

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**EXHIBIT 100**

...and Has Actually Been Negative in the United States This Cycle

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If we are wrong and 2017 turns out to be a down year across the global capital markets, then we believe that it will be linked to continued slow productivity amidst a surging U.S. dollar. Specifically, under our bear case, we think that an overly robust dollar becomes financially restrictive both domestically and abroad. A stronger dollar could also likely coincide with higher rates, which may pressure yields not only in the U.S. but also in Europe and Japan. As we have indicated in our outlook, we do not see the dollar’s move getting extreme in our base case, but there are multiple scenarios where it could move beyond its fair value in 2017.
In sum, we still see significant opportunity for our target portfolio to outperform during what we believe will be a structural paradigm shift across the global capital markets in 2017, including more fiscal spending, a greater focus on domestic priorities, increasing deregulation agendas, and heightened interest rate volatility. Tail risks have clearly increased, even under our base case. Said differently, investment-led productivity has to take hold quickly for the aforementioned policies to be effective, and if it does not, then volatility is likely to surge.

Also, as we outlined earlier, many of our models suggest more limited upside to asset class returns than in the recent past. Accordingly, we continue to favor a strategy that takes advantage of idiosyncratic opportunities, particularly those that enjoy better pricing during periods of market dislocations as well as those that harness complexity to their benefit. On the other hand, we continue to shun simplicity and/or areas of the market where we believe recent inflows have been too exuberant, particularly around visibility of earning streams.

"Consistent with this view, we believe that there are four major potentially secular changes that all investment professionals must consider: fiscal stimulus over monetary, domestic agendas over global ones, deregulation over reregulation, and a broadening of outsized volatility from the currency markets to include global interest rate markets."
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