Time to Focus: Five Key Investment Themes

Rising macroeconomic and geopolitical tensions are creating both opportunities and risks for global investors across the entire global capital markets. We continue to emphasize our five key macro themes, many of which we think can perform against a variety of economic backdrops. First, we believe that assets with Yield and Growth will continue to outperform. Second, we would avoid exposures linked to China’s structural slowing, though we do finally see some emerging investment opportunities in China’s ‘new’ export strategy. Third, we see the opportunity for a significant and potentially sustained upward revaluation in the securities of large domestically-oriented economies. Fourth, the dismantling of the traditional financial services industry has emerged as both a blessing and a curse for investors; we outline our approach for navigating this complicated segment of the global economy. Finally, given the bifurcation across markets that we are now seeing, we believe folks should consider increasing exposure to complex stories, including earnings misses, restructurings, and/or corporate repositionings; at the same time we would be selling simplicity in instances where future earnings streams appear over-priced.

What good is the warmth of summer, without the cold of winter to give it sweetness.”

JOHN STEINBECK
AMERICAN AUTHOR
Summer is usually the time of year that allows investors to take a step back and reflect on some of the key long-term trends in our business. However, with Brexit, speculation of helicopter money in Japan, and another punk U.S. GDP reading in Q2 2016, it certainly has felt like anything but vacation time for many in the investment community. That’s the bad news.

The good news, we believe, is that dislocations and distractions create opportunity for our approach to investing. Indeed, recent geopolitical and macro-related events have only increased our conviction about our key investment themes, as well as the upside potential in our current target asset allocation positioning. See below for full details, but we note the following five macro trends on which we believe performance-oriented, multi-asset class investors should focus:

• Interest Rate Outlook: Lower for Longer Continues to Drive the Yawn for Yield and Growth

Without question, we remain in the lower for longer camp regarding rates. Importantly, recent events across Asia and Europe, Brexit in particular, only give us further confidence in our outlook. We also think that it is critical for investors to understand that the Federal Reserve in the U.S. may be signaling that it is now actually at an already modestly accommodative stance, despite rates at a record low and the Fed’s balance sheet at a record high. If we are right, then the traditional neutral level for the Fed Funds rate could be significantly lower than many economists now think. Not surprisingly, against this backdrop, we remain overweight both Opportunistic Liquid Credit and Private Credit, including Direct Lending and Mezzanine/Asset Based Lending. We also favor Real Assets that can produce both Yield and Growth, including Real Estate, Real Estate Credit, and Infrastructure assets such as pipelines, and are three hundred basis points overweight the asset class. One can see our preferences in Exhibit 9.

• Chinese GDP Growth Is Still Slowing; a New Playbook Is Required for Global Trade

Despite temporary periods of economic re-acceleration, we believe that China is structurally slowing. Embedded in this view is our cautious outlook for global trade, particularly as it relates to traditional Chinese imports. On the export side, our research shows that China is making huge inroads into higher value-added exports (Exhibit 25); this transition is a big deal and warrants investor attention for both offensive and defensive reasons in sectors such as telecommunications equipment, healthcare equipment, and optical equipment. At the same time, China appears to be flooding certain global markets with excess capacity in low value-added exports. If we are right, then it is too early to bottom fish in several cyclical industries, particularly those with excess capacity, unless valuations are extremely compelling. We also see additional margin headwinds in industries previously dominated by U.S. and European multinationals. By comparison, we think that there are increasing opportunities to partner with Chinese firms as they expand abroad. Details below.

• Post-Brexit, the Upward Revaluation of Domestic-Facing, Consumer-Oriented Economies Is Coming

In a post-Brexit environment, we expect an upward revaluation of countries that have large domestic-oriented consumer economies, particularly relative to trade-oriented economies that rely more on exports to grow. The United States is clearly the most obvious beneficiary, given its economy’s absolute size as well as the health of its consumers. However, we also anticipate India, Indonesia, and Mexico to be major beneficiaries of this change in investor perception. If we are right, then valuations in these countries could actually hold or even increase from current levels in certain instances.

• The Ongoing Dismantling of Levered Financial Services Intermediaries

Our travels across Europe, the U.S., and parts of Asia lead us to believe that the trend towards traditional financial services companies becoming more “utility-like” is ongoing, given the move towards low/negative rates by central banks as well as the desire by governments for significantly heightened regulation. Somewhat ironically, one outcome of these headwinds across traditional financial services is that credit creation will actually be harder to stimulate, which means central banks will likely have to continue to overcompensate with even more aggressive monetary policy initiatives. The other consequence of the current financial services backdrop is that more and more complex transactions will move into the non-bank market, which could provide significant opportunities for investors to step in and serve as important providers of liquidity.

• Buy Complexity, Sell Simplicity

Given today’s increasingly bifurcated market (one that feels similar to what we saw in 1999/2000 when tech and telecommunications stocks traded expansively at the same time cyclical stocks traded cheaply), we want to move capital to take advantage of the arbitrage we now see between complexity and simplicity. Indeed, despite record highs in the S&P 500, we are increasingly finding attractively complex stories that the market does not like because of limited earnings visibility, increased volatility, and/or cyclically out of favor offerings (Exhibit 41). For our nickel, we think that — with some value-added restructuring, repositioning, and/or “tuck-in” acquisitions — there is a significant opportunity today to dramatically boost valuation by merely improving a company’s earnings visibility, something that the market desperately craves in today’s low rate, slow growth world. On the other hand, it also feels to us that investors are now willing to potentially overpay for earnings visibility and/or yield. Indeed, with simplicity of story being so “hot” right now, we 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.

While we believe that our macro themes can help deliver differentiated relative performance for investors, 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 insight is not, however, “new” news. One can see in Exhibits 1 and 2 that returns have been actually trending down since 2000 in absolute terms, largely consistent with a 41% decline in nominal GDP growth (and interest rates) over the same period. However, with $13 trillion in negative yielding bonds around the globe, we have clearly entered into a new and more complicated era of financial repression. Just consider that, despite accounting for only four percent of the Barclays Multiverse index, U.S. junk bonds now make up almost 20% of total remaining positively yielding bonds in the world.

1 KKR GMAA Target Asset Allocation uses a benchmark similar to that of a large U.S. public pension.

2 Data as of August 18, 2016. Source: FT, Desperate investors turn to US junk bond market.
Returns for Financial Assets (Treasuries, Private Equity, MSCI ACWI and High Yield) Have Been Falling Since 1995

EXHIBIT 1

Trailing 5 Year Average Returns by Main Asset Class, %

- Treasury Returns
- Global PE Return
- ACWI Return
- HY Return


EXHIBIT 2

Five-year Trailing Nominal GDP Growth Rate in the U.S. Has Fallen by More Than 40% Since 2000. Not Surprisingly, Returns Too Have Slipped

EXHIBIT 3

With Bond Yields So Low, Equity Needs to Deliver Double-Digit Returns for Pensions to Come Even Close to Hitting Their Return Hurdles

EXHIBIT 4

Near-Term Returns for the Investment Management Industry Are Likely Headed Lower

We believe we have entered an environment of lower absolute returns for many asset classes.
ment in the outlook for absolute growth and returns, particularly in the developed world, is a reacceleration in long-term productivity trends. Unfortunately, as Exhibits 5 and 6 illustrate, productivity has been consistently declining this cycle. Given that productivity is one of the two key inputs to GDP growth (with labor force growth as the other one, and we do not currently see any major positive changes to immigration policy), recent trends are quite concerning, in our view.

EXHIBIT 5
Productivity Has Been Falling Around the Globe...

![Productivity: 10 Year CAGR, %]

Note: Real GDP growth equals labor force growth times productivity growth. Data as at April 12, 2016. Source: IMF, UN, Haver Analytics.

EXHIBIT 6
...and Has Actually Been Negative In the U.S. This Cycle

![Productivity Growth Comparison, %]

Note: Real GDP growth equals labor force growth times productivity growth. Data as at April 12, 2016. Source: IMF, UN, Haver Analytics.

EXHIBIT 7
U.K. CFOs’ Confidence Has Fallen to the Lowest Ever Level

![U.K. CFO Survey Next 12 Months, % (Axis Inverted)]

Data as at June 30, 2016. Source: Deloitte LLP, Haver Analytics.

EXHIBIT 8
“Uncertainty” Is Driving Defensive (Simplicity) Outperformance; We Now Favor Complexity

![U.S. Policy Uncertainty Index and Performance of Russell Defensive / Small Cap]

Beyond the need for a notable improvement in productivity, we also think some clarity around the global political landscape is now required too. Unfortunately, however, we do not see an imminent improvement in this area. For starters, we are still poised to have a divisive election in the United States; maybe more important, though, is that we also face surprisingly murky electoral outlooks across Italy, the Netherlands, Germany and France during the next 12-18 months. In each of these markets, protectionism, anti-immigration, and populism will likely feature prominently, we believe. Finally, we face increasing global uncertainty from the emergence of “strong men” leaders such as Vladimir Putin, Xi Jinping, and Recep Tayyip Erdoğan. Importantly, all these games of political chess are occurring at a time of notable instability across the Middle East.

In our view, it is the unusual — and sometimes unsettling intersection of all these macroeconomic and geopolitical forces — that still keeps us in an environment that we refer to as Adult Swim Only. As such, we continue to favor an asset allocation that rewards yield, embraces volatility, and tilts more idiosyncratic in nature at this point in the cycle. To this end, our most significant overweight positions include Private Credit, Opportunistic Liquid Credit, and select parts of Real Assets. One can see this in 

**EXHIBIT 9**

Select Overweight Positions in KKR GMAA’s 2016 Target Asset Allocation

<table>
<thead>
<tr>
<th>ASSET OR SUB-ASSET CLASS</th>
<th>KKR GMAA JUNE 2016 TARGET, %</th>
<th>STRATEGY BENCHMARK</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. PUBLIC EQUITIES</td>
<td>22</td>
<td>20</td>
</tr>
<tr>
<td>DIRECT LENDING</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>REAL ASSETS</td>
<td>8</td>
<td>5</td>
</tr>
<tr>
<td>ACTIVELY MANAGED OPPORTUNISTIC CREDIT</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>DISTRESSED / SPECIAL SITUATION</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>MEZZANINE / ASSET BASED LENDING</td>
<td>3</td>
<td>0</td>
</tr>
</tbody>
</table>

Please note that as of December 31, 2015 we have recalibrated Asia Public Equities as All Asia ex-Japan and Japan Public Equities. Strategy benchmark is the typical allocation of a large U.S. pension plan. Data as at July 31, 2016. Source: KKR Global Macro & Asset Allocation (GMAA).

If we are wrong in our outlook and growth reaccelerates more than expected, we think that returns across risk assets will ultimately be capped. Key to our thinking is that sustained stronger global growth would turn central bankers more hawkish (or at least less dovish), which likely would not be good for the global capital markets, currencies and rates in particular. As such, our base case remains a volatile backdrop that never fully favors the bulls or the bears, lending support to our base view that the global economy — and the capital markets that support it — remains in an asynchronous recovery.

**DETAILS**

In the following section we provide both further analyses on the key macro themes mentioned above as well as what we believe to be the key investment implications.

**Interest Rate Outlook: Lower for Longer Continues to Drive the Yearn for Yield and Growth**

Since we arrived at KKR in 2011, we have been pushing our Brave New World thesis (see Brave New World: The Yearning for Yield Across Asset Classes, December 2011), which we originally developed during our time at Morgan Stanley in macro strategy during the 2004-2007 period. Our basic premise has been — and remains — that secular macro forces, disinflation and demographics in particular, would ultimately drive an upward revaluation of securities that could provide investors with both yield and earnings growth. Put another way, the cash flow required to grow the dividend needs to be regenerative in nature, as we think that investors would ultimately shun levered entities that just squeeze yield out of a declining stream of cash from operations.

Whether we have been lucky or good, our Brave New World thesis has played out nicely in recent years. Today, however, we have begun to wonder whether this investment theme has fully run its course, given that the global capital markets are now filled with more than $13 trillion in negative yielding fixed income securities as well as many dividend yielding equities trading with valuations north of 20 times.³

To be sure, one has to be more selective at this stage in the cycle (including buying complexity), but our base view remains that technical forces are likely to win out over fundamentals in the near term, given that central bank buying is now overwhelming supply. One can see this in Exhibit 10, which shows that net issuance minus quantitative easing (QE) has actually shrunk to negative $300+ billion, compared to positive net issuance less QE of $1.1 trillion in 2011.

³ Data as at July 31, 2016. Source: Bloomberg.

**We believe that the Federal Reserve may be signaling that it is now actually at an already modestly accommodative stance; if so, then the traditional neutral rate for the Fed Funds rate could be significantly lower than many economists now think.**
**EXHIBIT 10**

**G4 Aggregate Net Issuance Is Now Actually Negative**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Net Issuance in U.S.$B Equivalents</th>
<th>Y/Y % Change</th>
<th>Central Bank Purchases</th>
<th>Y/Y % Change</th>
<th>Net Issuance Less QE</th>
<th>Y/Y % Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>2,446</td>
<td></td>
<td>1,300</td>
<td>1,146</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td>2,064</td>
<td>-16%</td>
<td>1,508</td>
<td>16%</td>
<td>557</td>
<td>-51%</td>
</tr>
<tr>
<td>2013</td>
<td>1,890</td>
<td>-8%</td>
<td>1,063</td>
<td>-29%</td>
<td>826</td>
<td>48%</td>
</tr>
<tr>
<td>2014</td>
<td>1,482</td>
<td>-22%</td>
<td>809</td>
<td>-24%</td>
<td>674</td>
<td>-18%</td>
</tr>
<tr>
<td>2015</td>
<td>1,044</td>
<td>-30%</td>
<td>1,091</td>
<td>35%</td>
<td>-48</td>
<td>-107%</td>
</tr>
<tr>
<td>2016E</td>
<td>1,045</td>
<td>0%</td>
<td>1,414</td>
<td>30%</td>
<td>-369</td>
<td>-669%</td>
</tr>
<tr>
<td>2017E</td>
<td>987</td>
<td>-6%</td>
<td>1,360</td>
<td>-4%</td>
<td>-373</td>
<td>-1%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>10,958</td>
<td></td>
<td>8,545</td>
<td></td>
<td>2,413</td>
<td></td>
</tr>
</tbody>
</table>

G4 equals U.S., Japan, U.K., Euro (Germany, France, Italy, Spain, Netherlands, Austria, Finland, Belgium, Greece, Ireland, Portugal). QE = quantitative easing. Data as at July 23, 2016. Source: National Treasuries, Morgan Stanley Research.

**EXHIBIT 11**

**More Than a Third of Developed Market Bonds Now Have Negative Yields**

<table>
<thead>
<tr>
<th>Country</th>
<th>% of Negative Yielding Government Securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.K.</td>
<td>0%</td>
</tr>
<tr>
<td>U.S.</td>
<td>16%</td>
</tr>
<tr>
<td>Spain</td>
<td>19%</td>
</tr>
<tr>
<td>Italy</td>
<td>36%</td>
</tr>
<tr>
<td>TOTAL DM</td>
<td>36%</td>
</tr>
<tr>
<td>Slovakia</td>
<td>44%</td>
</tr>
<tr>
<td>Slovenia</td>
<td>49%</td>
</tr>
<tr>
<td>Belgium</td>
<td>56%</td>
</tr>
<tr>
<td>Ireland</td>
<td>57%</td>
</tr>
<tr>
<td>Denmark</td>
<td>63%</td>
</tr>
<tr>
<td>France</td>
<td>66%</td>
</tr>
<tr>
<td>Austria</td>
<td>67%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>74%</td>
</tr>
<tr>
<td>Finland</td>
<td>74%</td>
</tr>
<tr>
<td>Japan</td>
<td>80%</td>
</tr>
<tr>
<td>Germany</td>
<td>84%</td>
</tr>
<tr>
<td>Sweden</td>
<td>84%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>97%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>100%</td>
</tr>
</tbody>
</table>


Importantly, we believe these statistics are likely to be revised downward (i.e., more shrinkage) following the Bank of England’s recent announcement on August 4, 2016 (BoE will be buying £60 billion additional gilts as well as £10 billion of corporate bonds). Also, we expect the European Central Bank to initiate some additional easing measures on September 8th, 2016; at the same time, we look for intensifying efforts from the Bank of Japan to buy both equity and fixed income products.

Beyond the aforementioned quantitative easing, there is another influence that shapes our view on our lower for longer thesis regarding rates. Specifically, despite a lot of the recent banter in the press surrounding the potential for higher rates, we are increasingly of the mindset that the Federal Reserve is closer to the real neutral rate through the cycle than many investors may now think. One proxy to measure this viewpoint is the Atlanta Fed, which shows that something akin to 75-85 basis points is where the neutral rate may be. One can see this in Exhibit 12.

We also believe that the Fed is sending important signals about how long and how low short-term rates may stay. At the June 2016 FOMC press conference, Federal Reserve Chairwoman Janet Yellen succinctly said that “there are long-lasting, more persistent factors that may be at work that are holding down the longer-run level of neutral rates.” She followed up by indicating that “It could stay low for a prolonged time... All of us are in a process of constantly reevaluating where the neutral rate is going, and what you see is a downward shift over time, that more of what is causing this to be low are factors that will not be disappearing.” Not surprisingly, given all these types of remarks as well as sluggish growth, the Fed Funds rate is now below one percent, and we think it will stay there over most of the time through 2020. One can see this in Exhibit 13.

**EXHIBIT 12**

**Some Fed Measures Suggest That Much of the Requisite Tightening Has Already Occurred**

Note: Unlike the observed federal funds rate, the shadow rate does not have a zero lower bound because it accounts for other monetary policy tools beyond rate cuts. Data as at July 31, 2016. Source: Federal Reserve Board, Federal Reserve Bank of Atlanta, National Bureau of Economic Research, Haver Analytics.
We Think That the Fed Funds Rate Could Trend Below One Percent Until At Least 2020

We think central tendency of Fed Funds could remain below 1.0% until 2020

Separately, Fed Governor John C. Williams recently authored a somewhat provocative essay that indicated that new important forces, such as global supply, shifting demographics and slower trend productivity, would all lead to a lower neutral rate. “The key takeaway from these global trends is that interest rates are going to stay lower than we have come to expect in the past,” he wrote. Interestingly, he also noted that, “…this future low level of interest rates is not due to easy monetary policy; it is the rate expected to prevail when the economy is at full strength and the stance of monetary policy is neutral.”

Against this backdrop, we think that the asset allocation implications of our thesis are quite significant for long-term investors. Specifically, we think that the opportunity for a traditional 60/40 equity/bond strategy to achieve a seven or eight percent return for its constituents is now quite limited. Indeed, if bond yields stay flat or increase from current levels, then public equities would have to return 10% or more per annum for most allocators of capital to meet their hurdle rates, a feat we see as highly unlikely after seven straight up years in the S&P 500 (Exhibit 15).

Including 2016 YTD, the S&P 500 Has Actually Delivered Positive Returns for Eight Years, Which Is Highly Unusual

---


---

Data as at August 10, 2016. Source: Federal Reserve Board, KKR Global Macro & Asset Allocation analysis.


Data as at December 31, 2015. Source: Standard & Poor’s, Shiller data.
EXHIBIT 16

We Are Leaving a Period of Very Strong Returns For Traditional Asset Allocation Programs


Given this outlook, our strong belief is that there will be a meaningful shift in allocation strategies by certain pensions, endowments, and even individual investors. For our nickel, we think that most major allocators of capital will likely shift from a diversified cross-asset strategy (including both active and passive) towards more of a barbell one that includes: 1) active, idiosyncratic managers that can truly deliver either alpha and/or operate in a market of higher returns relative to traditional liquid assets; and 2) extremely low-cost index funds that maximize beta exposure with limited tracking error. If we are right, then tolerance for performance mediocrity, particularly for liquid products with periodic drawdowns of significance, will become quite limited.

On the other hand, we think that the opportunity set for certain managers, particularly in private credit, is large and growing. Indeed, in an environment where the risk-free rate is near zero in real terms and between one and two percent in nominal terms, the opportunity to pick up three percent via an illiquidity premium (Exhibit 17), particularly if there is sound credit underwriting, is quite attractive, in our view, against a traditional seven to eight percent hurdle rate. Private equity too should benefit in both developed and emerging markets. Within the public equity markets, we are finally beginning to see more value in EM markets than DM markets. One can see the basis for our argument in Exhibit 18 which shows that some mean reversion might be likely after 70 consecutive months of EM under-performance.

EXHIBIT 17

Given Changes in the Banking Sector, We View the Illiquidity Premium as More Secular Than Cyclical

Data as at June 30, 2016. Source: Bloomberg, Ares company filings, KKR Credit.

"We do worry that the inability of banks to earn their cost of capital means that their capacity to repair their balance sheets by issuing accretive equity has vanished."
If the Fed Is Now More Dovish, the Long Drought in EM Underperformance Could Finally Be Over

Chinese GDP Growth Is Still Slowing; a New Playbook Is Required for Global Trade

Anybody who has had the opportunity to read our Insights papers in recent years knows that we feel strongly that China has endured a distinctly hard landing when it comes to nominal GDP growth. Indeed, one can see the severity of the trend in Exhibit 20, which shows that nominal GDP has actually fallen over 12 percentage points since 2Q11, compared to “just” the 3.3 percentage point decline that many sell-side forecasts use when describing real GDP during the same period. A decline of such magnitude in nominal terms is a big deal. In particular, from the perspective of an owner and operator of businesses, nominal — not real — is what matters because the revenues that cover overhead, pay employees, and hopefully generate a profit for investors are measured in nominal, not real terms.

We see the opportunity for a significant and potentially sustained upward revaluation in the securities of large domestically-oriented economies.

Nominal GDP Growth in China Has Fallen a Full 12.4% in Absolute Terms Since 2Q11, While Real GDP Has Slipped a More Modest 3.3%

That China’s overall growth at this point is slowing is certainly not “new” news to investors, we fully acknowledge. What we believe may not be fully understood are all the long-term consequences and long-term nature of this slowdown. We see several important ones to consider. First, as we show in Exhibit 19, global trade is slowing as China downshifts. To be sure, some of this reduction is linked to lower commodity prices, but there is another factor to consider. From what we can tell (and our data shows), China is also insourcing more of its production of intermediate goods, which means it now relies less on ships, planes, and content from its traditional trading partners. One can see the magnitude of this shift in Exhibit 21.
The Gap Between Imports and Exports in China Continues to Widen...

EXHIBIT 21

<table>
<thead>
<tr>
<th>China: LTM Current Account Balance, U.S.$B (L)</th>
<th>China Exports as a % of Global Exports, 12mma (R)</th>
<th>China Imports as a % of Global Imports, 12mma (R)</th>
</tr>
</thead>
</table>

Data as at March 31, 2016. Source: IMF, State Administration of Foreign Exchange, Haver Analytics.

EXHIBIT 22

...Notably, the Mix of Imports Is Shifting Towards Consumers and Away From Investment-related Goods

EXHIBIT 23

China Is Rebalancing to Higher Value Add Exports; We Now Think That Investors Should Focus on Facilitating - Not Fighting - This Transition

Data as at July 31, 2016. Source: China Customs, Haver Analytics.

Even within its import sector, China is importing less traditional goods and services. Indeed, as Exhibit 22 shows, investment-related imports have fallen to 60% in June 2016 from a peak of 67% in October 2008. On the other hand, consumer-related imports have jumped to 40% from 33% over the same period. We look for both trends to gain momentum in the quarters ahead.

Another important issue to consider is that less global trade means less foreign direct investment (FDI). Interestingly, a larger percentage of FDI is now coming from countries like China moving assets overseas than developed market economies putting fresh capital into fast-growing emerging markets. For example, in 2013 and 2014, Greater China’s cross border M&A made up 28% and 24% of world cross-border M&A, respectively.\(^5\) Trends of late have been even more powerful, as China’s outbound direct investment surged to $64B in 2Q16 from just $9B in 1Q11 and zero (yes zero) in 1Q07.\(^6\)

5 Greater China includes China, Hong Kong, Taiwan, and Macao. Source: UNCTAD.


From our vantage point, China’s slowdown is secular, not cyclical, and we see continued pricing pressure amidst slower activity across not only Asia but parts of Europe and Latin America.
Outward FDI Has Started to Flow from the EM World to the DM World

In terms of investment implications, there are several things to consider, in our view. First, we generally think that much of the commodity complex linked to China’s aggressive build-out during the last decade is likely to remain under pressure. Key commodities to potentially avoid, in our view, include iron ore, steel, and coal, all of which we still expect to trade flat to down in the coming quarters. Consistent with this view, we also think that many of China’s traditional trading partners, particularly those with an old economy interface, are not as well positioned to benefit from the country’s shift towards more consumer-oriented imports. This shift in focus by the Chinese is a big deal, in our view, and it will likely put additional pressure on much of South East Asia’s existing export product suite.

There are also unanticipated knock-on effects. For example, given the slowdown in China’s exports as well as the shift in its import mix, we remain leery that excess capacity in over-built areas such as ships and logistics may not snap back as quickly as the consensus now thinks. Separately, as China moves up the value chain in terms of value-added offerings (Exhibit 25), it is likely to increase competition, denting margins of well-known incumbents in key markets like the U.S. and Europe. If we are right, then shareholder returns for publicly traded companies in certain key markets could be at risk, we believe.

"We continue to favor an asset allocation that rewards yield, embraces volatility, and tilts more idiosyncratic in nature."

EXHIBIT 24

China Is Gaining Dominant Global Market Share in Higher Value-Added Sectors as Well as Moving Into New Important Growth Sectors

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>TELCO EQUIPMENT</td>
<td>3%</td>
<td>6%</td>
<td>30%</td>
<td>38%</td>
<td>32.9%</td>
</tr>
<tr>
<td>OPTICAL INSTRUMENTS AND APPARATUS</td>
<td>5%</td>
<td>8%</td>
<td>29%</td>
<td>37%</td>
<td>28.7%</td>
</tr>
<tr>
<td>HOUSEHOLD TYPE EQUIPMENT</td>
<td>4%</td>
<td>10%</td>
<td>30%</td>
<td>37%</td>
<td>26.5%</td>
</tr>
<tr>
<td>VAPOR GENERATING BOILERS, AUXILIARY PLANT; PARTS</td>
<td>1%</td>
<td>4%</td>
<td>32%</td>
<td>24%</td>
<td>20.4%</td>
</tr>
<tr>
<td>MOTORCYCLES AND CYCLES</td>
<td>5%</td>
<td>12%</td>
<td>27%</td>
<td>31%</td>
<td>19.6%</td>
</tr>
<tr>
<td>ELECTRIC POWER MACHINERY, AND PARTS THEREOF</td>
<td>7%</td>
<td>10%</td>
<td>23%</td>
<td>29%</td>
<td>19.4%</td>
</tr>
<tr>
<td>MINERAL MANUFACTURE</td>
<td>2%</td>
<td>2%</td>
<td>9%</td>
<td>17%</td>
<td>15.2%</td>
</tr>
<tr>
<td>RAILS AND RAILWAY TRACK CONSTRUCTION MATERIAL</td>
<td>2%</td>
<td>4%</td>
<td>10%</td>
<td>18%</td>
<td>14.0%</td>
</tr>
<tr>
<td>CIVIL ENGINEERING AND CONTRACTORS’ PLANT AND EQUIPMENT</td>
<td>1%</td>
<td>1%</td>
<td>8%</td>
<td>12%</td>
<td>10.5%</td>
</tr>
<tr>
<td>ELECTRO-DIAGNOSTIC APPARATUS FOR MEDICAL SCIENCES</td>
<td>0%</td>
<td>1%</td>
<td>5%</td>
<td>8%</td>
<td>7.0%</td>
</tr>
</tbody>
</table>


Given this backdrop, we think that an opportunity on the positive side of the ledger, particularly for global private equity firms and certain multinationals, is to partner with Chinese companies looking to expand abroad. In many instances, European and U.S. firms can provide local knowledge about consumer behavior, help to overcome regulatory hurdles, and teach operational best practices. Chinese firms will also need help with mergers and acquisitions, which should drive incremental need for local strategic advice, financings, and management talent.

The Upward Revaluation of Domestic-Facing, Consumer-Oriented Economies

While many investors are focused on the negative long-term ramifications of Brexit, including slower global trade, less tolerance around immigration, and growing social/economic discord, we see an important silver lining. Specifically, we think that there will be a notable upward revaluation opportunity in the economies of countries with large domestic markets that are less affected by many of the aforementioned macroeconomic concerns. Key to our thinking is that investors increasingly do not want to be dependent on economies that are overly reliant on global connectivity (i.e., trade and/or flows)
to deliver growth. Said differently, after the boom in globalization that we have seen over the past 20-30 years, we now think that intensifying geopolitics and macroeconomic concerns may lower the risk premium for countries that do not have to depend on outside forces to sustain their current way of living.

A favorite within our framework is the United States, which we keep as the one overweight position within Public Equities (where we are actually underweight as an asset class) in our target asset allocation. We see several important positives to consider:

**U.S. housing is still well below trend** See below for details, but we continue to think that U.S. residential construction is one of the least cyclically extended areas of the global economy. Just consider that we estimate that residential construction is currently near a historic low of just 55% of structural demand. By comparison, we estimate that construction activity was running at 116% and 115% of true structural demand in 1986 and 2005, respectively (which were the big housing busts). As such, we retain the bullish outlook we laid out on the housing sector and its subcomponents dating back to *U.S. Housing: A Changing Dynamic*, March 2012.

**The U.S. consumer is in much better shape** From our vantage point, it appears that the U.S. consumer has been acting — well — very “un-American” during the current expansion. Indeed, 86 months into a recovery, savings rates are going up, not down; at the same time, consumption of basic consumables is running well below trend. Also, given low rates and improving net worth, debt service burdens have actually reached historic lows. However, the consumer is spending, but as we detail below, investors should focus more on businesses that can deliver value-added experiences to the consumer.

**U.S. corporate profits are not so far above trend relative to prior cycles** After essentially no earnings growth during the last 36 months in the U.S., it is abundantly clear we have not had the typical broad-based earnings recovery that defines the average cycle. In fact, earnings growth for the S&P 500 has delivered just a 2.6% CAGR in EPS since 2009, compared to a solid 15% during the prior cycle. To be sure, margins are now high across several sectors, but earnings relative to nominal GDP suggest less of a shock than what investors endured in the 1987 and 2007 downturns.

**We have already experienced a manufacturing/trade recession in the United States** With China’s notable slowing reverberating across Asia as well as the oil “bust” in the U.S., many parts of the manufacturing sector have already experienced peak to trough declines in their businesses. To be sure, manufacturing does not hold the same influence in the U.S. the way it did in the past, but it is still an important part of the U.S. economy. Moreover, until recently the energy industry and its related sectors were key drivers of U.S. capital expenditures. Specifically, we estimate that roughly 15% of total U.S. investment growth from 2011 to 2014 was related to the shale revolution. Today, by comparison, rig count in the U.S. is now just 408, compared to a peak of 1,608 in October 2014, supporting our view that an important part of the U.S. manufacturing/commodity sector has already experienced a major boom-to-bust cycle.

---

**EXHIBIT 26**

**Consumption In the U.S. Is Almost 70% of GDP and Far Outpaces Other Global Economies**

<table>
<thead>
<tr>
<th></th>
<th>PRIVATE CONSUMPTION (US$ TRILLIONS)</th>
<th>CAGR 2015 VS. 2005 (%)</th>
<th>PRIVATE CONSUMPTION AS A % OF GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>2015</td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S.</td>
<td>8.8</td>
<td>12.3</td>
<td>6.9% 68.4%</td>
</tr>
<tr>
<td>JAPAN</td>
<td>2.5</td>
<td>2.4</td>
<td>-0.3% 59.0%</td>
</tr>
<tr>
<td>GERMANY</td>
<td>1.6</td>
<td>1.8</td>
<td>2.6% 53.0%</td>
</tr>
<tr>
<td>U.K.</td>
<td>1.5</td>
<td>1.8</td>
<td>4.2% 63.1%</td>
</tr>
<tr>
<td>FRANCE</td>
<td>1.2</td>
<td>1.3</td>
<td>2.6% 54.0%</td>
</tr>
<tr>
<td>CHINA</td>
<td>0.9</td>
<td>3.7</td>
<td>31.9% 33.9%</td>
</tr>
<tr>
<td>BRAZIL</td>
<td>0.6</td>
<td>1.0</td>
<td>11.6% 54.1%</td>
</tr>
<tr>
<td>AVERAGE</td>
<td></td>
<td></td>
<td>8.5% 55.1%</td>
</tr>
</tbody>
</table>

---

**EXHIBIT 27**

**The Savings Rate Is Now More Than Double 2007 and On Par with the Beginning of the Last Cycle (2003)**

---

8 Data as at August 24, 2016. Source: Bloomberg.
Historically, Residential Construction Downturns Have Been Split Between Mild and Extreme

**EXHIBIT 28**

Peak-to-Trough Change in U.S. Housing Starts

<table>
<thead>
<tr>
<th>Year</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>'86-91</td>
<td>-44%</td>
</tr>
<tr>
<td>'94-95</td>
<td>-6%</td>
</tr>
<tr>
<td>'99-00</td>
<td>-4%</td>
</tr>
<tr>
<td>'05-09</td>
<td>-73%</td>
</tr>
</tbody>
</table>

When housing activity is running near structurally low levels, the cyclical downturns tend to be mild.

Data as at July 19, 2016. Source: Census Bureau, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Beyond the U.S., we think that investors should too consider increasing exposure to some of the larger consumer-facing EM economies, including Indonesia, India, and Mexico. Indeed, as we show in Exhibit 30, these three economies have, on average, a full 62% of their economies, or $2.5 trillion in absolute buying power, linked to domestic consumption, which should provide them with more of a buffer than many other countries to the slowdown in trade, cross-border flows, and China growth that we continue to forecast. They are all fast growing, representing a major force in the 16% increase in EM’s share of total global consumption since 2003.10

**EXHIBIT 29**

The Mild GDP Downturns Tend to Occur When Construction Activity Isn’t Structurally Excessive, Which Is Clearly the Story Today

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>116%</td>
</tr>
<tr>
<td>1994</td>
<td>81%</td>
</tr>
<tr>
<td>1999</td>
<td>96%</td>
</tr>
<tr>
<td>2015</td>
<td>55%</td>
</tr>
<tr>
<td>2020e</td>
<td>85%</td>
</tr>
</tbody>
</table>


**EXHIBIT 30**

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

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>HOUSEHOLD CONSUMPTION IN U.S.$ TRILLIONS</th>
<th>% CHANGE FROM 2005 TO 2015</th>
<th>CONSUMPTION AS A % OF GDP, 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>INDIA</td>
<td>0.5</td>
<td>150%</td>
<td>59%</td>
</tr>
<tr>
<td>INDONESIA</td>
<td>0.2</td>
<td>167%</td>
<td>57%</td>
</tr>
<tr>
<td>MEXICO</td>
<td>0.6</td>
<td>35%</td>
<td>69%</td>
</tr>
<tr>
<td>U.S.</td>
<td>8.8</td>
<td>40%</td>
<td>68%</td>
</tr>
</tbody>
</table>


**EXHIBIT 31**

As a Macro Theme, We See Global Capital Supporting/Improving Valuations in Large Domestic Economies

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>Forward Price-to-Earnings Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>17.4</td>
</tr>
<tr>
<td>India</td>
<td>19.0</td>
</tr>
<tr>
<td>Mexico</td>
<td>18.7</td>
</tr>
<tr>
<td>Indonesia</td>
<td>16.9</td>
</tr>
</tbody>
</table>

Data as at July 31, 2016. Average since January 2006. Shaded area represents +/- one standard deviation. Source: Bloomberg.

* Structural housing demand is a KKR GMAA estimate composed of the following:
  1. Structural demand from household formation: This is the demand that would come from pure population growth, assuming no change in household headship rates (grouped by age decile) vs. the prior year
  2. Structural demand from scrappage: This is the demand that would come from the scrappage of existing housing stock, assuming that it is scrapped at the 10yr trailing average rate relative to the total housing stock

e = KKR GMAA estimate. Data as at July 19, 2016. Source: Census Bureau, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Global Household Consumption Has Roughly Doubled Since 2013; EM Consumption Is Now Growing 3x as Fast as DM Consumption

EXHIBIT 32

Global Household Consumption (U.S.$ Trillions)


EM Share of Global Consumption Has Exploded in Recent Years, Despite a More Sluggish Growth Environment

EXHIBIT 33

Emerging Market Consumption as a % of Global Consumption

Since 2003, EM’s share of global consumption has grown 16.1 ppt


If we are correct in the notable change in investment perception that we are forecasting, then the long-term implications are significant. Specifically, large, consumer-oriented countries could see their valuation multiples stay at the high end of their historical ranges—or even increase further—as global investors reallocate towards more stable, consumer-oriented economies. Under this outcome (which we think likely), multiples are not likely to contract quite as much during recessions, which mean trough multiples could be higher than in the past (Exhibit 31).

In our view, another point to consider is that strategic buyers are likely to deploy more capital into these economies, which means cross-border M&A could accelerate further. Importantly, we expect to see both private and strategic capital intensify their focus on these countries. Finally, with a backdrop of a more dovish Fed, local currencies and bond yields in these economies are likely to remain well bid, which should help with cost of capital decisions, particularly those linked to refinancing opportunities.

The Ongoing Dismantling of Levered Financial Services Intermediaries

Over the years we have had the good fortune to meet with a variety of central bank officials from around the world. Inevitably, after the obligatory deep-dive into growth and inflation trends, our discussions turn towards interest rates and the banking system. To date—and despite a lot of attempts to sway our thinking—we still have not had anyone convince us that Negative Interest Rate Policy (NIRP) makes sense. Simply stated, we believe that negative rates fundamentally violate the unwritten—but fundamental—tenets of financial services theory that:

- A bank should be able to make money from holding risky inventory;
- Users of capital should be charged some economic “rent” for borrowing capital

Beyond negative rates, we also note that reregulation has become a major negative headwind for banks in two ways. First, as we show in Exhibit 34, banks have paid out nearly 14% of their equity in fines since 2009. In addition, banks are increasingly being forced to hold huge sums of money against their positions, which all but ensures an inability to earn their costs of capital. One can see this in Exhibit 35.

What we believe is really needed to sustain an improvement in the outlook for absolute growth and returns, particularly in the developed world, is a reacceleration in long-term productivity trends.

“...
Seven Years of Fines Have Taken a Heavy Toll on Banks, Wiping Out the Equivalent of 14% of Total Equity Capital

EXHIBIT 34

Ten Banks Total Equity Capital

Loss Due to Fines and Penalties 14%

Ten Banks include Barclays, Bank of America, Citigroup, Credit Suisse, Deutsche Bank, GS, HSBC, JPM, MS and UBS. Data as at March 27, 2016. Source: FT, Corlytics.

EXHIBIT 35

Banks Have Built Over $100 Billion of Common Equity Between 2012 and 2015, Deteriorating Their Core ROEs by At Least 100 Basis Points

EXHIBIT 36

The U.S. Yield Curve Is Actually Still Steep Relative to the Eurozone, the U.K. and Japan

EXHIBIT 37

Given Current Valuations, Capital Raises Across the Global Banking Industry Are Now Dilutive

Without question, we are all living in an unusual time when a bank’s cost of capital is actually rising as its leverage profile is declining. As a result, today banks can only issue dilutive equity (i.e., below book value, as shown in Exhibit 37), which ensures that they may not be able to create the necessary equity buffer required to sustain a cyclical downturn in credit quality.

For investors, we think that the most actionable opportunity is to participate as a substitute lender where complex transactions are moving off-market. We see this opportunity best presenting itself in the direct lending arena, which often includes mid-market financings, acquisitions, and divestitures. In addition, within the asset-based
finance market, we believe there are a growing number of off-market financings now occurring, including first or second lien loans with some form of upside equity participation.

Separately, given that we continue to forecast slow nominal GDP, we think that the potential for non-performing loans to increase, particularly in regions where nominal lending growth is still running well above nominal GDP growth, is significant. If we are right, then distressed credit and restructuring managers in markets ranging from Italy to Greece to China to India should prosper, especially if we are right about a more synchronized global economic slowdown in 2018. Finally, unless central bank strategy shifts in major markets like Japan and Europe, we think that the opportunity for active management across both public and private markets to outperform relative to static benchmarks (the lion’s share of which are heavily weighted towards banks) is now quite significant. Implicit in what we are saying is that services-based investments, particularly those that are levered to rising GDP-per-capita, are likely to outperform spread lending institutions in today’s low rate world.

**EXHIBIT 38**

Current Bank Market Capitalizations In Europe Appear Notably Sub-Scale Relative to Their Asset Bases

<table>
<thead>
<tr>
<th>Year</th>
<th>Europe</th>
<th>U.K.</th>
<th>U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec-07</td>
<td>10%</td>
<td>20%</td>
<td>40%</td>
</tr>
<tr>
<td>Dec-08</td>
<td>20%</td>
<td>30%</td>
<td>50%</td>
</tr>
<tr>
<td>Dec-09</td>
<td>30%</td>
<td>40%</td>
<td>60%</td>
</tr>
<tr>
<td>Dec-10</td>
<td>40%</td>
<td>50%</td>
<td>70%</td>
</tr>
<tr>
<td>Dec-11</td>
<td>50%</td>
<td>60%</td>
<td>80%</td>
</tr>
<tr>
<td>Dec-12</td>
<td>60%</td>
<td>70%</td>
<td>90%</td>
</tr>
<tr>
<td>Dec-13</td>
<td>70%</td>
<td>80%</td>
<td>100%</td>
</tr>
<tr>
<td>Dec-14</td>
<td>80%</td>
<td>90%</td>
<td></td>
</tr>
</tbody>
</table>

Data as at June 30, 2016. Source: Bloomberg.

**EXHIBIT 39**

Central Bank Policy Towards Negative Rates Has Significantly Affected Bank Performance

**Buy Complexity, Sell Simplicity**

As we mentioned in our mid-year update (see Adult Swim Only: 2016 Mid-year Update, June 2016), we believe that the market is now potentially over-pricing assets with steady cash flows, while under-paying for complexity, particularly around cyclical earnings, conglomerates, and/or busted deals. On the one hand, there are an increasing number of opportunities to monetize cash flows on long-term investments, particularly in areas such as Real Estate, Infrastructure, and Private Equity. Specifically, there have been more and more opportunities to carve out and sell certain long-term leases at low cap rates and use proceeds to essentially de-risk much of the overall real estate investment project. On the other hand, we see forced sellers across the private markets that need capital to avoid downgrades and/or reposition their businesses to compete more effectively. Importantly, this opportunity set is a global one; in fact, we actually believe that there will be more near-term activity surrounding complex situations in Europe and Asia, Japan in particular, than in the United States over the next 12 months. Key to our thinking is that slower growth in Japan and Europe are forcing executives in these regions to think more thoroughly through the strategic value of their existing footprints.

Looking at the big picture, our base view is that a 1998-2000 analogy is a good one to use. In 1998, the Federal Reserve eased, which fueled a concentrated bet into speculative technology and telecom stocks at the same time that many other parts of the market became extremely unloved. Just consider that in the fall of 1998 (right before the China Growth Miracle unfolded), Caterpillar was trading at 9 times depressed earnings, while Deere was trading at 8 times near-trough earnings. At the same time, however Cisco and Microsoft commanded multiples of around 48 times forward earnings. Meanwhile, the S&P 500 was trading 21 times, so these technology multiples were over 200% of the market’s elevated multiple, while
CAT was at 50% of the market’s multiple. This was right before the decade that saw CAT’s earnings triple.

Today, we see yield — not high flying technology and telecommunications stocks per se — getting expensive. Just consider that at 1.5%, the 10-year Treasury trades at ~66 times its yield, while U.S. Utility stocks trade at 20 times earnings. A similar revaluation has occurred in the U.S. REIT sector.

While we do expect rates to remain low, we are increasingly of the mindset that investors are starting to overpay for the forward earnings stream of many yield-oriented equity securities. If we are right, investors could — similar to 1999 — end up buying great companies that prove to be less stellar investments because the entry multiple was just too high to provide solid, above average performance.

Utilities in the U.S. Are Trading at 20x Forward EPS. In General, We Are a Seller of Simplicity/Visibility of EPS

EXHIBIT 40

Bottom Quintile Performing Stocks in the S&P 500 Are the Most Volatile; We Would Shop for Bargains in This Area of the Market

EXHIBIT 41

Conclusion

Overall, we continue to view the current cycle as the Asynchronous Recovery (see Investment Implications of an Asynchronous Global Recovery, September 2014). Indeed, rising macroeconomic and geopolitical tensions are creating both opportunities and risks for global investors across both equities and fixed income. Our base view is not to shun risk. Rather, we continue to suggest that investors should embrace our key macro themes, many of which we think can perform against a variety of economic backdrops and capital markets environments.

First, as we discussed earlier in this paper, we believe that assets with Yield and Growth will outperform. Strong demographic forces, coupled with low inflation and shrinking supply, lead us to believe that yield assets, particularly those that can compound their cash flows, should do quite well in the environment that we envision. Consistent with this view, we hold overweight positions across Real Assets, including Real Estate, Real Estate Credit, and Infrastructure. We also favor both ‘spicy’ Liquid and Private Credit.

Second, we would avoid exposures linked to China’s structural slowing. From our vantage point, China’s slowdown is secular, not cyclical, and we see continued pricing pressure amidst slower activity across not only Asia but parts of Europe and Latin America. That said, we are increasingly of the mindset that there is the opportunity to help Chinese companies expand abroad. Key areas of focus include telecommunications, optical instruments, and electric power machinery.

Third, we see the opportunity for a significant and potentially sustained upward revaluation in the securities of large domestically-oriented economies. Some of this has already occurred, but we think it could go further than some in the investment community now think. The U.S. remains our top choice, though other countries, including India, Mexico, and Indonesia could benefit as well.

Large, consumer-oriented countries could see their valuation multiples stay at the high end of their historical range — or even increase further — as global investors reallocate towards more stable, consumer-oriented economies.

11 Data as at August 24, 2016. Source: Caterpillar, Cisco, Microsoft company filings, Bloomberg.
Fourth, the dismantling of the traditional financial services opportunity is both a blessing and a curse. On the opportunity side, we believe that non-bank lending will continue to gain share, and by doing so, provide pensions and endowments with the opportunity to earn a yield that often exceeds their current target return rate. In our view, this opportunity is a secular, not a cyclical one, though we do believe that the current illiquidity premium could face some downward cyclical pressure. On the other hand, we do worry that the inability of banks to earn their costs of capital means that their capacity to repair their balance sheets by issuing accretive equity has vanished. This shift in the landscape is important because it means that banks will be forced to rely primarily on retained earnings to deal with cyclical flare-ups in credit quality — not an easy task when net interest margins are shrinking. As a result, total credit creation is likely to remain subpar, which is not a favorable backdrop for helping global GDP rebound towards more normalized levels.

Finally, given the bifurcation across markets, we advise folks to consider increasing exposure to complex stories, including earnings misses, restructurings, and/or corporate repositionings. At the moment, Japan appears to be one of the most actionable markets, though we are also seeing some interesting opportunities in the United States and Europe. Conversely, we think that earnings visibility and simplicity are potentially being overvalued, and as such, our inclination is to harvest existing gains in these areas.

Overall, our message is that the current environment is not likely to change materially in the near term, and as such, pursuing idiosyncratic themes like the five mentioned above is likely to yield better performance results than increasing exposure to beta plays at this point in the cycle. Not surprisingly, this world view leads us to overweight positions across Private Equity, Opportunistic Credit, and Private Credit. By comparison, we fund these positions with underweight positions in Public Equities, Government Bonds, and Growth Equities.

Important Information

The views expressed in this publication are the personal views of Henry McVey of Kohlberg Kravis Roberts & Co. L.P. (together with its affiliates, “KKR”) and do not necessarily reflect the views of KKR itself or any investment professional at KKR. This document is not research and should not be treated as research. This document does not represent valuation judgments with respect to any financial instrument, issuer, security or sector that may be described or referenced herein and does not represent a formal or official view of KKR. This document is not intended to, and does not, relate specifically to any investment strategy or product that KKR offers. It is being provided merely to provide a framework to assist in the implementation of an investor’s own analysis and an investor’s own views on the topic discussed herein. The views expressed reflect the current views of Mr. McVey as of the date hereof and neither Mr. McVey nor KKR undertakes to advise you of any changes in the views expressed herein. Opinions or statements regarding financial market trends are based on current market conditions and are subject to change without notice. The views expressed herein may not be reflected in the strategies and products that KKR offers, including strategies and products to which Mr. McVey provides investment advice on behalf of KKR. It should not be assumed that Mr. McVey has made or will make investment recommendations in the future that are consistent with the views expressed herein, or use any or all of the techniques or methods of analysis described herein in managing client accounts. Further, Mr. McVey may make investment recommendations and KKR and its affiliates may have positions (long or short) or engage in securities transactions that are not consistent with the information and views expressed in this document. This publication has been prepared solely for informational purposes. The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this document has been developed internally and/or obtained from sources believed to be reliable; however, neither KKR nor Mr. McVey guarantees the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied upon in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Target allocations contained herein are subject to change. There is no assurance that the target allocations will be achieved, and actual allocations may be significantly different than that shown here. This publication should not be viewed as a current or past recommendation or a solicitation of an offer to buy or sell any securities or to adopt any investment strategy. The information in this publication may contain projections or other forward looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Performance of all cited indices is calculated on a total return basis with dividends reinvested. The indices do not include any expenses, fees or charges and are unmanaged and should not be considered investments. The investment strategy and themes discussed herein may be unsuitable for investors depending on their specific investment objectives and financial situation. Please note that changes in the rate of exchange of a currency may affect the value, price or income of an investment adversely. Neither KKR nor Mr. McVey assumes any duty to, nor undertakes to update forward looking statements. No representation or warranty, express or implied, is made or given by or on behalf of KKR, Mr. McVey or any other person as to the accuracy and completeness or fairness of the information contained in this publication and no responsibility or liability is accepted for any such information. By accepting this document, the recipient acknowledges its understanding and acceptance of the foregoing statement. The MSCI sourced information in this document is the exclusive property of MSCI Inc. (MSCI). MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.

“

We believe that the market is now potentially over-pricing assets with steady cash flows, while under-paying for complexity.

“