

# Asia: Beating to a Different Drum

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Of the many changes associated with COVID, one of the most impactful for me personally was the loss of routine and ritual, including being able to travel and spend time with others outside of my day-to-day life in New York City. Many of you who have read my insights over the years know that I've been going to Asia fairly regularly since 1995. My first trip to the region, which took place the summer before I enrolled in business school, involved some traveler's checks, a back pack, and four budget airline connections to get there from Richmond, Virginia. I also had no cell phone – only a determination to learn more about Asia, China in particular. Importantly, though, that trip made me realize early on in my career how that emerging region would likely reshape the global economy. It also inspired a strong desire – which I was able to enact until the onset of COVID – to return as frequently as possible to deepen my knowledge of all that Asia has to offer both economically and culturally.

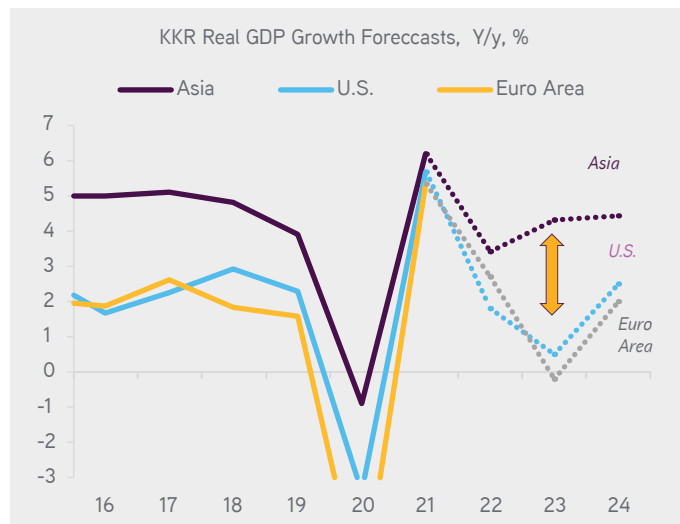
So a few weeks ago, for the first time since the beginning of COVID, I was able to return to Asia. Specifically, I traveled to Singapore and Tokyo, spending time with members of my Asia 'local' team who focus on macro and portfolio construction – Frances Lim, Changchun Hua, Deepali Bhargava and Hemant Pandey – as well as other colleagues who cover asset classes and lines of business for KKR in the region. It was, for me personally, a wonderful opportunity to not only refresh my view on many parts of Asia, but also to better compare and contrast investment opportunities and macro risks that we are seeing across the four major regions where KKR does business. See below for details, but our key conclusions are as follows:

**Within a world that is enduring an asynchronous recovery, Asia is beating to a different drum.**

As we show in *Exhibit 1*, Asia still has the world's strongest regional growth in absolute terms. However, China is lagging badly, particularly in nominal terms, relative to pre-COVID times. The good news is that slow growth in Asia is still better than what we are seeing across all of Europe and many parts of the United States. Moreover, domestic and international tourism are now rebounding in most countries in the region, which should help inspire more growth in 2023 as well as narrow output gaps.

## Exhibit 1

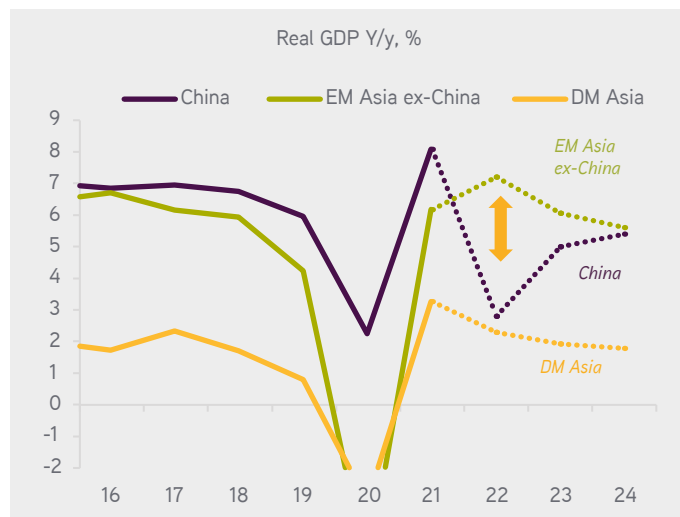
### We Expect Growth in Asia to Hold Up Better Than the U.S. and Europe...



Data as at August 31, 2022. Nominal GDP weighted. Source: National statistical agencies, central banks, Haver, KKR Global Macro & Asset Allocation analysis.

## Exhibit 2

### ...Though Growth Trends Differ Significantly by Country Within the Region



KKR Global Macro & Asset Allocation estimates China, IMF estimates for other Asia Pacific countries, nominal GDP weighted. Data as at September 30, 2022. Source: Haver, IMF, KKR Global Macro & Asset Allocation analysis.

The second piece of good news is that in the aggregate, Asia also has low inflation (*Exhibits 13 and 14*). In fact, central

banks in China and Japan are actually embracing loose monetary policy to stimulate growth. Given that we are again forecasting above consensus inflation in 2023 for both the United States and Europe, Asia felt like somewhat of a 'safe haven' from a central banking perspective.

**Japan, Singapore, and Vietnam are market share winners in the macro environment we are envisioning.** Japan is still benefitting from structural reforms designed to bolster return on equity; it should also enjoy the cyclical tailwinds of a weaker currency and an increase in both domestic and international tourism. Meanwhile, Singapore is booming, as ex-pats and new joiners to the region flock to the country. Real estate and services in Singapore have strong momentum, and are trends we see continuing for the next few years. Finally, while we did not visit Vietnam this trip, our belief that the country is a major beneficiary of multinational corporations' China Plus One manufacturing strategy was confirmed by executives we spoke with across trade and manufacturing.

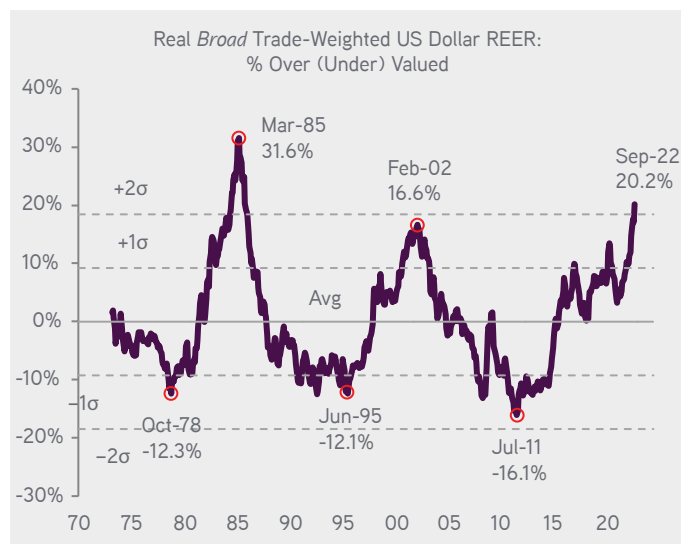
**While Asia macro matters a lot, the U.S. dollar is probably the 'fulcrum security' on which to focus at this point, we believe.** Indeed, almost every meeting started and ended with a question about the Fed's path forward on interest rates and its balance sheet. We were not surprised, as the Fed is tightening fast and furiously. We remain hawkish, with my colleague David McNellis recently revising upward his 2023 inflation forecast for the U.S. to 4.8% from 4.5%. In Dave's scenario analyses that he executes for KKR deal teams, there is now almost a 50% chance of short-rates getting into the five percent range in 2023.

To date, Asia is holding up much better than during the Taper Tantrum in 2013, a feat we attribute to better management of both fiscal and current account deficits across the region. To be sure, the interest rate differentials in countries like Japan are surging, and as such, the region has not been immune to the abruptness of the Fed's interest rate increases of late. However, when the dollar's ascent cools, which we think could happen by the end of 2023, we believe global investors as well as strategic buyers from the corporate sector will conclude that Asia is cheap from both an absolute perspective (i.e., P/E, P/B, etc.) and maybe more importantly, from

a relative perspective (i.e., on a currency-adjusted basis, the region is really interesting if you can buy local assets with U.S. dollars). Just remember that over the years fully 30-40% of total EM Equity returns typically come from currency, not earnings growth or multiple expansion. So, if one can pick the right asset with currency movements shifting from headwind to tailwind as well as the potential for some operational improvements, the upside potential could be quite significant relative to where we have been the past couple of years.

### Exhibit 3

#### The U.S. Dollar Cycle Is Likely Now Approaching a Well Advanced Stage in Its Bull Run

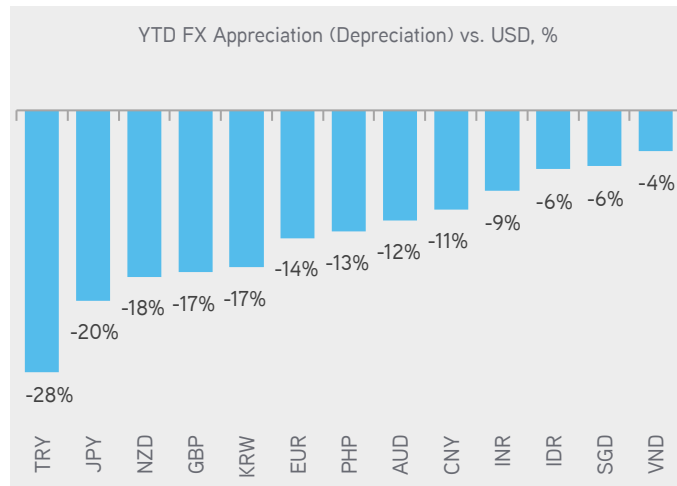


Data as at September 30, 2022. Source: Federal Reserve, Haver Analytics.

**Despite all the changes in the region, many of our key investment themes are still intact. Indeed, we left confident that KKR’s penchant for buying complexity, particularly around large corporate carve-outs, and selling simplicity once we have made operational improvements, has a lot of momentum in the region, especially in Korea, Japan, and Australia.**

### Exhibit 4

#### The Dollar’s Ascent Has Pressured Most Currencies of Late, Including Many of Those in Asia



Data as at September 30, 2022. Source: Bloomberg.

**Despite all the changes in the region, many of our key investment themes are still intact.** Indeed, we left confident that KKR’s penchant for buying complexity, particularly around large corporate carve-outs, and selling simplicity once we have made operational improvements, has a lot of momentum in the region, especially in Korea, Japan, and Australia. This viewpoint is significant because although corporate carve-outs usually provide above average returns, they also require larger sums of capital than the average private equity deal. Second, automation/digitalization is a powerful investment theme that is reshaping how corporates produce goods and services as well as how individuals buy them. Third, consumption upgrades as a play on rising GDP-per-capita remains a mega theme, and as such, Healthcare, Financial Services, and Technology still represent compelling sectors of interest to us. Importantly, many of the public market indices do not have exposure to these themes, and as such, we continue to believe that Private Equity and Growth Equity remain more efficient investment vehicles for accessing these themes relative to the public markets.

**Geopolitics is on everyone’s mind.** As we mentioned earlier, concern number one for almost everyone with whom we spoke is the speed and level of the Fed’s path to normalization. However, in the runner-up position is geopolitics,

including Russia’s invasion of Ukraine, U.S.-China tensions, and North Korea’s recent missile launches. For investors, unfortunately, there is no silver bullet. Rather, we see many leading CIOs capping their China exposure (see our [The Times They Are A-Changin’](#) note) at around 5-10% of total portfolio allocations as well as diversifying across asset class and country. We also think our ‘security of everything’ thesis, including cyber, data security, energy security, and transportation, should likely be a larger percentage of everyone’s portfolio on a go-forward basis.

Looking at the big picture, the most important conclusion from our trip is that CIOs should start to increase exposure to Asia over the coming twelve months. As we detail below, we remain firmly of the view that private markets, especially Private Equity, will continue to outperform public markets. However, public markets are cheap at the moment, and for more tactical accounts, valuations appear compelling (*Exhibit 11*). Also, from a portfolio construction perspective, we want to reiterate that Asia does carry a lot of idiosyncratic, individualistic traits, given its vastness and notable differences amongst its economies. There is also a lot of opportunity in many of the major asset classes where KKR invests, which is one of the key reasons we have almost doubled our balance sheet exposure to the region since before the pandemic.

To be sure, one has to be authentically local, know your themes, and likely tilt more domestically than in the past. However, valuations are improving, sentiment is negative, and currencies are at record lows. Our bottom line: Amidst this high visibility backdrop, there are some great companies and management teams doing compelling things that we think will create substantial value for stakeholders during the next 5-10 years. So, now is the time, in our view, to – at a minimum – get shopping lists ready to lean in.

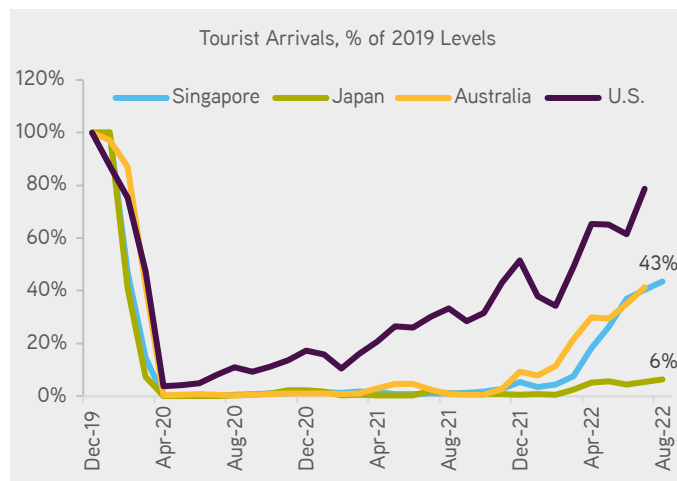
**DETAILS**

**On this first trip to Asia since the onset of COVID**, it was clear upon my arriving in Singapore that much has changed since December 2019. For starters, our KKR footprint in Asia has grown meaningfully across asset classes, with our balance sheet in recent years helping to seed Asia Real Estate, Asia Credit, and Asia Infrastructure – in addition to

our existing sizeable presence in Asian Private Equity. Headcount has also increased: Frances Lim, who heads our Asia Macro team, has left New York for Singapore, and Hemant Pandey has also relocated there, with the aim of developing a portfolio construction presence for the region.

**Exhibit 5**

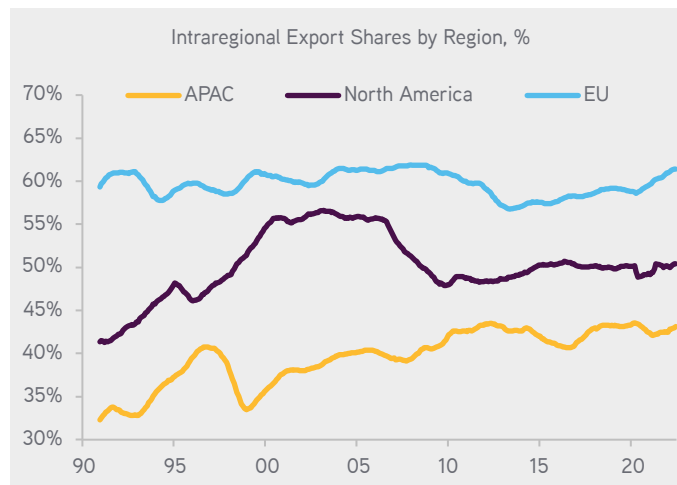
**Asia’s Travel Recovery Is Lagging the U.S., But We See That Changing in 2023**



Data as at August 30, 2022. Source: Department of Statistics Singapore, Japan National Tourism Organization, Australia Bureau of Statistics, U.S. National Travel and Tourism Office, Haver Analytics.

**Exhibit 6**

**Asia Pacific Intra-regional Trade Has Increased**



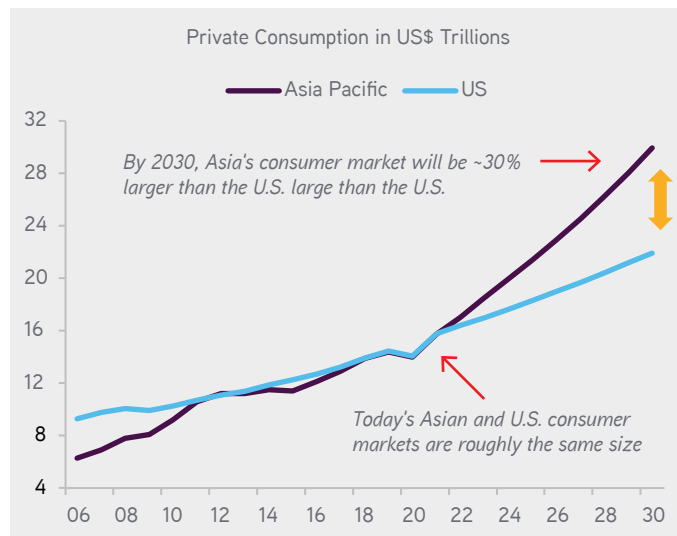
Data as at June 30, 2022. Source: IMF, KKR Global Macro & Asset Allocation analysis.

Outside of the expanded KKR footprint, there were also some other notable changes. First, besides clear post-COVID winners like Singapore and Vietnam (e.g., we heard several reports that available space to build a factory in Vietnam is very limited these days), overall growth feels slower. The catalyst? As China struggles with a massive property downturn as well as tough zero-COVID policies, most of Asia is still feeling somewhat of a ‘hangover’ effect from the slowdown in the world’s most important growth economy. Remember that prior to COVID, China consistently accounted for almost one-third of total incremental global growth; in doing so, it created a massive tailwind for the regional economy. Geopolitical tensions are also higher, with North Korean missiles and U.S.-China relations top of mind with almost every CEO and investor with whom we spoke. Finally, we heard so many CEOs and advisers speak to ‘in Asia, for Asia.’ Said differently, the Asia story has shifted from being focused on ‘the exporter to the world’ towards one of supplying greater internal and regional demand. This shift in focus is significant, and while it does not rival the intensity of Trump’s battle cry of ‘America First,’ it does underscore that regional economic preferences have emerged more clearly in recent years.

**However, a lot has *not* changed.** For one thing, there is still a massive consumption upgrade story unfolding in Asia. All told, Asia’s consumer market will be at \$30 trillion by 2030, or 30% larger than that of the United States. Just a few years ago, by comparison, the two markets were roughly the same in size. Not surprisingly, this growth is driving mega trends such as e-commerce and growth in services. Consumption upgrades also go hand in hand with the continued acceleration in urbanization. For example, estimates are that the urbanization in the ASEAN region alone will lead to almost 250 million *more* citizens living in cities by 2035, compared to 2014. Not surprisingly, infrastructure needs, including water, efficient electricity, transportation, and data centers will lead to \$1.4 trillion in additional spending by 2030.

### Exhibit 7

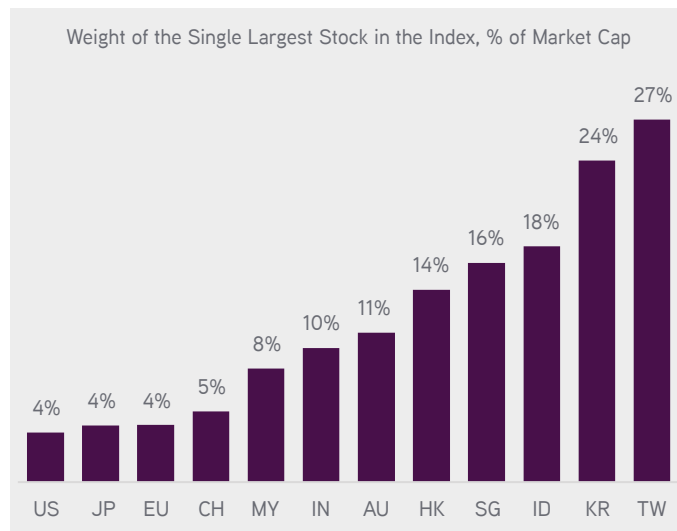
#### Asia’s Consumer Market Is As Large As That of the U.S.



Asia Pacific includes Asia, Australia and New Zealand. Asia includes China, Hong Kong, Taiwan, India, Japan, Korea, and ASEAN (Indonesia, Malaysia, Philippines, Thailand, Singapore, Vietnam, Myanmar, Cambodia, Laos, Brunei). Data as at December 31, 2021. Source: IMF, World Bank, National Statistical Agencies, Haver, KKR Global Macro & Asset Allocation analysis.

### Exhibit 8

#### Asia Indices Are Very Concentrated



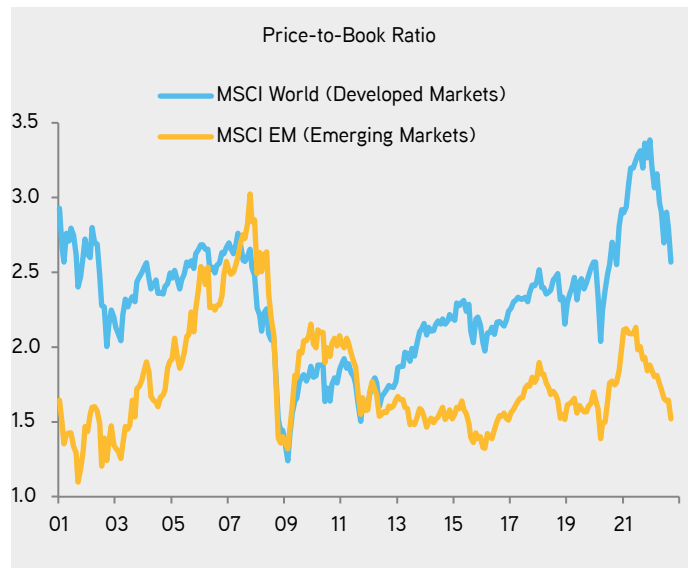
Data as at August 6, 2019. Source: MSCI, Factset, Bloomberg, KKR Global Macro & Asset Allocation analysis.

Second, the trend towards more corporate carve-outs, especially in Japan and Korea, continues to gain momentum. This backdrop is an important one for large scale private equity players, especially those with strong operational improvement capabilities. Third, automation and digitalization trends are only accelerating, especially in markets impacted by labor shortages. In Tokyo, for example, our breakfast plates were taken away by a robot at the hotel restaurant. Artificial Intelligence is also certainly a piece of this mega theme. As part of our diligence, we spent time with a very sharp CEO in Japan whose company is using artificial intelligence to better identify cancer patterns, which makes it easier for doctors to spend more time on cases that carry the most serious risks. Finally, our 'security of everything' thesis is alive and well in Asia too, and it is leading to growth in countries such as Vietnam across sectors such as cyber and logistics, and across business models, including high levels of inventories, more people, and more of a focus on energy conservation. Security of data and energy infrastructure is also gaining significant momentum.

In terms of other key conclusions, **assets in Asia are now cheap across a variety of metrics including price-to-earnings and price-to-book**. They are even more attractive once you adjust for currencies in countries like Japan. One can see this in *Exhibit 9*. For U.S. investors, this arbitrage is not to be underestimated, and if we are right that the Fed will stop its interest rate assault in 2023, now is the time to start thinking about relative value. Without question, the tailwind this region really needs is a weaker dollar. The good news is that Asian currencies have performed meaningfully better this cycle than they did back during prior periods of upheaval (e.g., 1998 and/or 2013). We attribute this improved status to smaller current account and fiscal deficits, an economic reality that really began to improve after the Taper Tantrum in 2013. Somewhat ironically, we heard several executives express concern that it might be a developed country, like the United Kingdom, not an emerging one like Thailand, Malaysia or Indonesia, that could present more global risk this cycle.

### Exhibit 9

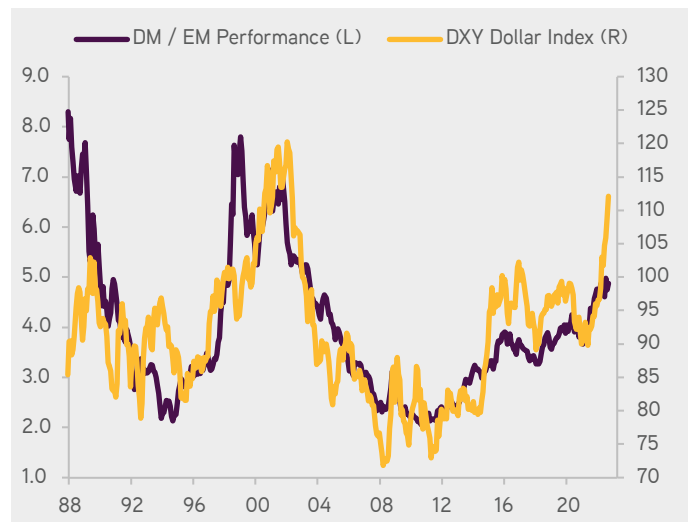
#### EM Valuations Are Much Lower than DM



Data as at September 30, 2022. Source: MSCI, Bloomberg, Factset.

### Exhibit 10

#### EM Should Perform Better as USD Strength Fades by 2024, We Believe



Data as at September 30, 2022. Source: MSCI, Bloomberg.

## Exhibit 11

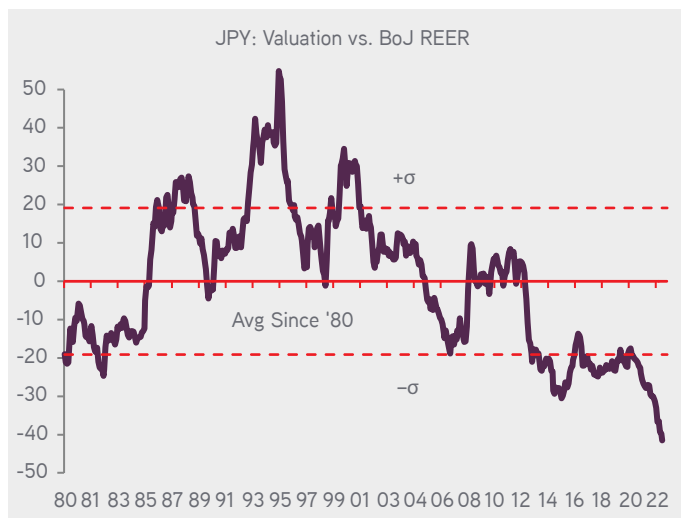
### MSCI EM Historical Peak-To-Trough Analysis Suggests Current Valuations Are Attractive

Peak	Trough	Days to Trough	Fall From Peak	Next Peak	Days to Next Peak	Gain From Trough to Next Peak
9-Jul-97	10-Sep-98	428	-59%	10-Feb-00	518	125%
10-Feb-00	21-Sep-01	589	-54%	18-Apr-02	209	48%
18-Apr-02	10-Oct-02	175	-30%	12-Apr-04	550	95%
12-Apr-04	17-May-04	35	-20%	8-May-06	721	123%
8-May-06	13-Jun-06	36	-25%	23-Jul-07	405	75%
29-Oct-07	27-Oct-08	364	-66%	11-Jan-10	441	126%
2-May-11	4-Oct-11	155	-31%	29-Feb-12	148	30%
3-Sep-14	21-Jan-16	505	-37%	26-Jan-18	736	85%
26-Jan-18	29-Oct-18	276	-27%	20-Jan-20	448	23%
20-Jan-20	23-Mar-20	63	-34%	17-Feb-21	331	91%
17-Feb-21	30-Sep-22	590	-39%	?	?	?
<b>Average 1997-2020</b>		<b>292</b>	<b>-38%</b>		<b>451</b>	<b>82%</b>

Data as at September 30, 2022 Source: MSCI, FactSet, Morgan Stanley Research.

## Exhibit 12

### The Japanese Yen Is 2.2x Standard Deviation Below Its Long Term Average on a Real Effective Exchange Rate Basis



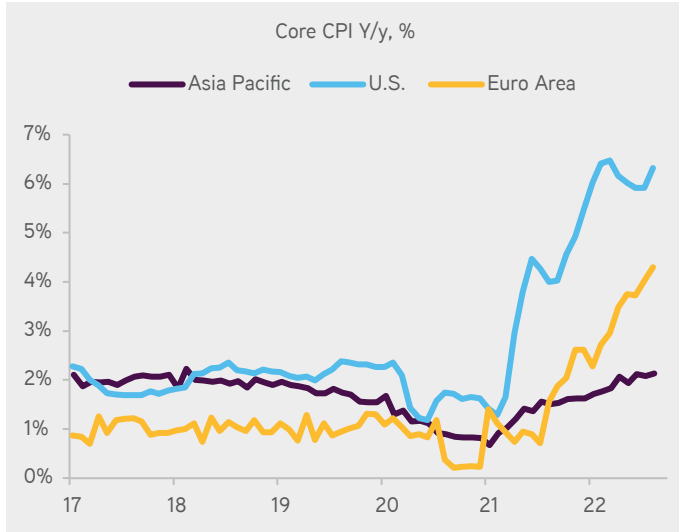
Data as at August 31, 2022, Source: BoJ, KKR Global Macro & Asset Allocation analysis.

Another big take-away is that, while inflation is rising, it is not out of control in Asia. In China, for example, Frances and Changchun forecast inflation to hit 2.5% in 2023, compared to 4.8% in the United States and 5.5% in Europe during the same period. This backdrop is significant, and it makes China unique relative to its global peers. Importantly, because inflation is not out of control, monetary policy authorities have a lot more wiggle room. In fact, both China and Japan, two of the titans in Asia, are actually using loose monetary policy to reinvigorate growth.

**While Asia macro matters a lot, the U.S. dollar is probably the 'fulcrum security' on which to focus at this point, we believe.**

**Exhibit 13**

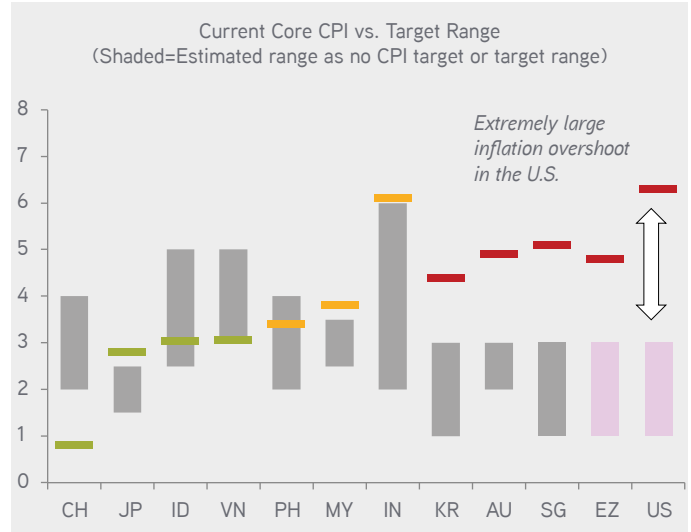
**Lower Inflationary Pressures Across Asia...**



Data as at September 30, 2022. Source: Haver, KKR Global Macro & Asset Allocation analysis.

**Exhibit 14**

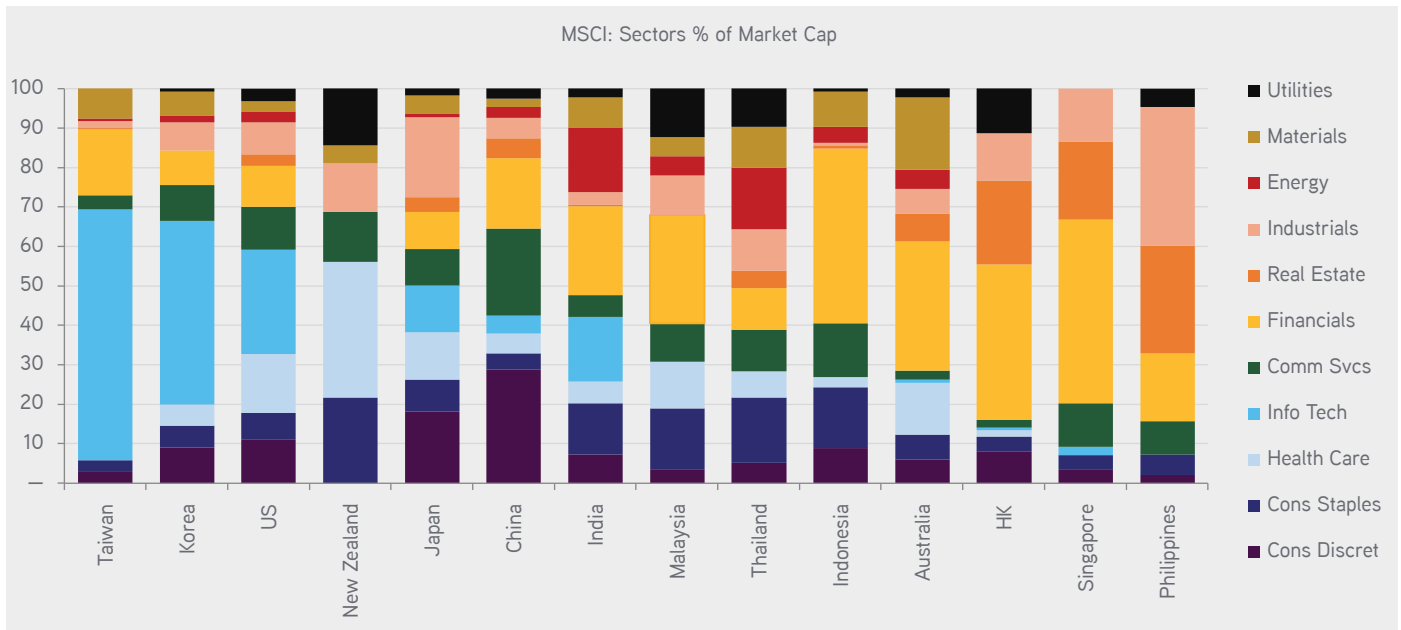
**...Contrast Distinctly With the U.S. and Europe**



Data as at September 30, 2022. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

**Exhibit 15**

**Asia's Capital Markets Are Not Currently Linked to Some of the Best Growth Themes in the Region. It Is One of the Key Reasons We Continue to Favor Private Equity Over Public Equity in Asia**



Data at May 31, 2020. Source: MSCI, Factset, KKR Global Macro & Asset Allocation analysis.



Finally, this visit to Asia reminded us of an important point about the region: the public markets may not always be the best way to access Asia's most compelling themes, including rising GDP-per-capita. One can see this in *Exhibit 15*, which shows how public market indices in places like Singapore, the Philippines and Indonesia have little to no exposure to fast growing and often compelling sectors like technology and consumer discretionary. By comparison, many of the indices in the region are massively overweight financials, including banks that are sometimes bogged down with big commercial loans to state-run enterprises. Against this backdrop, we continue to encourage CIOs to think through what is the best way to tap into the growth that is available in the region, particularly as it relates to consumption upgrades, digitalization, and urbanization.

## Conclusion

As we continue to navigate the post-COVID reality of developed market central banks no longer being accommodative, we do believe that we have entered a regime change for investors. We do not make this statement lightly: If we are right, CIOs will need to shift money from longer duration fixed income towards more collateral-based cash flows, and higher free cash flow conversion Equities versus just pure Growth Equities (which was the right choice during the prior decade).

It also likely means that – from a regional perspective – always overweighting the U.S. at the expense of international markets like Asia may not work as consistently as it did in the past. Above all else, we think that Asia currently offers better organic growth as well as lower inflation relative to other regions of the world. Importantly, these attributes are provided against a backdrop of attractively priced currency levels in most countries within Asia.

We also like the key themes unfolding across Asia, including automation, digitalization, consumption upgrades, and corporate carve-outs. Our trip also reaffirmed our longer-term belief that Alternatives often provide a more efficient way to capture these themes relative to the public markets.

However, there are clear risks, including North Korea and China. As my colleague Vance Serchuk suggests, 'we have

migrated from a world of benign globalization towards one of great power competition.' As such, geopolitical risks are not to be ignored. How does that impact portfolio construction? It likely means that more diversification across Asia, particularly in the emerging markets, is required than in the past. It also suggests more of an emphasis on services and domestic trends than on companies and investments that require intricate supply chains and for those supply chains to perform flawlessly – a backdrop that is probably not going to happen in the world we envision on a go-forward basis.

So, our bottom line is that our trip to the region left us feeling that the intersection between valuation and fundamentals suggests Asia should become a larger percentage of one's portfolio as we transition through 2023. If we are right, then it only reinforces our belief that we should all likely be getting our shopping lists ready.

**Finally, this visit to Asia reminded us of an important point about the region: the public markets may not always be the best way to access Asia's most compelling themes, including rising GDP-per-capita. Public market indices in places like Singapore, the Philippines and Indonesia have little to no exposure to fast growing and often compelling sectors like technology and consumer discretionary. By comparison, many of the indices in the region are massively overweight financials, including banks that are sometimes bogged down with big commercial loans to state-run enterprises.**

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