Getting Closer to Home

While the general backdrop for risk assets remains favorable, we are no longer advising folks to “Stay the Course” as we did in our January 2014 Outlook piece. Rather, given where we are in the cycle and the magnitude of gains in recent years, we have begun the inevitable process of “Getting Closer to Home” in terms of our asset allocation targets. Importantly, though, we think this transition should be more evolutionary than revolutionary, but we do advise folks to raise some cash and to tilt the invested part of the portfolio to become more opportunistic in 2015. In terms of key themes, we see several compelling “arbitrages” in the global macro landscape that CIOs and portfolio managers should pursue this year. First, we believe that China’s slowing is not an aberration. As such, its role in the global economy is materially shifting, which means that we expect to see sizeable restructuring and recapitalization opportunities in sectors that previously over-earned and/or overstretched their footprints. Second, many corporations still have inefficient capital structures, including too much cash and too little debt, in our view. As such, investors can still benefit from corporate and/or shareholder actions to lower companies’ cost of capital and/or improve growth, including buybacks, dividends, capital expenditures and acquisitions. Third, despite a slew of liquidity in the system, many companies across both emerging and developed economies still can’t get proper access to credit. Hence, we still see a compelling illiquidity premium that is worth pursuing, particularly in today’s low rate environment. Fourth, in a world of contango commodity pricing, we continue to favor private real asset investments with upfront yield, growth and long-term inflation hedging relative to traditional liquid commodity notes and swaps. Finally, government deleveraging in the developed markets is disinflationary, which drives our thinking about the direction of long-term interest rates as well as the relative value of risk assets against the risk-free rates.

“...The best safety device is a rearview mirror with a cop in it.”

DUDLEY MOORE
ENGLISH ACTOR, COMEDIAN, MUSICIAN, AND COMPOSER
Since my team and I arrived at KKR in 2011, our asset allocation targets have been consistently aggressive relative to the benchmark against which we measure ourselves. In particular, given our strong view that the global economic recovery would last longer than the consensus, we have been willing to overweight public equities, "spicy" credit, private real assets, and other illiquid products to garner excess returns that we viewed as unachievable through many traditional liquid asset classes, including generic commodity notes and sovereign debt.

This strategy has served us well (see performance Exhibits 74, 75, and 76) in recent years, but now we think it is time to start "Getting Closer to Home" on the asset allocation front, including raising some cash and getting more opportunistic across the portfolio in 2015. To be sure, as we discuss in detail below, we are still running with a pro-risk tilt, but after 67 months of economic expansion, we just do not think that it is necessary — as Dudley Moore so eloquently stated — to wait to fully see the policeman in the rearview mirror before we began to embrace some higher level of safety.

Several influential macro considerations shape our more opportunistic approach. First is cumulative performance this cycle of risk assets. All told, the S&P 500 has now appreciated six consecutive years in a row, returning a full 204% through December 31, 2014 versus an historical average of 115% during bull markets (Exhibit 39). During this period its multiple has expanded a full 40%, now in line with the historical median of 42% (Exhibit 39).

Outside the U.S., valuations are certainly less demanding; however, consistent with our Asynchronous Recovery thesis (see Investment Implications of an Asynchronous Global Recovery), we still expect some additional bumpiness in 2015 as many parts of Europe, Latin America, and Asia must endure some important but painful economic restructuring initiatives, including debt deleveraging, fiscal belt-tightening, and wage compression.

Finally, we think the monetary backdrop is becoming more complicated. On the one hand, the central banks in Europe, Japan, and China are all likely to be more accommodative during 2015 in order to stoke growth. On the other hand, the U.S. Federal Reserve is now in the process of reducing its ultra-accommodative stance (Exhibit 4). Hence, unlike in past years, central bank policy around the world is now less in sync, which could create some tension in global capital markets, currencies in particular, during parts of 2015.

So, against the macro backdrop that we envision for 2015, how should one position a multi-asset class portfolio? Our highest conviction asset allocation ideas are as follows:

- **We further embrace our Asynchronous Global Recovery theme by lifting our highest conviction idea, Distressed / Special Situation, to a 15% allocation from nine percent previously.** We now target a full 15% allocation, notably above our benchmark weighting of zero, to Distressed / Special Situation. **Our bottom line: This sizeable allocation allows us to efficiently invest behind — not against — the Asynchronous Global Recovery we continue to forecast.** Importantly, beyond the European restructurings/recapitalizations that we have been highlighting for some time, two recent trips to Asia confirm to us that we are now seeing "emerging" opportunities in Asia as the China Growth Miracle wanes — and companies are forced to restructure, recapitalize, and resize. Finally, we believe some notable dislocations across the energy market, the U.S. in particular, are also starting to emerge for managers of opportunistic capital.

  - **To pay for this increased overweight position, we have lowered our growth equity allocation in our Other Alternatives bucket.** To underwrite our increased Distressed / Special Situation allocation, we take five percent from Growth Capital / VC / Other and reduce this weighting to zero versus a benchmark of five percent. Importantly, given the carnage we are seeing in areas like U.S. energy, European banks, and Asian commodity plays, we are more interested in taking advantage of current dislocations around the globe, and in so doing, we seek to avoid some of the hefty valuations we now see in “hot” growth parts of the market, including the Internet and life sciences (Exhibit 67).

  - **Our Fixed Income allocation also becomes less “spicy” in 2015, but we increase flexibility in the liquid credit portion of our portfolio.** For the past three years, we have been substantially overweight “spicy credit,” including Mezzanine, Direct Lending, and Fixed Income Hedge Funds, based on our view that the economic cycle 1) would be longer than expected in duration; 2) the illiquidity premium represented a massive opportunity amid lower rates; and 3) the return profile of spicy credit would approach that of equities but with less risk. In 2015, however, we are shifting course by beginning to dial back some of our liquid, “spicy” credit positions. Specifically, we are moving our Mezzanine allocation to two percent from five percent versus a benchmark weighting of zero. Within our liquid book, we are reducing our hedge fund allocation, but we are increasing our weighting towards Actively Managed Opportunistic Credit to seven percent from four percent. Our intent is to allow investment managers to toggle between bank loans, high yield, and other credit-sensitive products as opportunities/dislocations present themselves this year. Separately, we have added three percent to investment grade credit versus a benchmark of five percent and a previous weighting of zero percent. Our goal is to add some ballast to the fixed income portion of the portfolio during what we believe could be a more volatile year for the asset class. Overall, our total fixed income book remains small at just 18% of the portfolio versus a benchmark of 30% and is unchanged from June 2014.

  - **We are reducing our long-term overweight positions in Public Equities back to equal weight and are now more opportunistic at this point in the cycle.** Our research suggests less upside for equities than in past years, and as such, we now want to be a little more opportunistic in our approach. As we discuss below in more detail, our base view is that not only is the absolute return in global equities likely to be lower on a go-forward basis, but we also believe the Sharpe ratio is likely to decline. From a regional perspective, we stay overweight Asia and move to underweight in Latin America to reflect our cautious view on Brazil’s near-term prospects.

  - **In order to become more opportunistic in equities, we are raising Cash to start 2015 with — boosting this allocation to three percent from zero during the entire 2011-2014 period.**
While we think that 2015 could again be another up year for many stocks, our view is that more volatility lies ahead than in recent years. So at the moment, we think it finally makes sense to have a little “dry powder” to add to risk assets in the event of a downdraft in 2015.

- **Within Real Assets**, we believe investors should still avoid traditional commodity notes and swaps with no yield; we stay overweight income-producing Real Assets and short Gold. As in past years, we continue to stay away from liquid commodity swaps/notes again in 2015, particularly given 1) near-record negative roll features (Exhibit 62); and 2) our view that spot oil and other commodity prices could display some additional downside volatility in 1H15. We also stay short Gold again this year, as we see deflation, not inflation, as the bigger near-term risk. By comparison, we still think that there is a substantial opportunity to own cash-flowing hard assets that can produce yield, growth, and long-term inflation hedging. Our favorites include real estate, infrastructure, and pipelines. Given the significant price appreciation in certain gateway cities, however, we have reduced our Real Estate weighting to three percent from five percent and a benchmark weighting of two percent.

- **Currency**: We believe the USD freight train remains on track. At the risk of staying in a crowded trade, we remain positive on the U.S. dollar against most major currencies, including the euro, Japanese yen and commodity currencies, including Brazilian real, Russian ruble, and Nigerian naira. Within the EM currency arena, we favor the Indian rupee, while in terms of EM “crosses,” we champion MXN over BRL again in 2015.

- **Risks/Hedges**: Tactically, we consider buying downside protection in equities, currency, and rates when volatility compresses. We think that investors should expect spasms of risk asset de-ratings in 2015 when either growth and/or forward inflation expectations periodically drop towards uncomfortable levels. Consistent with this view, we are also increasingly concerned that the currencies of commodity exporting countries may cause further dislocations across the global capital markets in 2015. Our research shows that we are not likely to have a full 1997 unwind, but we are going to continue to endure a sizeable adjustment period ahead. In terms of implementation, we believe an investor should use periodic compression of volatility levels to purchase tactical protection across equity, currency, and fixed income markets. Details below.

We now think it is now time to start “Getting Closer to Home” on the asset allocation front, including raising some cash and getting more opportunistic in 2015.

### EXHIBIT 1

**KKR GMAA 2015 Target Asset Allocation**

<table>
<thead>
<tr>
<th>ASSET CLASS</th>
<th>KKR GMAA JANUARY 2015 TARGET (%)</th>
<th>STRATEGY BENCHMARK (%)</th>
<th>KKR GMAA JUNE 2014 TARGET (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>PUBLIC EQUITIES</td>
<td>53</td>
<td>53</td>
<td>55</td>
</tr>
<tr>
<td>U.S.</td>
<td>20</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>EUROPE</td>
<td>15</td>
<td>15</td>
<td>16</td>
</tr>
<tr>
<td>ALL ASIA</td>
<td>13</td>
<td>12</td>
<td>13</td>
</tr>
<tr>
<td>LATIN AMERICA</td>
<td>5</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>TOTAL FIXED INCOME</td>
<td>18</td>
<td>30</td>
<td>18</td>
</tr>
<tr>
<td>GLOBAL GOVERNMENT</td>
<td>3</td>
<td>20</td>
<td>3</td>
</tr>
<tr>
<td>MEZZANINE</td>
<td>2</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>HIGH YIELD</td>
<td>0</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>BANK LOANS</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>HIGH GRADE</td>
<td>3</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>EMERGING MARKET DEBT</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>ACTIVELY MANAGED OPPORTUNISTIC CREDIT</td>
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<td>0</td>
<td>4</td>
</tr>
<tr>
<td>FIXED INCOME HEDGE FUNDS</td>
<td>0</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>DIRECT LENDING</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>REAL ESTATE</td>
<td>6</td>
<td>5</td>
<td>8</td>
</tr>
<tr>
<td>ENERGY / INFRASTRUCTURE</td>
<td>3</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>GOLD</td>
<td>-2</td>
<td>1</td>
<td>-2</td>
</tr>
<tr>
<td>OTHER ALTERNATIVES</td>
<td>20</td>
<td>10</td>
<td>19</td>
</tr>
<tr>
<td>TRADITIONAL PE</td>
<td>5</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>DISTRESSED / SPECIAL SITUATION</td>
<td>15</td>
<td>0</td>
<td>9</td>
</tr>
<tr>
<td>GROWTH CAPITAL / VC / OTHER</td>
<td>0</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>CASH</td>
<td>3</td>
<td>2</td>
<td>0</td>
</tr>
</tbody>
</table>


Importantly, our asset allocation framework for 2015 is driven by five key top-down themes that we think represent macro “mismatches,” or arbitrages between real and perceived values. They are as follows:

1. **First, China’s fixed investment slowing is not an aberration.** China’s environmental headwinds, including pollution, water concerns and food safety, now represent potentially more contentious political issues than job creation, in our view. This priority realignment is a big deal because it means fixed investment and low-end manufacturing will be de-emphasized. As such, we believe that investors should expect to see sizeable restructuring and recapitalization opportunities in sectors that previously over-earned and/or overstretched their footprints during the China...
Growth Miracle that defined the 2000-2010 period in the global economy.

2. Second, many corporations still have inefficient capital structures, including too much cash and too little debt. Hence, we believe that investors can still benefit from corporate actions to lower their costs of capital and/or improve growth, including buybacks, dividends, capital expenditures and acquisitions. Without question, activist managers are clear beneficiaries, but we also think LBOs and MBOs make sense.

3. Third, despite a surge in the global monetary base, access to credit remains a major issue, particularly for small- to medium-size businesses. As such, investors should continue to be able to garner an attractive illiquidity premium in the private markets. Interestingly, our research shows the premium actually widens again in 2014 (Exhibit 27). In the public markets, there too is opportunity as balance sheet downsizing across Wall Street and limited dealer inventory should fuel periodic market dislocations for investors with patient capital.

4. Fourth, in a world of contango commodity pricing, we continue to favor cash-flowing private real asset investments, including real estate, infrastructure, and energy, with upfront yield, growth and long-term inflation hedging relative to traditional liquid commodity notes and swaps. Already, the relative performance between these two sub-asset class groups has widened substantially in recent quarters, but we still see more opportunity ahead for even greater divergence.

5. Finally, government deleveraging in the developed markets is disinflationary, which drives our thinking about the direction of long-term interest rates as well as the relative value of risk assets against the risk-free rates. In particular, given our view that the economic cycle will stretch into 2017, we think that many public and private equity stories with capital management and operational improvements still appear attractive.

Importantly, several of the aforementioned themes are continuations of high conviction ideas that we have developed during the past few years. Put another way, while we are beginning to turn more conservative in our overall outlook towards risk assets, we still feel very strongly about the key macro trends we are championing – and more importantly – their ability to deliver alpha again in 2015.

What has changed, however, is that 1) we are now 12 months later in the cycle at a time when asset prices are higher and the world’s most influential central bank is about to shift its stance on monetary policy (and our models point towards stronger growth by late 2015/early 2016); 2) China’s structural overbuild in its fixed investment arena is now under greater pressure than the consensus now appreciates, which has broad-based implications for global industrials, commodities and currencies. We believe that China is also likely to influence global inflation rates as it tries to export away some of its excess capacity.
We Believe Central Bank Differentiation Will Be a Key Theme in 2015

$902bn

$520bn

$944bn

$478bn

EXHIBIT 4

Change in Central Bank Balance Sheet Additions 2014-2015

ECB BOJ FED Total


Of course, there are always macro risks to consider. As we discuss in greater detail in our hedging section, we think that one risk for 2015 lies in maintaining inflation expectations at proper levels. Stocks and high yielding credit are really only attractively priced relative to sovereign debt if the earnings come through. At the moment, the U.S. seems to be decoupling from some of the “bad” inflation levels we see in China, Japan and Europe, but history has often shown that – over time – decoupling tends to be a flawed investment theory, particularly in an increasingly global economy. Separately, while reserves are higher and external debt lower in many EM countries than in 1997, many developing countries are increasingly facing both fiscal and export-related headwinds. Finally, we think that EM consumers who binged on credit are likely to see some retrenchment in 2015. For instance, we take a cautious stance on high-priced Brazilian consumer stories as we expect to see below consensus growth amid weaker employment trends.

SECTION I: Key Trends/Themes for 2015

Less Government Austerity and Lower Commodity Prices May Help to Drive Global Growth Higher, but We Expect the Recovery to Remain Asynchronous

Today, as we peer around the corner on tomorrow, we think that less government “drag” on the global economy could provide a nice tailwind to global growth in 2015. In the United States, for example, less government austerity is a significant growth driver, as it is expected to be just a 30 basis point “drag” versus a 1.0% drag in 2014 and a full 2.1% in 2013 (Exhibit 5). This reduction could go a long way towards reducing the sizeable gap that has existed between the private sector and overall GDP since as far back as 1Q10 (Exhibit 6).

U.S. Fiscal Drag Is Now Finally Waning

United States: Structural Fiscal Expansion/(Consolidation), %

-1.4

-1.3

-2.1

-1.0

-0.3

160bp per year, on average over three years

2011 2012 2013 2014e 2015e

EXHIBIT 5

Measured as change in general government underlying primary balance, adjusted for cycle and one-offs. Data as at December 31, 2014. Source: OECD Economic Outlook 96 Database.

Real Private Sector GDP Has Outpaced Overall U.S. GDP Growth by Approximately 90 Basis Points, On Average, Since 2010. This Gap Should Narrow in 2015

1.0%

1.5%

2.0%

2.5%

3.0%

3.5%

4.0%

4.5%

1Q10 3Q10 1Q11 3Q11 1Q12 3Q12 1Q13 3Q13 1Q14 3Q14

U.S. Real GDP y/y U.S. Real Private GDP y/y

Avg. 3.1% 3Q14 2.9%

Avg. 2.2% 2.4%

EXHIBIT 6

Data as at 3Q14. Source: Bureau of Economic Analysis, Haver Analytics.

European austerity, which has also been a big macro theme in recent years, is also starting to wane. One can see this in Exhibit 7, which shows that fiscal drag in 2015 could be essentially zero. Ironically though, a comparison of the data in Exhibits 5 and 7 also suggests that Europe, despite being in the press all the time for major budget tightening initiatives, has actually implemented less fiscal consolidation than the U.S. All told, Europe’s structural budget deficit closed, on average, by just 100 basis points per year from 2011-2013 versus 160 basis points in the United States.

That said, we do think the headline austerity numbers in Europe may actually understated the actual impact. Key to our thinking is that Europe’s numbers mask the fact that the region’s fiscal contraction
took place amidst 1) notable regional fragmentation and 2) without as much offsetting monetary stimulus for the hardest hit countries. As such, some work done by my colleague David McNellis concludes that every percentage point of fiscal consolidation has equated to a full 1.4% GDP drag in Europe of late (Exhibit 8), which is far above the 0.50-0.75% GDP drag we might expect from the same austerity impulse in the U.S. (Exhibit 5)

EXHIBIT 7
Fiscal Headwinds in Europe Are Now Slowing …

![Graph showing Euro Area: Structural Fiscal Expansion/(Consolidation), %]

-1.0 -1.3 -0.7 0.0 1.0 1.4
2011 2012 2013 2014e 2015e

70 bp less austerity in ’15e vs. ’13
100 bp per year, on average over three years

Measured as change in general government underlying primary balance, adjusted for cycle and one-offs. Data as at December 31, 2014. Source: OECD Economic Outlook 96 Database, Haver Analytics.

EXHIBIT 8
…Which Is Critical, as Austerity Has Taken a Big Economic Bite Out of Growth in Recent Years in the Eurozone

![Graph showing Annualized Real GDP Growth (‘09-’14e)]

-1.4x + 1.6%
y = -1.4x + 1.6%
R² = 82.4%

One percentage point of fiscal contraction has equated to 1.4% slower GDP growth

In Japan, there is also good news on the austerity front these days. What’s changed is that Prime Minister Shinzo Abe has successfully pushed to have the second leg of the consumption tax increase shelved. To review, after increasing the consumption tax to eight percent from five percent in April 2014, Abe recently shelved the proposed follow-on tax scheduled for October 2015, which was intended to increase the consumption tax to ten percent from eight percent. While the impact of the consumption tax would have been minimal in 2015 as it was scheduled for 4Q15, GDP growth in calendar year 2016 may now reach 1.8% versus 1.0% if the tax regime had been implemented.1

Separately, the other big consideration for the global economy’s growth trajectory is the potential benefit from lower commodity prices. If we use Brent oil as a proxy, it has declined a sizeable 50% over the past few months to $57.33/barrel (bbl) from a high of $115.06/bbl in June 2014. Beyond adding what we estimate to be over $1.7 trillion of annualized savings for energy consumers worldwide (Exhibit 12), we think the fall in the price of Brent crude also provides an important tailwind to central bank policy in many of the world’s major economies. Already, with oil prices now acting as a less of a drag on one of the world’s most dependent commodity importers, Japan has allowed its currency to rise to a high of 120 yen per U.S. dollar from 101 in July 2014.2

Meanwhile, in China — with inflation falling all the way to 1.4% in November 2014 from 6.5% in July 2011 — President Xi Jinping and Premier of the State Council Li Keqiang recently worked with the country’s central bank to cut rates for the first time since July 2012.3 In our view, this rate cut is a direct response to slower growth in the real economy and the increasing threat of deflation, and as such, we now expect additional easing measures after the Lunar New Year in February 2015.

In our view, this rate cut is a direct response to slower growth in the real economy and the increasing threat of deflation, and as such, we now expect additional easing measures after the Lunar New Year in February 2015.

Lower commodities – among other developments – are also shaping monetary policy in Europe, in our view. European Central Bank President Mario Draghi recently commented that he was not only going to increase the ECB’s balance sheet by one trillion euros but also that, beyond asset backed and covered bond purchases, “other unconventional measures might entail the purchase of a variety of assets, one of which is government bonds.” This statement, in our view, is a big deal, and as Exhibit 12 suggests, a lower-priced commodity environment now gives him a lot more flexibility to pursue a broader range of non-conventional measures to counter the downward pressure we now see on forward-looking inflation expectations.

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1 Data as at December 1, 2014. Source: Morgan Stanley Equity Research, Four Punches Knock Out Deflation.
2 Data as at December 31, 2014. Source: Bloomberg.
The ECB Target for Inflation Is Two Percent. Only Services Is Currently Even Close to Reaching That Level


As Such, Inflation Expectations Are Now Falling to Dangerously Low Levels

Market expected inflation is as per Eurozone inflation swaps. Data as at November 30, 2014. Source: Eurostat, Bloomberg.

So, our bottom line is that the collective benefit of both less government drag and lower commodity prices on global growth could be one of the more important macro stories in 2015. Consistent with this view, we are now comfortable forecasting that global growth will reach 3.1% in 2015 versus 2.7% in 2014 and 2.5% in 2013. One can see this in Exhibit 11, which also shows that the global economy finally starts to turn down around 2017 in our base case.


That said, our bigger picture view for 2015 is that we still expect ongoing bouts of significant volatility during this Asynchronous Recovery for several reasons. First, while a recent rate cut by China could help, it does not overshadow the structural issues the country faces as it shrinks its outsized fixed investment outlays. Also, given that China and its emerging market brethren are expected to account for nearly 74% of global growth (Exhibit 14), we worry that these

estimates place too much responsibility on the emerging consumer to drive growth up without some hiccups along the way. Let us not forget that U.S. and European shoppers still out-consume the BRIC countries by nearly a 3.5:1 ratio.

Second, we think the recovery will remain asynchronous because the global economy still lacks the type of overall demand that we have seen in prior recoveries. We believe real wage growth across the developed markets remains a major issue. As such, it is impossible for every country to narrow its deficits through more competitive exports when the lion’s share of countries we visit are now more focused on producing goods, not consuming them. Third, governments in the developed markets still need to deleverage, which historically has led to increased volatility in the global capital markets. Finally, we think many emerging market economies must deal with the overhang from too much money supply and credit growth in recent years. As a proxy, we note that today China’s M2 money supply growth is now running in the low double digits, versus a peak of around 30% in 2009. Without question, this slowdown in China’s M2 is affecting the growth trajectory of global fixed investment, commodity-related inputs in particular.

EXHIBIT 13
We Remain Committed to Our View That This Recovery Remains Asynchronous, Including Lower Than Expected Inflation

2015 GROWTH & INFLATION BASE CASE ESTIMATES

<table>
<thead>
<tr>
<th></th>
<th>KKR 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>3.2%</td>
<td>3.0%</td>
<td>0.7%</td>
<td>1.5%</td>
</tr>
<tr>
<td>EURO AREA</td>
<td>1.3%</td>
<td>1.1%</td>
<td>0.4%</td>
<td>0.6%</td>
</tr>
<tr>
<td>CHINA</td>
<td>6.9-7.0%</td>
<td>7.0%</td>
<td>1.8%</td>
<td>2.0%</td>
</tr>
<tr>
<td>BRAZIL</td>
<td>0.25%</td>
<td>0.85%</td>
<td>6.5%</td>
<td>6.4%</td>
</tr>
</tbody>
</table>


Unlike in past years, central bank policy around the world is now less in synch, which could create some tension in global capital markets, currencies in particular, during parts of 2015.

EXHIBIT 14
Consensus Forecast Now Relies on Strong EM Growth to Carry Global Growth. We Are More Cautious

Ongoing Commodity Pressures Amid Declining Currencies Could Create a Major Change in the Outlook for Both Commodity Producers and Consumer Nations

While the recent decline in oil is noteworthy, we think it is more reflective of three bigger macro trends that we see playing out in the global commodity arena. First, after a decade of China literally consuming almost all the incremental commodity supply (Exhibit 15), we think that its insatiable appetite is now waning. True, recent initiatives by the People’s Bank of China to lower interest rates could provide a short-term boost, but we do not think it will be enough to offset fixed investment overcapacity amid a period of slowing growth and falling inflation. Ultimately, China needs more credit extension in the consumer sector, not the corporate sector (which caters more to exports and fixed investments). However, as it stands now, consumer mortgages have higher capital charges (they can’t be securitized), have less of a government-implicit guarantee, and are being impaired by lack of deposit growth in the channel.

Second, technological improvements, particularly in the area of oil production, are contributing to record supplies of oil and natural gas. In 2014, for example, we estimate global crude oil supply grew by almost 1.5 million barrels per day (Mb/d), which is far higher than the roughly 1.0 Mb/d of run-rate demand growth we expect in coming years. As has been well documented in the press, the trend towards robust production is most apparent in the United States, but over time we also expect additional transfer of skills and technology to certain international destinations, including Mexico. Moreover, beyond ongoing technological advances, our research shows that Iran and Libya are still currently producing far below their historical rates and normalization could add to global supply over the longer term. However, unless there is an agreement on the Iranian nuclear

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program that reduces sanctions that currently keeps about a million barrels per day of Iranian crude off the market, we do not expect significant additions in 2015.

Third, given that many commodities are quoted in U.S. dollars, recent appreciation in the greenback has put further downward pressure on prices – a trend history suggests will continue (see Currency section for more details). Key to our thinking is that, as their currencies depreciate versus the dollar, local producers in countries like Russia, Brazil and South Africa are encouraged to still produce as it may be profitable in local terms, even if it is not in U.S. dollar terms. In many instances, commodity producers in EM countries can be affiliated with the government, often serving as a major source of fiscal revenue.

The examples can be striking: While crude oil fell about 50% in USD terms in June-December 2014, it was down only 9% in Russian ruble terms over the same period. Similarly, gold was down 10% in USD terms, but fell only three percent in South African rand. In Brazil, in coffee, Arabica futures were up 50% in USD terms in 2014, but up fully 69% in Brazilian real.8

So our bottom line is that we think that the current unwind of the commodity boom that defined much of the 2000-2010 period will continue. Importantly, amid this decline we do not think it is unreasonable for commodities to trade through their marginal cost curves. To be sure, we think that there will be opportunities amid the carnage, but a purge is coming as access to the recently outsized flow of credit wanes, suggesting that a much smaller universe of low-cost and lowly leveraged companies in sectors like copper and unconventional oil and gas garner outsized profits, not the entire sector as the consensus had – until recently – come to believe. Over time, this purge should be bullish. According to the investment bank Morgan Stanley, looking at when oil dropped 20% or more since 1982, 85% of the time the average one-year forward return was 34.9% (Exhibit 38).

China’s environmental headwinds, including pollution, water concerns and food safety, now represent potentially more contentious political issues than job creation, in our view.

---

8 Data as at December 31, 2014. Source: Bloomberg, Haver Analytics.
Against this backdrop, we think that the commodity-dependent countries like India and Japan stand to benefit mightily. Importantly, India is starting to enjoy not only lower inflation but also a smaller current account deficit (compliments of lower prices of imported oil and higher interest rates), which is important for its currency. Japan too should benefit from lower oil prices, given that it is a major oil importer. Already, the country’s central bank has elected to run with a significantly cheaper currency because oil prices become less of a deterrent to consumer spending at $50-$70 a barrel than they do at $95-$105 a barrel.

We believe both the U.S. and Europe should see stronger consumer activity in 2H15 if commodity prices, oil in particular, remain subdued. All told, our research shows that each 10% drop in oil initially adds around 0.2% to U.S. GDP growth. At the consumer level, we note that, according to the Bureau of Labor Statistics, gasoline/motor oil usage represents about $2,600 of total household income of around $64,000. So the recent 40% drop in gasoline prices, coupled with the 50% drop in oil, provides at least $1,000 of incremental shopping power per household\(^9\). Importantly, though, our work shows about a 12-month lag (i.e., lower oil prices are not a coincident indicator); moreover, given the importance of energy activity in fueling U.S. GDP growth during the 2010-2014 period, we do think that there will be important offsets to the standard notion that lower oil prices are universally good for growth throughout the United States.

**EXHIBIT 17**

Our Model Suggests a Notable Tailwind from Oil Price Declines, but Cautions That the Benefit Might Not Be Felt Fully for Several Quarters

---

**EXHIBIT 18**

We Think the Fall In Oil Prices Will Provide a 1.6% Boost to U.S. Consumers, Which Is Only Partially Offset by the Hit to Domestic Oil Producers

<table>
<thead>
<tr>
<th></th>
<th>BARRELS / DAY</th>
<th>ANNUAL VALUE ($BN)</th>
<th>IMPLIED GAIN / LOSS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>@ $100/ BBL</td>
<td>@ $60/ BBL</td>
</tr>
<tr>
<td>U.S. CRUDE CONSUMERS</td>
<td>19,010</td>
<td>694</td>
<td>416</td>
</tr>
<tr>
<td>U.S. CRUDE PRODUCERS</td>
<td>8,595</td>
<td>314</td>
<td>188</td>
</tr>
<tr>
<td>U.S. NET CRUDE POSITION</td>
<td>10,415</td>
<td>380</td>
<td>228</td>
</tr>
</tbody>
</table>

1 We estimate U.S. upstream investment may need to fall by roughly $40bn, half of which we assume is funded by credit, and therefore not captured by the $125bn cash hit to producers shown above. Data as at December 19, 2014. Source: Energy Intelligence, U.S. Bureau of Economic Analysis, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

---

On the other hand, we expect that the fiscal situations in Russia, Nigeria, Chile, South Africa, and Brazil will remain under pressure as the “hangover” effect from lower commodity prices ripples through the economic outlook for these commodity export-dependent economies. This viewpoint is significant because we think it also means that their currencies and certain related credits could remain under pressure. Already, many of the aforementioned commodity plays have seen their currencies fall substantially since the beginning of 2014. However, given that many of these countries are now experiencing declines in both export volume and price, we still see bumper roads ahead as fiscal balances are harder to achieve amid increasing social unrest and rising inflation. At the moment, we are most cautious on the economies of Russia and Brazil.

If there is good news, in the near term we think that the overall markets can withstand the tension being created between beneficiaries of and losers from lower prices in the commodity arena. As such, we expect to hear a lot in the investment community about a “decoupling” of commodity beneficiaries from commodity-inflicted countries.

However, we should not underestimate the impact of shifting $1.7 trillion of value from producing nations to consumer nations in a relatively short period of time (Exhibit 12). Our work, which we detail below, shows neither a global recession nor a capital markets crisis is likely, particularly given higher reserves and lower debt levels.

---


However, we think that the ongoing tension that is already being created in the global capital markets from this massive shift of economic value from commodity producing nations towards consumer-oriented, import-dependent nations is not likely to abate, and as such, it could be one of the biggest macro stories in 2015.

**EXHIBIT 19**

In Aggregate, External Debt to GDP Levels Are 25% Lower Than in 1997...

![Graph showing external debt as a % of GDP]

Data as at December 31, 2013. Source: IMF, Haver Analytics

---

*Our base view is that not only is the absolute return in global equities likely to be lower on a go-forward basis, but we also believe the Sharpe ratio is likely to decline.*

---

**EXHIBIT 20**

...But Some Countries Are Still Challenged vis-à-vis Import Cover

**Reserves in Months Import Cover**

<table>
<thead>
<tr>
<th>Country</th>
<th>1997</th>
<th>Current</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>10.5</td>
<td>18.8</td>
</tr>
<tr>
<td>Russia</td>
<td>7.7</td>
<td>14.7</td>
</tr>
<tr>
<td>Colombia</td>
<td>9.6</td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>8.5</td>
<td></td>
</tr>
<tr>
<td>India</td>
<td>8.2</td>
<td></td>
</tr>
<tr>
<td>Nigeria</td>
<td>8.8</td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>7.3</td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>7.1</td>
<td></td>
</tr>
<tr>
<td>Turkey</td>
<td>7.0</td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>6.1</td>
<td></td>
</tr>
<tr>
<td>Venezuela</td>
<td>5.9</td>
<td>16.2</td>
</tr>
<tr>
<td>South Africa</td>
<td>5.8</td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>8.8</td>
<td>18.4</td>
</tr>
<tr>
<td>Egypt</td>
<td>3.1</td>
<td></td>
</tr>
<tr>
<td>Vietnam</td>
<td>3.1</td>
<td></td>
</tr>
</tbody>
</table>

Data as at November 30, 2014 or latest available. Source: Above referenced respective central banks, World Bank, Haver Analytics.

**EXHIBIT 21**

Overall, Though, Reserves Are More Than Sufficient to Cover Short-term External Debt Needs...

**Reserves / Short Term External Debt**

<table>
<thead>
<tr>
<th>Country</th>
<th>1997</th>
<th>Current</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nigeria</td>
<td>1.3</td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>1.5</td>
<td></td>
</tr>
<tr>
<td>Russia</td>
<td>2.1</td>
<td></td>
</tr>
<tr>
<td>Colombia</td>
<td>1.7</td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>0.5</td>
<td></td>
</tr>
<tr>
<td>Vietnam</td>
<td>0.8</td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>1.0</td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>0.7</td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>1.5</td>
<td></td>
</tr>
<tr>
<td>Turkey</td>
<td>1.5</td>
<td></td>
</tr>
<tr>
<td>Venezuela</td>
<td>1.1</td>
<td></td>
</tr>
<tr>
<td>India</td>
<td>3.6</td>
<td>5.5</td>
</tr>
<tr>
<td>Egypt</td>
<td>4.6</td>
<td>6.8</td>
</tr>
</tbody>
</table>

Data as at November 30, 2014 or latest available. Source: Above referenced respective central banks, World Bank, Haver Analytics.
Financial Services “Plumbing” Still Not Working, in Our View, Despite Surging Global Monetary Base

Though it has been 75 months since Lehman Brothers filed for bankruptcy, our work shows that the traditional financial services industry is still not functioning properly. Supporting our view is that, as one can see in Exhibit 23, the money multiplier remains somewhat “broken.” This realization is particularly noteworthy, given the size of the increases in central bank balance sheets in recent years (Exhibit 24).

To be sure, the illiquidity premium that we identified three years ago has begun to erode in some areas of the market (and hence, why we have reduced some of our overweight positioning). However, in a world of extremely low government bond yields, we think that the benefit of 300-400 basis points of illiquidity premium that one can obtain through the direct, non-bank lending market is extremely compelling versus a seven percent hurdle rate for many pensions and – depending on the country – a 50 basis points to 2.5% 10-year “risk-free rate” in today’s market environment. Also, given the lack of liquidity in the traditional credit markets these days, we are of the mindset that there is an ongoing blurring between the over-the-counter and the negotiated private markets, particularly during periods of stress in the system.

What’s driving this opportunity set? In addition to a deflated money multiplier, the traditional banking industry is also suffering from its inability to facilitate customer flow the way it did in the past. Indeed, as Exhibit 26 shows, dealer inventories have shrunk to a puny $59 billion in November 2014 from a sizeable $285 billion in October 2007. Not surprisingly, this decline coincides with a dramatic fall-off in leverage within the broker-dealer and universal bank community, which has collapsed by more than 40% since 2008 (Exhibit 25). Moreover, because of heightened regulation, traditional financial intermediaries are unable to participate in many of the higher margin,
non-traditional lending opportunities at a time when many small- to medium-size businesses need access to credit. Finally, there are just more needy industries that are either impaired and/or require customized lending solutions. As such, we expect skilled managers to be able to increasingly earn near distressed-like returns, but in performing situations.

**EXHIBIT 25**

**Leverage for Broker-Dealers Has Collapsed, Creating a Significant Opportunity for Non-Traditional Lenders**

Wall Street Assets / Equity Ratio

- 3Q08 18.2
- 3Q14 10.6

-42% in aggregate, but varying between -27% and -66% on a company level

Aggregate of GS, MS, BAC, C, and JPM balance sheets. Data as at 3Q14 Source: Factset.

**EXHIBIT 26**

**Lower Inventories in the Broker Dealer Community Have Massively Dented Liquidity**

Primary Dealer Positions: Corp Securities, U.S. $ Billions

- Oct-07 285
- 59

A decline of nearly 80%


**EXHIBIT 27**

**A Yield Comparison of Originated vs. Traded Leveraged Loans Suggests the Illiquidity Premium Is Still Significant**

<table>
<thead>
<tr>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014 YTD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Weighted Average Yield of Originated Senior Term Debt</td>
<td>11.2%</td>
<td>12.0%</td>
<td>11.4%</td>
<td>10.8%</td>
<td>9.7%</td>
<td>9.6%</td>
<td>7.8%</td>
</tr>
<tr>
<td>12-Month Average Yield of Traded Loans</td>
<td>8.3%</td>
<td>10.7%</td>
<td>5.8%</td>
<td>5.8%</td>
<td>6.0%</td>
<td>5.1%</td>
<td>4.8%</td>
</tr>
</tbody>
</table>


**EXHIBIT 28**

**Over 240 Basis Points of Illiquidity Premium on Offer in European Middle Market Loans Today**

| European Syndicated Leveraged Loan New Issue Spreads (B+/B) (Average senior leverage: 5.0x) (Note 1) | Credit Risk Premium for Middle Market Loans (Note 2) | Illiquidity Premium (Note 3) | Underwriting Fees (Note 4) | All-in Spread plus fees for European Middle Market Loans (Average senior leverage: 4.7x) (Note 5) |
| 4.1% | 2.4% | 0.9% | 8.0% |

Data as at November 30, 2014. Source: KKR Credit. See endnote 1 for important disclosures1.
Importantly, we see this opportunity set as a global one. In Europe, for example, banks appear to be backing away from smaller companies and credits that are non-traditional or complex. Separately, in many parts of Asia we see a growing number of non-bank lending opportunities, including India and Indonesia. To be sure, these types of investments require more due diligence and a higher risk premium, but our conclusion is that the global disconnect between the growing demand for non-traditional capital by small- to medium-size businesses as well as the inability of traditional financial intermediaries to meet this need – despite a sea of central bank-induced liquidity – remains one of the great anomalies in the global capital markets.

Styles to Pursue Within Public Equities: We Retain a Barbell Approach

We approach global equities with two dramatically different strategies in 2015. On the one hand, in the developed markets we retain our bias for relatively inexpensive stocks with excess cash flow that is being redeployed in the form of dividends, buybacks and/or acquisitions. Without question, we still favor our Brave New World names (see our earlier note Brave New World: The Yearning For Yield Across Asset Classes for further details), which places an additional emphasis on rising dividends and improving returns on equity. Importantly, we are not alone in this view, as the recent surge in activist investors validates our view that many companies in the United States are operating with cost of capital that is equal to their cost of equity and significantly in excess of cost of debt, which is usually sub-optimal outside of the hyper-growth part of the market. Consistent with this view, we also expect global M&A activity to exceed 2014’s level of $2.9 trillion.

EXHIBIT 29

We Remain Constructive On Stocks With Yield and Growth

Indexed Returns for Various Dividend Yield Buckets

<table>
<thead>
<tr>
<th>Dividend Yield Bucket</th>
<th>Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-1%</td>
<td>30</td>
</tr>
<tr>
<td>1-2%</td>
<td>25</td>
</tr>
<tr>
<td>2-3%</td>
<td>20</td>
</tr>
<tr>
<td>3-4%</td>
<td>15</td>
</tr>
<tr>
<td>4-5%</td>
<td>10</td>
</tr>
<tr>
<td>&gt;5%</td>
<td>5</td>
</tr>
</tbody>
</table>


EXHIBIT 30

A Record Number of European Companies Now Have Dividend Yields Above Corporate Bond Yields


We see similar opportunities to buy attractively priced high dividend yield, cash flowing companies outside of the United States. In Europe, for example, nearly 65% of the companies now trade with a dividend yield that is above their corporate bond yield. Importantly, as Exhibit 29 shows, positioning appears quite clean as many investors exited the region in the fall of 2014 after the IMF cited concerns about Europe’s growth profile.

On the other hand, in the emerging markets we are willing to pay up for high quality consumption stories that are linked to improving GDP per capita dynamics versus just GDP growth. Our favorites for 2015 again include both India and Mexico. In India, we are more bullish than the consensus expectations for lower inflation, which we think is constructive for trading multiples. We also believe that earnings growth could be stronger than many folks think as improving confidence encourages both consumers and businesses to spend more.

In Mexico we think that the negative shock of last year’s tax increases has abated. Meanwhile, Mexico’s export economy is accelerating at a time when even the naysayers of President Enrique Pena Nieto’s reforms acknowledge that this multi-year transition is still ahead of schedule in many areas. To be sure, lower oil prices will hurt government spending in the near term, and we are closely watching the Pena-Nieto administration’s response to recent rule of law and corruption allegations. Nonetheless, our overall view is that both Mexico’s capital markets and its currency represent good long-term value at current levels. Within Mexico we are most favorable on real estate; in particular, we think that commercial real estate is underpriced at a time when many multinationals are increasingly considering calling Mexico City, not Sao Paulo, their home base in Latin America.


12 Data as at November 26, 2014. Source: Itaú BBA.
SECTION II: Asset Class Review

Distressed/Special Situation: Our Largest Wager for 2015

There is no harm in repeating a good thing. Plato

When we did our 2014 mid-year outlook update (see Midyear Outlook: Four Big Macro Trends at Work), we spent a significant amount of time discussing why we believe that in today’s uneven growth environment investors should consider allocating more capital to special situations-type investments. In the past, many of the most attractive opportunities were related to corporate restructurings and deleveraging stories in the developed markets.

However, based on recent trips to India, Indonesia and China, we see that many banks in the region are now carrying too much bad corporate credit and, as a result, there is a growing role for private lenders and restructuring professionals to step in and provide value-added capital to struggling corporations across a variety of sectors in the emerging markets. Importantly, we see this opportunity as secular, not cyclical, as credit creation in the emerging markets in recent years has been outsized.

In many instances these deals are large and complicated, requiring not only expertise in financial engineering but also in operational capability. This insight is important, we believe, because many investment managers in emerging markets are currently set up to do public investing and/or private equity, but not the restructurings, recaps, and deleveragings that we think are needed. As a result, we think many firms, particularly in the alternatives space, will be forced to overhaul their models. In particular, we think the ability to move up and down the capital structure and provide corporate partners with value-added financial and operational expertise will go from being a luxury offering to becoming a prerequisite for success in the new era of emerging market investing we now envision.
EM Credit Has Mushroomed Since the Great Recession

<table>
<thead>
<tr>
<th>Emerging Markets Domestic Bank Loans as a % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
</tr>
<tr>
<td>Emerging Markets</td>
</tr>
<tr>
<td>EM Asia</td>
</tr>
<tr>
<td>China</td>
</tr>
<tr>
<td>India</td>
</tr>
<tr>
<td>Indonesia</td>
</tr>
<tr>
<td>Singapore</td>
</tr>
<tr>
<td>Thailand</td>
</tr>
<tr>
<td>Hong Kong</td>
</tr>
<tr>
<td>Latin America</td>
</tr>
<tr>
<td>Brazil</td>
</tr>
<tr>
<td>Mexico</td>
</tr>
<tr>
<td>Argentina</td>
</tr>
<tr>
<td>EMEA EM</td>
</tr>
<tr>
<td>Russia</td>
</tr>
<tr>
<td>South Africa</td>
</tr>
<tr>
<td>Turkey</td>
</tr>
</tbody>
</table>

Data as at August 31, 2014. Source: JPMorgan Research, IMF.

We also think that the recent carnage in energy will ultimately prove to be an interesting investment opportunity. According to work done by my colleague David McNellis, both rig counts and investment could fall notably over the next 12 months. One can see his research in Exhibits 35 and 36. Without question, calling the bottom in commodities is hard, but as Exhibit 37 shows, there is certainly a lot of stress now in the system, which we think could create some opportunities to support low cost producers with differentiated strategies as well as help to repair the finances of companies that were too optimistic about both prices and drilling activity. Importantly, derivative structures, including selling puts that harness the market’s outsized volatility in the energy sector, appear compelling. All told, volatility in the sector is now upwards of 60%, nearly triple where it was in the spring of 2014 (Exhibit 37).
E&P and Oil Service Volatility Is Up 200% Since June 2014; Our Intent Is to Harness It

Exhibit 37

Implied Volatility, %

Market Vectors Oil Service
SPDR S&P Oil & Gas Exploration and Production


Looking at History, There Seems to Be Opportunity When Oil Declines 20% or More

Exhibit 38

<table>
<thead>
<tr>
<th>WTI Spot Oil Price, % Change of U.S.$ Price / Barrel and Subsequent 1 Year Forward Return</th>
<th>Date of Trough</th>
<th>Date of Peak</th>
<th>Duration Trough to Peak (Months)</th>
<th>% Change Trough to Peak</th>
<th>P/E Multiple</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apr-42</td>
<td>May-46</td>
<td>49</td>
<td>157.1%</td>
<td>177%</td>
<td></td>
</tr>
<tr>
<td>Jun-49</td>
<td>Dec-52</td>
<td>42</td>
<td>96.2%</td>
<td>87%</td>
<td></td>
</tr>
<tr>
<td>Sep-53</td>
<td>Aug-56</td>
<td>35</td>
<td>119.0%</td>
<td>51%</td>
<td></td>
</tr>
<tr>
<td>Dec-57</td>
<td>Jul-59</td>
<td>19</td>
<td>53.8%</td>
<td>45%</td>
<td></td>
</tr>
<tr>
<td>Oct-60</td>
<td>Dec-61</td>
<td>14</td>
<td>38.9%</td>
<td>39%</td>
<td></td>
</tr>
<tr>
<td>Jun-62</td>
<td>Jan-66</td>
<td>43</td>
<td>79.8%</td>
<td>2%</td>
<td></td>
</tr>
<tr>
<td>Sep-66</td>
<td>Nov-68</td>
<td>25</td>
<td>48.0%</td>
<td>35%</td>
<td></td>
</tr>
<tr>
<td>Jun-70</td>
<td>Jan-73</td>
<td>31</td>
<td>73.5%</td>
<td>32%</td>
<td></td>
</tr>
<tr>
<td>Oct-74</td>
<td>Dec-76</td>
<td>26</td>
<td>72.5%</td>
<td>57%</td>
<td></td>
</tr>
<tr>
<td>Mar-78</td>
<td>Nov-80</td>
<td>32</td>
<td>61.7%</td>
<td>21%</td>
<td></td>
</tr>
<tr>
<td>Aug-82</td>
<td>Aug-87</td>
<td>60</td>
<td>228.8%</td>
<td>166%</td>
<td></td>
</tr>
<tr>
<td>Dec-87</td>
<td>Jul-90</td>
<td>31</td>
<td>64.8%</td>
<td>18%</td>
<td></td>
</tr>
<tr>
<td>Oct-90</td>
<td>Mar-00</td>
<td>112</td>
<td>417.0%</td>
<td>113%</td>
<td></td>
</tr>
<tr>
<td>Oct-02</td>
<td>Oct-07</td>
<td>60</td>
<td>101.5%</td>
<td>-1%</td>
<td></td>
</tr>
<tr>
<td>Average</td>
<td></td>
<td>41.3</td>
<td>115.0%</td>
<td>42%</td>
<td></td>
</tr>
<tr>
<td>Mar-09</td>
<td>Dec-14</td>
<td>68</td>
<td>204.0%</td>
<td>40%</td>
<td></td>
</tr>
</tbody>
</table>

Performance on a monthly basis, peak to trough. PE Multiple as of nearest month end. Data as at December 31, 2014. Source: Standard & Poor’s, Omega Advisors.

Public Equities: Less Aggressive Posture to Start the Year

As we indicated earlier, we have begun to lower our Public Equities allocation for the first time since joining KKR in 2011. We are not bearish per se, as we expect S&P 500 earnings to grow a solid 6.0% in 2015. Overall though, we need to recognize that this bull market has been an over-achiever from almost any vantage point, recent dollar gains are now likely to more than offset the benefits of corporate buyback activity, and the tailwind from multiple expansion is now finally abating, in our view. All told, as Exhibit 39 shows, the total return on the S&P 500 is now already 204% this cycle versus a historical norm of 115%. Moreover, as Exhibit 40 shows, even amid some of the great bull markets, the propensity for the market to go up consistently every single year is not that high this late in the cycle.

“There is certainly a lot of stress now in the system, which we think could create some opportunities to support low cost producers with differentiated strategies as well as help to repair the finances of companies that were too optimistic about both prices and drilling activity.”
As one can see in Exhibit 42, price-to-earnings ratios tend to contract around decisions by the Federal Reserve to become less accommodative. This outcome makes sense to us as the transition from a P/E led market to an earnings-driven one means that volatility typically increases. We certainly expect this fact pattern to hold true in 2015, though we do expect less multiple compression this tightening cycle for two reasons. First, commodity prices are falling, which lowers the risk premium on owning stock in many equity markets, particularly developed ones. Second, as we describe below in detail in the fixed income section, we think that low inflation will encourage the Federal Reserve to keep its tightening campaign quite mild by historical standards. In particular, we expect the Fed to hike only 275 basis points this cycle versus 319, on average, during prior cycles (see Exhibit 55 for details).

So as we look ahead, we think that the S&P 500 can deliver around $126 in earnings in 2015, which would represent around 6.0% in earnings growth, versus $118.50 in 2014. We also think that the multiple on the S&P 500 can trade at 17.1 times in 2015, down from 17.5 in 2014. If we are right about a slight multiple contraction in 2015 against a backdrop of modest earnings growth, then our outlook
for 2015 would suggest a target for the U.S. market index of around 2,155 (Exhibit 45). Including a dividend yield of just under 2.0%, we therefore expect the S&P 500 to return of 6-7% in 2015.

EXHIBIT 43

In Current Environment, Falling Yields Look Like a Valuation Headwind...


EXHIBIT 45

Amid Some Volatility, We See More Modest Gains for the S&P 500 in 2015

Data as at December 31, 2014 Source: Factset.
Acquirers Are Still Being Rewarded for Acquisitions

Acquirers Average One Day Stock Performance Relative to the S&P 500


Dividends and Stock Buybacks Remain Strong, Growing at a 22% CAGR from 2009-2014E

Data as at December 18, 2014. Source: Standard and Poor’s, KKR Global Macro & Asset Allocation analysis.

Outside of the United States, we are overweight Asia, underweight Latin America and equal weight Europe. In Asia, we see equity markets in India, Japan and China all doing well. Key to our thinking is that, as a region, we believe Asia benefits mightily from lower oil prices. By comparison, we retain our negative stance towards Brazil, Latin America’s largest market. As our below consensus GDP forecast indicates, we are quite concerned about growth, particu-

Fixed Income: Less “Spicy” but More Opportunistic

While fixed income is never easy to predict, we do feel some relief as we think about 2015. Why? Because we think the direction of global rates has become more of a relative call — not an absolute one. Specifically, our message for how the long-term rates trade remains unchanged: follow the German bund and then decide how much you think Treasuries can trade above that. At the moment, the yield on the Bund is approximately 54 basis points. As Exhibit 49 shows, the US 10-year has not traded more than 200 basis points above the Bund in over 25 years, and as such, we are willing to wager that rates stay bound within this range in 2015. Specifically, we see the U.S. 10-year yield rising only modestly to 2.6%.

German Yields Are Likely to Remain at Historic Lows...


Our goal is to add some ballast to fixed income portion of the portfolio during what we believe could be a more volatile year for the asset class.
And With the U.S.-German Spread Near a Historic High, We Think It Will Constrain the Near-Term Upside to U.S. Treasury Yields.

<table>
<thead>
<tr>
<th>Date</th>
<th>Spread (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apr-89</td>
<td>2.16</td>
</tr>
<tr>
<td>May-99</td>
<td>1.51</td>
</tr>
<tr>
<td>Sep-05</td>
<td>1.18</td>
</tr>
<tr>
<td>Dec-14</td>
<td>1.63</td>
</tr>
<tr>
<td>Dec-15e</td>
<td>1.90</td>
</tr>
</tbody>
</table>

At the moment, our forecast envisions German yields of 70 basis points next year, based off forwards market pricing that looks reasonable to us given the disinflationary forces at work in Europe. Importantly, our “fundamental” 2.6% forecast for the U.S. 10-year next year, which incorporates the relative value impact of ultra-low German rates, is well below the 3.0% rate forecast of our “quantitative” modeling, which is based purely on the present value of our future short-term rate expectations. One can see the difference between our “fundamental” and “quantitative” forecasts in Exhibit 50.

Looking further ahead, our modeling suggests a U.S. 10-year yield that could reach a fair value of 3.25% by 2017, which coincides with what we believe will be the approximate peak for this cycle. Importantly, though, in the near term, we do not see a lot of wiggle room in longer-term rates. Consistent with this view, our rates forecasts imply only slight upside to current market pricing this year (on the order of 10-20 basis points), whereas we are 30-50 basis points higher than the consensus on three-year forward implied expectations for interest rates.

**Despite a surge in the global monetary base, access to credit remains a major issue, particularly for small- to medium-size businesses.**

### Exhibit 50

<table>
<thead>
<tr>
<th>Interest Rates: We Forecast a Slow Crawl to Higher Levels</th>
</tr>
</thead>
</table>
| KKR GMAA “fundamental” forecast for 2015 assumes that U.S. 10yr yield is capped at 2.6%, which is 190 basis points above the one-year forward German 10yr yield of 0.7%. Quantitative fair values are based on our estimates of the present value of future short term rates. Data as of December 31, 2014. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

<table>
<thead>
<tr>
<th>Year</th>
<th>KKR GMAA FUNDAMENTAL</th>
<th>KKR GMAA QUANT “FAIR VALUE”</th>
<th>MARKET</th>
<th>KKR GMAA VS. MARKET (BASIS PTS.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>10YR YIELD, 2015</td>
<td>2.60%</td>
<td>3.00%</td>
<td>2.43%</td>
<td>17</td>
</tr>
<tr>
<td>10YR YIELD, 2017</td>
<td>3.25%</td>
<td>3.25%</td>
<td>2.68%</td>
<td>57</td>
</tr>
<tr>
<td>10YR REAL, 2015</td>
<td>0.70%</td>
<td>1.00%</td>
<td>0.50%</td>
<td>20</td>
</tr>
<tr>
<td>10YR REAL, 2017</td>
<td>1.25%</td>
<td>1.25%</td>
<td>0.71%</td>
<td>54</td>
</tr>
<tr>
<td>5YR YIELD, 2015</td>
<td>2.20%</td>
<td>2.60%</td>
<td>2.15%</td>
<td>5</td>
</tr>
<tr>
<td>5YR YIELD, 2017</td>
<td>3.00%</td>
<td>3.00%</td>
<td>2.67%</td>
<td>33</td>
</tr>
<tr>
<td>5YR REAL, 2015</td>
<td>0.40%</td>
<td>0.50%</td>
<td>0.37%</td>
<td>3</td>
</tr>
<tr>
<td>5YR REAL, 2017</td>
<td>1.00%</td>
<td>1.00%</td>
<td>0.63%</td>
<td>37</td>
</tr>
</tbody>
</table>

Implicit in our forecasts is that inflation stays low not only in Europe but also in the United States. Otherwise, we think the relative comparisons versus Europe would become irrelevant and our Fed outlook would likely need to accelerate too. But from where we stand today, U.S. inflation seems set for an exceedingly moderate reading of just 0.7% or so in 2015. Exhibit 51 details our expectations. On the one hand, we forecast core CPI to remain at 1.75%. Moreover, we expect energy deflation of fully 12% or so, which envisions that OPEC continues its policy of not supporting oil markets, holding oil range-bound around $50-70 per barrel. Beyond 2015, we see oil stabilizing and eventually moving back towards $80-100 per barrel, as EM countries eventually achieve higher economic growth and producers reduce previously anticipated growth expectations. As such, we ultimately see the longer term outlook of inflation reverting back towards two percent (Exhibit 64), but investors should make no mistake that inflation is going to be extraordinarily low in 2015.
EXHIBIT 51

Implicit in Our Rates Forecast Is That Inflation Stays Low in 2015

**KKR GMAA 2015e U.S. Inflation Forecast**

<table>
<thead>
<tr>
<th>Core CPI (ex Food &amp; Energy)</th>
<th>Food</th>
<th>Energy</th>
<th>Headline CPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.75%</td>
<td>3%</td>
<td>-12%</td>
<td>0.7%</td>
</tr>
</tbody>
</table>


EXHIBIT 52

Our Fed Expectations Are Above the Market’s, but Below the Fed’s Own Forecasts

**Fed Funds Expected Rates**

- **FOMC Forecast**
- **GMAA Forecast**
- **Market**


EXHIBIT 53

U.S. Average Hourly Earnings Rise as Unemployment Decreases. We See This as a Risk to the Front End of the Curve by 2H15/1H16

**U.S. Average Hourly Earnings Y/y For Various U.S. Unemployment Rates (1985-2013), %**

- ≤ 5%
- 5–6%
- 6–7%
- 7–8%
- > 8%


EXHIBIT 54

We Finally Think Some Wage Growth Could Be a Risk by 2H15 as More Firms Commit to Adding Workers

**Net % Planning to Raise Worker Compensation (L)**

- **US: Average Hourly Earnings Y/y (R)**


Our low near-term inflation backdrop also influences our short-term rate views. Specifically, while we believe that growth and employment trends remain solid, we see few examples of the wage inflation that might be required to inspire the Federal Reserve to hike aggressively in 2015 and beyond. At the moment, our base case is that the Fed begins hiking around June 2015, then proceeds at a historically slow pace of just 150 basis points per year (Exhibit 55), which
equates to hiking 25 basis points at six of its eight meetings each year. Thereafter, we see rates topping out around 3.0% in 2017, then rolling over in 2018 as a mild recession takes hold. Exhibit 52 shows that our medium-term Fed expectations are considerably higher than current market pricing as expressed by Fed Funds and Eurodollar futures, but considerably lower than the Fed’s own forecasts. Hence, we continue to think that this arbitrage between market pricing versus ours and the Fed’s forecasts is one of the more interesting hedging opportunities in the global rates space.

In terms of credit, we have bolstered our Opportunistic Credit allocation in 2015 to take advantage of ongoing dislocations we are now seeing across high yield, bank loans, and other credit instruments. In addition to heightened government regulation on the dealer community, pure technical flows, including the now sizeable ETF market, can periodically create attractive entry prices for managers who are patient and nimble.

At the moment, our work shows that instruments still appear attractive on both an absolute and relative basis. As Exhibit 56 shows, the implied “earnings yield” on high yield bonds versus stocks has not been this compelling since January of 2010. We see a similar message when compared on a relative basis as one can see in Exhibit 57. To be sure, we are not arguing that we are back to a 2009-like buying opportunity, but – following the recent energy-related sell-off in 4Q14 – the risk profile of credit, high yield in particular, now appears more attractive in our view. As Exhibit 58 also shows, we think that high yield looks attractive relative to bank loans at the moment, though we fully acknowledge that this may change during the year as technical forces and renewed fears about the Fed gain momentum (hence, the desire to bolster our Opportunistic Credit allocation this year).

Separately, we retain a zero percent weighting in Emerging Market Debt in 2015. We continue to see EM growth as disappointing, and we believe that the recent explosion in both sovereign and foreign debt means that issuer quality may have declined more than the consensus may now currently think.

---

**EXHIBIT 55**

We Believe Next Interest Rate Hike Cycle Will Be Historically Mild Relative to History

<table>
<thead>
<tr>
<th>TROUGH MONTH</th>
<th>PEAK MONTH</th>
<th>MONTHS</th>
<th>TROUGH RATE</th>
<th>PEAK RATE</th>
<th>CHANGE (BASIS POINTS)</th>
<th>RATE OF CHANGE (BASIS POINTS/YR)</th>
<th>CPI Y/Y AT PEAK</th>
<th>REAL FED RATE AT PEAK</th>
</tr>
</thead>
<tbody>
<tr>
<td>FEB-83</td>
<td>AUG-84</td>
<td>18</td>
<td>8.50%</td>
<td>11.50%</td>
<td>300</td>
<td>200</td>
<td>4.3%</td>
<td>7.2%</td>
</tr>
<tr>
<td>DEC-86</td>
<td>MAY-89</td>
<td>29</td>
<td>5.88%</td>
<td>9.81%</td>
<td>394</td>
<td>163</td>
<td>5.4%</td>
<td>4.4%</td>
</tr>
<tr>
<td>JAN-94</td>
<td>FEB-95</td>
<td>13</td>
<td>3.00%</td>
<td>6.00%</td>
<td>300</td>
<td>279</td>
<td>2.9%</td>
<td>3.1%</td>
</tr>
<tr>
<td>MAY-99</td>
<td>MAY-00</td>
<td>12</td>
<td>4.75%</td>
<td>6.50%</td>
<td>175</td>
<td>175</td>
<td>3.2%</td>
<td>3.3%</td>
</tr>
<tr>
<td>MAY-04</td>
<td>JUN-06</td>
<td>25</td>
<td>1.00%</td>
<td>5.25%</td>
<td>425</td>
<td>205</td>
<td>4.3%</td>
<td>1.0%</td>
</tr>
<tr>
<td>AVERAGE</td>
<td></td>
<td>19</td>
<td>4.6%</td>
<td>7.8%</td>
<td>319</td>
<td>204</td>
<td>4.0%</td>
<td>3.8%</td>
</tr>
<tr>
<td>KKR GMAA ’15-’17 EST.</td>
<td>20-24</td>
<td>0.25%</td>
<td>3.00%</td>
<td>275</td>
<td>150</td>
<td>2.0%</td>
<td>1.0%</td>
<td></td>
</tr>
</tbody>
</table>


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**EXHIBIT 56**

High Yield Relative Valuation Is Most Attractive Since Mid-2010, but Still Near Low End of Historical Range Because of QE

U.S. High Yield STW vs. U.S. Equities Earnings Yield*

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We are now 12 months later in the cycle at a time when asset prices are higher and the world’s most influential central bank is about to shift its stance on monetary policy.

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**EXHIBIT 57**

On a Spread Basis, Junk Yields vs. Equity Earnings Yields Are the Most Attractive Since Mid-2010

![Graph](image)


**EXHIBIT 58**

The Spread Between U.S. High Yield and Leveraged Loans Has Moved Back Towards 2011 Levels

![Graph](image)

Data as at December 31, 2014. Source: JPMorgan High Yield Bond Index STW US (CSSWUS), JPMorgan Leveraged Loan Index Loans Spread to Maturity (JLSMLLI), Bloomberg.

**EXHIBIT 59**

Bond Index Fund Flows Have Increased Over 400% Since 2008

![Graph](image)


Other Alternatives: Growth Capital Allocation / VC/ Other Comes Down

Beyond the sizeable opportunities we see in Distressed / Special Situation, we retain a five percent allocation to Traditional Private Equity because we believe that this asset class can play a meaningful role in both boosting performance and increasing diversification.

From a regional perspective, we are particularly bullish on Asia private equity as we believe it is a superior asset class to public emerging market equities, many of which are plagued with large state-affiliated — and often underperforming — companies. Also, private equity allows an investor to get access to key themes, including healthcare, environmental services, and education, that may not be available or well represented in a public stock market index. That said, in the traditional public markets EM’s relative underperformance has been extreme in many instances, which now seems to be creating valuation opportunities not currently seen in the developed public equity markets these days in sectors like consumer durables and industrials. Separately, we are more reserved in Latin America, as we think that a Dilma Rousseff-led Brazil still needs to do more to stabilize its macro backdrop. Mexico clearly has a better macro backdrop than Brazil, but we think a local presence and solid industry expertise are prerequisites for success.

Meanwhile, we still see some interesting opportunities in the traditional developed market buyout space, though less so at this point in the cycle. In the U.S., for example, we think that managers must find companies where there is substantial opportunity for consolidation and/or operational improvement. Even so, given that we are 67 months into an economic recovery, we think any new long-term investment likely needs to incorporate some type of recession into its base case forecast. As Exhibit 60 shows, we are also becoming more skeptical of sponsor-to-sponsor transactions, given the recent surge in activity. Separately, in Europe, we believe that the consumer “trade down” thesis, which was so vibrant in the United States post-2009,
is now gaining momentum. We also see the opportunity for PE firms to acquire global players that are occasionally trading at discounted valuations because they are domiciled in Europe.

**EXHIBIT 60**

Sponsor LBO Volume Spiked Notably in 2014, While Traditional LBO Volume Has Shrunk

![Graph showing distribution of LBO volume by type](image)

Data as at 3Q14. Source: S&P Capital IQ, S&P LCD.

**EXHIBIT 61**

The Valuations of Hyper-Growth Investments Now Appear Rich to Us in Many Instances

![Graph showing price-to-book, change from January 2012 to December 2014](image)


As we mentioned in our introduction, we are less sanguine on growth/VC investments. Valuations have moved up considerably in both the private and public markets (Exhibit 61), and we now view this part of the market as more expensive relative to risk-adjusted return profiles we think that investors can achieve being higher up in the capital structure at this point in the cycle in restructurings, recapitalizations, and certain de-leveragings.

**Real Assets: Strategy Still Working – Outlook Largely Unchanged**

Whether we have been lucky or good, we have been strong advocates of owning private real assets with yield, growth, and inflation hedging versus traditional liquid commodity swaps and notes. We have held this view for two reasons. First, our cautious view of the China growth story, fixed investment in particular, has made us question the sustainability of permanently elevated commodity prices. Second, as Exhibit 62 shows, the negative roll feature has made these investments both beta and alpha destroyers in recent years. All told, the S&P GSCI index has underperformed the underlying commodities by a full 89% since 2004.

Importantly, as we look ahead, we are neither bullish on prices nor on the roll feature on which liquid products depend. In fact, our most recent analysis shows that a full 18 of the 24 underlying commodities in the GSCI are now in contango, as measured by spot (or front month) to 1-year future/forward price. This sizeable percentage is meaningful as these 18 commodities represent a full 89% weighting in the index. Moreover, in many instances the discounts are quite large. Indeed, as shown in Exhibit 63, the major weights in the GSCI, including Brent, WTI, Gas Oil, Corn and Wheat, are all currently in 1-year forward contango, with a range of five to 18%.

By comparison, we still see a somewhat differentiated opportunity in the private market for real assets. Key to our thinking is that by owning value-added real estate, energy wells and infrastructure, we get real assets that yield cash flow and are less dependent on pure commodity prices and/or the shape of their respective curves. As such, an investor can often get paid handsomely each year to own non-correlated assets that also have the capability to outperform if inflation does ultimately rear its ugly head. Without question, we like this type of broad-based optionality, particularly in today’s low rate environment. Importantly, the yield on offer is quite compelling as infrastructure and other real assets often allow us to earn a coupon that is in many instances higher than what one can get in most traditional fixed income instruments – and sometimes without the same level of credit risk.

"We think that EM consumers who binged on credit are likely to see some retrenchment in 2015."
EXHIBIT 62
S&P GSCI Has Underperformed Commodity Prices for Quite Some Time

In essence, this is the “roll return” which has been negative due to contango (upward sloping futures curve).


EXHIBIT 63
S&P GSCI Set Up to Underperform: 1-Yr Forward Curves of Largest Index Weights in Contango by Five to 18 Percent

Degree of 1yr Forward Contango; Measured as % of Spot


EXHIBIT 64
We Believe Inflation Is Running Too Low Today and Will Rise Over Time


EXHIBIT 65
Current Monetary Policy Is Rewarding Real Assets With Yield and Growth

Within Real Estate, we did lower our allocation in 2015 to three percent from five percent. This reduction is predicated on our view that certain gateway cities have gotten expensive. We note that London and New York have now become a “safe haven” for foreign capital, driving up property values while reducing existing inventory. By comparison, we still continue to see good opportunities across non-core
and opportunistic in the U.S., Europe and even certain parts of Asia. Consistent with this view, we still see buyers finding opportunities to enter at seven to eight percent capitalization rates, with the opportunity to create property improvements that can drive valuations down 100 to 300 basis points and still retain upside to annual lease-based pricing.

Currencies: Expect Periods of Volatility; U.S. Dollar Bull Market Continues

*When a train goes through a tunnel and it gets dark, you don’t throw away the ticket and jump off. You sit still and trust the engineer.* Corrie Ten Boom

While there will certainly be periods of “darkness” along the way that might test one’s conviction, our “trust” level is still high as we remain convinced that we have entered a sustained, multi-year U.S. dollar bull market. We certainly appreciate our pro-dollar outlook is now somewhat the consensus view, but in this instance we think the consensus is right.

There are several important forces at work that should be considered, in our view. Indeed, at a time when both the Bank of Japan and the ECB are embracing even more extreme forms of quantitative easing (QE), the Federal Reserve has not only ended its tapering campaign but also laid out a rate increase forecast that is still notably more aggressive than the market consensus. Moreover, our research leads us to believe that lower oil prices could provide $278 billion of increased purchasing power to U.S. consumers by early 2016 (Exhibit 18). As such, we think that the dollar could have another compelling year against the yen, the euro and even the British pound.

**EXHIBIT 66**

We Are Less Than Halfway Through the Dollar Bull Cycle...

**EXHIBIT 67**

...And the Dollar Is Still Undervalued

Traditional financial intermediaries are now unable to participate in many of the higher margin, non-traditional lending opportunities at a time when many small- to medium-size businesses need access to credit.
Outside of Russia, Volatility in Most EM Currencies Has Remained Surprisingly Low

RUB, MXN, BRL, CLP and COP 3 Month Implied Volatility


We Think BRL Remains Overvalued, and As Such, Faces Further Depreciation Headwinds

U.S.$/Brazil Real Spot Rate


Risks

The sources of deflation are not a mystery.

Ben S. Bernanke, Deflation: Making Sure “It” Doesn’t Happen Here, November 1, 2002

Without question, we see any downside risk to the global markets through the lens of a deflationist in the near term. There are two macro situations we are watching closely that are heavily influencing our thinking. First, China gross capital formation, which accounted for 48% of GDP in 2013, is slowing as the government is forced to bring nominal lending back down towards nominal GDP. As this transition unfolds further, we believe commodity prices are likely to remain under pressure on a global basis as the Chinese try to pivot their economy more towards services. Importantly, our recent trip to China underscored that environmental concerns are now a major focus, which means that the government is more focused on services growth than construction/manufacturing. This economic transition is a big deal, and it significantly affects our thinking on where we expect stress in the global economy during 2015.

Importantly, because of the significant excess capacity that exists because of over-investment, we think China is likely to continue to run with a negative producer price index (PPI). Thus far, this cycle China’s PPI has been negative for 33 consecutive months. Our take: As the world’s leading export economy, there is a growing risk that China begins to export some of its deflation to other parts of the global economy. If we are right, then this issue is likely to affect both internal prices for consumer goods as well as the underlying currencies in which these goods are bought and sold in local terms.

Second, the European economy now seems to be running with dangerously low inflation. As wages are brought down to be more competitive, this development is likely to affect demand – and hence, inflationary expectations. Also, with oil and other commodity prices falling, we think that inflation could turn negative in 1H15. Our recent travels confirm this threat. In fact, in France, for example, already about one third of the CPI inputs are in deflation.

Against this backdrop, bond yields have collapsed around the world. Not surprisingly, risk assets, equities in particular, look attractive relative to low yielding government bonds in this environment. We tend to agree with this argument, but we are watching two areas closely. First, as we saw with Japan in the 1990s, low interest rates were foreshadowing a fall-off in corporate profitability and growth. Our current global outlook is more positive, but we do want to continue to remind ourselves that there is historical precedent for bonds and stocks giving investors the wrong macro signals. Second, because of central bank intervention, long-term interest rates are likely below fair value. Indeed, as we described in the fixed income section of this report, our quantitative value for the U.S. 10-year Treasury is closer to 3.0%, not the 2.2% at which it is currently trading – compliments of QE (Exhibit 50). So, the correct conclusion may – in fact – be that bonds are expensive – not that stocks are cheap.


14 Ibid 14.
EXHIBIT 70

Credit per Unit of GDP in China Is on an Upward Trajectory That We View as Worrisome

China: Credit per Unit GDP


EXHIBIT 71

Equities, Including the S&P 500, Only Look Attractive Relative to the Risk Free Rate if Earnings Trends Are Sustainable

S&P 500 Earnings Yield

US 10 Year Yield


EXHIBIT 72

Options Can Provide Substantial Leverage to an Idea at Current Prices...

EUR/USD 3-month Implied Volatility, % per Year


So, in the event that the aforementioned macro risks do dent investor confidence, we think that long volatility strategies can work, including equity index, interest rate, and certain FX "crosses" – if purchased and traded tactically. In S&P options, for example, three- and six-month put spreads remain attractive hedging vehicles when implied volatility compresses. In our view, the periodic times when the VIX trades to 12% - 13% are often the best times to accumulate put spread structures. At the moment, the “skew” or premium of downside puts over the “at the money” levels can drastically reduce the cost of just owning outright puts. We believe this could be the most attractive vehicle for leveraged protection against risk assets during the periods of volatility we expect in 2015.

Secondly, we think euro currency volatility is also cheap enough to own. While it has moved from 6 to 8.5% over the last few months, EURUSD volatility consistently realized between 12-16% for over four years following the financial crisis. While EUR volatility is probably not going back to premium levels seen during the worst bouts of the euro crisis, if one has a directional view, options afford smart leverage at current prices.

Finally, U.S. interest rate volatility remains low by historical standards, despite the end of QE and pending removal of historic accommodative conditions. For example, 6-month, 10-year swaption volatility – which represents the costs of owning a 6-month option to short 10-year swaps (i.e., 10-year bonds) – is currently 77 basis points. At 77 basis points, the market is pricing 10-yr swaps to move just +/- 5 basis points a day to break even on a long option position. This is a historically “cheap” level that should conceivably move back to its long run average of 100 to 120 basis points once the Fed suppression of interest rate levels returns to normal. As such, if one had a bias towards higher rates, owning swaption volatility would be a smart way to leverage those protection bets.

Conclusion: Getting Closer to Home

As we have detailed in this outlook piece, we are of the mindset that the general backdrop for risk assets remains favorable. However, given where we are in the cycle and the magnitude of gains in recent years, we have begun the inevitable process of “Getting Closer to Home” in terms of our asset allocation targets, including raising cash and tilting the invested part of the portfolio to be more opportunistic in nature during 2015.

Importantly, given some of the dislocation we are already seeing across Europe and Asia as well as in the U.S. energy complex, we feel confident having a sizeable 15% of our portfolio in the Distressed / Special Situation investing bucket. We like this investment opportunity not only for its global appeal but also because it allows us to move up in the capital structure – and potentially still earn equity-like returns but often with less volatility/risk.

We think the ability to move up and down the capital structure and provide corporate partners with value-added financial and operational expertise will become a prerequisite for success.
2014 Returns Were Driven by Real Assets and Alternatives, Though Equities and Fixed Income Selections Lagged

Overall though, we do think now is the time in the cycle to start “Getting Closer to Home” in terms of risk exposure. Importantly, we think this transition should be more evolutionary than revolutionary. Rates are low, global growth should be solid, and central banks are easing in many instances.

Moreover, we still see several compelling “arbitrages” in the global macro landscape that CIOs and portfolio managers should pursue. First, China’s slowing is not an aberration. As such, its role in the global economy is materially shifting, which means that we expect to see sizeable restructuring and recapitalization opportunities in sectors that previously over-earned and/or overstretched their footprints during the China Growth Miracle.

Second, many corporations still have inefficient capital structures, including too much cash and too little debt, in our view. As such, investors can still benefit from corporate actions to lower their costs of capital and/or improve growth, including buybacks, dividends, capital expenditures and acquisitions.

Third, despite a slew of liquidity in the system, many companies across both emerging and developed economies still can’t get proper access to credit. As such, we still see a compelling illiquidity premium that is worth pursuing, particularly in today’s low rate environment. Importantly, with Wall Street leverage low and an increasing portion of the global economy under stress, we see a more intense blurring across many parts of the liquid and illiquid fixed income markets in 2015.

Fourth, in a world of contango commodity pricing, we continue to favor private real asset investments with upfront yield, growth, and long-term inflation hedging relative to traditional liquid commodity notes and swaps. Already, performance between these two sub-asset classes in the real asset arena has been substantial, but we still see more opportunity ahead.

Finally, government deleveraging in the developed markets is disinflationary, which drives our thinking about the direction of long-term interest rates as well as the relative value of risk assets against the risk-free rates. In particular, given our view that the economic cycle will stretch into 2017, we think that many public and private equity stories with capital management and operational improvements still appear attractive.

To be sure, there are risks to our strategy amid what remains an unsettled time across the global capital markets. First, in terms of both duration and performance, the economic cycle in the United States is already notably beyond average at 67 months. However, with oil

**EXHIBIT 75**

Arithmetic Returns, Volatility, and Return/Risk of the Target Portfolio as at December 2014

<table>
<thead>
<tr>
<th></th>
<th>RETURNS</th>
<th></th>
<th>VOLATILITY</th>
<th></th>
<th>RETURN / RISK</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GMAA</td>
<td>BENCHMARK</td>
<td>DIFFERENCE</td>
<td>GMAA</td>
<td>BENCHMARK</td>
</tr>
<tr>
<td>2012</td>
<td>14.8</td>
<td>11.3</td>
<td>3.5</td>
<td>9.3%</td>
<td>8.9%</td>
</tr>
<tr>
<td>2013</td>
<td>14.6</td>
<td>10.6</td>
<td>4.1</td>
<td>7.4%</td>
<td>6.9%</td>
</tr>
<tr>
<td>2014</td>
<td>4.2</td>
<td>2.2</td>
<td>1.9</td>
<td>6.7%</td>
<td>6.4%</td>
</tr>
</tbody>
</table>

prices falling and consumer leverage low, we still feel comfortable owning a pro-growth portfolio. Also, while we think China’s economy will continue to slow, we do not think it is poised to collapse. As we discussed earlier, Europe and Japan should again be able to muddle through with less government drag in 2015.

Second, central bank differentiation is now upon us as 2015 will be the first year since before the Great Recession where the Federal Reserve will be reducing its liquidity profile (Exhibit 4). Third, while China is transitioning well towards a service economy, the legacy of its fixed investment boom remains a major overhang on the global economy.

Our bottom line: We continue to embrace a pro-risk portfolio, but we think “Getting Closer to Home” reflects not only where we are in the cycle but also assigns some value to the strong appreciation in asset prices we have had in recent years. Moreover, by building up a little cash and turning a little more conservative in our overall allocations, we now have more flexibility to embrace volatility during 2015, an option that was not available to our fully invested portfolio in 2014.

"We do think now is the time in the cycle to start “Getting Closer to Home” in terms of risk exposure. Importantly, we think this transition should be more evolutionary than revolutionary. Rates are low, global growth should be solid, and central banks are easing in many instances."

i Note 1: New issue leveraged loan spreads rated B+/B as per S&P LCD Q3 2014 Quarterly Report. Average senior leverage on these loans is 4.9x. Note 2: Difference in loss given default for Middle Market leveraged loans and larger company leveraged loans. Middle Market loans are defined as those with €200m or lower facility size. Large company leveraged loans are those with a facility size of €200m of larger. Total default volume and leveraged loan market size is based on the Credit Suisse European Leveraged Loan Index. The proportionate split between middle market loans and larger leveraged loans is based on S&P LCD loan pipeline issuance statistics with facility sizes of less than or greater than €200m. Defaults by size is based S&P LCD Default and Recovery Database cross-referenced versus S&P historic issuance to evaluate facility size. Average recovery rate is assumed at 79% based on the study “Loss-Given-Default of Corporate Bank Loans: Large-Scale Evidence from Europe” by Laurence Deborgies-Sanches, Lyubka Sokolova & Michel Van Beest, March 2014. Note 3: This is the difference between the average coupon and fees described in Notes 4 and 5 and credit risk premium and spreads described in Notes 2 and 1 respectively. Note 4: Average underwriting fees for all European Direct Lending deals executed in KKR Lending Partners L.P. and CCT is 2.8%. Assuming a 3 year life for the loans, this equates to an average incremental return of c.0.9% per annum. Note 5: Based on average coupon (including Euribor floors) based on active European Direct Lending pipeline as at 5 November 2014. Average senior leverage of 4.7x, plus the fees described in Note 4.
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