The World in Rebalancing Mode: A Marathon, Not Sprint
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After nearly a decade of accumulating macro imbalances in the global economy, something had to give. The boom-bust cycle of 2001–2008 saw growing disparity between nations with current-account surpluses and deficits, inflating asset bubbles financed by surplus countries, and profligate spending throughout much of the developed world. We are now witnessing the painful but necessary correction toward macro equilibrium among nations. Although some countries are gliding down this path more smoothly than others, the general destination is obvious—though the potential implications for investors during this period of transition in the global capital markets are clearly more complex. Our base view is that, as its export business matures, China will need to rebalance itself toward increased consumption and away from fixed investments. But this transition will not be easy. Meanwhile, the U.S. government’s retrenchment may soon come at the expense of the private sector, including the defense, information-technology and healthcare industries. Probably most important, though, is that much of Europe appears to be struggling with questionable economic policies, at least in the near term. No doubt, this will affect this region’s pace of rebalancing. The bottom line is that global rebalancing will likely be a marathon, not a sprint, and it is sure to have many peaks and valleys along the way. But the rebalancing process has started, and we believe it will create a variety of compelling investment opportunities. Here we offer our views on why we think rebalancing matters—and on the potential opportunities and pitfalls for investors to consider.

Although our intellect always longs for clarity and certainty, our nature often finds uncertainty fascinating.

CARL VON CLAUSEWITZ
PRUSSIAN SOLDIER AND MILITARY THEORIST (1780–1831)
In our view, cross currents in the global landscape have led investors to be more “fascinated” by macro developments than “clear” or “certain” about them in recent months. Whether it has been sovereign debt concerns in Europe, fears of a China hard-landing, or the threat of a U.S. fiscal cliff, there has certainly been a lot for macro folks to digest.

Today’s imbalances are a reflection of yesterday’s excesses. Our recent visits to Asia, Latin America, Europe, and the Middle East only reaffirmed to us that we are still dealing with the aftermath of several outsized global imbalances created over the boom-and-bust cycle of 2001–2008. These excesses took many shapes and sizes across the global economy during that period, with three that stand out in our view:

1. a widening disparity between current account surplus and deficit nations;
2. a buildup of asset bubbles largely financed with capital exported from surplus countries; and
3. a loss of fiscal discipline across much of the developed world.

If there is any good news about the current state of global affairs, we believe it’s that many imbalances appear to be moving toward correction. The disparity between current account surplus and deficit countries has been receding pretty consistently since 2006—a trend we think will continue in the next few years. Meanwhile, real estate bubbles have largely deflated in the developed world, including in the United States. Fiscal deficits have even begun to narrow, albeit at a frustratingly slow pace.

A correction in global imbalances requires a change in one’s investment playbook, we believe. We think a key principle in today’s Phase III environment is to make investments that will benefit from this rebalancing (Exhibit 1). These include investments in businesses that will benefit from emerging market consumption and a U.S. manufacturing renaissance, or businesses that have already been adversely affected by the rebalancing, such as those involved in the U.S. housing market. Conversely, we think avoiding areas in which rebalancing has much further to run, including securities that would be sensitive to a further deterioration in European credit conditions, such as Spanish government bonds.

Looking further, we see many developed-market businesses, particularly in the export sector, that have not only become wage-competitive but that are also technologically superior to their emerging-market counterparts. In particular, we believe that automation, logistics, and petrochemical companies in many of the developed markets have emerged as compelling in the wake of global rebalancing. These companies, in many instances, are domiciled in the U.S. or Europe but collect a significant portion of their revenues in fast-growing emerging markets, which means that they still have exposure to significant global growth. We also favor U.S. cyclical rebound themes in such sectors as home improvement, which suffered mightily when imbalances peaked circa 2007. Finally, we believe that countries like Ireland, which were hard-hit by the global imbalances, may be attractive investment destinations in this new era of rebalancing.

The downsizing of the financial-services industry in developed countries is in keeping with a more rebalanced world and may present investment opportunities. We estimate that the U.S. banking system’s balance sheet has already shrunk from a peak assets-to-equity ratio of 17.9 in the fourth quarter of 2008 to 11.3 in the first quarter of 2012, a 37% decline. This contraction reflects a rebalanced financial services sector characterized by lower leverage and heightened regulatory scrutiny for traditional banks and brokerage companies. But corporations and individuals still need access to credit, and as a result, a tremendous origination, lending, and servicing void has been opened for non-traditional entrants to fill. Middle-market lending, real estate, and mezzanine debt all appear to be fertile opportunities for these new entrants—and large alternative asset managers could begin to look more like merchant banks than in the past. A similar scenario could play out in Europe, though we believe it would take more time and patience.

At the same time, opportunities may emerge as the developing world, including countries like China, rebalances toward consumption and away from fixed investment. In our view, the first quarter of 2012 will be remembered as a landmark quarter when consumer companies like Apple and Coach reported huge increases in sales originating in their Chinese subsidiaries, while companies relating to infrastructure development like Caterpillar faced slowing demand for fixed investments. We believe that the rebalancing away from fixed investment and toward consumption is a secular—not cyclical—phenomenon. Frankly, it is also what the global economy so badly needs. This has implications for commodity prices, which we think may not appreciate at the same level going forward, and could even decline if the rebalancing process becomes rapid in China.

But we believe in exercising near-term caution in the many areas that are still far behind in the rebalancing process. Many parts of Europe have not yet kept pace with global rebalancing, and we are wary about deploying significant amounts of capital toward exposure to domestic consumption until we see a change in macroeconomic policies to stabilize household employment. Indeed, exacerbating this lag in rebalancing is the fiscal austerity practiced throughout Europe, whereas the issues that need to be addressed are the balance of payments and economic competitiveness. The U.S. government is also in need of serious fiscal rebalancing, and once this occurs, there could be significant pressure on government-related sectors of the economy. State and local-government jobs have decreased by 607,000 during this recovery—versus an average gain of 559,000 in past recoveries—and we haven’t even begun to witness a reduction in federal jobs.

For now, we are comfortable with our target allocation, which includes underweight positions in cash, European exposure and government bonds, and overweight positions in most forms of credit, real assets and private investments. We remain comfortable with our sizeable overweight position to credit despite the recent pullback—and particularly at the expense of government bonds  

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2 Refer to Exhibit 30.
3 Refer to Exhibit 37.
of developed markets. We also continue to view such alternative investments as private equity and distressed credit as better risk-adjusted performers than public equities, many of which are heavily exposed to financial services. The bottom line is that our asset allocation framework remains unchanged: We aim to garner a substantial amount of income upfront, gain exposure to the deleveraged part of the market (corporates), and hedge this exposure with real assets, which tend to outperform when input costs or inflationary pressures rise (Exhibit 2).

EXHIBIT 1
Our Global Rebalancing “Playbook”

Exercise Caution

Early Stage of Rebalancing

Investments Geared to U.S. Fiscal Health

Growth Opportunities for the Rebalancing Era

U.S. Manufacturing Renaissance Plays

Mid-Mkt Lending Alt. RE Finance Mezz Lenders

EM Consumer Plays

Selectivity Required

Late Stage of Rebalancing

Pockets of Deep Value

Traditional DM Financial Services

EM FX

Source: Qualitative assessments KKR Global Macro and Asset Allocation as of May 31, 2012.

How to Invest in a Rebalancing World

Former U.N. secretary general Kofi Annan once noted that “arguing against globalization is like arguing against the laws of gravity.” I was not a science major in college (I was a history major, and a mediocre one at that), but I do remember enough from my coursework that gravity is a natural phenomenon responsible for things like keeping the earth spinning around the sun and the moon around the earth. The good news is that the laws of gravity still appear to be working just fine.

EXHIBIT 2
KKR GMAA Target Asset Allocation

<table>
<thead>
<tr>
<th>ASSET CLASS</th>
<th>KKR GMAA TARGET ASSET ALLOCATION (%)</th>
<th>STRATEGY BENCHMARK (%)</th>
<th>DIFFERENCE (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>PUBLIC EQUITIES</td>
<td>50</td>
<td>53</td>
<td>-3</td>
</tr>
<tr>
<td>U.S.</td>
<td>20</td>
<td>20</td>
<td>0</td>
</tr>
<tr>
<td>EUROPE</td>
<td>12</td>
<td>15</td>
<td>0</td>
</tr>
<tr>
<td>ALL ASIA</td>
<td>12</td>
<td>12</td>
<td>0</td>
</tr>
<tr>
<td>LATIN AMERICA</td>
<td>6</td>
<td>6</td>
<td>0</td>
</tr>
<tr>
<td>TOTAL FIXED INCOME</td>
<td>25</td>
<td>30</td>
<td>-5</td>
</tr>
<tr>
<td>GLOBAL GOVERNMENT</td>
<td>5</td>
<td>20</td>
<td>-15</td>
</tr>
<tr>
<td>MEZZANINE</td>
<td>5</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>HIGH YIELD</td>
<td>5</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>HIGH GRADE</td>
<td>5</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>EMD</td>
<td>5</td>
<td>0</td>
<td>5</td>
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<tr>
<td>REAL ASSETS</td>
<td>10</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>REAL ESTATE</td>
<td>3</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>ENERGY/INFRA-STRUCTURE</td>
<td>5</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>GOLD/CORN/OTHER</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>OTHER ALTERNATIVES</td>
<td>15</td>
<td>10</td>
<td>5</td>
</tr>
<tr>
<td>TRADITIONAL PE</td>
<td>5</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>DISTRESSED &amp; SPECIAL SITUATION</td>
<td>5</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>OTHER</td>
<td>5</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>CASH</td>
<td>0</td>
<td>2</td>
<td>-2</td>
</tr>
</tbody>
</table>

Source: Qualitative assessments of KKR Global Macro and Asset Allocation as of May 31, 2012.
**Exhibit 3**

Rebalancing Has Begun, But It is a Marathon, Not a Sprint

Oil exporters include Middle East & North African countries, Netherlands, Norway, Nigeria, Russia and Venezuela. * Europe includes all European Union countries except Germany, Netherlands, and Norway which are in other categories. ** Latam includes all of Latin America & the Caribbean ex-Venezuela which is under Oil Exporters. ASEAN includes Indonesia, Malaysia, Philippines, Thailand and Vietnam. Data as at April 17, 2012. Source: IMFWEO April 2012.

What appears to working less well are the “laws” of globalization, or at least the improvements that we once thought a globally connected world would bring. In fact, I cannot remember a time during my career when the global economy felt so divided into Haves and Have-Nots. On one hand, my recent visits to Latin America, Asia, Turkey, and the Middle East confirmed to me that the quality of middle-class life in emerging markets is rising by leaps and bounds. Wages in China and Brazil, for example, grew by about 230% between 2002 and 2010 (Exhibit 4), and the trend of rising living standards extends well beyond the BRIC to countries like Saudi Arabia, Chile, and Columbia (Exhibit 5).

**Exhibit 4**

Many Economies Enjoyed Increases In Wages

<table>
<thead>
<tr>
<th>Change in Hourly Compensation Costs in Manufacturing in U.S. dollars between 2002 and 2010 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico</td>
</tr>
<tr>
<td>11</td>
</tr>
</tbody>
</table>

Latest China data per the December 31, 2011 release http://www.bls.gov/fts/china.htm was for 2008 which had Manufacturing urban units at US $2.38/hour. We have assumed an annual 15% wage increase in 2009-2010. All other BLS data are through 2010 as of December 31, 2011. Source: U.S. Bureau of Labor Statistics.

**"**

We suggest considering investments in businesses that will benefit from emerging market consumption and a U.S. manufacturing renaissance, or businesses that have already been adversely affected by macro rebalancing, such as those involved in the U.S. housing market.

**"**
Many Emerging Market Countries Are Now in Much Better Shape

<table>
<thead>
<tr>
<th>COUNTRIES</th>
<th>2010 GDP COMPOSITION</th>
<th>GOVERNMENT FINANCES</th>
<th>BALANCE OF PAYMENTS</th>
<th>GROWTH &amp; COMPETITIVENESS</th>
<th>LEVERAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>PRIVATE CONSUMPTION</td>
<td>GOVT CONSUMPTION</td>
<td>INVESTMENT % GDP</td>
<td>NET EXPORTS % GDP</td>
<td>SHADOW ECON%GDP</td>
</tr>
<tr>
<td>SAUDI ARABIA</td>
<td>35.4</td>
<td>22.2</td>
<td>22.9</td>
<td>34.1</td>
<td>16.8</td>
</tr>
<tr>
<td>PHILIPPINES</td>
<td>71.5</td>
<td>9.7</td>
<td>20.5</td>
<td>-5.5</td>
<td>38.3</td>
</tr>
<tr>
<td>INDIA</td>
<td>56.5</td>
<td>19.2</td>
<td>30.4</td>
<td>-6.1</td>
<td>20.7</td>
</tr>
<tr>
<td>PERU</td>
<td>61.9</td>
<td>10.2</td>
<td>25.4</td>
<td>4.4</td>
<td>53.7</td>
</tr>
<tr>
<td>COLOMBIA</td>
<td>63.0</td>
<td>16.2</td>
<td>22.2</td>
<td>0.7</td>
<td>33.5</td>
</tr>
<tr>
<td>MEXICO</td>
<td>65.9</td>
<td>11.8</td>
<td>23.8</td>
<td>-0.3</td>
<td>28.8</td>
</tr>
<tr>
<td>TURKEY</td>
<td>71.3</td>
<td>14.3</td>
<td>19.9</td>
<td>-7.7</td>
<td>29.1</td>
</tr>
<tr>
<td>ARGENTINA</td>
<td>57.3</td>
<td>14.9</td>
<td>24.5</td>
<td>3.9</td>
<td>23.0</td>
</tr>
<tr>
<td>VIETNAM</td>
<td>66.5</td>
<td>6.5</td>
<td>39.0</td>
<td>-5.0</td>
<td>14.4</td>
</tr>
<tr>
<td>BRAZIL</td>
<td>59.6</td>
<td>21.1</td>
<td>20.2</td>
<td>0.9</td>
<td>36.6</td>
</tr>
<tr>
<td>CHILE</td>
<td>57.3</td>
<td>13.1</td>
<td>23.5</td>
<td>7.3</td>
<td>18.5</td>
</tr>
<tr>
<td>THAILAND</td>
<td>53.7</td>
<td>13.0</td>
<td>25.9</td>
<td>9.9</td>
<td>48.2</td>
</tr>
<tr>
<td>CHINA</td>
<td>34.8</td>
<td>13.2</td>
<td>47.7</td>
<td>4.3</td>
<td>11.9</td>
</tr>
<tr>
<td>KOREA</td>
<td>52.5</td>
<td>15.4</td>
<td>29.5</td>
<td>4.1</td>
<td>25.6</td>
</tr>
<tr>
<td>POLAND</td>
<td>61.4</td>
<td>18.9</td>
<td>21.0</td>
<td>-2.5</td>
<td>26.0</td>
</tr>
<tr>
<td>RUSSIA</td>
<td>50.6</td>
<td>19.0</td>
<td>20.7</td>
<td>10.2</td>
<td>40.6</td>
</tr>
</tbody>
</table>

**EMERGING MARKETS**

**MEDIAN** | 58.5 | 14.6 | 23.7 | 2.4 | 27.4 | 0.5% | -1.6% | -0.7% | 26.8% | 2.4% | 4.3% | 16.0% | 10,338 | 30 | 39% | 26% | 48% | 73% |

**+1 SD** | 68.1 | 19.3 | 33.7 | 13.2 | 41.1 | 5.5% | 4.5% | 8.2% | 49.3% | 13.2% | 6.2% | 33.7% | 16,139 | 39 | 55% | 44% | 100% | 106% |

**-1 SD** | 46.8 | 10.6 | 18.5 | -6.6 | 17.1 | -3.2% | -5.7% | -6.3% | 13.7% | -6.6% | 3.1% | -3.9% | 3,503 | 17 | 18% | 16% | 24% | 35% |

On the other hand, in many of the world’s large developed economies, stagnant labor markets and government austerity are stunting growth amid significant financial deleveraging, in our view. Unemployment has reached crisis levels in a country like Spain, particularly among the youth (Exhibit 6). In addition to too few jobs, our research shows that Spain still faces significant headwinds in banking and housing, which are likely to dent any improvement in unemployment in the near-term.

EXHIBIT 6

...But the “Have-Nots” Are Now Dealing With the Consequences of Rising Deficits and Lack of Competitiveness

Have’s are competitive economies with low budget deficits; Have Not’s are economies that are struggling to maintain competitiveness and have debt burdens and/or high budget deficits. Data as at December 31, 2011. Unemployment Rate of Persons Under Age 25. Source: Statistical Office of the European Communities, Haver.

Observing such disparities, one might conclude that the globalization process remains as disruptive, imbalanced and complex as ever. And while some days it feels tempting to just despair at all the complexities, we deem it more constructive to focus on how the world came to be so imbalanced in the first place, how to resolve these imbalances, and how to invest in a rebalancing world.

What happened to make the world so imbalanced? In our view, it was a confluence of several major macro trends that took shape around the turn of the 21st century. China’s assent to the World Trade Organization (WTO) in 2001 represented an inflection point for a country that employed cheap labor, kept its currency weak and exploited low interest rates to fuel its growth as manufacturer to the world. From 2001 to 2007, China’s current account surplus as a percentage of its GDP surged from 1.3% to 10.1% as its share of total world manufacturing jumped from 9% to 13% over the same period. At the same time, developed economies including the United States, Japan and parts of Europe were becoming increasingly uncompetitive. They were also dealing with the bursting of the tech and telecom equity bubbles of the prior decade. Faced with these difficulties, many developed market central banks enacted monetary-easing policies, which fueled a housing and consumption boom. Between 2001 and 2007, house price-to-income ratios rose 16% in the United States, 40% in Ireland, and 65% in Spain (Exhibit 7). Ironically, for a time, our research shows that these countries actually benefitted from cheap imports and low rates that were partially driven by increased ownership of sovereign debt issued by the world’s producers, including China.

These unsustainable dynamics became more apparent as global housing markets crested in 2007. We believe the problem was that the asset-driven consumption bubble had not only saddled the world financial system with a glut of risky mortgages; it had also lulled many governments into taking on structural spending commitments that would ultimately prove untenable as the economic tide ebbed. In 2009, during the worst of the Great Recession, the primary deficits of the United States, Ireland, and Spain hit 11.2%, 12.3%, and 9.9%, respectively (Exhibit 8). In the Eurozone, inflated housing and generous government spending were particularly pernicious we believe, as the illusion of shared prosperity masked widening competitiveness differentials measured by factors such as unit labor costs and employment rigidities (Exhibit 9).

EXHIBIT 7

Real Estate Prices Have Rebalanced in the U.S. and Ireland, But Significantly Less So in the Rest of Europe

We see developed-market businesses that have become wage-competitive and are also technologically superior to their emerging-market counterparts.

Data as at April 17, 2012. Source: IMF WEO April 2012.

See Exhibit 12.
Fiscal Rebalancing Is Underway But Has Much Further to Go, Particularly in the U.S. and Japan

In terms of global trade, the disparity between current account surplus and deficit countries has been receding consistently since 2006—a trend which the IMF predicts will continue over the next few years (Exhibit 3). We believe slow income growth and scarcity of consumer credit have played a part curtailing imports in the deficit countries. At the same time, however, Chinese authorities have worked to tighten financial conditions—notably via a combination of currency appreciation (Exhibit 13) and strict bank reserve requirements—which has also helped rebalance global trade on the export side.

Turning to global asset values, we note that housing prices have already deflated sharply in the developed world, particularly in the United States and Ireland. However, our recent trip to Europe confirmed to us that the deflating process is ongoing and still has further room to run in several countries. One can see this in Exhibit 7, which shows that, valuations in France, Spain, Italy, and the U.K. look like they may still have room to fall.

In terms of the global fiscal situation, the pace of rebalancing remains frustratingly slow, particularly in two of the largest and most mature economies—the United States and Japan. Right now these countries enjoy the market’s confidence, and as a result they have been able to run large fiscal imbalances and still fund themselves at record-low interest rates. In our view, the wide gap between high deficits and low rates will not last forever. Meanwhile, the capital markets have spoken, and they are forcing countries that need to shrink their deficits to do so. Though we think some form of a growth plan will ultimately be needed in Europe to bring debt levels down, several European countries are indeed making progress on

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5 Data as at May 13, 2012. China’s Reserve Requirement Ratio was 20.0%. Source: People’s Bank of China data.
Ultimately, we think the global rebalancing process is now finally underway—albeit geographically uneven—and that it requires a new investment playbook. Specifically, whereas it paid to own or invest in the parts of the economic food chain that profited from the global imbalances that had built up over the last decade or so, we are now recommending investing more in the beneficiaries of the rebalancing process. We especially favor investments linked to consumption in China, unlike the kind of fixed investment and export-related areas that defined the country’s growth over the last decade. This viewpoint has implications for our outlook on the price and velocity of certain commodities.

Our framework also suggests examining industries that are now in recovery after regaining competitiveness (e.g., U.S. industrials) or that are rebounding after their collapse from when capital influx was at its peak (such as housing and home improvement). It may also mean considering investments in places like Ireland—a country with competitive wages and improving exports.

All the same, we underscore that rebalancing is like running a marathon, not a sprint—and that there is no such thing as a lucky marathon runner. Fixing global imbalances is a process that requires discipline, sacrifice, and focus. It also takes time, and along the way there are likely to be relapses and flare-ups that shake investor confidence. Yet even with these inherent risks, we think there could be a significant investment opportunity for investors utilizing our framework to better identify the winners and losers that are inevitable as the global economy attempts to rebalance itself in the aftermath of the Great Recession.

In the sections that follow, we assess the opportunities and pitfalls of rebalancing that we see unfolding across three key regions of the global economy: China, the United States and Europe.

**China: Rebalancing Towards Consumption**

In China, we believe the rebalancing toward consumption and away from fixed investment and exports is positive and gaining momentum. But it is starting from a small base and will take years to occur. After its ascension to the WTO in 2001, China became the manufacturer of basic goods to the world. Its share of total world manufacturing surged (Exhibit 10). Turbo-charging this strategy was a conscious decision by the government to maintain low real rates and a competitive currency. These policies brought tremendous change to the economy, including a massive build out of its fixed investment and export sectors; they also led to major economic imbalances that are now just beginning to be addressed6.

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6 See Exhibits 12 and 16.

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**Exhibit 10**

**China’s Emergence as a World Player was Most Notable After Its Entry into the World Trade Organization**

- **Share of Total World Manufacturing (%)**
- **China enters WTO in 2001**
- **1990, 3%**
- **2001, 26%**
- **2010, 18%**


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**Exhibit 11**

**Between 1998 and 2010 the U.S. Lost 6.2 million Manufacturing Jobs**

- **All Employees: Manufacturing (SA, Thous)**
- **Feb-46, 11,922**
- **Jun-79, 19,553**
- **Mar-98, 17,637**
- **Jan-10, 11,458**


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In 2007, around the time of the peak excesses, Premier Wen Jiabao, clearly cognizant of the growing risks associated with these imbalances, demanded a rebalancing towards consumption and away from fixed investment, calling the economy increasingly “unstable, unbalanced, uncoordinated, and ultimately unsustainable”. His words did not fall on deaf ears, as the government began to implement long-term reforms.

The good news is that the country’s first phase rebalancing already appears well under way, if not ahead of schedule. Our research shows that in the first quarter of 2012, Chinese GDP growth was 8.1% year-over-year, with final consumption expenditures accounting for 76% of total growth. This total is up from a more modest 37% in the fourth quarter of 2010 and 52% in the fourth quarter of 2011. While we do not believe this level of consumption influence is sustainable in the near-term, we do think it sends an important message towards the direction the government is seeking over the longer term\textsuperscript{8}.

The bad news is that we do not believe overall consumption is big enough as a percentage of the economy to allow the country to maintain the same growth rate that it has in the past. There is historical precedent to support this view of a slower growth trajectory. As Exhibits 14 and 15 show, overall GDP growth tends to slow meaningfully when consumption increases as a percentage of GDP above 40% and fixed investment falls below the same level.

\textbf{EXHIBIT 14}

\textbf{GDP Falls as Consumption Rises}

Despite the shrinking banking sector, corporations and individuals still need access to credit—and a tremendous void has opened for non-traditional entrants to fill, including middle-market lenders and providers of real estate and mezzanine financing.

\textsuperscript{8} Data as at April 16, 2012. Source: China National Bureau of Statistics.
GDP Rises as Investment Rises

China: Average Real GDP Growth Given Different Levels of Investment (%)

Investment % GDP  
Current = 49%

<table>
<thead>
<tr>
<th>&lt;34</th>
<th>34-36</th>
<th>36-38</th>
<th>38-40</th>
<th>&gt;40</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.9</td>
<td>7.7</td>
<td>9.0</td>
<td>11.7</td>
<td>11.2</td>
</tr>
</tbody>
</table>


Not surprisingly, the rebalancing of its GDP inputs is also leading to rebalancing in others areas of the Chinese economy. For example, China’s current account surplus fell to just 2.8% in 2011, which is a long way from the 10.1% surplus the country ran in 2007 at the height of an imbalanced world (Exhibit 16). We certainly attribute some of this change to a 24% strengthening of the renminbi versus the U.S. dollar over the same period (Exhibit 13), but it also speaks to growth in the consumer’s rapidly rising wages and increased purchasing power.

China Is Now Finally Addressing its Unbalanced Economy

2011 Gross Domestic Product (GDP) Components


We Expect Consumption in China to Grow 10-15% Over the Next Five Years

<table>
<thead>
<tr>
<th>Year</th>
<th>CHINA Nominal Consumption Growth Y/Y</th>
<th>CHINA Inflation CPI Y/Y</th>
<th>CHINA Real Consumption Growth Y/Y</th>
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<tbody>
<tr>
<td>2009</td>
<td>9.5</td>
<td>-0.7</td>
<td>10.2</td>
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<td>10.0</td>
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<td>6.7</td>
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<tr>
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<td>15.7</td>
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<tr>
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</tr>
<tr>
<td>2014</td>
<td>12.3</td>
<td>3.0</td>
<td>9.3</td>
</tr>
<tr>
<td>2015</td>
<td>13.1</td>
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<td>10.1</td>
</tr>
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<td>2016</td>
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<tr>
<td>2017</td>
<td>13.4</td>
<td>3.0</td>
<td>10.4</td>
</tr>
</tbody>
</table>


Looking ahead, we think estimates for consumption in China to grow 10–15% per year for the next 5 years (Exhibit 17) appear reasonable. However, consumption-driven growth isn’t limited to China alone: We believe this trend will occur throughout Asia, and expect it to significantly impact consumption trends throughout the region and to affect export trends of the countries that are best positioned to service this market. As it stands now, Asia makes up 60% of the world population, of which China is 19.3% and India is 17.8% (Exhibit 18). Between 2011 and 2030, the United Nations forecasts Asia’s population will grow another 16% to 4.9 billion from 4.2 billion today, implying that, within 20 years, 70% of the entire world population will be Asian.

Increases in income of this growing population will likely give rise to tremendous growth in the middle- and upper-class populations in Asia. A study by the Organization of Economic Cooperation and Development (OECD) estimates that the middle class in Asia will grow 515% between 2009 and 2030, increasing to 3.3 billion people from 525 million (Exhibit 19). Let’s put this in context: The U.S. population stands today at 313 million, which means the current number of middle-class citizens in Asia outnumbers the entire U.S. population. Probably more important, however, is that, the purchasing power of the Asian middle class is expected to multiply more than six times from its present level. The OECD also reveals that globally, demand from the middle class may grow from $21 trillion in 2009 to $56 trillion by 2030. As Exhibit 19 shows, Asia will account for the lion’s share of this, growing from $5 trillion to $33 trillion.
EXHIBIT 18

Asia Makes Up 60% of World Population


EXHIBIT 19

Growth will be Driven by the Emerging Middle Class

Data as at January 31, 2010. Source: OECD.

Meanwhile, we are also encouraged that Chinese fixed investment has started to cool. All told, Chinese fixed asset investment growth has decelerated to 20.2% in April 2012, down from a peak of 33.3% in September 2009 — the slowest pace since 2002 (Exhibit 21). In our view, one potential fall-out from the trend away from fixed investment is a slower rate of growth in terms of commodity demand. One has to keep things in perspective as 20% year-over-year growth is still extremely compelling in our view, but what we are saying is that investors should expect the rate of growth to moderate from such frenetic levels.

EXHIBIT 20

Consumer Sector Doing Better Than Industrials

Data as at May 16, 2012. Source: Company reports, Bloomberg.

Our aim is to garner a substantial amount of income upfront, gain exposure to the deleveraged part of the market, and hedge this exposure with real assets.

EXHIBIT 21

A New Era for China Fixed Investment

Strong Fixed Investment Has Made China a Major Destination for Commodities

In the U.S., Some Good and Some Bad. Like China, the U.S. has also started rebalancing in several important areas of the economy, creating some significant opportunities for investors. Following the Great Recession, the United States has followed a pattern of increasing productivity and aggressively deflating both unit labor cost (Exhibits 23 and 24) and residential real estate values. Measured along those lines, the United States has made more progress than almost any other country in the developed world, save China. All told, it has cut its current account deficit in half to 3.2% as of the fourth quarter of 2011 from a peak of 6.5% in the fourth quarter of 2005 (Exhibit 25). This improvement in the current account deficit often gets overshadowed by the fiscal deficit, but it is an important story that has more to run, in our view.

...While The U.S. is Attacking Its Deficits Through Growth, With a Particular Focus on Trade

Armed with innovation, competitive wages, and global reach, many U.S. industrial and multinational firms are experiencing a strong and sustained rebound in their competitiveness. Also helping their cause are a weaker currency and rapidly rising productivity, particularly relative to Europe. CEOs are taking notice, with 37% of companies now considering bringing manufacturing back to the United States (Exhibit 26). Another key reason, which we detail in Exhibit 27, is that we estimate that the wage gap between China and the U.S., on average, is shrinking mightily.

Exhibit 26
37% of Companies Considering Bringing Manufacturing Back to the U.S.

Given the fact that China’s wage costs are expected to grow 15-20% per year, do you expect your company will move manufacturing to the United States?

- Not considering re-shoring: 63%
- Plan to, or are actively considering re-shoring: 37%

Source: BCG Manufacturing Survey, February 2012.

Exhibit 27
A Key Reason is Wages Gap Between U.S. and China is Shrinking


While a U.S. manufacturing renaissance seemed implausible a few years ago, it is reflective of the competitive improvement U.S. firms have made at a time when wages in many emerging market countries have risen dramatically. Those same EM firms now find themselves playing catch-up to their global peers, particularly in value-added areas. Consistent with what we show in Exhibit 28, this reversal in fortune is now just starting to show in market share statistics.

An encouraging trend is clear from a valuation perspective: As U.S. companies grow their international revenues and earnings, we expect that they will also enjoy significant multiple expansion for some time. Forward price-to-earnings ratios for U.S. companies with international exposure tend to climb until emerging market exposure exceeds 60% (Exhibit 29). Thereafter, investors seem to devalue those enterprises as they become more associated with local emerging markets and their embedded risks.
**EXHIBIT 28**

China is Now a More Important Destination for U.S. Exports, the Reverse is True for China

Data as at December 31, 2011. Source: International Monetary Fund, Haver.

**EXHIBIT 29**

30-50% EM Exposure is the Sweet Spot

Average FY1 P/E for U.S. Companies with Varying Degrees of Emerging Market Exposure


We also think that the rebalancing phenomenon is creating significant opportunities in the United States for non-traditional financials to fill the gap caused by downsizing and deleveraging on Wall Street. Outside of blue-chip Corporate America, many traditional borrowers are being forced to pursue unconventional access to capital. As Exhibit 31 shows, Wall Street inventories have collapsed after the Great Recession, which has given non-traditional lending intermediaries a significant opportunity to step in and fill the gap—often on attractive terms.

**EXHIBIT 30**

Wall Street Balance Sheets Have Shrunk…

Aggregate of GS, MS, BAC, C, JPM and WFC balance sheets. Data as at 1Q2012. Source: Factset.

**EXHIBIT 31**

…and Inventory of Corporate Securities has Collapsed

Data as at May 9, 2012. Source: Bloomberg.
may be partially seasonal. Meanwhile, housing starts have been accelerating and are now running close to our 750,000 forecast for 2012 (Exhibit 33).

**EXHIBIT 32**
Household Formation Already Above Our 2013 Estimate

![Household Formation Chart]


**EXHIBIT 33**
KKR Housing Forecast

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>DISPOSABLE INCOME GROWTH Y/Y</td>
<td>2.4%</td>
<td>3.5%</td>
<td>5.0%</td>
</tr>
<tr>
<td>HOUSEHOLD FORMATION (’000S)</td>
<td>850</td>
<td>1,000</td>
<td>1,300</td>
</tr>
<tr>
<td>HOUSING STARTS (’000S)</td>
<td>750</td>
<td>850</td>
<td>1,050</td>
</tr>
<tr>
<td>HOME PRICE APPRECIATION Y/Y</td>
<td>-0.6%</td>
<td>1.3%</td>
<td>3.3%</td>
</tr>
</tbody>
</table>

Source: KKR Global Macro and Asset Allocation estimates as at February 29, 2012.

Within the housing market, our research indicates a rebound in the home-improvement sector, given that even a return toward normalcy suggests significant growth upside from current levels. According to analyst Greg Melich at ISI, a U.S. research boutique, quarterly retail home improvement spending fell 35% in this latest cycle, and now appears poised to rebound (Exhibit 35).

**EXHIBIT 34**
Reducing the Debt Burden Will Become a Full Time Job

![Revenue and Spending Graph]


But not all of the required rebalancing in the United States is on track. In particular, the primary deficit remains mountainous at 6.1%, not significantly lower than its 11.2% peak\(^\text{10}\). This outsized deficit makes us nervous for several reasons. First, the government’s work to bring the deficit under control will act as a major drag on

\(^{10}\) Source: Exhibit 8.
growth in our view. As shown in Exhibits 37 and 38, we have seen massive contraction at the state and government level since the recovery began and expect this to continue once the federal government begins to tackle the debt burden. As we look ahead, if there is any mean reversion, it appears that whether by sequestration or a grand bargain, the Federal government will need its own share of downsizing as well.

EXHIBIT 36
The Public Sector Is Hobbling the Economy...

| Change in Employment 34 Months After End of Recession (%) |
|----------------|----------------|
| Private Employment | Government Employment |
| 6.5% | 5.9% |
| Government cut 600,000 jobs versus adding jobs in a normal recovery |
| -2.7% |

Average of Post-1950 Recessions, First 34 Months of Recovery
Current Recovery Beginning June 2009


EXHIBIT 37
...Particularly State and Local Governments

| Change in Employment 34 Months After End of Recession ('000s) |
|----------------|----------------|
| Private | Federal | State | Local |
| 4,053 | 28 | 147 | 412 |
| 3,087 | 6 | -103 | -504 |

Average of Post-1950 Recessions, First 34 Months of Recovery
Current Recovery Beginning June 2009


EXHIBIT 38
State & Local Government Spending

U.S. State & Local Government Consumption & Investment, % of GDP

Exhibit 38 Data as at 1Q2012. Source: Bureau of Economic Analysis, Haver.

EXHIBIT 39
U.S. Total Government Spending, % of GDP

U.S. Total Government Spending % GDP (Left Axis)
Entitlement Spending (Right Axis)

Data as at 1Q2012. Source: Bureau of Economic Analysis, Haver.

Complicating the matter on the fiscal front is our belief that quantitative easing (QE) is allowing the federal government to postpone dealing with its share of the deficit overhang, which is ultimately preventing the necessary rebalancing from occurring. In the past, as deficits increased, the bond market “vigilantes” would put upward pressure on rates until the Congress made deficit reduction a priority. However, we believe in a ZIRP (zero interest rate policy) world that relies on quantitative easing, there are very few real signals, including higher rates, which can be effectively and efficiently communicated by bond market participants. In the short-term this may

be good for keeping rates low amid uneven economic growth, but over time it appears to allow fiscal excesses to go unchecked.

In Europe: More Rebalancing to be Done. We believe that unlike the United States and China, Europe is still in its early rebalancing days. This is not from a lack of effort; rather, we think that they are following the wrong playbook, and as a result their rebalancing process is being stymied by larger forces that effort alone cannot overcome.

Why are Europe’s rebalancing efforts not working? When faced with a debt crisis, a sovereign debtor can (i) default either explicitly via debt rescheduling, or implicitly via breaking entitlement promises; (ii) devalue its currency; or (iii) deflate its wages. At the moment, Europe is largely focused on the third, which takes time and is often the most difficult because it is hard to reduce deficits and gross debt levels without growth. Moreover, strict austerity often leads to social tension and political unrest, which makes embracing a consistent message of reform challenging, in our view.

Also, if one excludes Greece from the analysis, we are not sure we are dealing with a fiscal crisis. Rather, what we think what we are seeing is a balance of payments crisis. Our work shows that fixing a balance of payments crisis often requires transfer payments and/or currency devaluation, neither of which is happening in the Eurozone. We believe real GDP growth is almost always required as well. To address this point, we looked at every example of deleveraging going back to the 1800s (excluding wartime activities) and found that the dynamics are as follows: the average deleveraging cycle took about 12 years, with debt as a percentage of GDP falling by about 4.1% per year, and during this period, real GDP growing at a CAGR of 2.3%, while the CPI was essentially flat. One can see the various examples in Exhibit 41.

EXHIBIT 40

2012e Nominal GDP Minus 10-Year Government Bond Yield, Basis Points

<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>UK</td>
<td>6%</td>
<td>7%</td>
<td>5%</td>
<td>4%</td>
<td>3%</td>
<td>2%</td>
<td>-1%</td>
<td>0%</td>
<td>1%</td>
<td>2%</td>
<td>3%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>7%</td>
<td>8%</td>
<td>6%</td>
<td>5%</td>
<td>4%</td>
<td>3%</td>
<td>2%</td>
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<td>7%</td>
<td>6%</td>
<td>5%</td>
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<td>1%</td>
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<td>1%</td>
</tr>
<tr>
<td>Netherlands</td>
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<td>8%</td>
<td>7%</td>
<td>6%</td>
<td>5%</td>
<td>4%</td>
<td>3%</td>
<td>2%</td>
<td>1%</td>
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</tr>
<tr>
<td>Italy</td>
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<td>11%</td>
<td>9%</td>
<td>8%</td>
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<td>6%</td>
<td>5%</td>
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<td>1%</td>
</tr>
<tr>
<td>Spain</td>
<td>11%</td>
<td>12%</td>
<td>10%</td>
<td>9%</td>
<td>8%</td>
<td>7%</td>
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<td>Netherlands</td>
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<td>8%</td>
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<td>Canada</td>
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<td>12%</td>
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<td>9%</td>
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</table>

EXHIBIT 41

No Good Examples of Developed Countries Deleveraging Without Growth

<table>
<thead>
<tr>
<th>Median Real GDP CAGR, 2.3%</th>
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</thead>
<tbody>
<tr>
<td>Real Debt Growth</td>
</tr>
<tr>
<td>Real GDP CAGR</td>
</tr>
<tr>
<td>CPI CAGR</td>
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</table>

So, while the government is clearly behind on fiscal rebalancing, we believe that the financial services industry also needs to rebalance via deleveraging too. As Exhibit 42 shows, European banks—even after adjusting for large amounts of derivatives and sovereign debt—are still much more levered than their U.S. counterparts. As we mentioned in our U.S analysis above, we think that there is an important opportunity for non-traditional firms to replace commercial and investment banks as capital providers in certain situations. One can see in Exhibit 43 that banking crises typically take 6 years, which means the current lack of credit availability is likely to remain with us for some time. If our outlook for the reshaping of the competitive landscape in the global wholesale business is accurate, then leading alternative asset managers, particularly those with strong balance sheets, may likely prosper in the type of environment that allows them to still earn attractive returns even being higher up than normal in the client capital structure.
**EXHIBIT 42**

European Banks Have to Deleverage Further

<table>
<thead>
<tr>
<th>YEAR</th>
<th>ASSETS/EQUITY</th>
<th>ASSETS EU TRILLION</th>
<th>EQUITY € TRILLION</th>
<th>US BANKS &amp; DIVERSIFIED FINANCIALS</th>
<th>ASSETS/EQUITY</th>
<th>ASSETS $ TRILLION</th>
<th>EQUITY $ TRILLION</th>
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<td>22.6</td>
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<td>1.2</td>
<td></td>
</tr>
</tbody>
</table>


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**EXHIBIT 43**

Banking Crisis Usually Take Roughly 6 Years, Which Means Corporates Will Need Alternative Lenders In the Interim

If there is good news, it is that the Eurozone countries have cut their collective budget deficits to 2.8% as of the fourth quarter of 2011, from a peak of 8.3% near the depths of the last recession in the first quarter of 2010 (Exhibit 44). Also, we believe many signs point to further narrowing of deficits in coming years as the Eurozone implements its Fiscal Pact and the U.K. maintains its focus on closing its own fiscal imbalance. In some cases the pain of austerity and financial market dislocation has also promoted gains in competitiveness. Consider that in Spain, the trade balance narrowed to -4.3% of GDP in 2011 from -9.4% in 2007 (Exhibit 8). Such improvement in the current account deficits suggests to us that once the crisis eventually stabilizes, export-driven stories could be of interest, particularly given their current valuation levels.

Macro rebalancing is like running a marathon, not a sprint—and it requires discipline, sacrifice, focus and time. Along the way there will likely be flare-ups that shake investor confidence, yet even with these risks, there is significant opportunity.
As Europe Starts to Reign in Its Deficits Via Fiscal Austerity, Consumption is Likely to Be Adversely Affected

![Graph showing Euro Area Budget Surplus (Deficit) % GDP](image)

**EXHIBIT 44**

Data as at 4Q2011. Source: European Central Bank, Haver.

Ireland has Become a Competitive Exports Sector...

**EXHIBIT 45**


One country that has the potential to rebound sharply is Ireland, which has a flexible and a competitive labor force that has been instrumental in driving net exports to 23% of the economy (Exhibits 45 and 46). We also believe that the European Central Bank (ECB) and Germany view Ireland as the proverbial “model student” in its austerity program, and consequently seems compelled to do whatever necessary to ensure that the “Celtic Tiger” rebounds from recent woes.

...and its Labor Market is Extremely Flexible

**EXHIBIT 46**

Rigidity of Employment Index

France 52
Greece 50
Spain 46
Brazil 43
Portugal 42
Germany 38
Italy 31
China 30
India 16
Japan 10
U.K. 10
Ireland 10
U.S. 0

0-Less Rigid to 100-More Rigid


Summary

These are complex and difficult times for the global economy. Deleveraging and rebalancing are long-tail processes that take years, not months, and typically involve substantial volatility along the way.

We see at least three areas of the global economy that could come under pressure as the world rebalances further. First, China’s rebalancing toward consumption may not support the rising valuations of pure commodities or the rate of industrial activity, since it would mean that the growth in fixed investments and exports would fall from the peak levels that defined the 2009-2010 recovery period.

Second, government retrenchment at the federal, state and local levels in the United States may adversely affect sectors that have traditionally benefitted from government spending. Defense, information technology, and even parts of healthcare industry could all face challenges in the longer run.

Third, Europe’s playbook for rebalancing may likely not prove effective in the near term, and we remain wary of domestic trends—particularly regarding consumption—in that region.

On the other hand, we believe there is likely to be a tremendous opportunity for firms that can allocate capital to regions, countries, or businesses that are taking advantage of the rebalancing process we envision. Beneficiaries of the rebalancing process we favor include many parts of U.S. industrials, U.S. housing, emerging market consumption stories, and even certain investments in Ireland. We also think that there is a big ‘substitution’ trade on which investors should focus. Specifically, we believe given the massive amount of deleveraging that has occurred in the U.S. and will likely occur over time in Europe, there is a ample opportunity for non-traditional lenders to step in and fill the gap being created by Wall Street’s downsizing.

The rebalancing process we witness will likely not be linear. Yet
with capital markets now ridding the global economy of its excesses, and accelerating the pace of reform, we are confident that rebalancing will continue. Moreover, given that equity valuations are now trading at multiples of half or less of what they were trading at the turn of the century (when imbalances began to accumulate), we think that the next few years could see one of the strongest periods for capital deployment we have witnessed in quite some time.

“
In Europe, there is an opportunity for non-traditional financial players to replace commercial and investment banks as capital providers in certain situations.
“

12 Source: Bloomberg as at May 31, 2012.
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