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Europe: Focus on the Marginal Change

KKR

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Europe: Focus on the Marginal Change

Similar to what we saw in the after-math of the 1998 Asian Financial Crisis, Europe is now undergoing a brutal restructuring. No doubt, we believe this means below trend growth in the near-term, and that it will take time to 'fix' more than a decade of excessive consumption, declining competitiveness, and increased leverage. However, it also means that there are countries, sectors, and companies in Europe where the cost of capital is now higher than normal but the outlook is improving faster than the consensus may now appreciate. So, in an increasingly inter-connected global economy, it is the dynamic of this macro backdrop in Europe that makes us think now is the time to focus on investments where positive marginal change may not be fully priced into the equity and/or debt of certain European corporations and sovereigns.

"Good fortune often happens when opportunity meets with preparation."

THOMAS A. EDISON
AMERICAN INVENTOR AND BUSINESSMAN (1847 – 1931)

Given all the cross-currents we are still seeing in Europe, I recently made another trip to the region to update our macro outlook for the Eurozone. In periods of dislocation like we are now seeing in Europe, we think that Thomas Edison was right when he said that "good fortune often happens when opportunity meets with preparation."

As in past trips, I was joined along the way by several of my colleagues from various divisions of KKR. Though KKR operates globally, the vast majority of our European professionals are locals. As usual, their 'local' insights help to better inform my thinking about the intricacies of Europe's monetary union, political tendencies, and economic trends.

So, what did I learn? My conclusions are as follows:

1. **Below Trend Growth is Likely to Persist for Some Time**. At this point, I think we can all agree that Mario Draghi, the head of ECB, used his "it will be enough" speech in July 2012 to almost single-handedly prevent Europe from taking a major step backwards. But it is also clear that he may now need to do even more, including further lowering the level of interest rates, encouraging the flow of capital to small and medium size businesses, and improving the competitiveness of the region's currency, the euro. More importantly, it is time for all politicians to help their economies take positive steps forward. And in our view, just extending austerity deadlines will likely not be enough. Domestic cyclical industries should be resuscitated, while other sectors, including infrastructure and exports, should be encouraged. Barring significant policy change in these areas, our new proprietary model suggests Eurozone GDP will still likely contract by -0.2% in 12 months' time. In particular, if tighter spreads and lower interest rates do not soon start driving better fundamental growth in private cyclical sectors of the European economy, 2014 could be Europe's third straight year of recessionary conditions.

2. **The Cyprus Effect.** See below for details, but we think that recent events in Cyprus will challenge the power and the reach of the European Stability Mechanism (ESM) until the Troika feels comfortable that banking and political excesses have been largely eliminated from the Union's weaker countries. While this strategy may be the right one long-term, it is likely to encourage repatriation of cross-border flows, which may create an interesting opportunity for private capital to fill this growing hole.

3. **Germany and France At Odds Isn't Helping.** I may be just plain wrong, but I left Berlin, my last stop during my week-long trip, more worried about France's relationship with Germany—and its overall position in the EU—than I did about Italian politics or regional secession issues in Spain. Without question, France's current attempts to secure ESM capital for its banks without forcing its banking system to be fully subject to the 'new' banking laws is a non-starter with every German political official we met. Also, it appears there is growing frustration among the German electorate that French President Francois Hollande is just not doing enough to reform his economy. In our view, this tension should be resolved, because for the European Union to succeed over time, the two largest economies cannot be fundamentally at odds on how it will work.

4. **For Investors, It is the 'Marginal Change' That Now Matters.** As a student of financial history, I believe there are important lessons from the 1998 Asian Financial Crisis playbook that we can apply to the current European situation. Specifically, painful corporate and sovereign restructurings, similar to what we saw in a country like Indonesia post-1998, can ultimately lead to sizeable gains for investors willing to step-in during tumultuous periods to provide financing when the cost of capital moves above trend (*Exhibits 1 & 2*). To this end, we think asset allocators should be starting to put more capital back into European destinations such as Ireland, Spain, and potentially even Portugal.

5. **Key Investment Themes on Which to Focus.** We see several important investment themes worth pursuing. First is our belief that, similar to what we saw in the U.S. when wages began to stagnate/decline on a real basis five plus years ago, we are now seeing notable consumer "trade-down" trends across Europe. In our view, this investment thesis is a compelling one and represents a macro tailwind for companies that can dis-intermediate traditional retail vendors or provide cheaper substitutes that don't sacrifice quality. We would also just mention that our cautious outlook for Continental Europe's current consumption patterns does not extend to some of the emerging economies linked to Europe. We believe Turkey, Israel, Africa, and even parts of the Middle East are now full of attractive rising GDP per capita stories (similar to ones we see in China and Brazil, but sometimes with less wage inflation). Second, there is an accelerating export story in Ireland, Portugal, Spain, and even the U.K. (compliments of its recent currency devaluation). Third, we think that there are significant opportunities to own some secular global winners in areas like digitalization, education, and/or energy that are domiciled in Europe and trade at more reasonable valuations than their global comps. Finally, with the European financial services system under siege, we think that there is a significant opportunity to earn strong returns by providing credit to companies that are seeing their traditional trade finance and cross-border lending capacity wither.

Our bottom line: we applaud those who were early to turn cautious on Europe as they saw how huge current account deficits and 100% dependence on external fund flows would eventually cause the recent sovereign debt crisis. But I do not believe that 2013 is the time to turn bearish on Europe at large. That time has largely passed, in our view.

No doubt, Europe faces many challenges, but amid the consternation, our visit confirms that marginal macro momentum is turning more positive in some areas; and in other more tender areas of the regional economy, we think the balance between supply of capital and demand for capital is now quite favorable for investors. No doubt, as Thomas Edison pointed out, one has to be "prepared" and know where to focus. But as we saw in Asia after its debt crisis (*Exhibits 1 & 2*), it is the marginal change that matters as restructurings can – over time – often lead to more competitive countries, sectors, and companies in many instances.

EXHIBIT 1

The Asian Financial Crisis Economic Workout is Similar to the Story Playing Out In the Eurozone…

CURRENT ACCOUNT BALANCE, % GDP			
ASIAN FINANCIAL CRISIS COUNTRIES		EURO CRISIS COUNTRIES	
THAILAND 1996	-7.9	GREECE 2008	-14.9
THAILAND 2012	0.7	GREECE 2012	-2.9
MALAYSIA 1996	-4.4	PORTUGAL 2008	-12.6
MALAYSIA 2012	6.4	PORTUGAL 2012	-1.5
KOREA 1996	-4.0	SPAIN 2008	-9.6
KOREA 2012	3.7	SPAIN 2012	-1.1
INDONESIA 1996	-3.2	IRELAND 2008	-5.7
INDONESIA 2012	-2.8	IRELAND 2012	4.9
		ITALY 2008	-2.9
		ITALY 2012	-0.5
AVERAGE 1996	-4.9	AVERAGE 2008	-9.1
AVERAGE 2012	2.0	AVERAGE 2012	-0.2

Data as at April 16, 2013. Source: IMF, Haver Analytics.

EXHIBIT 2

…Bond Spreads Also Tell a Similar Story

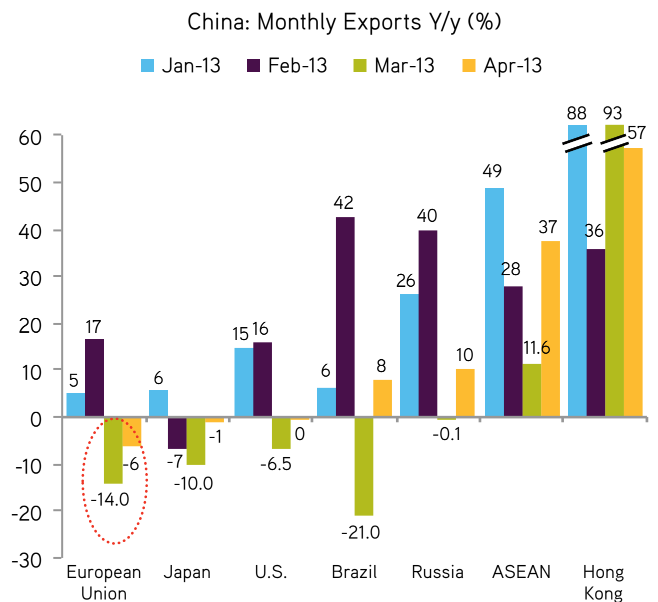
GOVERNMENT BOND YIELDS			
ASIAN FINANCIAL CRISIS COUNTRIES		EURO CRISIS COUNTRIES	
THAILAND 1996	10.75	GREECE 2008	5.08
THAILAND 2012	3.55	GREECE 2012	13.33
MALAYSIA 1996	6.55	PORTUGAL 2008	4.01
MALAYSIA 2012	3.24	PORTUGAL 2012	7.25
KOREA 1996	11.4	SPAIN 2008	3.86
KOREA 2012	3.1	SPAIN 2012	5.34
INDONESIA 1996	12.8	IRELAND 2008	4.57
INDONESIA 2012	5.75	IRELAND 2012	4.67
		ITALY 2008	4.47
		ITALY 2012	4.54
AVERAGE 1996	**10.38**	**AVERAGE 2008**	**4.4**
AVERAGE 2012	**3.91**	**AVERAGE 2012**	**7.03**

Thailand = Bank allotted Gov't Bond Coupon Yield; Malaysia = 5 yr Gov't Bond Yield; Korea = Gov't Housing Bond Yield Weighted Average; Indonesia = Central Bank Policy Rate; Greece = 10 yr Fixed Rate Gov't Bond Yield; Portugal = Public Debt Instruments Subject to Withholding Tax; Spain = 2 yr & Over Gov't Bond Yield; Italy = 9-10 yr Gov't Bond Yield; Ireland = 15 yr Gov't Bond Yield; German = 3 yrs & Over Gov't Agency Bond Yield; US = 10 yr Gov't Bond Yield. All data as at December of respective years 1996, 2008 and 2012. Source: IMF, Haver Analytics.

Our bigger picture conclusion after recent trips to Latin America, South East Asia, the Middle East, and Europe is that the world, as author Thomas Friedman wrote, is "flat." Indeed, everywhere I go these days, policy makers and business leaders tell me about some economic reverberation that started outside their country but is now having a direct impact on how they view the world. Just consider that consumption slowdowns in the U.S. and Europe are now crimping exports in China, which is now impacting commodity business trends from Indonesia to Brazil (*Exhibit 3*). On the other hand, lower oil prices (compliments of slower growth in China) are now helping the balance of trade in Japan, India and Turkey, but hurting it in Canada, Russia, and Norway[1]. From what we can tell, these linkages of the global economy are likely to persist for the foreseeable future, and as a result, macro and asset allocation professionals should think about running a more balanced global book than in the past. So, as one can see in *Exhibit 4*, this is exactly what we are doing with our geographic disbursements in our global overall asset allocation.

EXHIBIT 3

A Slowdown in China Exports Is Now Being Felt Globally



Data as at April 30, 2013. Source: China Customs, Haver.

1 Significant oil importing and exporting countries, as per US Energy Information Administration data as of 2011.

EXHIBIT 4

In Our Target Asset Allocation for 2013, We Think a Regionally Balanced Approach Makes Sense

ASSET CLASS (%)	TARGET (%)	STRATEGY BENCH-MARK (%)	TARGET VS. BENCHMARK DIFFERENCE (%)
PUBLIC EQUITIES	**55**	**53**	**2**
U.S.	20	20	0
EUROPE	15	15	0
ALL ASIA	14	12	2
LATIN AMERICA	6	6	0
TOTAL FIXED INCOME	**20**	**30**	**-10**
GLOBAL GOVERNMENT	3	20	-17
MEZZANINE	5	0	5
HIGH YIELD	2	5	-3
BANK LOANS	2	0	2
HIGH GRADE	0	5	-5
EMD	5	0	5
DIRECT LENDING	3	0	3
REAL ASSETS	**10**	**5**	**5**
REAL ESTATE	5	2	3
ENERGY/ INFRASTRUCTURE	5	2	3
GOLD/CORN/OTHER	0	1	-1
OTHER ALTERNATIVES	**15**	**10**	**5**
TRADITIONAL PE	5	5	0
DISTRESSED / SPECIAL SITUATION	5	0	5
GROWTH CAPITAL/ OTHER	5	5	0
CASH	0	2	-2

Target % is the January 2013 KKR Global Macro and Asset Allocation Target Asset Allocation Percentage. Source: KKR Global Macro and Asset Allocation (GMAA) as at January 10, 2013. Strategy benchmark is the typical allocation of a large US pension plan. Please visit www.KKRinsights.com to review our *Outlook for 2013: A Changing Playbook* note which further reviews these ideas.

The Details

In the following section we detail some key conclusions from our recent trip to Europe.

Playbook for Growth in Europe

"While I think this policy (austerity) is fundamentally right, I think it has reached its limits." European Commission President José Manuel Barroso April 2013

Given all the cross-currents in Europe these days, our view is that any economist, macro strategist, or portfolio manager who tells you it is possible to pinpoint with accuracy how Europe will grow over next few years likely needs to have his or her head examined. What we do think, though, is that an investor can leverage historical precedents to create a framework for better understanding what might happen. To this end, we remain focused on two areas of important macro analysis. First, as we show below in *Exhibit 5*, past successful de-leveraging experiences in developed markets were associated with healthy real annual GDP growth – 2.3% per to be exact. In fact, as *Exhibit 6* illustrates, countries that prioritize growth have actually managed to deleverage faster, in debt-to-GDP terms, than those that take a belt-tightening approach. This insight is significant, as current European policy is almost 100% focused on austerity, which is why it's important to note that leaders like European Commission President José Manuel Barroso are finally beginning to change their tune on its effectiveness. It is also worth reiterating that in the past, countries could devalue their currencies as a means to stimulate growth. In our mind, the removal of this option from the economic toolkit reinforces our view that economic policies that encourage more growth are what's needed.

"If tighter spreads and lower interest rates do not soon start driving better fundamental growth in private cyclical sectors, 2014 could be Europe's third straight year of recessionary conditions."

EXHIBIT 5

Developed Countries Claw Their Way Out of Debt Through Growth, Not Inflation

	DEBT/GDP					DYNAMICS DURING DELEVERAGING			
COUNTRY	PEAK YEAR	'RECOVERY' YEAR	YEARS: PEAK TO RECOVERY	PEAK LEVEL	'RECOVERY' LEVEL	DEBT/GDP REDUCTION PER YEAR	REAL DEBT GROWTH	REAL GDP CAGR	CPI CAGR
UK	1821	1863	42	260%	90%	-4.1%	-0.5%	2.0%	0.0%
NETHERLANDS	1834	1873	39	278%	85%	-4.9%	-1.5%	1.5%	-1.2%
FRANCE	1887	1906	19	117%	85%	-1.7%	-0.1%	1.6%	-0.3%
NETHERLANDS	1887	1898	11	104%	87%	-1.5%	-0.4%	1.2%	-0.6%
ITALY	1897	1906	9	118%	82%	-3.9%	-0.1%	3.9%	0.5%
SPAIN	1902	1910	8	128%	90%	-4.8%	-3.3%	1.1%	-0.1%
ITALY	1921	1935	14	153%	95%	-4.1%	-1.0%	2.4%	-1.4%
UK	1947	1965	18	238%	85%	-8.5%	-3.1%	2.7%	4.1%
IRELAND	1987	1994	7	109%	89%	-2.9%	1.7%	4.7%	2.8%
BELGIUM	1994	2006	12	134%	87%	-3.9%	-1.3%	2.3%	1.8%
CANADA	1996	2000	4	102%	82%	-4.9%	-0.7%	4.8%	1.8%
MEDIAN			12	128%	87%	-4.1%	-0.7%	2.3%	0.0%
MAX			42	278%	95%	-8.5%	1.7%	4.8%	4.1%
MIN			4	102%	82%	-1.5%	-3.3%	1.1%	-1.4%

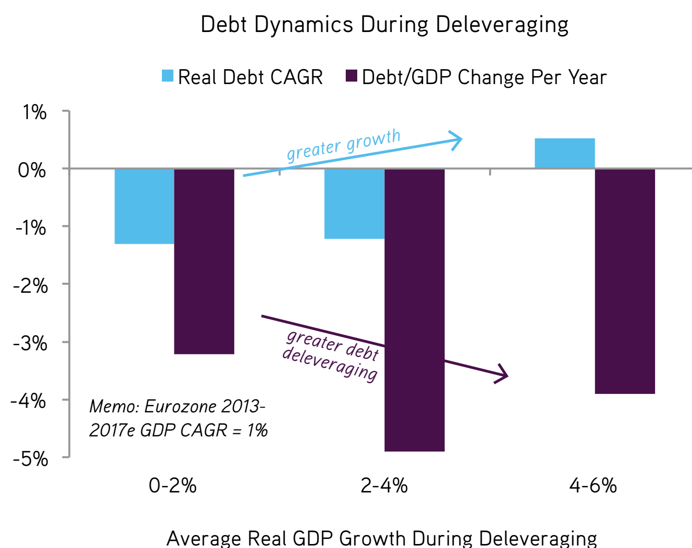
Examples above are of countries that have recovered from high debt levels without defaulting. Source: KKR Global Macro and Asset Allocation team analysis of annual data from 1821-2006 available on reinhartandrogoff.com.

The second macro variable on which we have been focused is the fiscal multiplier. Simply stated, when a government tries to reduce its deficits by – as an example – one percent, there is usually some knock-on effect on GDP growth. In Europe for the 20 years leading up to 2010, the fiscal multiplier, or the knock-on effect from austerity, was around 30 basis points (*Exhibit 7*). However, as the exhibit shows, the fiscal multiplier is now closer to 1.6 times, so that one percent of fiscal contraction equates to 1.6% slower GDP growth. We link the huge jump to several factors, including lack of bank credit availability, multiple countries de-leveraging at the same time, and an unusually strong currency.

> **"We also think that private capital will be required to step in and provide cross-border financing throughout Europe."**

EXHIBIT 6

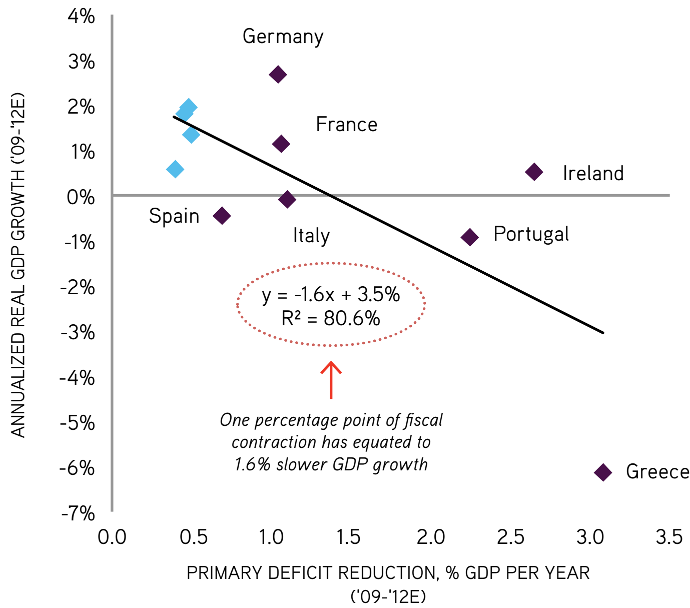
An Austere Approach to Deleveraging May Actually Lead to Slower Debt/GDP Reduction



Based on analysis of case studies outlined in *Exhibit 5* above. Source: KKR Global Macro and Asset Allocation analysis of data available on reinhartandrogoff.com.

EXHIBIT 7

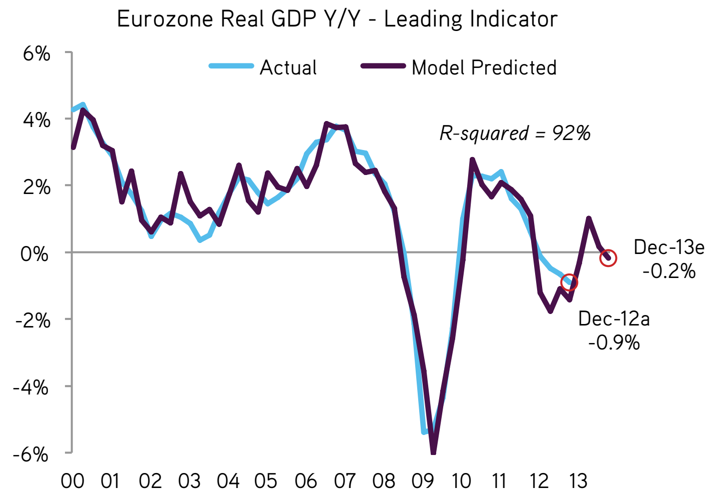
One Percent of Fiscal Contraction Has Equated to 1.6% Slower GDP Growth (R2 = 81%)



e = IMF estimates as at April 16, 2013. Source: KKR Global Macro & Asset Allocation analysis of IMF data.

EXHIBIT 8

Eurozone GDP Lead Indicator Suggests Recession Continues in 4Q13e, Albeit at a Moderate Pace



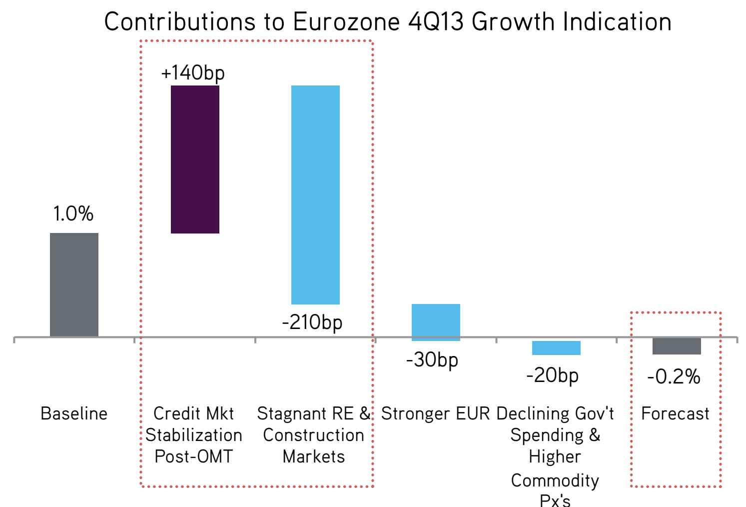
Our GDP Leading Indicator contains seven variable inputs that contribute meaningfully to the forecast. a = Actual; e = Estimate. Data as of May 9, 2013. Source: Bloomberg, Haver Analytics, KKR Global Macro and Asset Allocation analysis.

So, armed with what we think is a better understanding of the macro backdrop/tendencies in Europe, I tasked Dave McNellis on my team to take our analysis one step further and help us build a Eurozone GDP model that takes us through not only a potential growth glide path but also the important inputs to growth. So, what is our model telling us? Our model forecasts that the Eurozone recession continues through the end of 2013, albeit at a slower pace so that if GDP falls to -20 basis points (bps) on a 4Q/4Q basis, versus -90 bps last year (*Exhibit 8*). The model's message is consistent with our 'official' 2013 forecast of -50 bps to +10 bps, and is also essentially in-line with the consensus (which has moved down quite a bit of late).

> "If there are any lessons from our work studying the Asian Financial Crisis, it is that there will ultimately be a recovery over the next few years as adjustments began to yield some benefits."

EXHIBIT 9

Positive Impulse from Easier Credit Is Offset by Stagnant Conditions in the Real Economy



Our GDP Leading Indicator contains seven variable inputs that contribute meaningfully to the forecast. a = Actual; e = Estimate. Data as of May 9, 2013. Source: Bloomberg, Haver Analytics, KKR Global Macro and Asset Allocation analysis.

While the headline forecast may not be particularly provocative, the moving parts underneath are much more interesting, we believe. Indeed, as *Exhibit 9* shows, the only major factor supporting 2013 growth is tied to easier credit conditions due to the introduction of three-year Longer-Term Refinancing Operations (LTRO) in December 2011 and Draghi's commitment to do "whatever it takes" in July 2012:

- The weighted-average yield of 3-year Eurozone government bonds fell to just 1.4% at the end of March from 7.6% a year earlier.

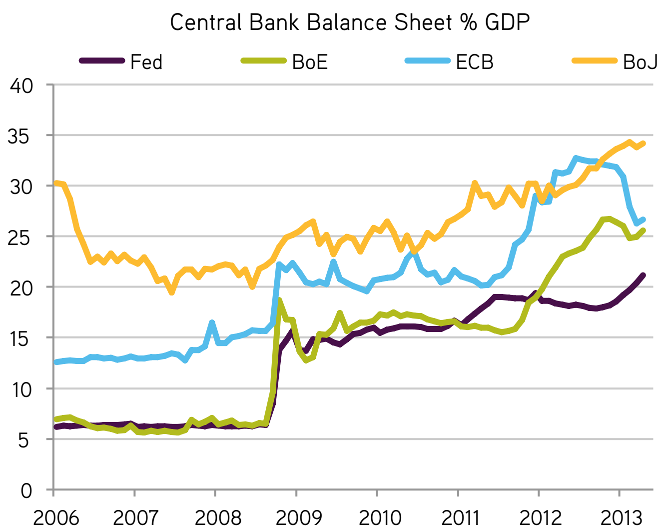
- European high yield spreads have fallen back to near cycle lows of around 500 bps versus over 1000 bps in late 2011.

However, these factors now appear to have run their course. Put another way, if Europe is to see any improvement in growth, it should come from new areas. So, what could they be? From our vantage point, there are two influences that could improve the trajectory of growth from here. First, the ECB, in our view, could do more. In particular, even with the recent 0.25 percent cut, Europe's policy rate benchmark is not nearly as accommodative as other developed markets like the U.S. Moreover, its balance sheet is now shrinking at a time when others continue to expand. One can see this in *Exhibit 10*.

Second, the central bank could to do more to talk down the level of the euro (*Exhibit 11*). Ironically, despite all the headline risk in Europe, the currency has actually appreciated. So, if it does not do more to reduce deflation fears associated with slower growth and de-leveraging, then the current currency strength may offset some of the benefit of recent wage compression in countries like Spain. Finally, the ECB should consider doing more to improve the flow of capital to small and medium size businesses. To date, the U.K.'s "funding for lending" scheme has not worked well, but we believe a program that rewards banks in other ways, including more efficient capital relief and/or net interest margin could work better.

EXHIBIT 10

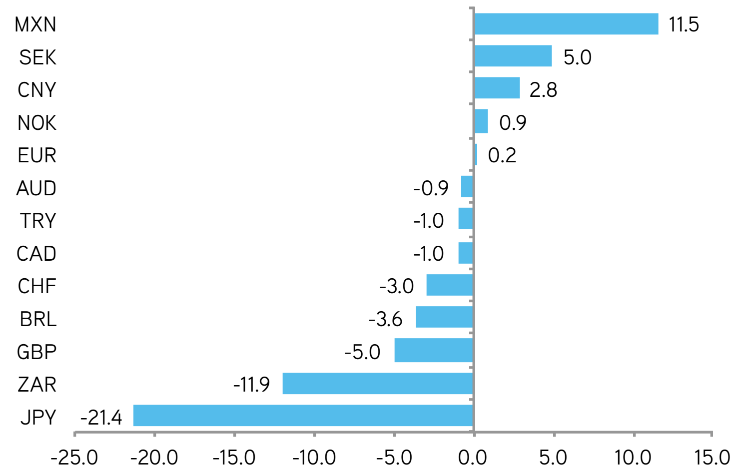
The ECB's Balance Sheet Is Shrinking Just as the Federal Reserve and Bank Of Japan Expand Theirs Through Further Monetary Stimulus.



Data as at April 30, 2013. Source: Bank of Japan, ECB, Bank of England, US Federal Reserve, Haver Analytics.

EXHIBIT 11

The Euro Likely Needs to Weaken in Order to Foster Competitiveness



Data as at May 10, 2013. Source: Bloomberg.

The other big 'swing factor,' of course, is a potential turn in the private sector, which appears to be under massive pressure from higher taxes and lower business confidence. In particular, as the model shows in *Exhibit 9*, any improved policy initiatives and/or boost in business confidence around construction and real estate could serve as an important catalyst in terms or reversing current drags on the economy by the private sector.

Given our framework, we are moderately encouraged that austerity deadlines are being pushed back to 2016 in many countries. But that alone is not enough. In our view, all of the Eurozone–including the government sector, central bank, and private sector–should pivot together towards economic policies that encourage more growth. Importantly, as the quantitative framework we lay out in *Exhibits 8* and *9* demonstrates, the LTRO/OMT in isolation is not enough to stimulate growth; it only appears to be able prevent growth from getting worse rather than acting as a true agent of change in the private sector. In our view, change should now come from better credit availability and positive growth initiatives, including inspiring better business conditions and business confidence in cyclical sectors like housing, autos, and real estate. Coupled with a more competitive export sector, we think only then can Europe return to – and as our model suggests – baseline growth north of 1.0%.

The Cyprus Effect

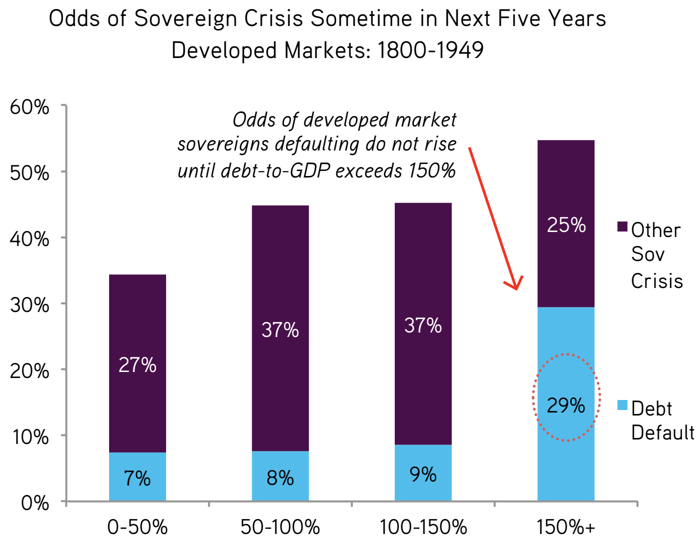
There has been a lot written and said about Cyprus in recent months, so we will spare investors another recap of what took place and focus on what we deem to be the key investment conclusions and insights.

First, we have never believed that the original proposal of taxing small depositors would remain a viable option. Key to our thinking was that IMF data reveals that of the 147 banking crises tracked since 1970, zero (yes, zero) have actually inflicted losses on all depositors. So, even factoring in all the distinct personalities in Europe, the original proposal of penalizing all depositors, including small ones, was truly unprecedented. Ultimately, 'just' larger depositors were affected, but in our view this precedent – coupled with capital controls – reverses a fair amount of the progress that the ECB had made with its LTRO and OMT programs, in our view.

We also think the idea of adding any bail-out 'penalty' to the government debt loads of a weakened country like Cyprus (it is a similar argument we made with Greece, and to some degree with Spain, if indeed Cyprus is forced to assume all the bank bailout capital) is actually a bad strategy too, particularly when it pushes debt levels to 150% of GDP. See *Exhibit 13* for a nation-by-nation breakdown, but in our view the bottom line is that these countries need direct bank bailouts and—whenever feasible—fresh third-party equity to stabilize the situation so that they can pay back their high levels of existing debt without incurring even more on top of that. Until the European authorities embrace this notion, we will continue to have periodic flare-ups, we believe. Case in point: Already, we believe that Cyprus is again at risk of default as its 2013/2014 GDP forecasts will now likely need to be cut at the same time its deficit projection will likely need to be raised.

EXHIBIT 12

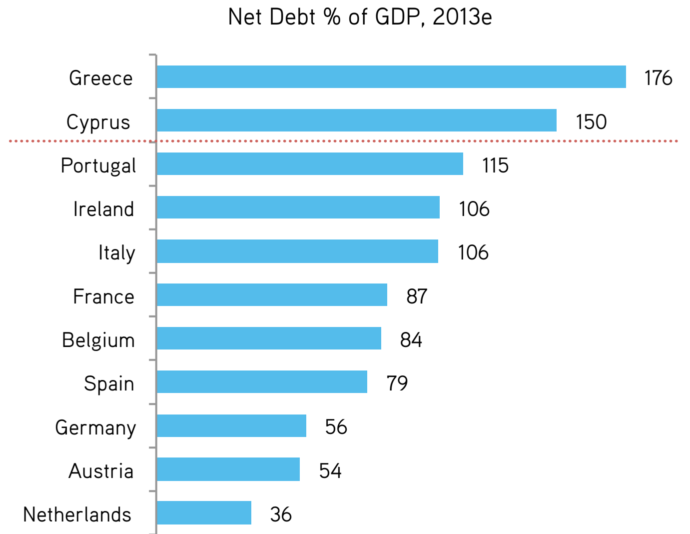
Odds of Developed Market Sovereign Defaults Remain Low Until Debt/GDP > 150%



"Other Sovereign Crisis" includes currency and inflation crises. Inflation crisis = inflation rate > 20%. Currency crisis = annual depreciation relative to a benchmark currency > 15%. Source: KKR Global Macro and Asset Allocation team analysis of annual data from 1800-2010 available on reinhartandrogoff.com.

EXHIBIT 13

Few European Countries Are Currently At or Above the 150% Threshold



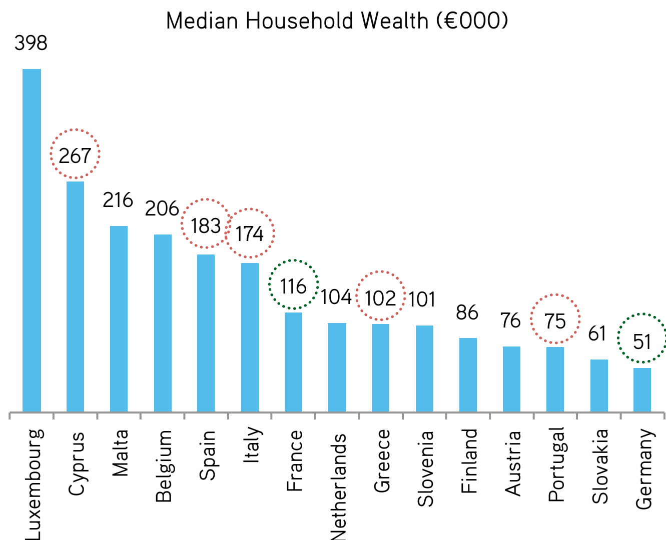
e = IMF estimates as of April 2013 for all except Cyprus, which is a KKR Global Macro & Asset Allocation estimate.

Our third conclusion relates to the ineffectiveness of the European Stability Mechanism (ESM). While it was created to—among other things—bail out European banks, we believe it is now apparent that none of the stronger countries want to use the ESM to wipe away prior bad behavior of the weaker countries as cultural and economic divides are still too wide to see the forest through the trees. Admittedly, it would be politically difficult to promote such fiscal union when the median household net worth income in many countries needing relief is actually higher than in those supplying it (*Exhibit 14*). But what's more worrisome is that this is not just a core versus peripheral stance. As we describe in more detail below, we heard a great deal of hesitancy from folks in Germany surrounding giving any money to French banks as well.

So, while the ESM initially appeared large in size and scope, investors now seem to understand that it is not as powerful as previously thought, given the implicit restrictions attached to the money. The net result, unfortunately, is that the Eurozone remains weighed down by the highest average government borrowing costs among major developed economies, even though it actually has the lowest average aggregate debt load (*Exhibit 15*).

EXHIBIT 14

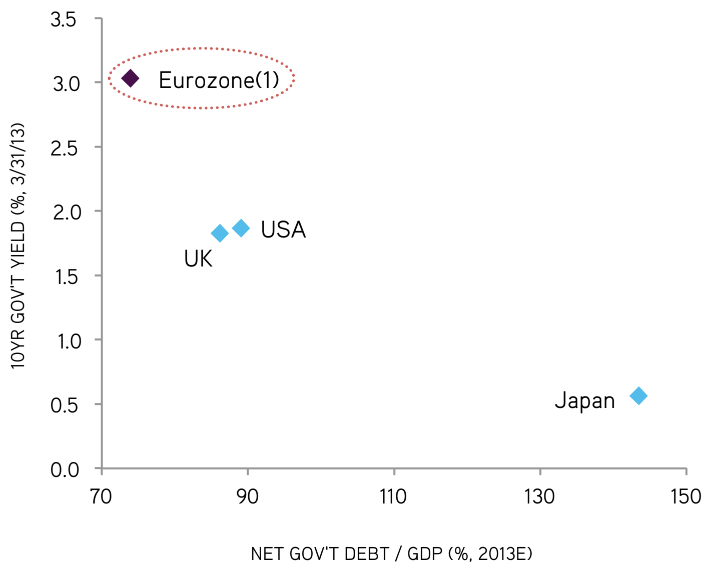
Difficult to Promote Fiscal Union When Many Peripheral Households Are Wealthier Than Those At the Core



Note: Dates vary by country in 2008-10; Household wealth defined as total assets minus total liabilities such as mortgages and credit card debt. Source: ECB Statistics Paper, "The Eurosystem Household Finance and Consumption Survey," April 2013.

EXHIBIT 15

Eurozone Has Lowest Government Debt Among Major Developed Economies, But Highest Interest Costs



(1) Average of Eurozone members, weighted by debt outstanding. e = IMF estimates. Data as of April 2013. Source: ECB, BOE, Federal Reserve, BOJ, IMF, Haver.

An important step forward, we believe, would be completing the originally proposed banking union that would work across the region. Until then, however, we expect the purse strings on the ESM to remain quite tight, which clearly impacts the rate of growth of existing companies as well as new business formation.

Fourth, even with the way the Cyprus situation was mishandled, we believe that a larger knock-on crisis — similar to either the events of 2010 or 2011 — is unlikely, which means that current volatility could create opportunities for long-term, patient capital. Three things have changed in our minds. First, we have a leader like Draghi in place, who with the OMT and the LTRO has become the lender of last resort. Second, we think the global economic recovery is now further along, and while the U.S. recovery was in doubt in prior years (and there was risk of a Chinese hard landing), that does not seem to be the case in 2013. Third and finally, many of the weaker European countries have dramatically narrowed their funding deficits, which make them much less reliant on external capital (*Exhibits 26* thru *29*). We think this is a big deal.

Fifth, we think growth in not only Cyprus but also the overall region is likely to suffer because of mismanagement surrounding the "bail-in." Unfortunately, all the energy being spent around Cyprus (and Italy to some degree) means that Eurozone officials are spending less time on growth initiatives. As we detailed above in our Eurozone GDP model discussion (*Exhibits 8* and *9*), we believe the Eurozone economy is at risk unless it transitions its growth drivers from Draghi-induced economic benefits towards private sector growth drivers. If this does not happen over the next 12 months, growth may again be negative in 2014 at a time when we are close to lifting our economic forecast in other regions of the world.

Germany and France: The 'Core' At Odds

On September 9th, 1962 speaking to a group of young Germans about the importance of Franco-German solidarity, French President Charles de Gaulle stated, "it goes without saying that it has to be organized. And it is the task of governments to do it." By January 1963, De Gaulle and his German counterpart, Chancellor Konrad Adenauer signed the Treaty for Franco-German cooperation, which ultimately became known as the Élysée Treaty, an important document for creating tighter bonds between the two countries.

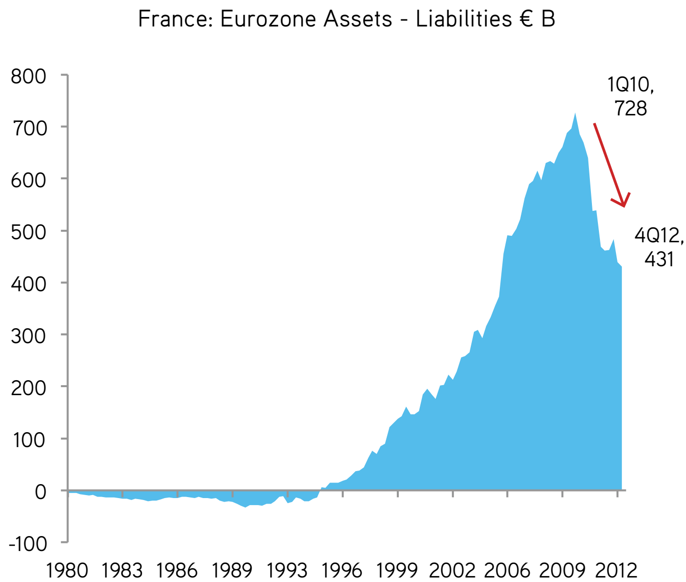
Given their size and their high level of post-war coordination, Germany and France quickly emerged as the major heavyweights of the euro since its establishment in 1999. And when the sovereign debt crisis began to unveil itself, the two governments became even closer; in fact, at times, journalists joked that 'Merkosi'—a nod to the tight relationship between Germany's Angela Merkel and France's Nicholas Sarkozy—was the 'one' calling the shots.

However, the election of Francois Hollande seems to have frosted the relationship between the two countries. Indeed, whereas France used to position itself as a Germany's primary ally in overseeing the rest of the Eurozone, France now seems be the key representative of Europe's weaker economies, including Spain and Italy. In this role, it is almost a foregone conclusion that its function entails challenging Germany's leadership in key decision making forums about issues like financial services, budget reforms, and bailout packages.

The fraying of the Franco-German solidarity was certainly on full display during my recent visit to Berlin. In particular, there was a lot of angst among Germans around a recent decision by France to push for capital for its banks via the emergency funding vehicle ESM without having to fully submit to the banking laws that are attached to receiving that capital. This issue is not to be understated because, as *Exhibit 16* shows, France has been aggressively pulling back on its cross-border lending in recent months, a trend that is likely to continue.

EXHIBIT 16

French Banks Now Have Just a €430bn Funding Gap In The Eurozone (i.e., Outside France), Significantly Down From Over €700bn At Its Peak. We Expect This Downward Trend to Continue

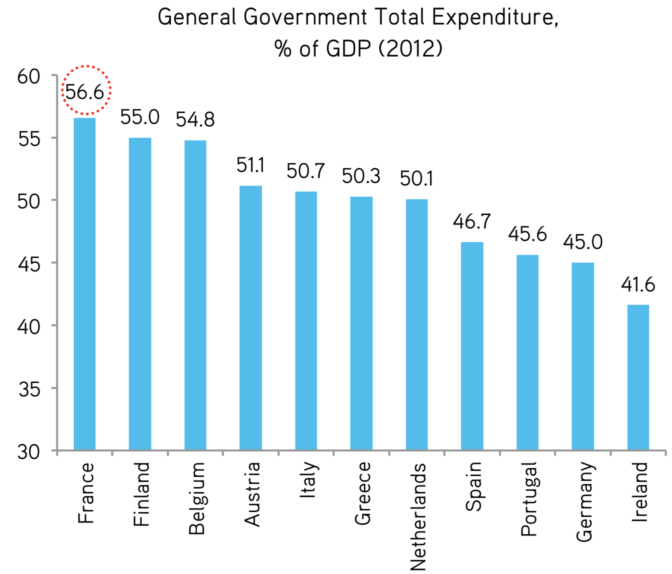


Data as at December 31, 2012. Source: Morgan Stanley Research, Banque de France.

> "We think that there is big opportunity for non-traditional lenders to step in and use private capital to fill the void being created by a de-leveraging banking sector."

EXHIBIT 17

Relative to GDP, France Has the Largest Government Sector In the Eurozone



Data as at April 2013. Source: IMF World Economic Outlook.

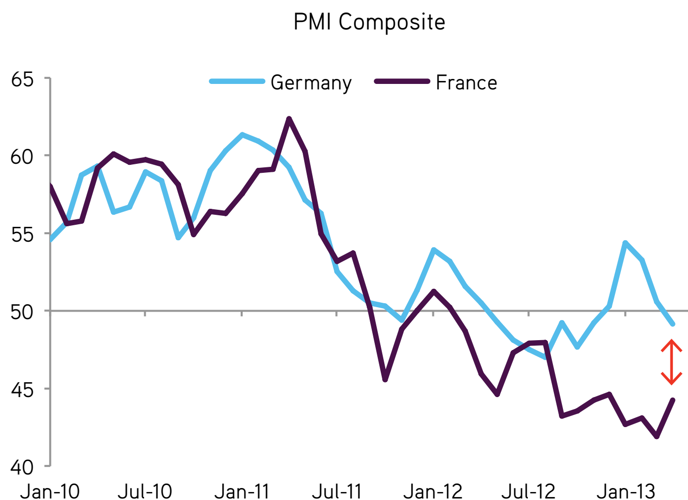
The other big issue that seemed to be at the forefront of every discussion was France's lack of desire to actually implement reform and rationalize its government. Measured relative to GDP, France has the largest government sector in the Eurozone (*Exhibit 17*), yet the budget bill introduced by President Hollande last year did relatively little to curb spending, instead favoring tax increases over expense cuts by a ratio of roughly 2:1[2].

So, where do we go from here? Our base view is that there is not much to be done to cool tensions among Europe's two largest constituents. But with both Hollande's popularity and France's economic growth both falling, we believe that Hollande will ultimately steer France's policy back closer towards what Germany is recommending. As *Exhibits 18* and *19* show, we think it is unlikely that France can retain such low bond yields and maintain its current economic policies, and ultimately we believe that the French government appreciates that this 'disconnect' is just too big for investors to ultimately ignore.

2 "France Budget: Taxes Favoured Over Spending Cuts," BBC News, September 28, 2012.

EXHIBIT 18

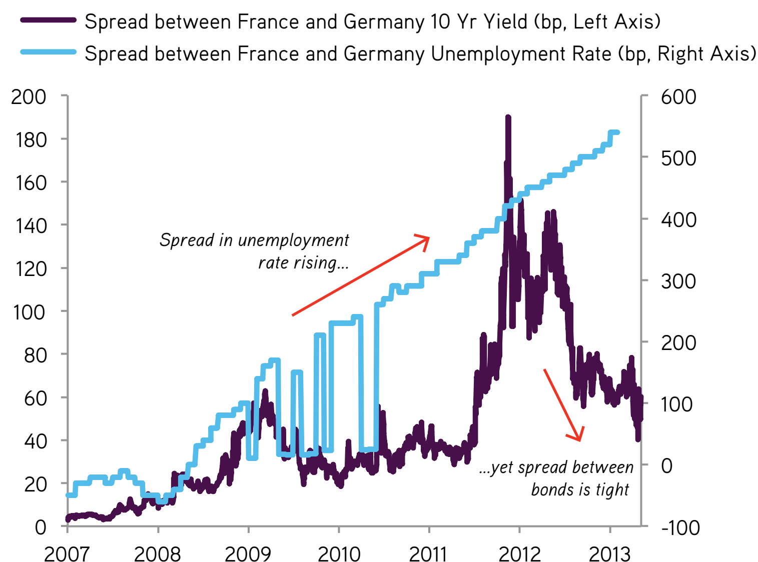
Diverging Growth Paths...



Data as at April 30, 2013. Source: Markit, Comp des Dirigeants et Acheteurs France, Haver Analytics.

EXHIBIT 19

...Yet Yield Spreads are Tight

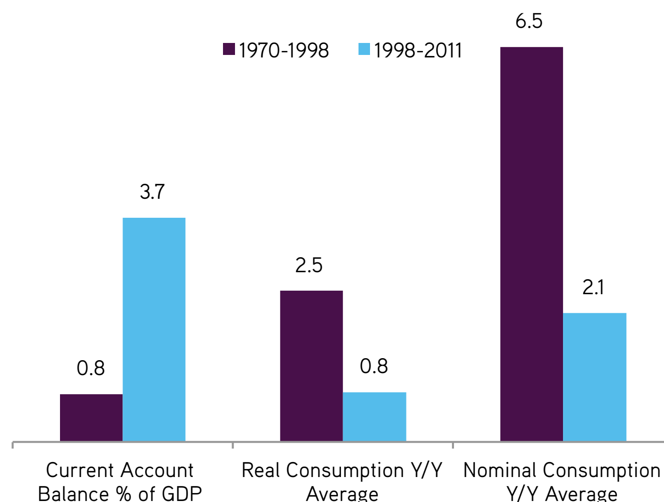


Data as at May 5, 2013. Source: Bloomberg.

However, in our view, there are also things that Germany can do to show France and other struggling European partners that it too intends to act in good faith. In particular, rebalancing would be a good place to start. One can see this in *Exhibit 20*. Were Germany to consume a little more and shrink its current account surplus a touch, it could create a meaningful tailwind at an important time for countries like France, likely giving them a little more wiggle room to embrace the type of reforms that German ultimately wants to see.

EXHIBIT 20

Germany's Influence in Europe Remains Outsized



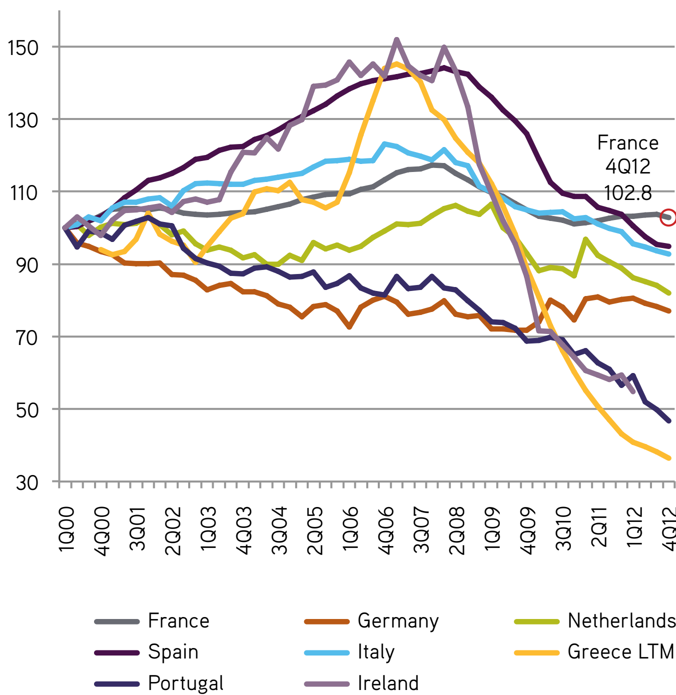
Data as at January 24, 2013. Source: Bloomberg.

Ultimately, the KKR GMAA team's base view is that France and Germany will again see eye to eye, but it may take a little sacrifice from both sides. Germany—and Europe—needs a strong France, one that is competitive and growing. All told, France has accounted for 21% of total Eurozone GDP over the past 10 years, so its well-being is not to be under-estimated[3]. In particular, as we show in *Exhibits 21* and *22*, France must improve its manufacturing sector and then limit downside in its housing market. France seems to have a fundamental competitiveness issue in its manufacturing sector, but much of this weakness has been – until now —masked by the robustness of the construction sector. Without its resilient real estate market (which we think is now on the wane), we believe the French economy would already be performing more like a peripheral economy than a core one.

3 Data as at March 31, 2013. Source: Statistical Office of the European Communities, Haver Analytics.

EXHIBIT 21

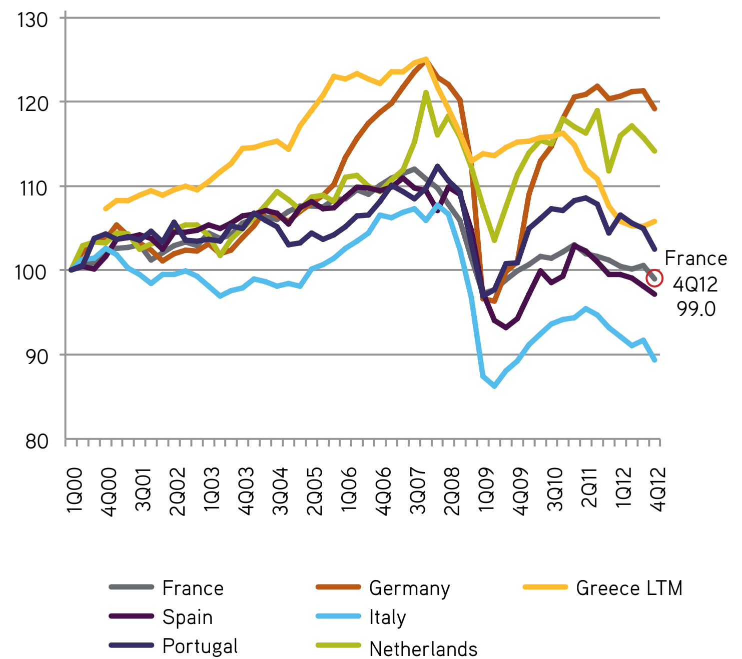
A Robust Real Estate Market...



Data as of March 20, 2013. Source: Eurostat, Haver Analytics.

EXHIBIT 22

...Has Disguised the Decline in Manufacturing



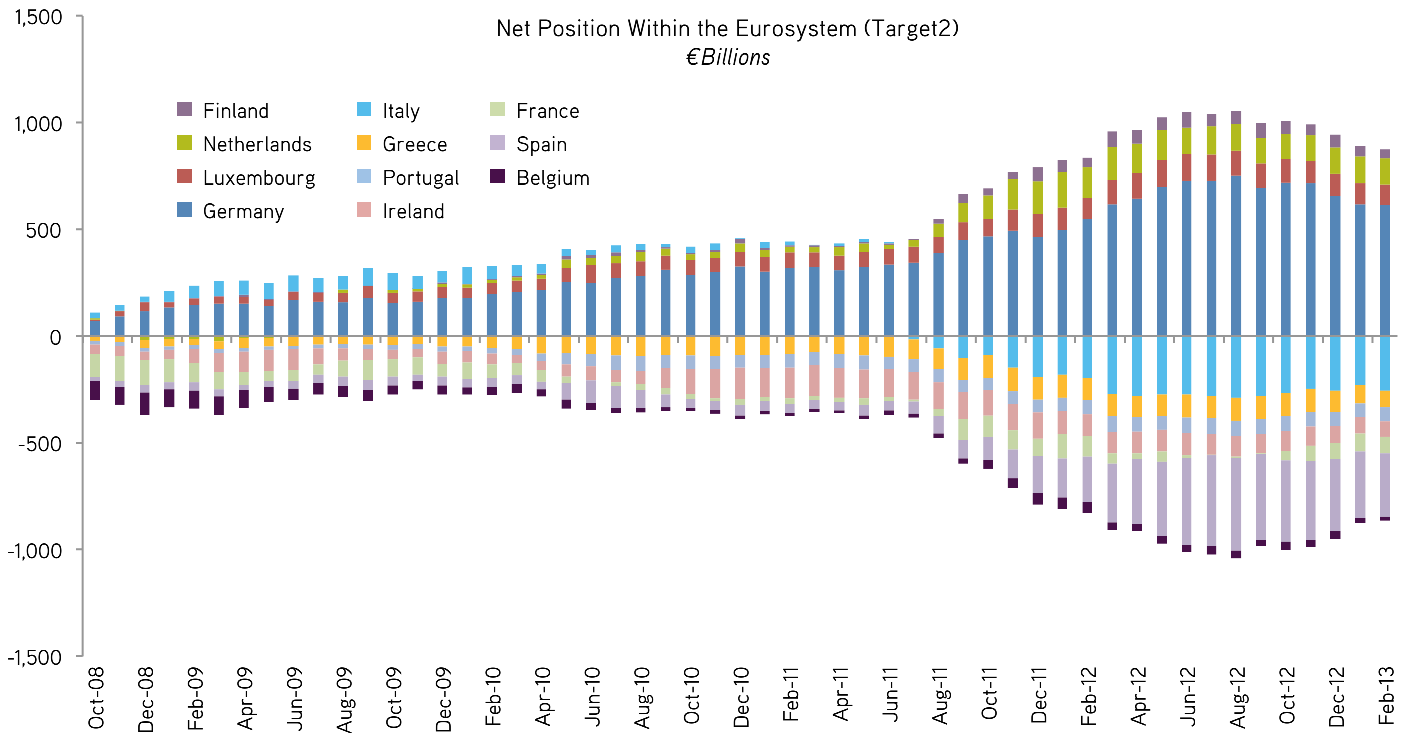
Data as of March 20, 2013. Source: Eurostat, Haver Analytics.

But Germany should ease off a bit too and shift its macro-economic policy towards greater consumption, in our view. Were it to shrink its current account surplus by 100 to 200 basis points (*Exhibit 20*), it would provide France and its peers some breathing room to better implement the austerity that is necessary to make a united Europe a more competitive region vis-à-vis the United States and China.

"I may be just plain wrong, but I left Berlin, my last stop during my week-long trip, more worried about France's relationship with Germany—and its overall position in the EU—than I did about Italian politics or regional secession issues in Spain."

EXHIBIT 23

Germany Still Accounts for the Majority of Europe's Target2 Positive Net Balances



Source: Deutsche Bundesbank, Banque Centrale du Luxembourg, De Nederlandsche Bank, Bank of Finland, Banca d'Italia, Bank of Greece, Bank de Portugal, Central Bank of Ireland, Banque de France, Banco de España, Banque Nationale de Belgique. Latest available data as of April 12, 2013.

Country Allocation: Focus on the Marginal Change

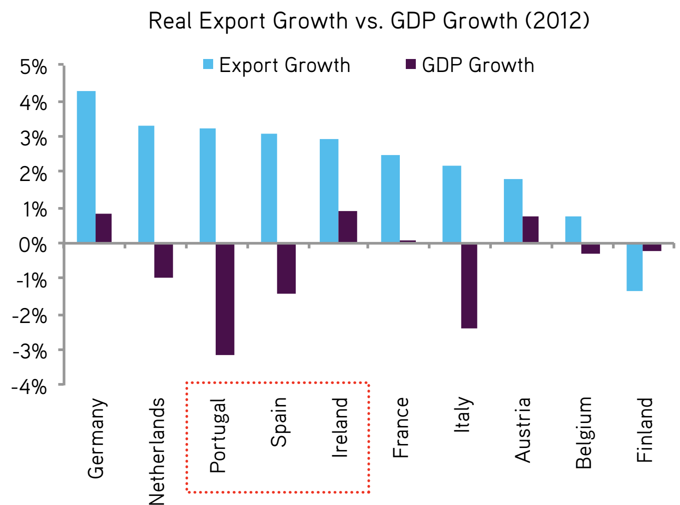
Having traveled extensively throughout Europe in recent months, I am reminded– to some degree–what Asia felt like after the financial crisis in 1998. At the time, growth in Asia was punk, banks needed capital, and investor sentiment was low. Sound familiar? To be sure, Asia has a much better demographic profile and it was far more aggressive in terms of currency devaluation. However, from the perspective of the current account deficits, dependence on foreign capital and the asset bubbles that built up leading into the crisis, Europe is now going through an economic "work out" pretty similar to what Asia faced 15 years prior (*Exhibits 1* and *2*).

So, if the Asian crisis is indeed the best playbook to follow (and we think it is), then we should all spend more time monitoring what is changing on the margin. Which countries are moving quickly to reign in debt, shore up financings, and grow competitiveness? Thus far, as *Exhibit 24* shows, Ireland and Spain are two of the countries that have begun to aggressively 'right' things to reposition their economies for more structural growth opportunities. On the other hand, France–to some degree–appears to be heading in the opposite direction while Italy appears to face some long-term competitive issues.

To date, one of the biggest shifts we are seeing relates to real unit labor costs. As *Exhibit 25* shows, real unit labor costs have plummeted in Spain, making it a much more competitive place to do business than France and Italy (Germany's costs were already low). Ireland and Greece have also made notable progress deflating real wages. Importantly, many countries that have worked to improve their competitive positions have already begun to reap the benefits. *Exhibit 24* shows that Portugal, Spain, and Ireland achieved some of the strongest export growth in Europe last year, despite headwinds including volatile credit markets and weak domestic demand.

EXHIBIT 24

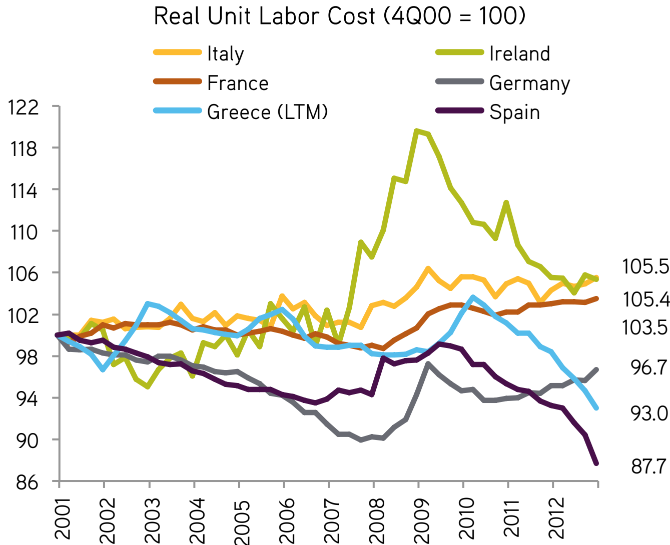
Many Peripheral Countries Posted Solid Export Growth, Despite Other Headwinds



Data as at May 6, 2013. Source: Statistical Office of the European Communities, Haver Analytics.

EXHIBIT 25

Change on the Margin Seems to Be What Matters During Periods of Restructuring

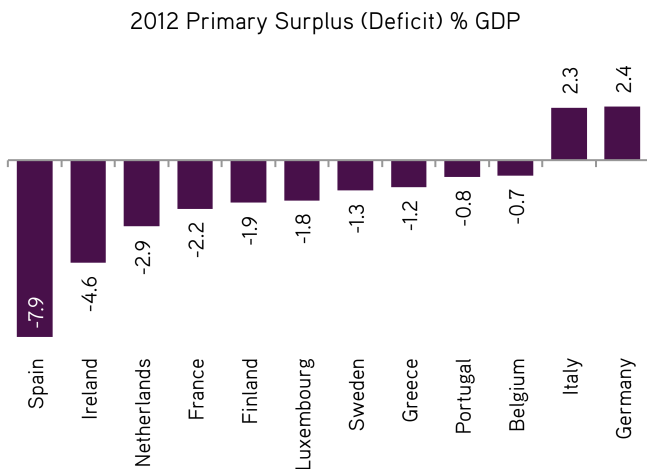


Data as at April 11, 2013. Source: Statistical Office of the European Communities, Haver Analytics.

Meanwhile, though very few countries actually have primary surpluses, many are moving in the 'right' direction, at least edging closer to surplus. One can see this in *Exhibits 26* and *27*. Furthermore, as *Exhibits 28* and *29* show, many of Europe's current account balances are in much better shape after some serious belt-tightening over the past few quarters.

EXHIBIT 26

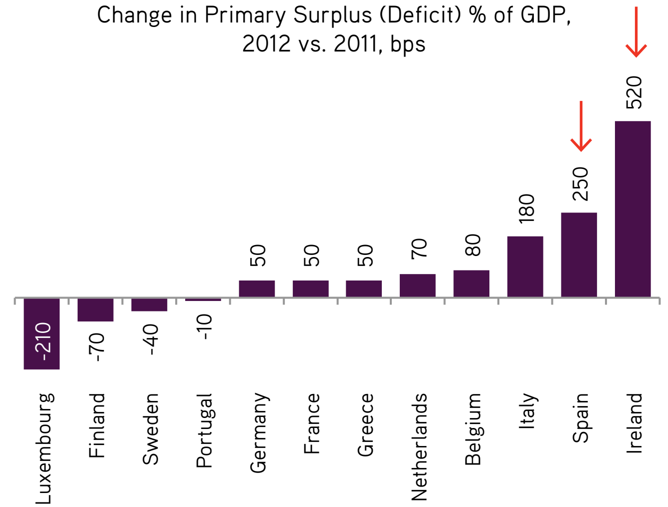
Many of Europe's Fiscal Deficits Are Still Large, But ...



Data as at April 22, 2013. Source: IMF, Haver Analytics.

EXHIBIT 27

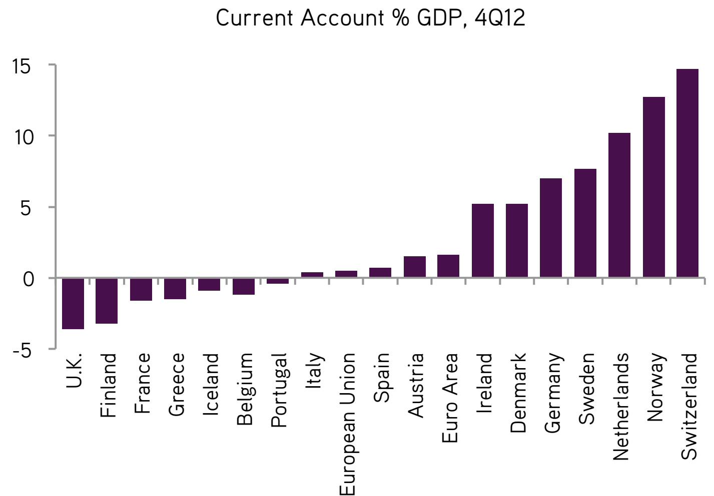
...They Are Starting to Improve, Compliments of Belt Tightening



Data as at April 22, 2013. Source: IMF, Haver Analytics.

EXHIBIT 28

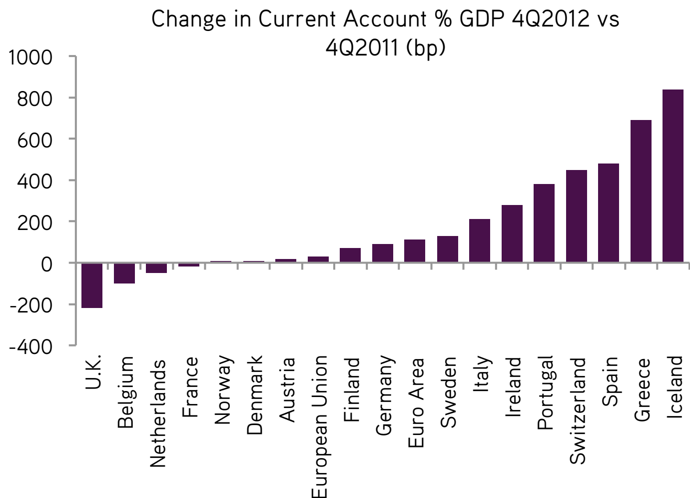
A Similar Story is True When It Comes to Current Account Balances ...



Data as of April 24, 2013. Source: Organization for Economic Co-operation and Development (OECD).

EXHIBIT 29

...As Some of the Biggest Offenders Have Worked Hard to Reduce Their Current Account Deficits

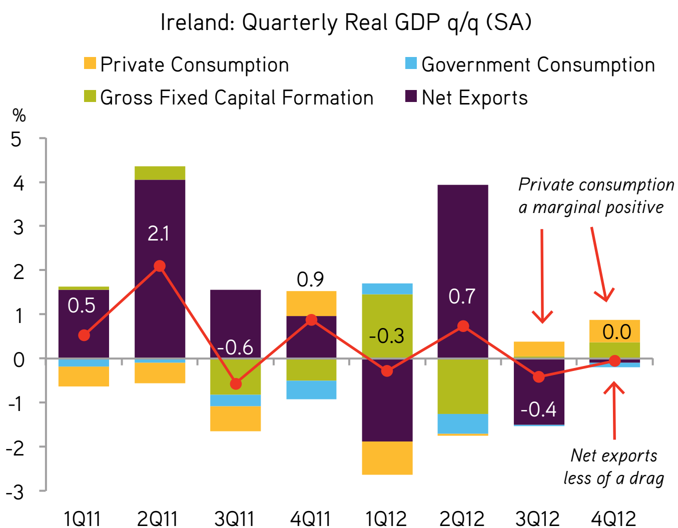


Data as of April 24, 2013. Source: Organization for Economic Co-operation and Development (OECD).

As we look ahead, we view Ireland as one of the most elegant plays on our positive change on the margin thesis. While it still has a sizeable fiscal deficit, it is now close to a primary surplus (*Exhibit 30*). Moreover, its consumption cycle is no longer subject to a major shock as its current account is now in surplus (*Exhibit 28*). Competitive wages, industry expertise, and technological prowess are all distinguishing features. Also, Ireland is one of the few European countries that repeatedly surprises positively versus its budget forecasts.

EXHIBIT 30

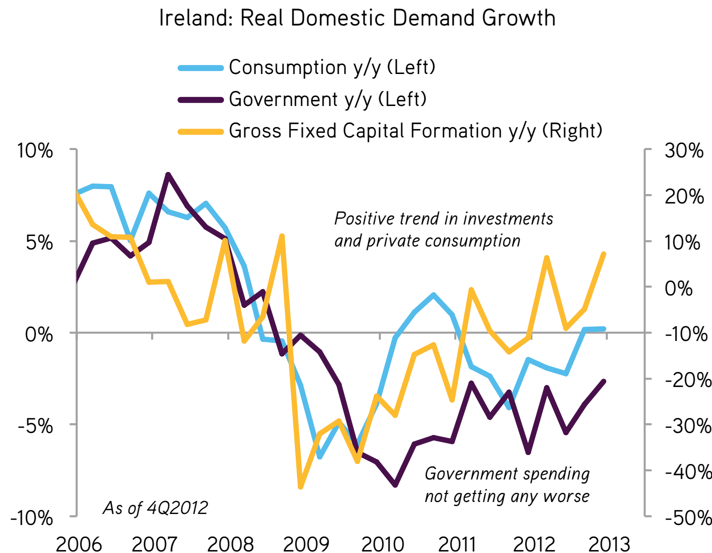
Fixed Capital Formation And Net Exports Are No Longer A Drag On Growth



Data as at March 21, 2013. Source: Central Statistics Office Ireland, Haver Analytics.

EXHIBIT 31

Domestic Demand Has Now Stabilized



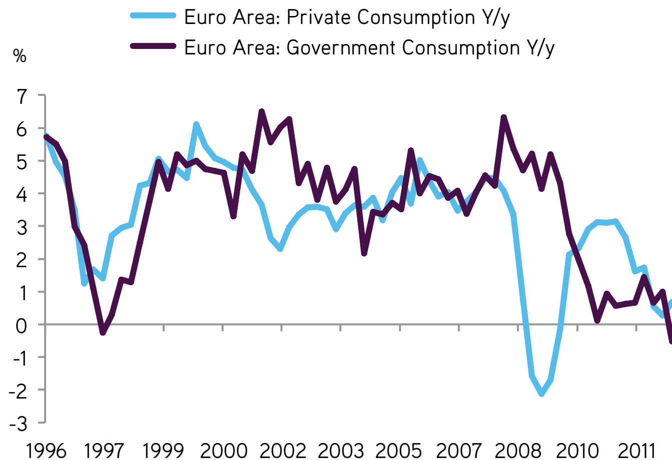
Data as at March 21, 2013. Source: Central Statistics Office Ireland, Haver Analytics.

Where to Allocate: Investment Themes

What are the investment implications of the macro view we laid out for Europe? We see several. First, we believe investors should shun traditional consumer and government consumption stories. Both are likely to remain pressured as we show in *Exhibit 32*.

EXHIBIT 32

Both Private and Government Consumption Trends Have Deteriorated Drastically Since 2008

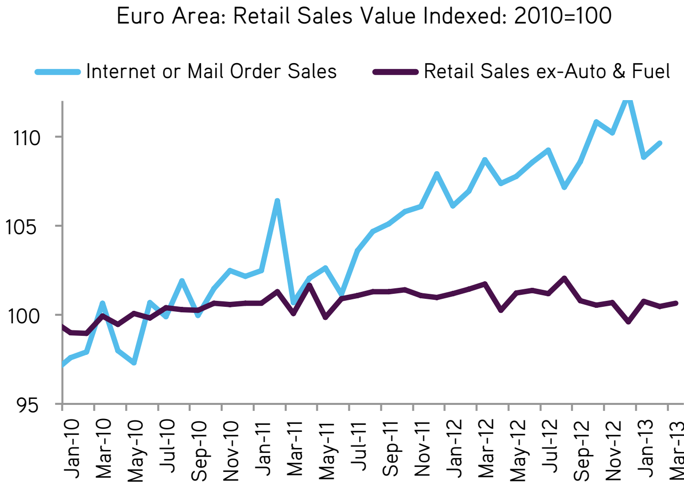


Data as at March 6, 2013. Source: Statistical Office of the European Communities, Haver Analytics.

By comparison, we see significant opportunity in our 'trade down' thesis. We have high conviction in this investment thesis as we saw it play out in the U.S. as corporations scaled back compensation increases in favor of expanding margins. As a result, real median household incomes in the U.S. have been stagnant for over fifteen years, propelling the masses to trade down and find substitutes that don't sacrifice quality[4]. So, in Europe, we expect wage austerity and government downsizing to drive consumer preferences towards low-cost airlines, generic drugs, and private label goods as consumers are limiting purchases to must-haves and looking for bargains as there will be very little growth in disposable incomes in 2013 (*Exhibits 33* and *34*).

EXHIBIT 33

Euro Area Internet Sales Performed Better Than Traditional Retail Sales



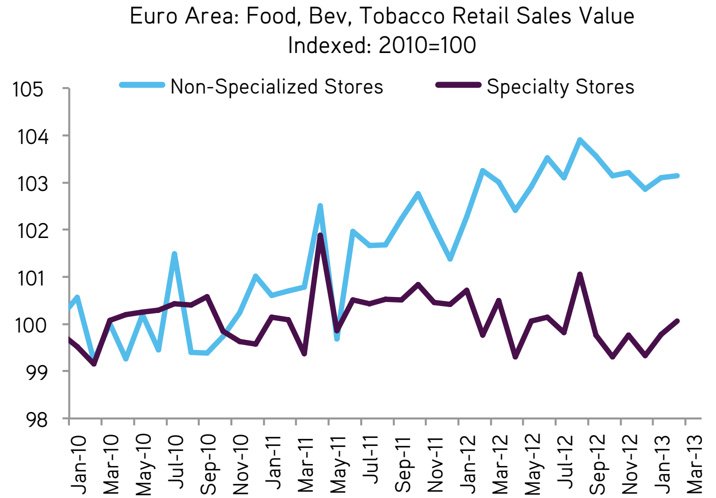
Data as at March 31, 2013. Source: Statistical Office of the European Communities, Haver Analytics.

> "
> **Change should now come from better credit availability and positive growth initiatives, including inspiring better business conditions and business confidence in cyclical sectors like housing, autos, and real estate.**
> "

4 Data as at February 18, 2013. Source: International Monetary Fund.

EXHIBIT 34

Higher-End Specialty Sales Stores Struggling While Non-Specialty Sales Continue to See Growth

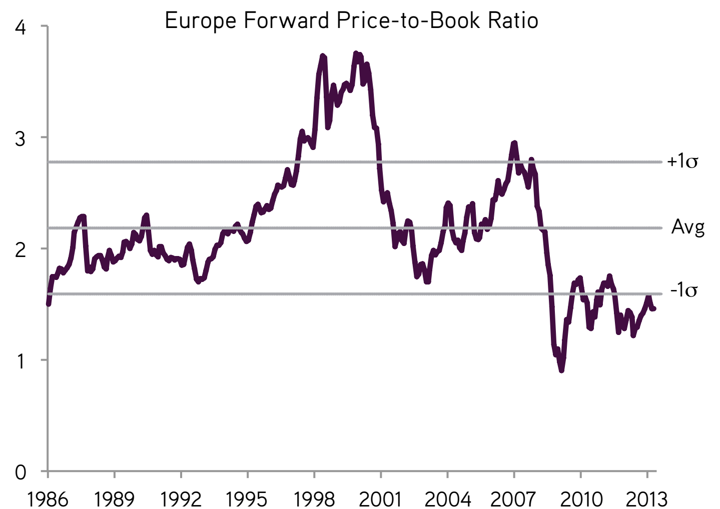


Data as at February 28, 2013. Source: Statistical Office of the European Communities, Haver Analytics.

In addition, investors should use the discount in European valuations to pursue opportunities in secular, high growth stories, including digitalization, energy efficiency, and health/wellness. We also see private education and re-training as industries with strong fundamental momentum. Overall, as we show in *Exhibit 35*, European assets are now relatively cheap, trading below book value and replacement costs in many instances. We also think the discount relative to the U.S. has gotten somewhat extreme. One can see that in *Exhibit 36*.

EXHIBIT 35

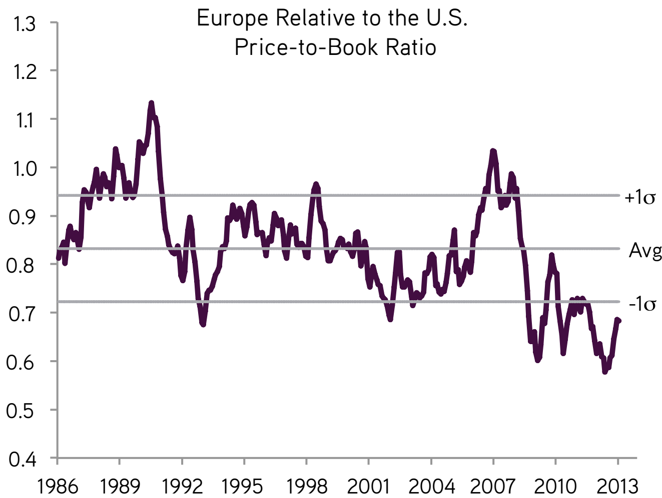
European Valuation is Now Cheap From a Variety of Metrics, Including Price-to-Book...



Europe refers to the countries of the European Union. Data as at April 30, 2013. Source: Factset Aggregates.

EXHIBIT 36

…And Relative to U.S. Stocks

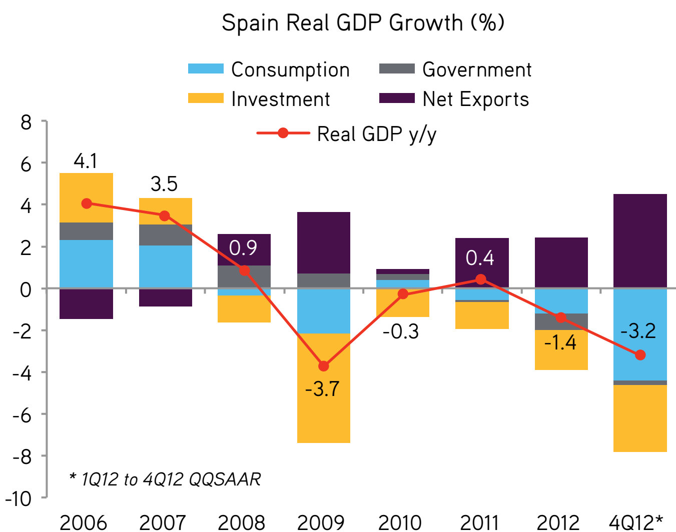


Europe refers to the countries of the European Union. Data as at April 30, 2013. Source: Factset Aggregates.

Another important area on which to focus is the export sector. Given its proximity between the U.S. and Asia, Europe has been a pivotal export economy for quite some time. In Spain for example, 82% of the increase in exports of late has come from outside of the Eurozone since 2007 (*Exhibit 37*). Plus, due to recent wage declines across the region, overall competitiveness seems to be improving. As *Exhibit 37* shows, exports have been a key driver of Spain's overall improving growth trend. In fact, although estimates vary, our research shows that many economists believe that exports in Spain can grow to 50% of GDP by 2018 from 33% in 2012, or by nearly 52% in six years.

EXHIBIT 37

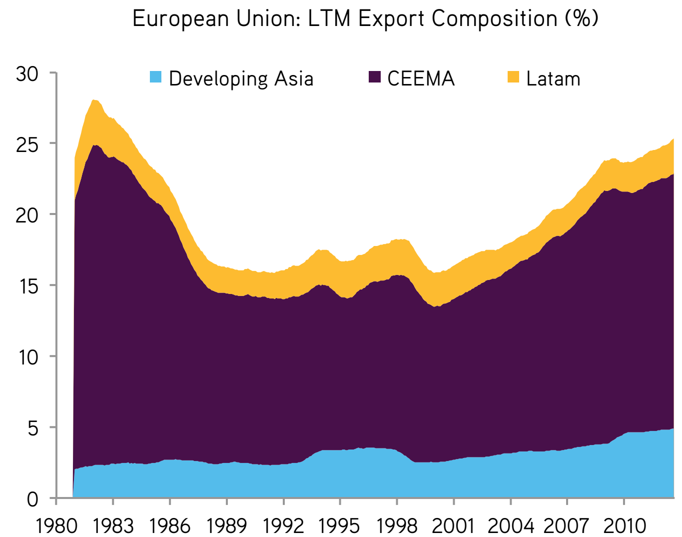
Exports Have Been a Key Driver of Spain's Improving Growth



Data as at February 28, 2013. Source: Instituto Nacional de Estadistica, Haver Analytics.

EXHIBIT 38

Stronger Global Demand, Particularly from the Emerging Markets, is Now Providing Europe With an Important Tailwind



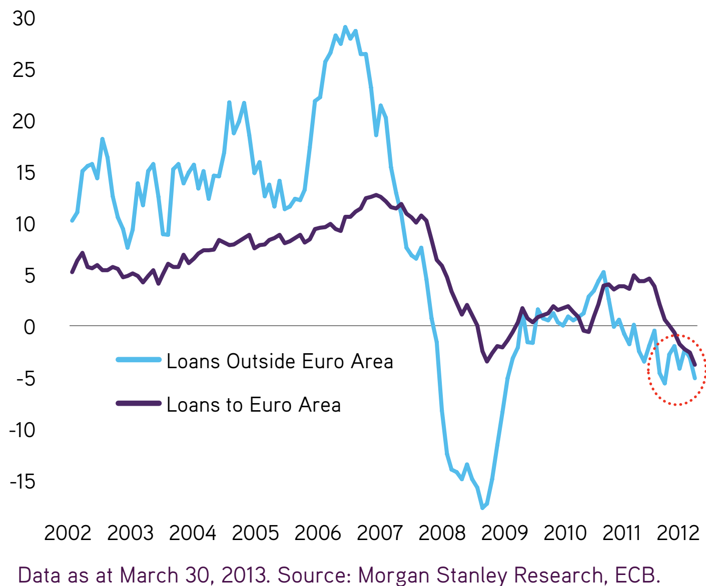
CEEMA = Europe & Central Asia, Mid East & N. Africa, Arab States, and Sub-Saharan Africa. Data as at May 3, 2013. Source: IMF, Haver Analytics.

But it is not just Spain. In fact, with the benefit of Germany's strong position in the global economy, Europe as a whole now actually runs a current account surplus. Moreover, as *Exhibit 38* shows, around one-third of total exports from Europe now go to an emerging market area, which we expect to increase as a percentage of the total in the coming years.

Separately, with the European financial services system under siege, we also think that private capital will be required to step in and provide trade and cross-border financing throughout Europe. As my former Morgan Stanley colleague Huw van Steenis pointed out to me during one of my recent trips, lending patterns within Europe have not recovered from the crisis in 2007. One can see this in *Exhibit 39*. Importantly, though, this shrinkage in capital commitment is not limited to just traditional lending on the continent. Rather, as we show in *Exhibit 40*, a retrenchment in European bank lending has been the part of a wholesale contraction in global cross-border flows. Looking ahead, we do not expect this trend to reverse course, and as such, we think that there is an opportunity for non-traditional lenders to fill the void being created by a deleveraging banking sector.

EXHIBIT 39

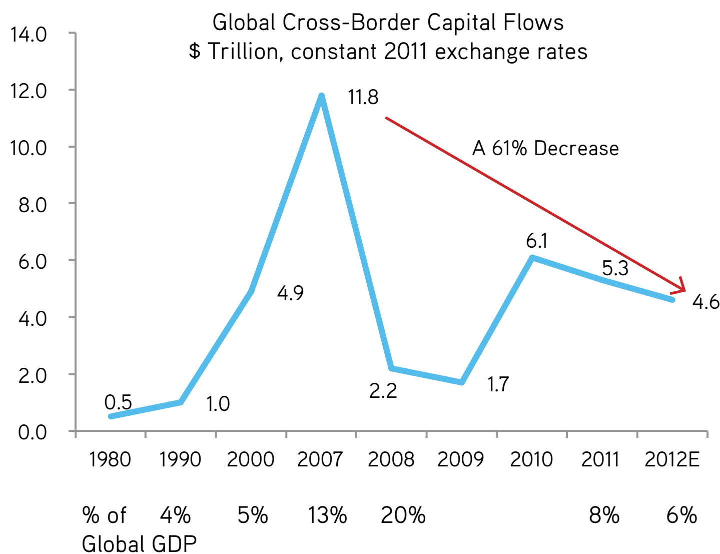
European Banks: Lending Outside vs. Within the Euro Area, Y/Y % Growth



Data as at March 30, 2013. Source: Morgan Stanley Research, ECB.

EXHIBIT 40

On a Global Basis, Cross-border Capital Flows Fell Sharply in 2008 and Today Still Remain More Than 60 Percent Below Their Pre-Crisis Peak

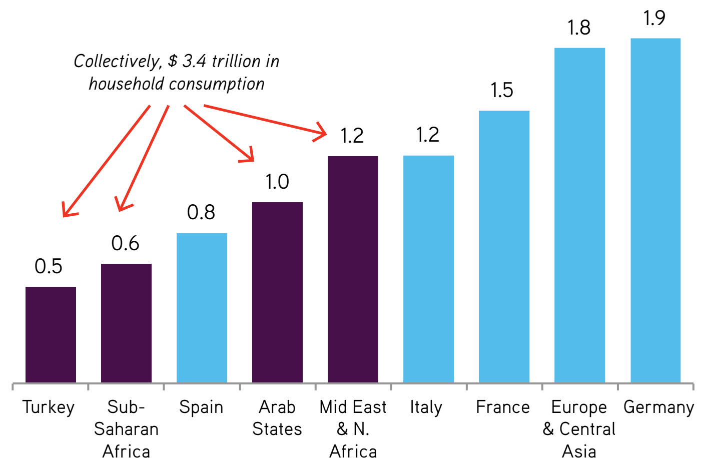


Capital flows includes foreign direct investment, purchases of foreign bonds and equities, and cross-border loans and deposits; 2012E = estimates based on data through the latest available quarter (Q3 for major developed economies, Q2 for other advanced and emerging economies). For countries without quarterly data, we use trends from the Institute of International Finance. Data as at March 31, 2013. Source: IMF Balance of Payments, Institute of International Finance, McKinsey Global Institute Analysis.

For investors who are comfortable investing in less developed markets, recent trips to the Middle East and Turkey reconfirm our strong belief that there is significant opportunity outside of core Europe. Parts of Africa, too, are interesting, but as we have learned, growth in emerging markets typically comes at a cost, including valuation, operational and/or control risk. Still, demographic and GDP per capita trends are compelling, and as we show in *Exhibits 41* and 42, more than offsetting some of the sluggish domestic consumption trends we are forecasting on the Continent.

EXHIBIT 41

Household Consumption in Middle East and Africa Is North of $3 Trillion...



Data as at March 19, 2011. Source: World Bank.

"

While the European Stability Mechanism (ESM) was created to — among other things — bail out European banks, it is now clear that none of the stronger countries want to use the ESM to wipe away prior bad behavior of the weaker countries as cultural and /economic divides are still too wide.

"

EXHIBIT 42

...and Growing at a Much More Rapid Clip

NOMINAL PRIVATE CONSUMPTION GROWTH Y/Y (%)			
	2011	2012	
GHANA	29%	NA	FAST
TURKEY	17%	8%	FAST
EGYPT	15%	18%	FAST
NIGERIA	14%	NA	FAST
NAMIBIA	9%	NA	FAST
MOROCCO	8%	NA	FAST
POLAND	7%	5%	FAST
KUWAIT	7%	NA	FAST
ISRAEL	7%	5%	FAST
SAUDI ARABIA	5%	7%	FAST
GERMANY	4%	2%	SLOW
ITALY	3%	-1%	SLOW
FRANCE	2%	2%	SLOW
SPAIN	2%	0%	SLOW
GREECE	-5%	-7%	SLOW

Data as at January 29, 2013. Source: Respective national statistical agencies, Statistical Office of the European Communities estimates, Haver.

"

We expect wage austerity and government downsizing to drive consumer preferences towards must-haves and bargains, as there will be very little growth in disposable incomes in 2013.

"

Summary

In terms of where do we go now from a macro perspective, several things appear clear. One is that the Troika needs to change perception about small bank deposit safety in the Eurozone after recent events in Cyprus. While we appreciate the need for the Troika to squelch excesses in the banking system, we think that it can do a much better job of communicating its intentions. Importantly, as we head into 2014, we think the completion of the banking union will serve as an important catalyst for allowing the ESM to take a more prominent role in the reconstruction of European financial services landscape than we have seen so far.

Second, we believe the ECB needs to lower rates even further and help make the currency more competitive in the global economy. Even with the latest 25 basis point reduction in rates, the European Central Bank is currently advocating one of the most conservative monetary policies in the developed economies.

Third, government officials need to collectively agree to at least a few more formal growth initiatives, including shoring up the housing market, in our view. As part of this process, it should also encourage more and better infrastructure.

Fourth, countries may need to follow through on wage competitiveness initiatives so that they can improve export-related activities. The EU must also make labor mobility and flexibility important priorities as it seeks to compete more effectively on the global stage. Fifth and finally, small and medium size businesses should be granted more and better access to funding, so that they can hire and pay people.

Our bigger picture conclusion is that, if there are any lessons from our work studying the Asian Financial Crisis, it is that there will ultimately be a recovery over the next few years as adjustments begin to yield some benefits. Our recent visit to Europe confirms that the marginal macro momentum is turning more positive in several areas; and in other areas, the balance between supply of capital and demand for capital, including trade finance and cross-border lending, appears now quite favorable for investors.

Already, we are seeing significant positive trends emerge. A key change, we believe, is the increased competitiveness that has resulted from better products (Ireland), wage compression (Spain), and/or a falling currency (U.K.). We also remain constructive on finding secular winners trading at discounted European valuations, including digitization, media, healthcare, and wellness/education.

Separately, with all the change going on in the consumer sector, we believe that there are interesting companies that are benefiting from the notable change we are seeing in consumer behavior as wages begin to adjust. Finally, for folks willing to take some direct emerging market exposure, we see compelling opportunities in Turkey, Israel, and the parts of the Middle East.

So, our bottom line is that when it comes to Europe, the macro backdrop will remain challenging, but there is as Thomas Edison said, "good fortune to be made" for those investors willing to spend the time focusing on where there may be positive marginal change in under-appreciated sectors, and/or specific countries in the region.

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