Spotlighting 2016’s Great Debates
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Despite the recent sell-off in risk assets, we still do not think that 2016 is the time to lean in. Our base case is that the investment climate remains a time for “Adult Swim Only.” Against this backdrop, we see four major macro debates where our views feel more pessimistic than the consensus. The first area that we are “spotlighting” is our thinking about what business models make sense in today’s environment. Looked at through the lens of nominal GDP rather than real GDP, we see much slower growth for business operators. As such, we believe that pricing power and prudent capital structures are fast becoming major differentiators in today’s low inflation, low rate environment. Second, our base view is that China’s capital account, not its current account, is driving the country’s need to weaken its currency. Importantly, if China does not realign its currency, we think that it could face an even slower growth trajectory, as debt loads now appear too high and inflation too low. Third, contrary to recent central bank commentary, we think that negative rates, particularly linked to deposits, are going to encourage risk-reducing – not risk-taking – behavior across the global capital markets. Fourth, we think oil will continue acting like a spot commodity, which in our view means it will bottom only when current supply and demand fundamentals finally return to balance.
Since publishing our 2016 outlook (see Adult Swim Only, January 2016), it feels like the “art of simplicity” has gotten even harder to find across most global capital markets. Indeed, many of the macro-economic crossovers that we are witnessing so far in 2016 feel more like a random “puzzle of complexity” than a market of predictable efficiency. Just consider that in the last ten weeks Japan has adopted negative interest rates, European banks have traded down 23%, on average1, on intensifying capital shortage and deflation fears, and China will have bled out $128 billion in reserves defending its currency.

Not surprisingly, against this volatile backdrop, we have been spending a lot of time “debating” with both internal and external constituents many of the important trends driving performance across the global capital markets. Interestingly, in doing so, what we have uncovered is that several of our highest conviction macro views do differ significantly from the consensus in a few key areas. To this end, we thought it might make sense to “spotlight” those few points of debate. See below for more details, but we note the following four areas where we think the consensus outlook is too optimistic:

1. We are focused on the structural slowdown in nominal GDP and revenues, not the real GDP figures quoted by many leading economists. Given that companies are compensated for growth in nominal, not real terms, we believe what we see right now at the macro level across economies is important not only for KKR as an owner/operator of 100+ companies across the globe, but for all owners of any business. Importantly, what we observe at the broadest macro level is a notable decline in nominal GDP growth across many key emerging markets, which collectively have accounted for two-thirds of incremental global growth in recent years2. In China, for example, nominal GDP growth has declined by 19% since 2011, compared to “just” a 31% decline in real GDP growth during the same period. Not surprisingly, we think a lower nominal GDP growth environment may require a different investment approach, capital structure, and operational focus. Further details below.

2. China’s currency dilemma is primarily linked to its capital account, not its current account, we believe. Contrary to popular opinion, China is actually not losing market share in exports. In fact, compliments of a successful high-end export strategy, China’s overall market share of total global exports has increased to 13.7% in 2015 from 10.7% in 2011. At the same time, however, the country’s debt load has ballooned to $23.9 trillion in 2015 from $14.4 trillion in 2011 (a 66% increase); meanwhile, its producer price index has been running negative for 47 consecutive months. As a result, its real 10-year rate has soared to 11% from -3.0% in 20113, which suggests to us that the country needs to significantly lower rates to offset this more restrictive monetary condition. If it does not, then we are confident that growth will likely continue to disappoint. However, if it does lower rates to ease the deflationary headwinds it now faces, its currency too must depreciate, we believe. See below for details, but this conundrum is being exacerbated by the fact that the country’s capital account outflows are now larger than its current account inflows.

3. We think that non-traditional monetary policy, including negative interest rates, could now be a negative, not a positive, for risk assets. For our nickel, we think we may look back at the decision by Governor Haruhiko Kuroda at the Bank of Japan on January 29th of this year to implement negative rates as a major inflection point in investor confidence towards unconventional monetary policy. Since making that announcement, the yen has actually appreciated 6.3%4. Meanwhile, in Europe the euro is close to flat over the same period, despite dovish comments about more support coming from the European Central Bank5. See below for details, but we think that investors are right to be concerned about what negative rates mean for many parts of the economy, the global financial services system in particular.

4. We think oil will likely remain in a bear market as long as supply continues to outpace demand, which we suspect will remain the case throughout most of 2016. We are often asked for a specific trough price target for crude oil. Our recent research leads us to believe that this is actually the wrong question, as we think investors should focus not on where crude will bottom, but when. See below for details, but we found that historically, oil bear markets have continued until the physical supply gluts that caused them finally ran out. In 2016 we do not see such rebalancing happening until 3Q16 at the earliest, and that is only if OPEC and Russia successfully extend—and implement—their supply freeze to include Iran and Iraq. Our colleagues at the KKR Global Institute (KGI) believe this will be difficult to execute, which leaves us concerned that the oversupply could continue into late 2016 or beyond.

Importantly, if our views on the aforementioned macro issues are correct, then our decision to take a more conservative view of the world in 2016 still seems logical. It also reinforces our defensive framework for global asset allocation at this point in the cycle. Specifically, in today’s bumpy environment we think that Credit, Levered Loans in particular, will likely outperform. They are high up in the capital structure and do not have the same exposure to Industrials and Energy as High Yield.

Consistent with this view, we also think we have entered a cyclical — and potentially a secular — bull market in Private Credit. Key to our thinking is that after a rash of disappointing earnings, leadership changes across the Financial Services sector (Europe in particular) and increased regulatory oversight (e.g., Basel III, TLAC), it is clear that most global wholesale banks will continue to move more aggressively to shrink their lending footprint and risk-based trading capital base in 2016. As a result, we think that new and attractive opportunities for non-traditional lenders, particularly those that embrace complexity and dislocation, have emerged across both the liquid and illiquid parts of the fixed income credit markets.

We also believe that, as nominal lending falls back below nominal GDP, managers that specialize in corporate restructurings, reposi-

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1. Data as at March 1, 2016. Source: Bloomberg.
5. Ibid.1.
6. Ibid.1.
tions, and recapitalizations, should see their opportunity sets expand meaningfully. As we describe below, there is now just too much debt relative to GDP growth across both developed and developing markets. To this end, we have maintained a healthy overweight to Special Situations/Distressed again in 2016.

Within Equities, we have already lowered our 2016 EPS for the S&P 500 to $118.50 from $126.00, implying essentially minimal growth again this year in the public equity markets. Consistent with this view, we remain underweight Public Equities, which is a position we recently took in 2016. We are equal-weight Private Equity in 2016, as this asset class could too face headwinds. However, history does suggest it will perform better than Public Equities. Indeed, as one can see in Exhibit 1, what we found is that low return environments for Public Equities have actually historically been decent environments for Private Equity. From what we can tell, it seems single-digit return environments for Public Equities tend to be markets where fundamentals are good enough to support deleveraging and operational improvements, but not so good that it is difficult for PE to keep pace with Public Equities as an asset class. Also, buyout opportunities in Private Equity tend to increase as the forward looking total return in Public Equities decreases. One can see this in Exhibit 2.

**EXHIBIT 1**

Private Equity Often Outperforms in Low Return Environments...

Private Equity Often Outperforms in Low Return Environments...

**EXHIBIT 2**

...And the Number of Buyout Opportunities Increases as We Move Into Negative Return

Looking at the big picture, our basic message remains that it is not business as usual across financial services. The risk to markets, in our view, is still notably skewed to the downside. Key to our thinking is that – just ten weeks into 2016 – the concerning undertow of cross currents that compelled us to label this year as one for “Adult Swim Only” have only gained in stature. In particular, we think there is the potential for the really slow nominal GDP growth environment to continue to exert significant downward pressure on revenues, despite upward pressure on labor costs. Against this backdrop, central banks in Europe and Japan have moved towards unconventional policies that many would have thought were beyond extreme less than 24 months ago. In the near-term, the implications for bank profitability in these regions are quite negative, we believe. Meanwhile, in the United States we are now a full 81 months into an economic expansion, profits have peaked, and multiples are not yet below average. Maybe most important, though, is that outside of developed markets, we see China’s slowdown in growth as structural – not cyclical. As a result, many businesses that boomed in the 2000-2010 period are now less relevant in the new world order that we are envisioning.

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"We think that the consensus has placed too much emphasis on real GDP – and too little on nominal GDP."
Not surprisingly, given the surging number of macro dislocations, an increasing number of interesting investment opportunities are now unfolding. However, because many of these crosscurrents feel more structural than cyclical in nature, we think that now is the time to demand a little extra in the form of risk premium to compensate for what are truly unprecedented times in the current global macro environment.

**EXHIBIT 3**

We Believe Profits Have Peaked...

- U.S. Trailing Corporate Profit 5 Yr CAGR (Left)
- U.S. Corporate Profit Margins (Right)

Data as at 3Q15. Source: Bureau of Economic Analysis, Haver Analytics.

**EXHIBIT 4**

...And That Wages Are On the Upswing

- U.S. Corporate Profits, % of GDP (Left Axis)
- U.S. Employee Compensation, % of GDP (Right Axis)


**EXHIBIT 5**

While China’s Real GDP Growth Has Fallen 31%, Its Nominal Growth Has Declined a More Sizeable 70%

A Similar Story Is Playing Out in Many Countries

<table>
<thead>
<tr>
<th>NOMINAL GDP (LOCAL FX) GROWTH Y/Y (%)</th>
<th>2Q11</th>
<th>3Q15</th>
<th>% CHG</th>
</tr>
</thead>
<tbody>
<tr>
<td>SAUDI ARABIA</td>
<td>33.7</td>
<td>-17.7</td>
<td>-153%</td>
</tr>
<tr>
<td>CANADA</td>
<td>6.5</td>
<td>0.4</td>
<td>-94%</td>
</tr>
<tr>
<td>RUSSIA</td>
<td>22.0</td>
<td>3.1</td>
<td>-86%</td>
</tr>
<tr>
<td>BRAZIL</td>
<td>16.7</td>
<td>3.2</td>
<td>-81%</td>
</tr>
<tr>
<td>SINGAPORE</td>
<td>6.7</td>
<td>1.4</td>
<td>-79%</td>
</tr>
<tr>
<td>AUSTRALIA</td>
<td>7.2</td>
<td>2.2</td>
<td>-70%</td>
</tr>
<tr>
<td>CHINA</td>
<td>19.6</td>
<td>6.0</td>
<td>-70%</td>
</tr>
<tr>
<td>INDIA</td>
<td>18.0</td>
<td>6.7</td>
<td>-63%</td>
</tr>
<tr>
<td>MEXICO</td>
<td>8.5</td>
<td>5.1</td>
<td>-40%</td>
</tr>
<tr>
<td>INDONESIA</td>
<td>13.0</td>
<td>9.3</td>
<td>-29%</td>
</tr>
<tr>
<td>U.S.</td>
<td>3.8</td>
<td>3.1</td>
<td>-20%</td>
</tr>
<tr>
<td>AVERAGE</td>
<td>14.2</td>
<td>2.1</td>
<td>-71%</td>
</tr>
</tbody>
</table>

Data as at 3Q15. Source: Respective national statistical agencies, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

So, what are the investment implications of a below consensus nominal GDP and nominal revenue environment? We see several. First is that investors are likely to pay lower multiples, on average, when the macro backdrop includes a low inflation/disinflationary environment. In our view, this outlook is potentially bearish for areas where too much capacity was built, including steel, mining, and shipping. By comparison, we believe companies that can grow and/or maintain pricing power in a low nominal rate environment are likely to be re-rated upward. As such, focus areas such as parts of healthcare, value-added technology, and consumer experiences should all benefit against the macro backdrop that we are envisioning.

EXHIBIT 7
Disinflation Hurts Revenues...

EXHIBIT 8
...And Multiples

We are increasingly concerned that too many EM countries took on too much debt relative to GDP in an effort to capture all the growth upside associated with China’s fixed investment splurge.
The Low Inflation Environment Is Impacting Nominal GDP in Both the U.S....

...and on a Global Scale as Nominal GDP in USD Recently Approached Recessionary Levels

Second, given the recent surge in debt, we are now on the cusp of what we believe will be a multi-year restructuring cycle that will involve billions of dollars of corporate debt that was issued against the backdrop of QE-induced low interest rates. In particular, we are increasingly concerned that in recent years too many EM countries took on too much debt relative to GDP, particularly in the corporate sector, in an effort to apparently capture all the growth upside associated with China’s fixed investment splurge. In our view, we are still in the early stages of this misplaced bet unwinding; thus, we would want to form capital (both long and short) around this long-tailed macro trend.

Finally, we think that capital structures must be rethought. In particular, structures likely need to be more conservative, because there is no longer a nominal tailwind that allows revenues to easily grow above the cost of financing. Moreover, rates are already so low that central bankers can’t really use lower rates to ease the cost of financing the way they did during downturns such as 1998, 2001, or 2008.

Our bottom line: It feels to us that we have entered a different investment climate, one where corporate debt burdens will no longer get bailed out by steady, dependable nominal annual revenue growth. Also, because rates are already so low, there are fewer and fewer chances for corporations to refinance while banks are rationalizing credit. Importantly, this shift is happening at a time when wages are growing after nearly a decade in the United States, while China appears to becoming increasingly competitive across a broadening set of global industries.
This shift in landscape is a big deal, in our view, and it suggests that the ability to merely arbitrage financing markets to create a lower cost of capital will likely become less of a prerequisite for success in the global macro environment we are envisioning. It also means that margins across a broader swath of industries could be more vulnerable in the next economic downturn if managers are not paying close attention. As such, having the ability to identify organic growth with pricing power and/or the opportunity to optimize business operations will likely become – to the upside – significant points of differentiation. If we are right, then now is the time for most allocators of capital to potentially rethink how they approach buying businesses, pricing acquisitions, and delivering operational improvements in the more subdued nominal GDP environment that we are forecasting.

China’s Currency Weakness Is Linked to Its Capital Account, Not Its Current Account

I had nothing to offer anybody except my own confusion.

Jack Kerouac

At the risk of sharing our own “confusion” with others, we thought it might make sense to offer some color on what we think China is trying to accomplish with its recent currency initiatives. Our bottom line: Contrary to popular opinion, we do not think China is necessarily trying to devalue its currency just to make itself more competitive on the export front. Rather, we think that China is feeling pressure to ease monetary policy and let its currency depreciate because it needs lower rates and a weaker currency to deal with deflation headwinds from too much debt and to re-liquefy an economy under pressure from significant capital outflows. Consistent with this viewpoint, China now faces the dilemma that its current account surplus is not large enough to offset the growing deficit from its capital account without taking a major step backwards in its liberalization campaign.

There are four considerations that we think warrant investor attention on why the consensus might be wrong to think that China needs to lower its currency just to remain competitive in the global export arena. First, even with a strong currency in recent years (Exhibit 13), China has been using its strength in high-end exports to drive increased market share into a slowing export growth environment. Importantly, these gains in share are coming, despite many of its closest trading partners significantly devaluing their currencies in recent quarters.

Our base view is that China’s capital account, not its current account, is driving the country’s need to weaken its currency.

EXHIBIT 13
The Yuan Has Appreciated Against Many Global Currencies Since 2012

<table>
<thead>
<tr>
<th>Currency</th>
<th>Change in Spot Exchange Rate vs the CNY Since Dec-2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>RUB</td>
<td>135</td>
</tr>
<tr>
<td>BRL</td>
<td>84</td>
</tr>
<tr>
<td>TRY</td>
<td>57</td>
</tr>
<tr>
<td>MXN</td>
<td>34</td>
</tr>
<tr>
<td>JPY</td>
<td>24</td>
</tr>
<tr>
<td>INR</td>
<td>19</td>
</tr>
<tr>
<td>KRW</td>
<td>11</td>
</tr>
<tr>
<td>GBP</td>
<td>-9</td>
</tr>
<tr>
<td>EUR</td>
<td>-13</td>
</tr>
<tr>
<td>AUD</td>
<td>-27</td>
</tr>
</tbody>
</table>

Data as at March 1, 2016. Source: Bloomberg.

Second (and probably more important in our view), China has been actually gaining share in global exports in recent years (Exhibit 15), even though it has ceded the low end of the market to players like Vietnam, Africa, and Mexico (Exhibit 14). Put another way, China has moved swiftly up the value chain in key high growth markets such as high speed rail, nuclear reactors, new energy vehicles, and e-commerce. Meanwhile, on the low end, it has thoughtfully and willingly ceded share in areas where either Chinese wages are no longer competitive, the environmental impacts are concerning, and/or there is excess capacity.

EXHIBIT 14
China Is Rebalancing to Higher Value Added Exports; the Risk to Multinationals Is That It Becomes Price Competitive in High Value Added Goods the Way It Did in Low Value Added

<table>
<thead>
<tr>
<th>Year</th>
<th>Ordinary Trade (Higher Value Add)</th>
<th>Reexports (Lower Value Add)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016 Jan</td>
<td>53.7</td>
<td>34.9</td>
</tr>
</tbody>
</table>

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

”

Our base view is that China’s capital account, not its current account, is driving the country’s need to weaken its currency.

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As China Rebalances Towards Higher Value-Added Exports, It Continues to Grow Its Share of Global Exports at the Expense of Japan, Germany, and the U.S.

**EXHIBIT 15**

As China Rebalances Towards Higher Value-Added Exports, It Continues to Grow Its Share of Global Exports at the Expense of Japan, Germany, and the U.S.

**EXHIBIT 16**

China Is Maintaining Share by Exporting More High-End Goods. However, It Is Also Importing Less as It Builds Local Competitive Advantages

Third, China does not want to start a major trade war after just having its currency included in the IMF’s SDR, an international reserve asset created by the IMF. Indeed, on January 28, 2015, Premier Li Keqiang commented that, “the Chinese government has no intention to promote exports through currency depreciation, nor will it launch a trade war.” Moreover, we perceive that the government is already content from a trade perspective that its recent decision to benchmark itself against a basket of currencies is providing the country with some additional flexibility to adjust as needed (Exhibit 17).

China’s Goal Is Maintaining Relative Stability Against a Basket of Currencies, Not the U.S. Dollar

The fourth thing to consider is that China is increasingly insourcing its supply chain well beyond traditional manufacturing areas to include a truly diverse set of industries, many of which are now strategic to the country’s growing middle class. As a result, China can now rely much more on its internal work force and capabilities versus needing to be currency competitive with its trading partners. For example, the private sector has worked hard to increase capacity in key markets such as dairy, poultry, and pork. One can see this in Exhibits 18 and 19. Importantly, to both enhance food safety and increase business efficiencies in these areas, government subsidies are often provided to enable more vertical integration and competitiveness.

China is increasingly insourcing its supply chain well beyond traditional manufacturing areas to include a truly diverse set of industries, many of which are now strategic to the country’s growing middle class.

"
**EXHIBIT 18**

China Has Become Less Reliant on External Vendors for Key Needs Like Protein

<table>
<thead>
<tr>
<th>1000 MT</th>
<th>1990</th>
<th>2015</th>
<th>% CHG</th>
</tr>
</thead>
<tbody>
<tr>
<td>DAIRY CONSUMPTION</td>
<td>66,985</td>
<td>94,390</td>
<td>41%</td>
</tr>
<tr>
<td>DAIRY PRODUCTION</td>
<td>67,005</td>
<td>94,480</td>
<td>41%</td>
</tr>
<tr>
<td>POULTRY CONSUMPTION</td>
<td>7,749</td>
<td>14,996</td>
<td>94%</td>
</tr>
<tr>
<td>POULTRY PRODUCTION</td>
<td>8,360</td>
<td>17,966</td>
<td>115%</td>
</tr>
<tr>
<td>SWINE CONSUMPTION</td>
<td>22,573</td>
<td>57,200</td>
<td>153%</td>
</tr>
<tr>
<td>SWINE PRODUCTION</td>
<td>22,808</td>
<td>56,375</td>
<td>147%</td>
</tr>
</tbody>
</table>

Data as at October 31, 2015. Source: USDA, Haver Analytics.

**EXHIBIT 19**

In Some Areas, China Is Now Actually Producing In Excess of Consumption

<table>
<thead>
<tr>
<th>PRODUCTION NET OF CONSUMPTION (1000 MT)</th>
<th>1990</th>
<th>2015</th>
<th>% CHG</th>
</tr>
</thead>
<tbody>
<tr>
<td>DAIRY</td>
<td>20</td>
<td>90</td>
<td>350%</td>
</tr>
<tr>
<td>POULTRY</td>
<td>611</td>
<td>2,970</td>
<td>386%</td>
</tr>
<tr>
<td>SWINE</td>
<td>235</td>
<td>-825</td>
<td>-451%</td>
</tr>
</tbody>
</table>

Data as at October 31, 2015. Source: USDA, Haver Analytics.

Our bottom line: As we have described above, we do not think that the Chinese government needs to devalue its currency to improve its competitiveness in trade. However, we do see several reasons why a lower currency could make sense for domestic reasons. First, there is just too much debt and too much excess capacity in China. All told, China’s debt to GDP ratio rose to 209% in 4Q15, with the greatest increase in recent years coming from the corporate sector. Meanwhile, the country has been running with a negative producer price index for 47 months in a row – suggesting that there is certainly way too much capacity on the industrial side of the economy.

Not surprisingly against a backdrop of excess debt loads and significant excess capacity, China’s nominal GDP has been hard hit, as inflation has plummeted and its GDP deflator is now a negative 80 basis points. As a result, nominal GDP in China has collapsed to 6.0% from 19.6% in 2Q11, a 70% decline and a far cry from the more modest 31% decline in real GDP that many sell-side analysts quote. This fall-off in nominal GDP is critical because local companies use nominal, not real, revenues to pay their increasingly cumbersome debt service burdens.

**EXHIBIT 20**

Nominal GDP Growth Has Fallen Faster Than Credit Growth in China

Our bottom line: As we have described above, we do not think that the Chinese government needs to devalue its currency to improve its competitiveness in trade. However, we do see several reasons why a lower currency could make sense for domestic reasons. First, there is just too much debt and too much excess capacity in China. All told, China’s debt to GDP ratio rose to 209% in 4Q15, with the greatest increase in recent years coming from the corporate sector. Meanwhile, the country has been running with a negative producer price index for 47 months in a row – suggesting that there is certainly way too much capacity on the industrial side of the economy.

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**EXHIBIT 21**

RMB Incremental Credit Growth per Unit of GDP Growth has Increased Meaningfully Since the Great Recession

We believe that China cannot ignore the one-two punch of deflation and capital outflows without having to ultimately realign its currency strategy.
China’s PPI and Capacity Utilization Have Largely Been Trending Downward Since March 2012

The other big headwind beyond excess capacity/too much debt is linked to capital outflows. All told, total net capital outflows across all parts of the Chinese economy surged to an estimated $600 billion in 2015 from a net inflow of $280 billion in 2013. We attribute this to a combination of influences, including FDI outflows, FX outflows, deposits outflows, and illicit outflows. To put this in perspective, in 2015 China saw outflows that were larger than the entire GDP of Sweden ($484 billion), Poland ($481 billion), or Norway ($398 billion).

The acceleration in capital outflows is significant for several reasons. First, as money leaves the country, it represents a tightening of financial conditions. Indeed, with inflation falling and liquidity drying up, China’s real 10-year rate has soared to 1.1% from -3.0% in 2011, which negatively impacts access to credit and growth.

Second, the country must replenish the money supply in the system via interest rate cuts and/or reserve ratio requirement reductions. Not only do outflows tighten liquidity, but currency intervention to support the yuan adds to onshore liquidity tightening. In today’s environment, capital outflows are so large that they are now actually bigger than the benefit the country receives from running a current account surplus of $60-70 billion (i.e., exporting capital more than exporting goods). The reality that capital account outflows are now bigger than current account inflows is quite significant, in our view, as it represents somewhat of a sea change in terms of how China must think about financing itself versus the flexibility and stability it enjoyed in prior years.

Given the recent surge in debt, we are now on the cusp of what we believe will be a multi-year restructuring cycle that will involve billions of dollars of corporate debt that was issued against the backdrop of QE-induced low interest rates.
We Believe That Some Corporate Debt in China Will Ultimately be Transferred to the Government’s Balance Sheet

EXHIBIT 25
We Believe That Some Corporate Debt in China Will Ultimately be Transferred to the Government’s Balance Sheet

Total Debt as a % of GDP

<table>
<thead>
<tr>
<th></th>
<th>Household</th>
<th>Corporate</th>
<th>Government</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>236</td>
<td>93</td>
<td>78</td>
</tr>
<tr>
<td>US</td>
<td>41</td>
<td>91</td>
<td>60</td>
</tr>
<tr>
<td>Euro Area</td>
<td>158</td>
<td>103</td>
<td>65</td>
</tr>
<tr>
<td>Japan</td>
<td>210</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


EXHIBIT 26
In China Capital Account Outflows Now Significantly Outpace Current Account Inflows

China: Quarterly Current Account Surplus vs Capital Outflows (US$B)

Looking ahead, we believe that China cannot ignore the one-two punch of deflation and capital outflows without having to ultimately realign its currency strategy. If it does choose to ignore these items, then we believe GDP growth could stagnate further the way it did in Japan during the 1990s (i.e., high real rates restrain growth amidst too much debt). In that scenario loan growth slows, but loan losses do not – a situation that would apply notable downward pressure on China’s banking sector, which is one of the largest sectors of the economy.

Importantly, we are not talking about a massive devaluation. In fact, my colleague Frances Lim believes that current fair value for the yuan is around 7.00. Against today’s level of 6.55, the differential between Frances’s forecast and the spot rate is around 6.5% over the next 12 months the currency could trade towards or beyond fair value on divergent monetary policy and interest rate differentials. As such, with volatility at 8-10%, an overshoot of fair value could easily imply 7.50 or more. By comparison, the 12-month forward is already priced at 6.75, which implies depreciation of 3.6% based on forward interest rate differentials, or about half of what we envision over the next year.

So, our bottom line is that, while we agree with the consensus that China will need to adjust its currency, we think it is for different reasons that what many leading Chinese prognosticators are identifying as the catalyst. Regardless, what does a weaker Chinese currency mean for investors? It means that further deflationary forces are coming, whether the country devalues or not. As such, we think that any company with outsized pricing power will likely get re-rated upwards in the environment that we are envisioning. On the other hand, companies that can’t defend margins in today’s low inflation, slow growth environment are likely to be de-rated. Financial services companies too would be hard hit.

Second, while China will likely experience more volatility during the next 12 months, we actually think any further depreciation of its currency by the PBoC would likely lead to more dislocation outside of China than within it. Key countries on which to focus include Korea.


EXHIBIT 27
China’s Reserves Have Turned Notably Downward

Looking ahead, we believe that China cannot ignore the one-two punch of deflation and capital outflows without having to ultimately realign its currency strategy. If it does choose to ignore these items, then we believe GDP growth could stagnate further the way it did in Japan during the 1990s (i.e., high real rates restrain growth amidst too much debt). In that scenario loan growth slows, but loan losses do not – a situation that would apply notable downward pressure on China’s banking sector, which is one of the largest sectors of the economy.

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We think that non-traditional monetary policy, including negative interest rates, could now be a negative, not a positive, for risk assets.

“...We think that non-traditional monetary policy, including negative interest rates, could now be a negative, not a positive, for risk assets. ...”
Japan, and Singapore. Finally, further movements by the Chinese government to adjust their currency and compete aggressively for high-end exports means that long-term bond yields should stay at historically low levels for longer than the market may currently be anticipating.

Extreme Central Bank Policy May Be Shifting From a Positive to a Negative

In our humble opinion, we may have reached an inflection point where central bank tools have gone too far with their unconventional policies. In particular (and somewhat contrary to conventional wisdom), we think we may look back at the decision by Governor Kuroda of the Bank of Japan on January 29, 2016 to implement negative deposit rates as a major inflection point in investor confidence towards unconventional monetary policy.

Importantly, the market seems to increasingly appreciate our growing concern about the extreme nature of recent central bank activity, particularly surrounding the trend towards negative deposit rates. Indeed, since Governor Kuroda made his announcement, the Japanese yen has actually appreciated 6.3%, suggesting that the central bank’s decision might encourage more of a risk-off than risk-on mentality amongst investors and business leaders. Meanwhile, in Europe the euro is close to flat over the same period, despite dovish comments about more support coming from the European Central Bank.

From our vantage point, we see several important adverse consequences linked to negative deposit rates that folks may not fully appreciate. First, we think that central bank authorities are underestimating the negative impact on the financial services system in the developed markets. At its core, we think that negative interest rates challenge two basic premises of financial/economic theory. They are as follows:

- A bank should earn more, not less, in net interest margin during periods of stress to offset any potential increase in loan loss provisions; in laymen’s terms, a higher net interest margin acts as an important “shock absorber” during periods of stress.
- A borrower should have to pay some economic rent commensurate with the risk associated with the ability to borrow money; otherwise, it either encourages fear at one extreme, or potentially reckless behavior (greed) at the other extreme.

Given the shortcomings associated with negative deposit rates, we are not surprised to see that the earnings power of European financials, whose earnings became subject to the ECB’s negative rate policy in July 2014, are responding poorly. One can see this in Exhibit 28 which shows that profits before taxes fell 67.9% year-over-year in 4Q15 on just a 4.4% decline in revenues over the same period. To be sure, European banks are also being squeezed in today’s QE-driven environment by low asset yields and increased regulation, but negative rates notably exacerbate an already uncomfortable backdrop. In Japan it is still too early to quantify the impact on earnings in the financial services sector. However, as Exhibit 29 shows, investors have already placed their bets on whether the banking system can earn a viable economic rent in a negative deposit rate environment.

Another important issue we see is no lower bound on negative deposit rates. With asset purchases, you cannot own more than 100% of a given market, and in reality, it is very difficult to get above 30% without causing huge distortions. Negative rates, however, have no such hard limit. Finally, history suggests there is little to no correlation between lower deposit rates and an increase in fixed investment spending and/or job creation. In fact, given that banks are reluctant to pass on the costs of negative interest rates to their depositors, a decline in bank profitability can tighten lending conditions and reduce credit supply.

Importantly, we want to highlight that not all negative deposit rate programs are created equal. In Japan, the sum of deposits subject to negative rates as a share of GDP is just two percent. Meanwhile, in Switzerland it is almost a full 18% (see Exhibit 30). At 6.7% of its...
GDP, Europe sits in the middle, but we are watching closely for a move towards the Swiss end of the scale.

**EXHIBIT 30**

The Scale of Deposits Actually Subject to Negative Rates Varies Wildly Across Central Banks...

<table>
<thead>
<tr>
<th></th>
<th>Current Negative Rate</th>
<th>Reserves Subject to Negative Rate as a % Share of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>EURO AREA</td>
<td>-0.30</td>
<td>6.7</td>
</tr>
<tr>
<td>JAPAN</td>
<td>-0.10</td>
<td>2.0</td>
</tr>
<tr>
<td>SWEDEN</td>
<td>-0.35</td>
<td>5.2</td>
</tr>
<tr>
<td>SWITZERLAND</td>
<td>-0.75</td>
<td>17.7</td>
</tr>
<tr>
<td>DENMARK</td>
<td>-0.65</td>
<td>5.8</td>
</tr>
</tbody>
</table>


In terms of where we are headed, our current base case is that the ECB's deposit rate now effectively becomes its main policy rate, and we think it is going further negative after the ECB provides its update on March 10, 2016. We believe a similar story likely will unfold in Japan too, though we do expect the central bank to focus more heavily in the near-term on buying more assets in an effort to appease the markets.

Our bottom line: With total negative-yielding sovereign debt now above $7 trillion globally (about a third of all global sovereign debt), markets are right to worry that the credit system is broken. From what we can tell, negative rates are not going to substantially boost nominal GDP, but they may reinforce the growing air of desperation among central banks.

Beyond many of the shortcomings that we identified in the policy of adopting negative deposit rates, we must also acknowledge that the asset side of the balance sheet is running out of room too. Just consider that, according to my colleague Aidan Corcoran, by 2017 current QE programs will put the BoJ's balance sheet at 115% of GDP and the ECB's at 40%. These are unprecedented numbers. Moreover, by 2017 the BoJ could own 45% of the JGB market and the ECB about 30% of Euro government bonds.

Ultimately, as we show below, some of this debt creation must be extinguished and/or forgiven. Key to our thinking is that nominal credit creation cannot run continually above nominal GDP without interruption. Otherwise, debt service burdens will eventually become unsustainable, creating income volatility and finally heightening the risks of insolvency.

**EXHIBIT 31**

..But What Is Consistent Is That Save for the U.S., Ownership Is On the Rise

Credit Growth Has Decoupled from Nominal GDP. More Deleveraging Is Needed as This Trend Is Unsustainable

In the interim, we think that recent actions by global central banks, Japan in particular, lead our asset allocation group to target a sizeable weighting towards both Direct Lending and Special Situations. Indeed, if traditional financial intermediaries are going to struggle to even earn a modest net interest margin amidst increasing regulatory pressures, then there is a high likelihood that complex transactions move off market. In doing so, we think that an investor can earn a premium rent in terms of yield, despite being high up in the capital structure.

Second, given the backdrop of low growth and inflation, we expect the number of corporate restructurings and deleveragings to increase materially in the environment we envision. As such, we think our hefty 10% target allocation to Special Situations/Distressed makes a lot of sense in this environment.

Finally, we maintain a seven percent Cash position and a six percent position in Levered Loans. In our view, both asset classes should perform well if we continue to head towards the very low inflation and low yield environment that we envision.
Our Roadmap for Energy Reminds Us Oil Is Not a Financial Asset

We’ve received lots of questions on what is the price target that crude oil needs to hit to mark an end to this energy bear market. Our thinking has been that this is the wrong question, as we believe marking an end to the oil bear market will be more a matter of time than price. Put another way, we are not expecting oil to act like a financial asset that bottoms when expectations about the future get too bearish and valuations too cheap. Instead, we think oil will continue acting like a physical commodity, which in our view means it will bottom when the current glut of excess supply is eliminated.

EXHIBIT 33
We Do Not Believe That Nominal WTI Spot Price Has Made a Low (Yet)

EXHIBIT 34
Historically, Price Troughs Have Always Been Coincident With Global Inventory Peaks

To help inform our thinking on oil, we looked at all the major historical oil bear markets over the past 30 years, including the ones that ended in 1986, 1998, and 2009 (Exhibit 33). We wanted to understand whether oil prices at these historical troughs tended to act in an anticipatory fashion relative to fundamentals—similar to the way that stock prices tend to anticipate earnings trends by a few quarters—or whether oil prices were generally more coincident in nature relative to the fundamentals. What we found is that the historical evidence is surprisingly clear-cut: oil prices have not troughed until oil inventories stopped building, i.e., until supply no longer exceeded demand (Exhibit 34).

At most, oil prices anticipated the peak in inventories by just a couple months (as in 1998). Just as often, oil prices actually continued declining for a couple months after inventories peaked (as in 2009).

EXHIBIT 35
Today, It Is Hard to Call a Peak in Inventories When Global Production Is Currently Running at a 1.9% Surplus to Demand

With total negative-yielding sovereign debt now above $7 trillion globally (about a third of all global sovereign debt), markets are right to worry that the credit system is broken.

Data as at January 22, 2016. Source: EIA, Haver Analytics, KKR Global Macro & Asset Allocation Analysis.
Significant Increases in OPEC Production Recently Have Exacerbated the Global Oversupply Issue

EXHIBIT 36

Y-Y Growth of Global Crude Oil Supply
(Millions of Barrels per Day)

Data as at February 24, 2016. Source: Energy Intelligence, EIA, Haver Analytics, KKR Global Macro & Asset Allocation Analysis.

We think the implication of our analysis for today is that investors probably should not expect a near-term oil trough. Global supply is currently running 1.9% in excess of demand (Exhibit 35), so inventories will almost certainly continue building. Furthermore, based on International Energy Agency forecasts for global oil demand and non-OPEC oil supply, the market would not return to balance until 3Q16, even if total OPEC production remained flat. Of course, if OPEC made a surprise supply cut, it could balance the market sooner than 3Q16.

Our fear, however, is that OPEC supply could actually continue growing (Exhibit 36). Importantly, holding steady at current levels would depend on OPEC delivering on the supply freezes recently negotiated in Doha and extending the agreement to include Iraq and Iran. At the moment, our colleagues at the KKR Global Institute (KGI) believe that threshold is unlikely to be reached in the near future. So, while KGI believes the Doha agreement is symbolically important, its terms are ambiguous and it relies on uneasy cooperation with Russia.

Historical evidence is surprisingly clear-cut: oil prices have not troughed until oil inventories stopped building, i.e., until supply no longer exceeded demand.

In fact, KGI views Iran growing production as the much more likely scenario and that Saudi Arabia remains committed to its market preservation strategy – especially since a change now would accommodate its rival Iran. At the moment, the U.S. Energy Information Administration (EIA) forecasts that Iran could feasibly grow supply by roughly 500 thousand barrels-per-day in 2016, which alone could delay the market rebalancing by another three months (i.e., to 4Q16 from 3Q16), but the quantum of Iranian increase beyond 2016 could increase as investors test the waters. Elsewhere, prolonged geopolitically-driven supply disruptions (such as in the KRG, Niger Delta, and Venezuela) have small odds in 2016, with the exception of Libya, whose volatile politics could oscillate supply between the down- or up-sides.

EXHIBIT 37

If U.S. Production Does Not Start Declining Soon, Even a 3Q16 Inventory Peak Could Prove Optimistic

"Historical evidence is surprisingly clear-cut: oil prices have not troughed until oil inventories stopped building, i.e., until supply no longer exceeded demand."

Finally, one more important wildcard we need to monitor is the U.S. supply picture. The 3Q16 oil balance shown in Exhibit 35 is predicated on U.S. production declining by about 500 thousand barrels-per-day this year, as per IEA estimates. The IEA forecasts do feel about right to us, but there is some risk that U.S. supply could surprise higher. We see that happening if conventional supply continues to accelerate to the upside due to major investment spending decisions made years ago, especially new Gulf of Mexico fields coming online in 2016 and 2017. In that scenario, overall U.S. supply could prove resilient even as unconventional shale supply falls. It actually wouldn’t be unprecedented for overall U.S. supply to remain buoyant even at today’s severely curtailed levels of upstream investment. As Exhibit 37 shows, today’s U.S. rig count around 400 has historically correlated with flat production growth, not negative.
Conclusion

Since I transitioned from covering financial services into a pure macro capacity in late 2003, I cannot remember a time when the crosscurrents have been as strong. To be sure, there is no “right” answer in terms of how to position one’s portfolio in today’s environment, as the Authorities are certainly working hard to encourage investors to move further out the risk curve. That said, our base case remains that, if 2015 was a time to get “Closer to Home” (see our 2015 Outlook piece), then 2016 still remains a time for “Adult Swim Only.” Importantly, just ten weeks into 2016, recent developments lead us to believe that the risks for the market are increasingly mounting to the downside.

As such, we wanted to use this piece to “spotlight” the debates where our macro thinking is more cautious than the consensus. For starters, we think that our focus on nominal GDP relative to real GDP is an important differentiator for driving our thinking on what business models make sense in today’s environment. Real GDP, in our view, underestimates the importance of pricing power and growth in today’s low inflation, low rate environment.

Second, our base view is that China’s capital account, not its current account, is driving the country’s need to weaken its currency. This viewpoint is significant because many sell-side folks seem focused on China’s need to devalue to remain competitive in terms of exports. However, in our view, the data just does not support this concern. It also makes us feel like many investors are not yet focused on the deflationary aspect of China’s massive debt load and what it means for their monetary policy and capital account strategy.

Third, we think that negative rates, particularly linked to deposits, are going to encourage risk-reducing – not risk-taking – across the global capital markets. Key to our thinking is that negative deposit rates not only send confusing signals to both borrowers and investors but also they significantly reduce profitability in many traditional financial intermediaries.

Fourth, our view is that oil should not be treated like a traditional financial asset that bottoms when expectations about the future get too washed out. Rather, we think oil will continue acting like a spot commodity, which in our view means it will bottom when current supply and demand fundamentals finally return to balance.

Overall, as we mentioned at the outset, we do not think that 2016 is the time to lean in towards risk assets, despite the recent reduction in prices. Within our target portfolio, Credit looks more interesting than Equities, and we think that Private Credit is probably the best risk-adjusted return asset at this point in the cycle. Finally, within Real Assets we prefer strategies that can deliver yield, growth, and inflation hedging versus betting on a cyclical bounce in beaten-down commodity prices.

Our bigger picture thought is that too much debt is accumulating too quickly relative to underlying GDP growth. In the near-term, we suggest that investors migrate towards investments where there is underlying fundamental growth, pricing power, and sustainable productivity gains. However, longer term we are increasingly of the mindset that aging demographics and excessive leverage mean that a sizeable extinguishment of debt may be required to get many economies properly functioning again. To be sure, we may be growing too pessimistic in our outlook, but we do ascribe to basic economic theory that nominal lending growth cannot outpace nominal GDP – and corresponding revenue growth – for an indefinite amount of time without some form of rebuttal from the global capital markets.
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