As part of the ongoing global macro and asset allocation effort at KKR, I try to spend time throughout the year in the various regions in which the Firm operates. This assignment is no small task, as we now have offices in 21 cities in 15 countries across five continents.

Most recently, my travels took my colleague Jaime Villa and me to Brazil where we completed a variety of meetings, including discussions with business leaders, macro folks, and government watchers. As our local KKR colleagues in our Sao Paulo office can attest, there is a lot going on in Brazil right now on the macro front. To this end, we thought it might make sense to detail some of our most recent Thoughts from the Road in Brazil. They are as follows:

- From a macro perspective, we believe Brazil’s economy is now experiencing somewhat of a “Perfect Storm,” including pressures from the Petrobras scandal, an epic drought (70% of power generation in Brazil is hydro), and a major fiscal adjustment under a new finance minister.

- Consistent with this choppy macro outlook, we estimate that the country’s total risk premium has nearly doubled to 10.4% from 6.5% in 2012 (Exhibit 15). As such, Brazil now joins countries like Nigeria and Russia at the high end of the perceived risk spectrum (and it is nearing Argentina).

- We see downside risk to our -0.75% GDP estimate for 2015 versus a consensus of -0.20%. Credit conditions are tightening.

1 Data as at January 19, 2015. Source: WSJ, Blackouts Roll Through Large Swath of Brazil.
amid higher rates, and both business and consumer confidence remain under pressure.

- Meanwhile, on the inflation front, we feel compelled to raise our inflation forecast for 2015 to 7.3% versus 6.5% previously and versus a consensus of 7.0%. See Exhibit 1 for details, but our previous estimate was predicated on our view that the adjustment in regulated prices and subsidies would be gradual and that the government would not allow inflation to break the 6.5% upper band of the inflation target for a sustained period. We no longer think this is the case.

- Despite significant nominal depreciation, Brazil’s real effective exchange rate may still need to come down if the economy is going to rebalance towards exports and investment versus the prior cycle of government-induced consumption, in our view.

- The last time we saw macro sentiment this bad in an EM market was in India before the prime minister and the head central banker were replaced in 2013 (note: it was actually a good time to get long risk assets in that summer). We do not envision President Dilma Rousseff being impeached, but we do think that “new” Finance Minister Joaquim Levy could emerge as the most influential figure in Brazil’s potential economic recovery story.

- We believe an upside case for 2016 and beyond can emerge if 1) President Dilma Rousseff continues to support recently appointed Finance Minister Levy and allows him to enact fiscal austerity without intervening; 2) as a result of tighter monetary and fiscal policy, inflation slips back towards more manageable levels; 3) CEOs regain confidence and spend, particularly on much-needed investment.

Against the current macro backdrop, one has to be selective on the investment front, which is exactly what our Brazilian investment professionals are doing on the private equity side. Importantly, beyond the traditional private equity opportunities that continue to accrue to a firm like KKR, we left Sao Paulo thinking that there are some interesting near-term opportunities for investors to consider. For example, after the most recent central bank increase of its overnight rate to 12.75% in early March, short-dated bonds offering real yields of 5.5% now appear quite attractive relative to most areas of the world.

In addition, we also heard a lot about distressed sales of subsidiaries and receivables from companies either being swept up in the events surrounding Petrobras or too over-leveraged to spending that has not occurred. On the other hand, certain services companies could face additional tax hikes, while many companies that benefitted from excessive credit and government outlays to middle class consumers are likely to face stiff headwinds from tighter credit and a deteriorating labor market.

Finally, we believe that public companies that can drive growth through expense control, consolidation, and export sales should be re-rated upward. Consistent with this opportunity set, we note that 30% of the Bovespa actually appreciated by 20% or more in 2014 (Exhibit 17).

Overall, from an asset allocation perspective, Brazil is reflective of the EM carnage we now see more broadly post-China’s recent growth binge. The key for Brazil, we believe, will be to refocus towards investment and savings and away from leveraged consumption. This transition will not be easy, but given risk premiums are up and valuations are down, now is probably not a bad time to be sniffing around, particularly for investors who can invest higher up in the capital structure (and still get some equity upside).

## DETAILS

From a macro perspective, we believe Brazil is experiencing somewhat of a “perfect storm.” We see three elements driving the current environment of stagflation that Brazil is now enduring. First, fiscal belt-tightening is tanking growth. To review, Joaquim Levy, a former fiscal hawk, has rejoined the government to serve as Minister of Finance. Without question, his goal of returning Brazil to a 2.0% primary surplus from a deficit of -0.6%, likely means the current environment of stagflation that Brazil is now enduring. We see three elements driving the current environment of stagflation that Brazil is now enduring.

<table>
<thead>
<tr>
<th>Country</th>
<th>KKR GMAA Target Real GDP Growth</th>
<th>Bloomberg Consensus Real GDP Growth</th>
<th>KKR GMAA Target Inflation</th>
<th>Bloomberg Consensus Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>3.2%</td>
<td>3.1%</td>
<td>0.25%</td>
<td>0.5%</td>
</tr>
<tr>
<td>EURO AREA</td>
<td>1.3%</td>
<td>1.2%</td>
<td>0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>CHINA</td>
<td>6.9-7.0%</td>
<td>7.0%</td>
<td>1.8%</td>
<td>1.6%</td>
</tr>
<tr>
<td>BRAZIL</td>
<td>-0.75%</td>
<td>-0.2%</td>
<td>7.3%</td>
<td>7.0%</td>
</tr>
</tbody>
</table>

GDP = Gross Domestic Product. Bloomberg consensus estimates as at March 9, 2015. Source: KKR Global Macro & Asset Allocation analysis of various variable inputs that contribute meaningfully to these forecasts.

2 Data as at February 8, 2015. Source: Forbes.

3 Ibid.1.
Brazil’s Real GDP Growth Has Slowed Dramatically

EXHIBIT 2

Brazil Real GDP qqsaar

EXHIBIT 3

Our Proprietary KKR Growth Model Is Now Forecasting Negative Growth for 2015

Against this backdrop, we believe that there is still downside risk to our below consensus -0.75% GDP outlook for this year. In particular, if there is formal energy rationing, our view is that GDP could contract as much as -2.0% this year. On the inflation front, we feel comfortable raising our inflation forecast to 7.3% versus 6.5% previously and versus a consensus of 7.0%. Our previous estimate was predicated on the assumption that the adjustment in regulated prices and subsidies would be gradual and that the government would not allow inflation to break the 6.5% upper band of the central bank’s inflation target for a sustained period. We no longer think this is the case. In fact, as can be seen in Exhibit 6, regulated price...
inflation is up 9.65\% year-over-year which supports our view that the government is now comfortable with higher inflation. We think this change in strategy is driven by the reality that higher inflation helps facilitate the required fiscal adjustment. Our recent trip confirmed that, in fact, the government is raising regulated prices faster than anticipated. In doing so, it remains comfortable with inflation above the 6.5\% upper band of the central bank’s stated target. We think this change of strategy is driven by the fact that higher inflation facilitates the fiscal adjustment. However, our concern is that this policy approach can cause inflation expectations to become unhinged. As shown below in Exhibit 7, 2016 inflation expectations, which are currently at 5.8\%, remain well above the mid-point of the central bank’s 4.5\% long-term inflation target.

Finally, we think the low unemployment rate of 5.3\% masks the reality of what is truly happening in the Brazilian labor market. Similar to what has occurred in the U.S., the participation rate in Brazil has declined as people have left the workforce. In 2014, for example, employment growth contracted by 0.47\% year-over-year, a rate that is nearly twice the contraction that occurred during the financial crisis (Exhibit 9).

**EXHIBIT 6**

Normalization of Regulated Prices Has Pushed Headline CPI to 7.70\% Year-over-year

![Brazil Inflation by Component (% Y/y)](image)

*Data as at February 28, 2015. Source IBGE, Haver Analytics.*

**EXHIBIT 7**

Expectations for 2015 and 2016 CPI Remain Well Above the 4.5\% Midpoint of the Central Bank’s Inflation Target

![Brazil Consensus Inflation Expectations (% Y/y)](image)

*Data as at February 25, 2015. Source Bloomberg.*

**EXHIBIT 8**

We Believe That the Official Unemployment Rate Does Not Capture the Reality of the Labor Market...

![Brazil Unemployment Rate (%)](image)

*Data as at January 31, 2015. Source: IBGE, Haver Analytics.*

**EXHIBIT 9**

...As Pure Employment Growth Contracted 47 Basis Points, Which Is Actually More Than During the Financial Crisis

![Brazil Employment Growth % Y/y](image)

*Data as at January 31, 2015. Source: IBGE, Haver Analytics.*
In our view, currency remains an issue. Our conservatism is not predicated on the Fed raising rates more than expected. Rather, because inflation is so high, we believe that the real effective exchange rate in Brazil still needs to come down by a significant amount (Exhibit 10). Second, with falling prices in the commodity arena amid nominal currency depreciation, we think the aforementioned decline could help Brazil to enjoy a much needed improvement in its terms of trade. Indeed, as we show in Exhibits 10 and 11, the real effective exchange rate still remains over 24% above its historical average, despite nominal depreciation of over 50% since 2011.

EXHIBIT 10
Brazil’s Real Effective Exchange Rate May Still Need to Fall...

![Brazilian Real Real Effective Exchange Rate (2000 = 100)](image)

Data as at February 28, 2015. Source: Bloomberg, JPMorgan.

EXHIBIT 11
...Despite Over 50% Depreciation in the Nominal Exchange Rate Since 2011

![USD/BRL Nominal Exchange Rate](image)

Data as at March 9, 2015. Source: Bloomberg.

Importantly, since May 2013, the Brazilian central bank has been stabilizing the currency via daily U.S. dollar swap sales to buy $200mm of real. All told, the Brazilian central bank has amassed $112.4 billion (or 30.5% of FX reserves) in USD short positions at an average exchange rate of 2.32. However, as we look ahead, we think that there is the potential that the government eases or even eliminates the swap program for two reasons. First, despite the central bank’s massive intervention in the FX market, the Brazilian real has actually continued to depreciate rapidly. Indeed, with an average entry cost of 2.32, the Brazilian central bank sits on an unrealized loss of nearly 25%. Beyond financial pain, we now think the government has fundamentally changed its stance towards the real. Secondly, the Brazilian central bank now seems more open to acknowledging that FX depreciation is mandatory to balance the current account deficit, which as shown in Exhibit 12, now exceeds FDI flows.

EXHIBIT 12
Direct Investment Is No Longer Sufficient to Cover the Current Account Balance

![Brazil Current Account: Trailing 12 Months](image)


Macro policies are likely to remain somewhat unorthodox as Finance Minister Levy attempts to drive fiscal prudence, in our view. In the Brazilian macro trinity of President Dilma Rousseff, Finance Minister Levy, and head Central Banker Alexandre Tombini, we see the Finance Minister as the key “swing factor” at the moment. Given his importance, we think that there are at least two unconventional macro policies of his regime that warrant investor attention. First, Finance Minister Levy may endogenously induce higher inflation by removing subsidies that help with the fiscal adjustment process on which he has publicly staked his reputation. Key to our thinking is that, as a deficit fighter, it is much easier to narrow the deficit via tax revenues when nominal GDP is growing in

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4 Data as at February 23, 2015. Source: BNP Paribas, Brazil: BCB’s Currency Swaps Tracker.
the high single digits (because of high inflation, which is currently 7.7% in Brazil), even if real GDP growth is negative.

Second, we think that there is the potential that Finance Minister Levy raises taxes on service companies to help narrow the deficit. To be sure, services have been the major area of growth in recent years. In fact, the service sector now accounts for a sizeable 59.4% of total GDP after having grown at a 10.7% nominal CAGR for the past 10 years5. In our view, a service tax levy would be somewhat of a “replay” of 2004. At that time, the Brazilian government hiked the PIS and Cofins taxes to Industry. Probably more important, though, is that this approach would be a mistake because it ignores the bigger issue: Brazil has an unwieldy and complex tax system that would need a major overhaul to prevent further productivity impediments.

The Petrobras scandal. If falling oil prices were the topic du jour in Mexico, then the equivalent “hot topic” in Brazil is the Petrobras scandal. At the moment, local consensus is that it will not reach the President. However, the financial effects are likely to be broad and deep. Key to our thinking is that Petrobras’ vast network of counterparties, including construction companies and banks, will be undoubtedly affected, in our view. As such, we believe we are likely to see many bankruptcies, pulled credit lines, and divestitures. All told, Petrobras accounts for 10% of total investment in Brazil, so the aggregate food chain being affected is hugely significant. Also, there is the potential that “Project Car Wash” seeps into other major state-owned enterprises-like firms, including Electrobras.

Overall, we believe the ongoing corruption scandal is likely to create volatility and severely dent Brazil’s economic growth in the near-term. Already, 54 or more politicians have been indicated in the scandal, including Renan Calheiros, the president of the Senate, and Eduardo Cunha, the head of the lower house of Congress. As such, progress on government reform and growth initiatives are now likely to be delayed even further.

If there is good news surrounding the Petrobras investigation, we do wonder if the scandal could serve as a long-term positive for the country, the energy sector in particular. Indeed, with an almost monopolistic position in Brazil’s pre-salt fields as well as the experience and human capital required to develop them, a leaner, more focused Petrobras could finally boost production, trim excessive spending, and drive growth in an economy that now faces several major headwinds across many other sectors of its economy.

Conclusion: Are the risks of a Perfect Storm now priced? To visit Brazil today is almost like visiting India a few years back. Sentiment is poor, economic growth equally poor in quality/deteriorating, and inflation high. But everything has a price, and as the exhibits below show, Brazil’s risk premium is now being priced closer to Russia and Nigeria, both more oil dependent and more corrupt countries6.

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5 Data as at December 31, 2014. Source Banco Central do Brasil, Haver Analytics.

At the moment, our base view is that the macro story in Brazil will get worse before it gets better, so the recent increase in the risk premium is likely justified. However, if Brazil can shrink its fiscal deficit, dampen its inflation, and increase savings/investment, then the outlook could brighten much more quickly than the current consensus now thinks. A Brazilian economic make-over will certainly not happen overnight, and it likely relies on Finance Minister Levy’s ability to maneuver a rapidly deteriorating political backdrop and push forward on his fiscal austerity plan while retaining the support of President Rousseff. However, crisis often forces both governments and citizens to embrace change, and our best guess is that we are fast approaching an important inflection point that could lead to a series of better and more shareholder-friendly policies by 2H16.

Despite the Index Falling, More Than 30% of the Bovespa Index Had Returns of Greater Than 20% in 2014...

**BOVESPA PERFORMANCE ANALYSIS, 2014**

<table>
<thead>
<tr>
<th>Index Return (%)</th>
<th>-2.5%</th>
</tr>
</thead>
<tbody>
<tr>
<td># of Companies in Index</td>
<td>68</td>
</tr>
<tr>
<td>Avg. Market Cap (BRL MM)</td>
<td>32,674</td>
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<tr>
<td>Median Market Cap (BRL MM)</td>
<td>11,687</td>
</tr>
<tr>
<td># Stocks Outperforming Index</td>
<td>25</td>
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<tr>
<td>% Market Cap Outperforming Index</td>
<td>44.3%</td>
</tr>
<tr>
<td>Avg. Return of Outperforming Stocks (%)</td>
<td>24.4%</td>
</tr>
<tr>
<td>% MKT CAP RETURN &gt; +20%</td>
<td>30.2%</td>
</tr>
<tr>
<td>Avg. Return of Stocks &gt;20%</td>
<td>31.5%</td>
</tr>
<tr>
<td># Stocks Underperforming Index</td>
<td>43</td>
</tr>
<tr>
<td>% of Market Cap Underperforming Index</td>
<td>55.7%</td>
</tr>
<tr>
<td>Avg. Return of Underperforming Stocks (%)</td>
<td>-26.0%</td>
</tr>
<tr>
<td>% MKT CAP RETURN &lt; -20%</td>
<td>26.4%</td>
</tr>
<tr>
<td>Avg. Return of Stocks &lt;-20%</td>
<td>-39.6%</td>
</tr>
</tbody>
</table>

We Are Now Beginning to See Opportunity in Some of the More ‘Beaten Down’ Sectors

Bovespa, Average 2014 Performance by GICS Sector, %

- Materials: -28.0%
- Energy: -27.0%
- Telco Services: -25.3%
- Utilities: -7.7%
- Consumer Discr: -5.3%
- Industrials: -2.5%
- Financials: 5.0%
- Consumer Staples: 6.1%
- Health Care: 23.6%
- Info Tech: 26.9%


In the interim, we think staying higher up in the capital structure and embracing some of the dislocation to one’s advantage seems like the most prudent route. In particular, we think more companies and existing investors are going to need to divest assets as credit tightens. In addition, we think the short-end of the sovereign curve is becoming appealing, while we talked to several managers who are finding beaten-up equities with turnaround potential and/or above average growth. Finally, we think commercial real estate valuations, which are directly related to long-term interest rates, could be approaching trough levels and warrant attention.
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