My colleague Frances Lim, now based in Sydney, and I recently traveled for a week throughout Asia, focusing primarily on key investment-related issues in China and Japan. Given recent events in China surrounding its currency and stock market as well as Prime Minister Abe’s rollout of his latest economic targets, the timing of our trip led to robust discussions on both micro and macro trends in the region. Our key takeaways, which we describe in more detail below, are as follows:

• China is in structural slowdown mode, as excess debt and capacity now weigh on profits, not just GDP. Slowing Chinese GDP data seems to garner all the headlines these days, but after our most recent trip, we think the focus should be on trends in corporate profits. Indeed, increasingly weighed down by excess capacity and too much leverage, many corporations are now delivering significantly negative profit growth. Just consider that industrial profits declined by a sizeable 8.8% year-over-year for the month of August, despite government reports that the country’s GDP is growing close to its 7.0% target. Traditional consumer businesses too are suffering from more mature penetration rates and the rise of e-commerce. If there is good news, our trip confirmed that there are still a lot of top- and bottom-line growth opportunities in the higher value-added services parts of the economy. In particular, we left most impressed with what we saw unfolding in the food safety, environmental services, and healthcare sectors of the Chinese economy.

• Japan is no longer just a macro story; focus on the micro too. In our humble opinion, the positive macro story in Japan

A Shifting Landscape

Henry H. McVey, Head of Global Macro & Asset Allocation

ASIA | OCTOBER 8, 2015

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Thoughts from the Road
is – on the margin – waning. To be sure, given sluggish GDP and inflation trends of late, we do expect more macro support from both the prime minister and the central bank in the months ahead; however, from what we can tell, the beta trade in Japan now seems to have run its course. As such, we think primarily just those companies that are actively shedding assets and/or returning cash to shareholders will outperform handily from current levels. We also see consolidators performing well, given the low cost of funding as well as the excess capacity. By comparison, inflexible players, particularly in the export sector of the economy, are likely to face stiff headwinds in 2016 and beyond.

- Overall, Asia is in somewhat of a funk. See below for more details, but our trip reconfirmed our thesis that many EM Asia countries recently redirected their economies — potentially at just the wrong time — to take advantage of what they thought would be ongoing strength in China’s economy (Exhibit 2). However, with China’s growth now stalling amid lower commodity prices and weak inbound trade, many EM countries, including Indonesia, Thailand, and Malaysia, are now enduring weaker than expected growth, bigger deficits, and heightened political tensions. We do not see this backdrop changing in the near-term, and as such, we think higher risk premiums are now warranted until more and bigger structural changes are embraced throughout the region.

Looking at the big picture, our key conclusion from the trip is that the slowdown we are seeing in China is secular, not cyclical. Given that China is expected to account for at least one-third of global GDP growth this year, this insight has important implications for global trade, monetary policy, and inflation expectations, we believe, as we think ahead about 2016 and beyond (Exhibit 1). It also means that the recent surge in consumer and corporate credit across many emerging market countries could — ultimately — act as the primary catalyst for the next global economic downturn.

**EXHIBIT 1**
The U.S. and China Will Be the Major Contributors to Global Growth in U.S.$ Terms in 2015

<table>
<thead>
<tr>
<th>Contribution to 2015e Global GDP Growth</th>
<th>1.0%</th>
<th>0.5%</th>
<th>0.7%</th>
<th>3.0%</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other EM</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>World</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


If we are right in our outlook for China and its EM trading partners, then there are two clear investment implications, both of which we feel are heavily reflected in our asset allocation targets. First, more money is likely headed away from EM countries and towards DM countries. As we detailed in our recent piece (U.S. Equities: Begin the Process of Leaning In), we expect the U.S. to be a major beneficiary. By comparison, we actually think non-China EM, particularly countries with levered corporates and low reserve balances, face significant macro risks ahead. Second, with China slowing even more than consensus expectations, the potential for an EM corporate and consumer debt unwind in many countries is now significant. This view is not “new” news, but our trip gives us renewed confidence that our outsized 15% overweight to Distressed/Special Situations makes sense against the sluggish, increasingly inter-connected, global macro backdrop we now see unfolding.

**Section I: China Update**

**China Macro Data Remains Weak** Factory orders, national holidays, and weak commodity prices are all to blame for the sluggish data out of China. Importantly, we only met with one executive who indicated that business trends could be up notably in September versus August. However, on the back of some targeted stimulus measures towards both residential property and public infrastructure, we do expect sequential economic data to get better when reported in late October and early November. For example, we believe property sales will continue to show signs of improvement, particularly as the PBOC recently lowered the down payment ratio on first and second home purchases. The central government has also started...
directly investing in infrastructure via the National Development and Reform Commission (NDRC), and as such, has two groups of projects each totaling $300 billion. Importantly, though, we would view any recovery as a bounce, not a sustained re-acceleration in the Chinese economy, as the structural headwinds remains significant.

Regardless of whether the next short term economic gyration of the economy is up or down, our overall macro view on China is unchanged: this economy now faces several large and structural headwinds, many that will manifest themselves further as the Chinese government is forced to bring nominal lending growth back below nominal GDP growth. See Exhibits 5 and 6 for details, but as nominal lending growth goes below nominal GDP growth, so too will fixed asset investment. At the moment, we are working under the assumption that fixed asset investment’s growth rate falls to 5-6% versus 9.1% in August and a peak of nearly 35% in 2009. If we are right, then we will likely need to lower our already below-consensus China GDP forecasts for 2015 and beyond. Equally as important, our viewpoint suggests that many of China’s trading partners, particularly commodity-related ones, still face significant macro challenges in the quarters ahead.
growth during the China Growth Miracle that defined the 2000-2010 period.

Somewhat more concerning, though, is that many folks with whom we spoke on this trip now believe that the “hard landing” aspect of the Chinese growth slowdown has extended itself to more traditional parts of the economy, including basic consumer purchases. A more accurate assessment, we believe, is that basic consumer purchases are now primarily linked to just periodic refresh and upgrade cycles, not to secular penetration stories like in the past (Exhibit 8).

EXHIBIT 7

Although the Chinese Economy Is Now Slowing...

![Graph showing various economic indicators including Monthly FAI Y/y, Exports Y/y, Retail Sales Y/y.


However, our trip did confirm that consumer trends are changing in China – and not for the positive. In particular, recent anti-corruption initiatives, a volatile stock market, and a weakened currency all serve as collective catalysts to squelch any animal spirits in the consumer arena. Prudence, not excess, is now in vogue when it comes to consumer behavior (with this playing out most at the high end, but also impacting general merchandise).

EXHIBIT 9

Many Consumer Purchases Are Now Primarily Linked to Just Periodic Refresh and Upgrade Cycles

![Graph showing ex-Factory Sales Volume, Y/y, % for various products like Autos, Air-conditioners, Fridge, Washing machine.

Data as at July 31, 2015. Source: Goldman Sachs Research.]

EXHIBIT 8

...There Are Certain Bright Spots in Less Penetrated Areas of the Economy

![Graph showing China Retail Sales Volume, Y/y, % for various categories like Movie Box office (Q2'15), Cosmetics import (July), Pau Sheng Sportswear Sales (July), Belle Sportswear (Q2'15), Autos (July), TV (July), Air-conditioners (July).

Data as at September 2015. Source: Goldman Sachs, Source: CEIC, SARFT, China Auto Market, China Oil, company data.]

EXHIBIT 10

Too Much Supply-Side Driven Capacity Has Dented Profitability Amid Weak GDP Growth

![Graph showing China: EPS Y/y, % (LHS) and China: Real GDP Y/y, % (RHS).

Data as at August 31, 2015. Source: Factset, MSCI, Haver Analytics, KKR Global Macro & Asset Allocation analysis.]

Therefore, our trip did confirm that consumer trends are changing in China – and not for the positive. In particular, recent anti-corruption initiatives, a volatile stock market, and a weakened currency all serve as collective catalysts to squelch any animal spirits in the consumer arena. Prudence, not excess, is now in vogue when it comes to consumer behavior (with this playing out most at the high end, but also impacting general merchandise).
EXHIBIT 11
Excess Capacity is Denting Profits in the Industrial Sector


EXHIBIT 12
Our Forecasts for China’s GDP Growth Remain Below Consensus; We Still See Significant Risks to the Downside

Data as at August 26, 2015. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis estimates.

We certainly never bought into the idea that there would be a seamless transition from fixed investment towards consumption, but recent events have clearly made the transition even bumpier than we had imagined. Moreover, given that wages are rising faster than pricing, and excess capacity is rampant, the impact on bottom-line corporate profitability from a slower consumer has been even more significant than the top-line slowdown in retail sales would suggest.

**A New Direction Is Needed In Terms Of Credit Creation** At the moment, we estimate corporate credit has ballooned to a sizeable 180-190% of GDP. Importantly, this surge in fixed interest costs helped to put further pressure on corporate earnings, which are already suffering from massive excess capacity headwinds across many key industries. As a proxy for this issue, we note that PPI in China has now been negative for 42 consecutive months.

Interestingly, our discussions in China led us to conclude that many companies continue to run at or near full capacity, despite waning demand for product in many instances. Moreover, we learned that frequently the banking system continues to lend, as annual credit creation and production targets often take precedence over return on capital decisions.

Our take: if China wants to drive growth through further credit creation, it needs to start to stimulate demand via consumer credit, and as such, should not consider not encouraging any further supply-side driven responses to increasing fixed investment via the corporate sector. Indeed, given that gross capital formation is 46% of GDP, one does not need to be an economist to appreciate that any additional spending on investment only leads to further excess capacity and more deflationary pricing in the corporate sector.

In addition, pushing to extend e-commerce into partnering with credit card companies versus relying on Alibaba (which just transfers cash) would help to build a consumer credit culture, something that China’s economy desperately needs if it is to transition properly away from fixed investment.

EXHIBIT 13
Credit Has Increased by Almost 100 Percentage Points of GDP Since 2000

EXHIBIT 14
Credit per Unit of GDP in China Remains on an Upward Trajectory

EXHIBIT 15
The USD is Not the Only Issue; the RMB Has Also Gotten Expensive Versus Both the Euro and Yen

EXHIBIT 16
We Expect Many Currencies With Weak Macro Fundamentals to Continue to Lose Ground to the USD


It Will Take Time to Restore Confidence While the government has traditionally had success influencing the Chinese economy by increasing or decreasing spending, recent interventions in the stock and currency markets may suggest that a command and control approach does not always translate as well into investor-based markets. Not surprisingly, risk premiums across the capital markets have increased in recent weeks, a trend we expect to continue in the near-term.

If there is good news, we left Beijing with the impression that there was not another imminent devaluation coming. The environment is just too unsettled at home, and abroad this week in the United States, President Xi Jinping has indicated a similar conclusion. That said, we do expect the government to push for further interest rate and currency liberalization, largely offset by tightening capital control, in the months ahead. Economic theory shows that this approach is long-term unsustainable, and as such, we think that a further devaluation of 3-7% is again likely in 2016, with Frances Lim even more bearish on the outlook for the RMB longer term.


Data as at October 1, 2015. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.
EXHIBIT 17

China’s Currency Appears Too High for its Level of Competitiveness


U.S. Treasury yields could rise as a consequence. Finally, China’s trading partners are likely at more risk than China, given they have smaller reserves and less diversified economies in many instances.

Recent Initiatives to Ease Capital Constraints on the Banks Are Working

Almost every time we visit Beijing we get pitched the bull case on the Chinese banks: cheap valuations, 20% ROE, robust dividends. The downside to the story is that stated NPL ratios for many banks are under two percent at a time when we know credit quality continues to meaningfully deteriorate. At the moment, according to some interesting research we reviewed with China International Capital Corporation (CICC), the sector appears to be discounting 14% NPLs. That’s a big number, suggesting a lot of bad news may now be in the price of these securities.

Moreover, given that LGFVs are repaying their bank debt, swapping the risk into longer-dated municipal bonds, and allowing banks to reserve only 20% against municipal bonds (versus 100% for LGFV loans), the banking sector is now enjoying a subtle but sizeable re-equification.

Overall, the changes being made to the banking system’s reserve requirements to free up capital without having to issue equity is emblematic of the many options the government has employed to extend the cycle. In real estate, for example, restrictions on second homes are being lowered to encourage more buying in the near-term. While these strategies do not make China’s problems go away, they do mask them in the near-term, providing a valuable chapter to the “extend and pretend” approach that has served many financial institutions – and countries for that matter – in recent years. The long-term, however, remains more uncertain and potentially more challenging. Put another way, China is now dealing with its bad loan issues using more of a Japan playbook post-bubble than a U.S. playbook post the Great Financial Crisis.

EXHIBIT 18

Reserve Levels Are Now Declining As the Government Attempts to Stabilize the Currency


Where to invest?

Amidst the bearishness we encountered, we used most of our time in China to learn more about growth-related bright spots. Not surprisingly, our focus was not on low value-added exports or manufacturing. Rather, we spent time with executives well versed on dynamic areas such as wellness/sports, beauty, and healthcare. In addition, we left Beijing again thinking that environmental services, food safety, and logistics remain attractive growth markets, we believe.

E-commerce, particularly the shift towards mobile, also remains a powerful growth story. With more than 95% of the population earning less than $15,000 per year and 90% without a car, online shopping with delivery remains an attractive proposition, particularly for “knock-off” shoes, shirts, and other discount purchases. Importantly, in this type of demand environment, Chinese Internet heavy weights such as Baidu, Alibaba, and Tencent Holdings face little competition from traditional retailers in the online space. Already, according to Goldman Sachs, e-commerce in China, including B2C and C2C, now totals a sizeable $454 billion, compared to $260 billion in the U.S.
There Have Been Notable Implications to the Chinese Environment From Its Successful Economic Growth

<table>
<thead>
<tr>
<th>China Approx. Annual GDP Growth Past Decade, %</th>
<th>China Portion of World Total Greenhouse Gas Output, %</th>
<th>World Bank Cost of Environmental Degradation to China Gross National Income, 2008, %</th>
<th>China’s Number of World’s 20 Most Polluted Cities</th>
<th>Life Expectancy Decrease in North China (Years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>33%</td>
<td>9%</td>
<td>16</td>
<td>5.5</td>
</tr>
</tbody>
</table>


Bottom line: With 1.4 billion people and a rapidly changing social, political, and economic backdrop, we believe there are still many double digit growth opportunities in the services arena. They just look a lot different than they did during the last 5-10 years, and many are now focused in the high value-added segment of the services market, not the traditional export or domestic retail markets.

Section II: Japan Update

Strange Days, Indeed... Having been to Latin America, Europe, and Asia in recent months, my “on the ground” visits lead me to believe that the strongest corporate fundamentals are now actually in Mexico, Japan, and Italy. Yes, Japan and Italy — both slow growth, demographically challenged, deficit countries — alongside EM powerhouse Mexico. Indeed, after delivering some of the weakest GDP growth during the past 20 years, both Italy and Japan are now delivering upside surprises in 2015. Both are reform-oriented, QE stories where “less bad” is probably enough to surpass investor expectations, as one can see in the exhibit below.

Our bigger picture conclusion is that global growth remains sluggish essentially across the board, not just necessarily in Japan. Indeed, from what we can tell, lack of demand in the developed markets is putting significant pressure on not only China but also non-China EM, including Indonesia, Malaysia, Brazil, and Nigeria. We see no quick turnaround to the asynchronous nature of the current global recovery, and as such, we continue to argue that higher risk premiums and tail hedges make sense, particularly across EM.

Japan Stands Out as One of the Few Countries with Positive Earnings Revisions

Factor = total number of upward revisions – total number of downward revisions/total number of estimates. Data as at September 30, 2015. Source: Factset Aggregates, KKR Global Macro & Asset Allocation analysis
DM Belt-Tightening Has Become a Headwind to Trade-Driven EM Growth

![Graph showing EM Exports, % of GDP (Left Axis) vs DM Gross Savings, % of GDP (Right Axis, Inverted)]


What Is New in Abenomics and Will It Be Enough? Prime Minister Shinzo Abe, now 1000 days into office, introduced three new policies during our visit that he hopes will drive Phase II of Abenomics: 1) increase the economy 20% to 600 trillion yen by 2020 from roughly 500 trillion yen today (which implies an average nominal rate of 3% GDP growth); 2) child rearing assistance to push up the low birth rate to 1.8 from 1.4 currently; 3) and new social security measures for increasing nursing facilities to help relieve people of elder care responsibilities that could otherwise keep them out of the workforce (already 500,000 of a population of 100 million people have nowhere to go in their later years).

While these recently announced measures represent official “new” targets for the government, they really appear to be a continuation of four key themes he has pursued since coming into office, in our view. They are 1) better fiscal policies (e.g., the introduction of tax IDs to ultimately force people and corporations to pay taxes), 2) liberalization of industry (e.g., make agricultural reform an economic, not a political issue), 3) improved competitiveness (e.g., push for a more flexible workforce), and 4) demographics (e.g., find ways to offset Japan’s massively shrinking population by encouraging women into the work force, bringing foreign workers in to do low-paying jobs, etc.)

Exhibit 23: Abenomics Has Been Good for Stocks, But Not Necessarily for the Economy

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Japan: Real GDP q/q saar, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1Q12</td>
<td>4.2</td>
</tr>
<tr>
<td>2Q12</td>
<td>-2.1</td>
</tr>
<tr>
<td>3Q12</td>
<td>-1.5</td>
</tr>
<tr>
<td>4Q12</td>
<td>-0.6</td>
</tr>
<tr>
<td>1Q13</td>
<td>5.4</td>
</tr>
<tr>
<td>2Q13</td>
<td>2.3</td>
</tr>
<tr>
<td>3Q13</td>
<td>2.5</td>
</tr>
<tr>
<td>4Q13</td>
<td>-0.9</td>
</tr>
<tr>
<td>1Q14</td>
<td>4.5</td>
</tr>
<tr>
<td>2Q14</td>
<td>-7.6</td>
</tr>
<tr>
<td>3Q14</td>
<td>1.1</td>
</tr>
<tr>
<td>4Q14</td>
<td>4.5</td>
</tr>
<tr>
<td>1Q15</td>
<td>-1.2</td>
</tr>
</tbody>
</table>

For the quarter ending 2Q15, net exports fell nearly 17% Y/y. What’s more, Japan’s Real GDP growth rate is projected to be just 0.1% q/q saar.

Exhibit 24: Nominal GDP in Japan is Growing Just 0.1% q/q saar

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Japan: Real GDP q/q saar (LHS), %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1Q12</td>
<td>4.2</td>
</tr>
<tr>
<td>2Q12</td>
<td>-2.1</td>
</tr>
<tr>
<td>3Q12</td>
<td>-1.5</td>
</tr>
<tr>
<td>4Q12</td>
<td>-0.6</td>
</tr>
<tr>
<td>1Q13</td>
<td>5.4</td>
</tr>
<tr>
<td>2Q13</td>
<td>2.3</td>
</tr>
<tr>
<td>3Q13</td>
<td>2.5</td>
</tr>
<tr>
<td>4Q13</td>
<td>-0.9</td>
</tr>
<tr>
<td>1Q14</td>
<td>4.5</td>
</tr>
<tr>
<td>2Q14</td>
<td>-7.6</td>
</tr>
<tr>
<td>3Q14</td>
<td>1.1</td>
</tr>
<tr>
<td>4Q14</td>
<td>4.5</td>
</tr>
</tbody>
</table>

For the quarter ending 2Q15, net exports fell nearly 17% Y/y. What’s more, Japan’s Real GDP growth rate is projected to be just 0.1% q/q saar.

Our bottom line on Abenomics: Relative to last trip: his programs feel more coherent. That’s the good news. The bad news is that the global environment has deteriorated, which will make it hard for him to deliver on growth, inflation, etc. As such, we think the Bank of Japan will eventually do more before year-end to support the economy via further quantitative easing. Just consider in the latest quarter of negative 1.2% GDP q/q saar, exports fell nearly 17% Y/y.

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1 Data as at September 25, 2015. Source: Nikkei Asian Review.
on an annualized basis, while household consumption was nearly negative at 2.7% (Exhibit 23). If we are right, then the outlook for stocks will continue to be better than for GDP growth.

EXHIBIT 25

The TOPIX Has Had 11 Straight Quarters of Earnings Beats

EXHIBIT 26

Indexed EPS in Japan is Outpacing Europe and Approaching U.S. Levels

EXHIBIT 27

Japanese Valuations are Reasonable Relative to Peers...

Moreover, we believe Japanese valuations still appear reasonable. Interestingly, unlike the U.S. and Europe in recent years, price-to-earnings multiples have consistently contracted each year, given ongoing concern that the earnings growth is not sustainable. In our view, that is the opportunity set in Japan.

EXHIBIT 28

…and Relative to Historical Trends

The Japanese Corporate Sector Is Slowly Headed in the Right Direction In many ways Japan Inc. feels a lot like the U.S. in 2011. Specifically, amid slow global growth and unsettled capital markets, Japanese corporates continue to plod ahead towards better earnings. Right now earnings are expected to grow 17% and 13% in 2015 and 2016, respectively. These growth rates compare favorably with the United States at 1% and 11%, respectively, over the same periods.
To be sure, a weaker currency has helped, but there is more going on, we believe. In particular, we think that companies are slowly becoming more focused on return on equity again (Exhibit 29). This insight may sound trivial, but after a multi-year hiatus, companies are starting to increase dividends and buy back stock. Improved corporate governance is also helping. From what we can tell, buybacks could account for 60 basis points of EPS growth this year in Japan. This outpouring of cash pales in comparison to the three percent buyback boost to EPS in the United States, but it is clearly a step in the right direction.

EXHIBIT 29
Corporations Will Need to Buy Back More Stock or Pay More Dividends To Drive ROE Higher

![Graph showing Japan: ROE from May-02 to Sep-15 with data points for Jan-07, 9.3, Jan-10, -1.4, Sep-15, 8.6, and May-02, -1.4, and Jan-10, -1.4. The graph includes a trend line with data as at September 10, 2015. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.]

EXHIBIT 30
Unlike Other Regions, Corporate Profit Trends Continue to be Revised Upwards In Japan

![Graph showing Consensus 2015 EPS Trend with data points for Jan-14, Feb-14, Mar-14, Apr-14, May-14, Jun-14, Jul-14, Aug-14, Sep-15, 105, 100, 95, 90, 85, 80, 75, 70, and 65. The graph includes a trend line with data as at August 14, 2015. Source: Morgan Stanley Research.]

How Much Do Global Forces Matter in Japan? It is clear being on the ground in Tokyo that August and September have been very weak months from an earnings trends perspective. Based on our travels in Asia, it feels like there was a major macro air pocket after China devalued on August 11, 2015 – one that has reverberated through Asia, including Japan.

Consistent with this view, 2015 EPS growth rates in Japan equities have fallen to 16% from 22-24% in recent weeks. Any decline from current levels should be much more modest, according to the current consensus. The rationale, we were told by many investors, is that emerging market revenues only account for 11% of total Tokyo Stock Exchange revenues. So, even a 50% drop in EM revenues (which is what some of the Japanese equipment companies are seeing) would not materially dent overall EPS.

This outlook seems too rosy, in our opinion, and as such, we take a more conservative view on EPS growth at this point in the cycle. Our ‘gut’ tells us that if China slows, then its impact on not only Japan but also China and Japan’s trading partners will be more substantial than what the consensus is currently forecasting. If there is good news, we do take some comfort that the U.S. represents a sizeable 19% of Japan’s total exports.

Beyond the China headwind, there are three other macro forces that warrant investor attention, we believe. First, while we continue to expect further yen weakness versus the U.S. dollar, this tailwind should now be much more modest, given the current starting point of USD-JPY 120. Second, many of the big transformational shifts in assets have transpired; for example, we now see the General Pension Investment Fund, Japan (GPIF) making marginal changes, not major ones, towards risk assets in the coming months. Third, while we do expect the BOJ to do more, we expect less of a “big bang.” Finally, even if the economy gains momentum, it still faces a consumption hike tax of 200 basis points in April 2017.

Bottom line, we think that Japan has emerged as somewhat of the best house in a bad neighborhood in Asia. To be sure, China’s weakness will affect Japan, but we still believe that there are enough other macro levers to ensure continued earnings momentum in the quarters ahead.

Where to Invest? Overall, we retain our positive bias towards Japan, despite increasing external headwinds. Valuations are reasonable, and earnings are likely to come through faster and more consistently than many other markets we visit. However, as we have detailed in this note, the macro tailwinds that drove significant beta outperformance over the last few years are now waning, we believe. Put another way, an investor in Japan will likely need to get the micro right, not the macro, to outperform meaningfully over the next few quarters.

In terms of investment opportunities, we believe that carve-outs with the potential for operational improvement and access to global growth seem attractive. We also like some of the soft activist stories we heard in the mid-cap public equity markets. In terms of sectors, we think the trend from deflation towards inflation in Japan means financials broadly should outperform. Finally, we think travel and tourism related stories in Japan will continue to gain momentum.
Indeed, even with China de-valuing of late and lots of political back and forth between the two countries, record numbers of Chinese are now visiting Japan after the Yen has moved to 120 from 80\(^2\).

In terms of areas of caution, our trip to China makes us feel like Japanese exports and manufacturers will continue to suffer. Importantly, it is not just China. Europe has weakened its currency, so too has Korea, and as such, global trade has gotten extraordinarily competitive at a time of waning demand from developed market consumers.

**Section III: Conclusion**

Our visits to China and Japan underscored our belief that many of the world’s major economies are experiencing sluggish growth. On the one hand, China’s shift towards a consumer economy remains a bumpy transition, adversely affected in recent weeks by concerns around a collapsing stock market and increased volatility of its currency. On the other hand, structural headwinds in Japan have limited some of the follow-through one would think that the local economy would enjoy after such significant currency devaluation in recent quarters. Not surprisingly, given these views, we remain of the mindset that Asian growth – and potentially total global growth – could continue to disappoint in the near-term.

That said, not all news is bad news in China and Japan – or its Asian trading partners for that matter. In fact, we actually left our time in Hong Kong, Beijing, and Tokyo with high conviction about several important long-term investment opportunities in Asia, many of which we think can help to create significant value across both private and public equity portfolios. First, we expect leading countries in Asia to benefit mightily from its growing share of high value-added exports (Exhibit 31). For example in both China and India, sophisticated healthcare companies are already exporting their goods and services to maturing societies in both the U.S. and Europe.

Second, while sales of basic consumer goods are suffering from excess capacity and mature penetration, differentiated consumer experiences are growing at extremely compelling rates. In particular, increasing demand for “safe” products, the shift towards wellness, and increased focus on beautification all represent compelling investment themes.

Third, disruptive technologies are gaining significant share, driving growth rates of 20% year-over-year or higher at a time of low single-digit GDP growth in many countries. Mobile commerce in markets like Korea and China are the most obvious examples, but we also learned of numerous other examples of disruptive technologies and processes that are now affecting large swaths of the Asian economy, including logistics and peer-to-peer financing.

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\(^2\) Data as at September 30, 2015. Source: Bloomberg.
We believe that corporate restructuring and carve-outs too represent major investment opportunities. An increased focus on shareholder returns is leading to compelling investment opportunities, particularly for private equity firms with value-added operational expertise in more mature countries like Japan. Meanwhile, in places like Indonesia and Australia, slower growth, weakening currencies, and too much debt are forcing companies to seek partners who can help them delever and reposition their companies for growth amidst the decline in China-related trade activity.

Bottom line: now is not the time to wager that EM fundamentals, China in particular, are turning more positive. Rather, we still advise caution, as our framework suggests that the inflection point for EM to finally outperform DM will likely coincide with the end – not the beginning – of the Fed tightening campaign (Exhibits 33 and 34).

In the interim, value creation will come from pursuing the aforementioned investment themes, many of which rely on alpha – not beta – to generate returns. Put another way, the top-down environment in Asia, China and Japan in particular, is telling us to focus on the micro for value creation, while using hedges and other innovative strategies to protect against the macro.
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