Asia: Leaning In

In a world largely starved for structural growth, both cyclical and secular forces are now working in concert to create a favorable environment for capital deployment across many parts of Asia. Key to our thinking is that the current macro backdrop, including a more favorable currency environment as well as a more stable China, has turned more positive. Beyond the compelling macroeconomic conditions that we now see, Asia has now also emerged as an elegant play on some of our highest conviction investment themes, including corporate carve-outs, experiences over things, and the illiquidity premium.

“I hope 15 years later people forget about e-commerce because they think it’s like electricity.”

JACK MA
FOUNDER AND CHAIRMAN OF ALIBABA
When I made my first trip to Asia in 1995, it changed the way I thought about the world. Beyond the diverse, rich cultures that countries like China, Indonesia, Vietnam, Thailand, and Malaysia offer, what struck me most about the region then—and still shapes my thinking today—is the explosiveness of its economic growth trajectory.

No doubt, China has clearly been the economic star performer in terms of sheer size during the past few decades, but as Exhibit 1 shows, its trading partners in EM Asia now actually account for 25% of incremental global growth, just behind China itself at 35%. Moreover, while Japan, Australia, and South Korea do not offer outsized growth rates, they are large economies with distinct macroeconomic and societal trends worthy of investor attention, we believe.

So, it should not surprise folks to learn that I was again back in the region with my colleague Frances Lim, looking for clues to stay ‘smart’ on the global macro trends that are helping to shape KKR the region with my colleague Frances Lim, looking for clues to stay ‘smart’ on the global macro trends that are helping to shape KKR investments both inside and outside the region. So, what did Frances and I learn during our latest Asian ‘deep dive’ this fall? See below for details, but our primary conclusions are as follows:

1. **Asia’s surging middle class, coupled with strong productivity trends, signal robust structural growth for the foreseeable future.**

   Without question, having the two key components of GDP – labor force growth and productivity – trending so strongly is an important differentiator for the Asian region at a time when many parts of the global economy are facing demographic and/or productivity challenges. Compelling urbanization patterns across the region are helping too. As a result, overall GDP-per-capita in Asia is growing significantly faster than in many other parts of the world. From an investment standpoint, we think that such high levels of strong structural growth across a variety of industries, including consumer financial services, payment processing, education, and healthcare delivery, will be constructive for the trajectory of earnings and multiples in the coming years.

2. **From a cyclical growth perspective, we think that China’s nominal GDP growth has already crashed, which has important and positive implications for the way we view the Asian emerging markets story during the next three to seven years.**

   Contrary to popular opinion, we believe that the earnings power of many Asian companies, including traditional ‘old’ economy sectors, has already troughed and is actually headed higher in coming quarters. For example, in Beijing we consistently heard that supply side reforms as well as increasing demand are boosting corporate profitability. Meanwhile, domestic consumption has accelerated across several Asian economies (including China), helping to drive what we believe is a slower, but sustained period of economic growth. Stronger local Asian currencies—compliments of not only a weaker dollar but also smaller deficits and higher real rates in the region—give us additional confidence that now is the time to be allocating more to EM Asia stories. See below for details, but our EM model, which began to inflect upward in early 2016, is now actually pointing towards the beginning of the ‘mid-cycle’ phase of a long-tailed recovery.

3. **As we detail below, we see Asia as a direct and compelling play on three of our global macro themes: de-conglomeratization, experiences over things, and the illiquidity premium within performing private credit.**

   Not surprisingly, having three of our highest conviction global investment themes playing out strongly across the region underscores our confidence in our macro outlook. Importantly, we think the lens through which we are looking extends across equities and debt, including both private and public securities, and it includes large, fast-growing industries such as healthcare, technology, consumer financial services, wellness, and leisure.

4. **The biggest changes in Asia we see are not only the continued migration up the value-added ‘food chain’ across a variety of domestic industries but also the impact that technology is having on delivery of these higher value-added goods and services.**

   This transition is a big deal, in our view, as it is creating notable winners and losers, particularly among providers that can offer the perception of aspirational value to middle class consumers who increasingly want to upgrade their lifestyles. Importantly, delivery preferences of both goods and services are changing quickly in Asia. Already, the digital payments market in China has surged to $9 trillion in size, up from just $15 billion in 2011 and now 80x greater than that of the United States. Not surprisingly, the impact of this shift in consumer preferences extends far beyond mobile commerce and financial services to include more traditional areas such as logistics, real estate, and transportation. Given the speed and the magnitude of the aforementioned changes, we think that investors need to keep well-informed on the enormity of this transition for both offensive and defensive reasons.

5. **Importantly, though, beyond strong growth in domestic demand stories, we also see more opportunities for allocators of capital to help Asian companies—both in developed and developing markets—expand abroad.**

   Somewhat differentiated, Asian companies are benefitting not only from surging domestic demand for higher value-added services, but also the opportunity to export their offerings abroad through a variety of channels, including M&A, joint-ventures, and de novo efforts. Key industries on which to focus include technology, healthcare, travel, and financials.

   To be sure, Asia is not without its macro and geopolitical blemishes. As we describe in more detail below, China is still growing its nominal debt well above the rate of its nominal GDP. At the moment, Frances’ base case forecast is that debt-to-GDP in the country could reach nearly 300% by December 2021 (Exhibit 58). In her bear case, however, if credit growth continues in the mid-teens, then debt-to-GDP could actually reach 300% by 2019. Meanwhile, geopolitical tensions in North Korea continue to escalate, a potential market-disrupting influence to which we believe that investors must pay attention. Finally, global trade, one of the key engines of growth during the past two decades, appears to have slowed notably. Given Asia’s outsized role in this once dynamic area of the global economy, we believe that investors must incorporate the potential for global trade to grow at or below the rate of overall global growth during the next five to seven years.

   Without question, our trip gives us great confidence in the region across several parts of our asset allocation framework. In fact, we are actually using this opportunity to increase our non-Japan Asia exposure to an overweight position of nine percent versus a benchmark of seven percent, an increase of two hundred basis points. We fund this by reduc-
ing our U.S. equity position to 17% from 19% and a benchmark of 20%. Key markets on which to focus include Indonesia, India, Vietnam, and China. See below for details, but our models increasingly suggest adding exposure to EM, particularly countries with large domestic economies that can withstand any further slowdown in global trade.

Meanwhile, we left Asia feeling more confident about our existing 200 basis point overweight position in Japan. Growth has been positive for six quarters in a row, and equally as important, we now have higher conviction that ongoing shareholder reforms will continue. Meanwhile, we have also gained further confidence that the benefits of the illiquidity premium in Private Credit extend nicely to Asian markets such as India, Indonesia, and Australia. Finally, our work continues to show that the U.S. dollar is in the process of topping, which suggests a much more favorable backdrop for both local debt and equity in the region versus the prior five years.

Overall, we now hold the view that a multi-year run of solid investment opportunities lies ahead. Indeed, with China rebounding off its low, rising GDP-per-capita stories are now working again across the region. In our view, the macro backdrop has not been this positive for these types of stories since China’s nominal GDP first began falling in 2011. Moreover, both long and short investment opportunities linked to Asia’s ‘new economy’ are now exploding, as middle class consumers are dramatically shifting the way they do business across almost every sector we reviewed during our trip. Finally, while growth remains more muted in more mature economies like South Korea, Australia, and Japan, we see both internal and external forces driving CEOs to create more efficient corporate structures, propelling what we believe will be an important wave of M&A activity during the coming quarters. If we are right about the aforementioned trends, then now is the time for multi-asset class investors to be ‘leaning in.’


As we detail in Exhibits 1 and 2, the lion’s share of global growth today is now being driven by Emerging Asia. Indeed, China and Emerging Asia’s total contribution to global growth represents a full 60% of incremental growth for the world this year. Importantly, though, this backdrop is not a one-off, or aberration. In fact, our work shows that Asia will account for a full 62% of total global growth this decade, compared to a more modest 43% during much of the prior two decades.

From a cyclical growth perspective, we think that China’s growth has already crashed, which has important and positive implications for the way we view the Asian emerging markets story during the next three to seven years.

EXHIBIT 1

60% of Total Global Growth Will Likely Come From China and Emerging Asia in 2017

EXHIBIT 2

Asia Has Replaced the U.S. as the Driver of Global GDP

So, what is driving this outsized GDP growth at a time when other regions of the world seem to be at risk of secular stagnation? Well, at the risk of winning the 2017 ‘Master of the Obvious’ award, GDP is really about just two things: working age population growth and productivity, and the good news is that Asia has both in spades. Also, Asia generally has sound fiscal policies, which has helped to support growth too.
Despite aging populations in markets such as South Korea, Japan, and Australia, we note that overall Asian population growth remains outsized, with the middle class alone expected to grow to 3,492 million by 2030 versus 525 million in 2009 and 1,380 million in 2015. Indeed, as Exhibit 3 shows, Asia’s 153% middle class growth rate during the 2015-2030 period will dwarf almost every region of the world. Importantly, this growth is large – and on large numbers. All told, the Asian region could account for 90% of the next one billion entrants into the global middle class (though we do acknowledge the definition of middle class can differ dramatically from an EM country versus more established, richer economies like the United States).

**EXHIBIT 3**

The Middle Class Population in Asia Will Grow 153%...

<table>
<thead>
<tr>
<th>Area</th>
<th>2015</th>
<th>2020</th>
<th>2025</th>
<th>2030</th>
<th>2030 VS. 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>335</td>
<td>344</td>
<td>350</td>
<td>354</td>
<td>6%</td>
</tr>
<tr>
<td>Europe</td>
<td>724</td>
<td>736</td>
<td>738</td>
<td>733</td>
<td>1%</td>
</tr>
<tr>
<td>Central and South America</td>
<td>285</td>
<td>303</td>
<td>321</td>
<td>335</td>
<td>18%</td>
</tr>
<tr>
<td>Asia Pacific</td>
<td>1,380</td>
<td>2,023</td>
<td>2,784</td>
<td>3,492</td>
<td>153%</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>114</td>
<td>132</td>
<td>166</td>
<td>212</td>
<td>86%</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>192</td>
<td>228</td>
<td>258</td>
<td>285</td>
<td>48%</td>
</tr>
<tr>
<td>WORLD</td>
<td>3,030</td>
<td>3,766</td>
<td>4,617</td>
<td>5,412</td>
<td>79%</td>
</tr>
</tbody>
</table>


Equally as important, overall productivity in the region remains robust. Indeed, as we show in Exhibit 6, countries like China, India, Vietnam, and Indonesia sport growth rates that are both large on an absolute and relative basis, dwarfing what many investors see in developed markets like Europe and the United States. Moreover, we think that, given that many Asian countries have not yet fully urbanized, there is likely still more upside as more citizens shift from agriculture towards higher value-add manufacturing and services jobs.

**EXHIBIT 5**

Across Much of the Developed Markets, Labor Productivity Growth Is Not What It Used to Be...

No doubt, China has clearly been the economic star performer in terms of sheer size during the past few decades, but its trading partners in EM Asia now actually account for 25% of incremental global growth, just behind China itself at 35%.

“...From Nearly 1.4 Billion in 2015 to 3.5 Billion in 2030

**EXHIBIT 4**

Growth of GDP, Per Capita Income and Labor Productivity, 2017

Data as at May 19, 2016. Source: Conference Board, *The Economist.*
...But That Is Not the Story in Emerging Asia, as Productivity Growth Remains Robust

Our bottom line: In a world where many leading thinkers are drawing on the ‘secular stagnation’ work of American economist Alvin Hansen during the Great Depression to describe the current environment in some of the world’s largest economies (e.g., the U.S. and Europe), Asia’s growth profile is – without question – a distinguishing feature. In our view, this appealing macro backdrop is really not up for debate, particularly given the strong growth in GDP-per-capita that we are seeing in Emerging Asia relative to other parts of the world (Exhibit 8). What is up for debate, however, is for investors to appreciate that growth does not always translate into corporate profits (with China, of course, being the most obvious example of this disconnect). As such, investors must focus on where there is a compelling intersection of growth and returns. As we describe below in more detail, we remain generally more constructive on consumption over investment as well as services over goods.

EXHIBIT 6

By 2030, Four of the Top 10 Economies Could Be In Asia

We Also Believe GDP-per-Capita Will Improve Meaningfully

In a world largely starved for structural growth, both cyclical and secular forces are now working in concert to create a favorable environment for capital deployment across many parts of Asia.
Section II: Key Themes/Insights on Why We Now Hold a More Positive View on Asia as an Investment Destination

In the following section we outline six key points on which we think Asia represents an interesting investment opportunity at this time in its history.

Point #1: In Our View, China Has Already Bottomed, Which Is Constructive for Our EM Call. At the risk of being somewhat provocative, we believe that the China ‘bears’ who are calling for major downside to growth from current levels are missing the point that the country has already had its economic crash. It was just in nominal, not real, terms. Indeed, as one can see below, nominal GDP fell from a recent peak of 19.7% in 2Q11 to a low of 6.4% in 4Q15, a 68% decline. In our humble opinion, a 68% decline in nominal GDP is amongst the most significant that we could find in our global economic history books; were it to happen again (i.e., China GDP crashes again), nominal GDP would need to fall to around three percent – a level we view as almost mathematically impossible to achieve – to replicate the same type of slowdown in statistical terms that the country just experienced.

So what do we think the consensus is missing? In our view, too many investors, particularly sell-side economists, have focused on China’s slowdown in real terms, which is much more subdued than in nominal terms. Specifically, at the same time that nominal GDP fell by 68% (Exhibit 9), real GDP fell a more modest 32% to 6.8% in 4Q15 from 10% in 2Q11. The delta between nominal GDP and real GDP is significant, however, as companies generate revenues in nominal – not in real terms; they pay their employees in nominal terms – not in real terms; and they reward shareholders in nominal terms – not real terms.

EXHIBIT 9

Nominal GDP Growth in China Fell 68% from 2011 to 2015...

What we heard on the ground in Hong Kong and Beijing is definitely supportive of our view that China has bottomed. Demand appears stronger, and given that anti-corruption activities are not intensifying, year-over-year comparisons now appear favorable. Moreover, local executives and investors with whom we spoke all agreed that capacity reductions of 20-25% have already come out of the steel and coal industries; this newfound discipline is leading to a notable rebound in corporate profits, a trend we expect to continue. One can already see the improvement in Exhibit 11.
Interestingly, by restricting the supply side overhang in the ‘old economy’ sectors such as steel and coal, the Chinese government is not only improving its standing with its 1.4 billion citizens by addressing a major environmental sticking point but it is also using the aforementioned supply side reform initiative to improve the cash flow characteristics of many of its highest default risk banking customers. Said differently, rationalization of the commodity sector is – at least in the near-term – a ‘win-win’ for President Xi Jinping, and as such, we expect this policy shift to maintain momentum even after the 19th Party Congress finishes in October.

Consistent with this view that China has bottomed in nominal terms amidst tighter supply side reforms as well as increasing demand, our overall EM model continues to send upbeat signals. As we first indicated in our October 2016 Insights note Asia: Pivot Required, our quantitative model has turned more positive on Public Equity Emerging Markets. These days, our latest work suggests that EM now seems to be entering more of a ‘mid-cycle’ phase of its recovery, wherein valuation is no longer screamingly cheap but fundamentals are improving, and positive price momentum has taken hold in both equity and FX. All told, we believe these factors argue for continued EM outperformance, though a firmer commodity price backdrop would definitely help bolster our conviction in the sustainability of recent fundamental improvements.

**EXHIBIT 12**

It Has Been a Long, Hard Road in EM. However, We Now Believe a Structural Turn Is Occurring

<table>
<thead>
<tr>
<th>RELATIVE TOTAL RETURN, MSCI EM/DM (Feb'87 = 0%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sep-94 288% 81 months</td>
</tr>
<tr>
<td>Sep-01 17% 03 07 09 11 13 15 17</td>
</tr>
<tr>
<td>Sep-10 305% 108 months</td>
</tr>
<tr>
<td>Sep-16 113% 194 months</td>
</tr>
<tr>
<td>Sep-17 143% 64 months</td>
</tr>
<tr>
<td>Jan-16 113% 20 months</td>
</tr>
</tbody>
</table>


Importantly, when we do a simple DuPont analysis to decompose return on equity, our work shows that operating margins are finally improving across all of EM after a five-year bear market, which is now boosting return on equity. One can see this in Exhibit 14. This notable improvement has led the ROE factor in our dashboard to send a ‘buy’ signal. While the margin increase is broad-based by region, commodity-related companies are driving the lion’s share of the increase, reinforcing our earlier point that commodity prices must at least stabilize at current levels for our EM dashboard to remain positive. Meanwhile, when we look at the two other components of a DuPont analysis, our work shows that financial leverage across EM is declining, while asset turnover remains essentially unchanged in recent quarters. Said differently, if ROE is going to improve the way we think it is, then margin expansion will most likely have to carry the day.

**Our EM model, which began to inflect upward in early 2016, is now actually pointing towards the beginning of the ‘mid-cycle’ phase of a long-tailed recovery.**

---

**EXHIBIT 13**

EM Is Now Entering the ‘Mid-Cycle’ Phase of Its Recovery. Wherein Relative Valuation is No Longer Compellingly Cheap, Momentum Has Turned and Fundamentals Are Improving

<table>
<thead>
<tr>
<th>‘RULE OF THE ROAD’</th>
<th>MAY’15</th>
<th>JAN’16</th>
<th>AUG’16</th>
<th>MAY’17</th>
<th>SEP’17</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Buy When ROE Is Stable or Rising</td>
<td>↔ ↔ ↔</td>
<td>↔ ↔ ↔</td>
<td>↔ ↔ ↔</td>
<td>↔ ↔ ↔</td>
<td></td>
</tr>
<tr>
<td>2. Valuation: It’s Not Different This Time</td>
<td>↔ ↔ ↔</td>
<td>↔ ↔ ↔</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. EM FX Follows EM Equities</td>
<td>↔ ↔ ↔</td>
<td>↔ ↔ ↔</td>
<td>↔ ↔ ↔</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Commodities Correlation in EM Is High</td>
<td>↔ ↔ ↔</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Momentum Matters in EM Equities</td>
<td>↔ ↔ ↔</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Overall: EM now seems to be entering a more ‘mid-cycle’ phase of its recovery. Valuation is no longer compellingly cheap, but equity and FX momentum have re-asserted themselves relative to DM. Maybe even more importantly, fundamentals are now improving, as manifested by rising ROEs, upward earnings revisions, and positive economic surprises. A firmer commodity price backdrop would help bolster our conviction in the sustainability of the recent fundamental improvements.

Data as at September 30, 2017. Source: KKR Global Macro & Asset Allocation analysis.
We Think Margins Have Bottomed…

We think emerging market net margins have bottomed in the past year. The emerging market net margin chart shows that margins have been in a prolonged bear market starting in 2010, with a bottom in September 2017. The pickup in margins may be related to a pickup in emerging market corporate profitability.

And Free Cash Flow Is Up Across EM

We also see a pickup in emerging market free cash flow yields. Emerging market capex-to-sales and free cash flow yield charts show that both measures have been improving, with the free cash flow yield having bottomed in 2017.

Another positive for emerging markets these days is that momentum has reasserted itself in both EM equity and FX. As has been the case for most of the period since September 2016, EM equities are outpacing DM on a year-over-year basis. Furthermore, FX momentum has improved, and as we outline in more detail below in Exhibits 16-20, we think prospects are good that FX will not be as much of an obstacle to EM equity returns in the future.

The USD Is Now Closer to a Peak Than a Trough, in Our View

The USD is now closer to a peak than a trough, in our view. The USD real effective exchange rate (REER) chart shows that the USD is now closer to a peak than it has been in the past five years. The chart also shows that the USD is now overvalued relative to many emerging market currencies.

The low U.S. unemployment rate suggests current account dynamics could soon move against the USD, benefiting local players in Asia that export abroad.

The low U.S. unemployment rate suggests imports will rise relative to exports. The chart shows that the US export/import volume index has been rising relative to the US unemployment rate, indicating that imports are rising relative to exports. This suggests that the USD may be on the verge of a peak.

Data as at 2017. Source: Bureau of Economic Analysis, Haver Analytics.
**EXHIBIT 18**

Real Yields in Emerging Asia Are Now Higher Than in Many Developed Markets

Real 10-year Yield, %

Data as at September 30, 2017. Source: Bloomberg.

**EXHIBIT 19**

EM Current Account Deficits Have Improved in Many Instances

Change in Current Account as a % of GDP: Latest Available vs. Pre-Taper Tantrum (June 2013), ppt

Data as at December 31, 2016. Source: Factset.

**EXHIBIT 20**

Cumulatively, the Currency Impact on MSCI EM Returns Has Negated Most of the Gains Since 2009. We Think This Headwind Is About to Become a Tailwind

Data as at September 30, 2017, Source: Bloomberg.

**EXHIBIT 21**

We Have Materially Shifted Our Sovereign Debt Holdings in Our Target Asset Allocation From Developed Market Local Debt Towards Local EM Debt Securities

10-year Government Bond Yield, Local Debt, %

Data as at September 30, 2017, Source: Bloomberg.

In addition to the more positive attitude we have been highlighting about many Asian EM Public Equities, we are also more constructive on local currency EM debt, including both sovereign (as reflected by our earlier shift out of 100% developed market sovereign debt towards areas like Mexico, Indonesia, and India in our mid-year outlook; see Mid-year Update: Five Areas of Focus) and corporate, for several reasons. Indeed, with the U.S. dollar now above fair value (Exhibit 16), EM currencies appear set to rebound, which could help increase the total return that a U.S. dollar-based investor could enjoy for owning local currency debt and equities. Another notable positive at this point in the cycle is that many EM companies have pared back some of their excessive capital expenditures, which – all else being equal – increases the potential for debt repayment. One can see the magnitude of this development in Exhibit 15.
In terms of the current upward EM cycle that we are forecasting, we think that it could be longer, more sustainable, and as a result, potentially warrant a higher valuation for many securities along the way. Key to our thinking is that the composition of the EM index is changing for the better. One can see this in Exhibit 22, which shows that Technology is becoming more influential than Financial Services. This ‘baton hand-off’ is important, as we view Technology as a less cyclical play on growth in GDP-per-capita than traditional lending based financial companies in EM, many of which are often state-run, or heavily influenced by ‘local’ governments. Meanwhile, in many instances Technology has impressive operating margins, strong cash flow, and enviable pricing power in certain fast-growing areas like online search. Consistent with this view, Technology is also becoming the key earnings driver in EM (Exhibit 23), despite the fact that many large countries like Indonesia currently still have zero technology representation in their public equity indexes.

**EXHIBIT 22**

Tech Has Surpassed Financials as the Largest Sector in Emerging Markets, Taking Share From Energy and Materials

![MSCI Emerging Markets Sector Weight as a % of Market Cap](image)


**EXHIBIT 23**

The Technology Sector Is Driving 2017 Earnings Growth Expectations

![MSCI EM 2017e Earnings Growth](image)

Data as at September 30, 2017. Source: MSCI and Factset.

**EXHIBIT 24**

Rate of Returns for FDI Declining in Many Areas of the Global Economy

![Rate of Return on Outward Foreign Direct Investment, %](image)

Data as at December 31, 2016 or latest available year. Source: National Statistics, OECD.

**EXHIBIT 25**

Point #2: Asia Is a Direct Play on Our De-Conglomeratization Thesis. As we mentioned in both our 2017 Outlook as well as our 2017 Mid-Year Update, we are seeing a notable acceleration in divestitures and carve-outs from the multinational community. In our view, this idea is a big one; it is global, and it has duration. It also reflects a push by more activist investors for management teams to optimize their global footprints, particularly as domestic agendas take precedence over global ones. Central to this story is that, as we show in Exhibits 24 and 25, returns are falling for many multinational companies.

"We view Technology as a less cyclical play on growth in GDP-per-capita than traditional lending based financial companies in EM, many of which are often state-run, or heavily influenced by ‘local’ governments."
At the moment, Japan has emerged as one of the most compelling pure play examples on our thesis about corporations shedding non-core assets and subsidiaries. The macro backdrop is compelling for at least three reasons, we believe. First, many of Japan’s largest companies have literally hundreds of subsidiaries that could be deemed non-core, and as corporate governance and shareholder activism gain momentum, they are increasingly being identified as potential sources of value creation. Second, the deposit-to-GDP ratio is 135.5% (Exhibit 26), underscoring that banks are hungry to lend to acquirers of these subsidiaries. In many instances, a private equity firm can get at least 7x debt leverage, with an all-in cost of funds that is below two percent. Finally, as we show in Exhibit 28, enterprise value-to-EBITDA multiples in Japan are still at or below historical averages, a setup that we can’t find in many other markets around the world.

Beyond compelling macroeconomic conditions that we now see, Asia has now also emerged as an elegant play on some of our highest conviction investment themes, including corporate carve-outs, experiences over things, and the illiquidity premium.
Unlike Many Other Markets, Japan’s Valuation Still Appears Reasonable

EXHIBIT 28

We Believe That There Is Great Potential for Operational Improvement in Japan, Including Better Margins, Faster Asset Turns, and More Efficient Leverage

South Korea is another interesting market on which to focus. In the past, the Korean chaebol system fostered growth of large family-controlled enterprises as well as additional expansion of divisions across multiple sectors with businesses formed to support the needs of the overall chaebol, including IT services, catering/food services, and logistics. Many of these captive businesses have grown into sizeable operations by supporting various chaebol affiliates, though many are fundamentally non-core and conduct limited business with third parties.

Interestingly, today we see a shift in the chaebols’ strategy, driven by both regulatory change and then the need for growth. Indeed, as demonstrated by recent examples like Samsung Group’s divestiture of its chemical and defense businesses, many chaebols are proactively spinning off businesses that are less core, allowing them to focus their efforts and capital on more critical segments and divisions. Importantly, we expect this trend to continue and expand beyond Samsung Group to other chaebols, which is likely to create a number of opportunities for global investors, particularly those with patient capital and a focus on operational improvement. The other emerging opportunity with South Korea, similar to what we are seeing Japan, is an increasing desire for growth outside South Korea, including acquisitions, joint ventures, and de novo efforts.

EXHIBIT 29

EXHIBIT 30

Korean Chaebols’ Recent Non-Core Divestiture Activity Has Been Significant

<table>
<thead>
<tr>
<th>CHAEBOL GROUP</th>
<th>ASSET DIVESTITURE</th>
<th>ACQUISER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Samsung Techwin, Samsung Thales, Samsung General Chemicals and Samsung Total Petrochemicals (2015)</td>
<td>Hanwha</td>
<td></td>
</tr>
<tr>
<td>Samsung SDI Chemical Division, Samsung BP Chemicals and Samsung Fine Chemicals (2015)</td>
<td>Lotte</td>
<td></td>
</tr>
<tr>
<td>Sold off 34 subsidiaries including POS-HIMetal and Posfine in 2015 alone</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plans to halve the number of subsidiaries by 2017 (25 domestic subsidiaries and 64 overseas subsidiaries to sell)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SRS Korea (KFC Korea, 2014)</td>
<td>CVC</td>
<td></td>
</tr>
<tr>
<td>Doosan Dong-A (2014)</td>
<td>YES24</td>
<td></td>
</tr>
<tr>
<td>Doosan InfraCore Machine Tool Division (2016)</td>
<td>MBK Partners</td>
<td></td>
</tr>
<tr>
<td>Doosan E&amp;C Heat Recovery Steam Generator Division (2016)</td>
<td>GE</td>
<td></td>
</tr>
<tr>
<td>Doosan DST (2016)</td>
<td>Hanwa</td>
<td></td>
</tr>
<tr>
<td>Hyundai Logistics (2016)</td>
<td>Lotte</td>
<td></td>
</tr>
<tr>
<td>Hyundai Securities, Hyundai Savings Bank and Hyundai Asset Management (2016)</td>
<td>KB</td>
<td></td>
</tr>
<tr>
<td>Dongbu Express (2014)</td>
<td>KTB PE</td>
<td></td>
</tr>
<tr>
<td>Dongbu Power Dangjin (2014)</td>
<td>SK Gas</td>
<td></td>
</tr>
<tr>
<td>FIS System (2015)</td>
<td>BK A&amp;G PE</td>
<td></td>
</tr>
<tr>
<td>Dongbu Parcel Services (2015)</td>
<td>KG Inicis</td>
<td></td>
</tr>
<tr>
<td>Dongbu Special Steel (2015)</td>
<td>HyundaiSteel</td>
<td></td>
</tr>
<tr>
<td>Dongbu Farm Hannong (2016)</td>
<td>LG Chem</td>
<td></td>
</tr>
</tbody>
</table>

Data as at August 2016. Source: Thomson Reuters SDC Platinum, Capital IQ.
While we have drilled down on examples in Japan and South Korea in this piece, our trip re-affirms our strong view that the move towards greater structural corporate efficiency is not only building momentum but also is extending further into other important Asian markets. Already, we have seen similar activity in Australia across financial services, in China across the quick service restaurant arena, and in India across the tower subsector of the telecommunications industry. Moreover, if credit conditions do turn less favorable in the coming years, we believe that more corporates will be forced to re-position their portfolios to compensate for the additional leverage that many companies have assumed during the current period of easy money and excess liquidity than we have seen in recent years.

**Point #3: Experiences Over Things Is Also Playing Out in Asia.**
While this theme is not a new one for us, the pace of implementation appears to have accelerated in recent months in Asia. Not surprisingly, the biggest and fastest growing bucket in the experiences market within EM Asia is services. Indeed, as one can see in Exhibit 31 below, Chinese millennials allocate three times more of their income to leisure activities than the average Chinese consumer. Another big area of growth potential within EM Asia is healthcare offerings, including private insurance and specialized surgery care, both of which continue to gain significant traction, especially in fast-growing consumer markets such as Vietnam, China, Indonesia, and India. Finally, within more traditional retail and restaurants we are seeing store designs that are being re-imagined with in store experiences as the primary attraction. Emerging consumer experiences that caught our attention during our trip include 1) the option of getting a manicure and/or massage while waiting for one’s dinner table; 2) multi-sensory dining experiences that incorporate – in addition of taste – sound, smell, and sight.

**EXHIBIT 31**

Chinese Millennials Not Only Save Less But Also Allocate More of Their Income to Leisure

<table>
<thead>
<tr>
<th>Spending Breakdown China Overall vs. Chinese Millennials</th>
</tr>
</thead>
<tbody>
<tr>
<td>Housing, Transport, Utilities</td>
</tr>
<tr>
<td>Shopping, Food</td>
</tr>
<tr>
<td>Shopping, Non-Food</td>
</tr>
<tr>
<td>Leisure</td>
</tr>
</tbody>
</table>

Data as at December 31, 2016. Source: Goldman Sachs Global Investment Research.

**EXHIBIT 32**

Given the Bifurcated Demographics in Asia, the Potential Remains Quite Significant in Both Developed and Developing Markets

**EXHIBIT 33**

Japan: Shift Towards Services as the Population Ages

Asia Pacific Tourists Accounted for More Than 25% of Global International Arrivals in 2016

25.6% of worldwide tourists came from the Asia Pacific region, with four out of five of those travelling intra-regionally.

Data as at 2017. Source: UNWTO.

There Is a Need for the Private Sector to Supplement Existing Healthcare Infrastructure...

Number of Hospital Beds per 1,000 People


However, it is not just EM Asia that is benefitting from the trend towards experiences, services in particular. Developed Asia too is an interesting play on this trend towards more services. In Japan, for example, low inflation and a declining population actually encourage savings and increase demand for services that support the elderly in single-person households, which is boosting overall services as a percentage of GDP (Exhibit 38). To be sure, one has to focus more on harnessing the benefits of aging demographics, but the magnitude and consistency of these structural trends are quite notable. Similar opportunities exist too in Australia, Singapore, and South Korea, we believe.

Our bottom line: We see a secular shift towards experiences over things in Asia that warrants investor attention. An aging society in large markets such as Japan and South Korea as well as steadily rising GDP-per-capita in Emerging Asia is creating a uniquely bifurcated market for service providers to access. Maybe more important, though, is that across all Asian markets that we periodically visit, including both developed and developing ones, there appears to be a secular shift away from conspicuous consumption of goods towards experiences such as travel, leisure, and wellness. If we are right and penetration rates do deepen further in the aforementioned areas, then asset allocators should be significantly increasing their weights to these areas while growth trends are still in acceleration mode.

The migration up the value-added ‘food chain’ is creating notable winners and losers, particularly among providers that can offer the perception of aspirational value to middle class consumers who increasingly want to upgrade their lifestyles.
The rise in services is playing out globally...


With Asia helping to lead the charge...


Point #4: Asia is also an emerging play on our private credit/illiquidity premium thesis. We also see an emerging trend – no pun intended – in many of the emerging markets that we have visited in recent quarters. Specifically, as we show in Exhibit 39, more and more corporates in places like India and Indonesia are shifting from traditional financial intermediaries in favor of complex solutions that can be underwritten by leading private credit players.

Our work continues to show that the U.S. dollar is in the process of topping, which suggests a much more favorable backdrop for both local debt and equity in the region versus the prior five years.
**EXHIBIT 40**

India Has a Relatively High Cost of Equity, and as Such...

India: Cost of Equity

<table>
<thead>
<tr>
<th>US 10 Yr Tsy Yield</th>
<th>India CDS USD SR 5 Yr</th>
<th>India INR Bond Yield</th>
<th>Equity Risk Premium</th>
<th>Cost of Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.2%</td>
<td>+80bp</td>
<td>6.6%</td>
<td>+360bp</td>
<td>11-13%</td>
</tr>
<tr>
<td>2.9%</td>
<td>+500-600bp</td>
<td>11-13%</td>
<td>11-13%</td>
<td></td>
</tr>
</tbody>
</table>


**EXHIBIT 41**

...In a Higher Growth Economy with Strong Nominal Growth, Local Debt Is Often a More Palatable Capital Markets Solution for Entrepreneurs

India: Cost of Debt

<table>
<thead>
<tr>
<th>US 10 Yr Tsy Yield</th>
<th>Sovereign Risk</th>
<th>Inflation/FX Risk</th>
<th>Credit Risk Premium</th>
<th>Cost of Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.2%</td>
<td>2.9%</td>
<td>6.6%</td>
<td>+940bp</td>
<td>16%</td>
</tr>
<tr>
<td>2.9%</td>
<td>+360bp</td>
<td>6.6%</td>
<td>+940bp</td>
<td>16%</td>
</tr>
</tbody>
</table>


Our bottom line: We believe that Private Credit is finally coming of age in Asia as an asset class, as both cyclical and secular tailwinds unfold. Many traditional banks are pulling back because of resource constraints (e.g., Indonesia), while others are suffering from the hangover from state-run competitors with artificially low cost of capital (e.g., India). Moreover, as private equity and capital expenditures rebound in the region, entrepreneurs as well as investment financiers are migrating towards non-traditional providers who can move quickly and are willing to embrace complexity. Given that we saw a similar backdrop in the United States and Europe after the Global Financial Crisis in 2009, our conviction is high that Asian Private Credit will follow a similar path in the coming years.

**Point #5: Robust Consumption Trends Remain; However, Understanding the Shift Towards Higher Value Offerings and the Corresponding Delivery Channels Is Now Much More Critical.** In the past investors could enjoy strong returns by just investing in basic consumption-per-capita stories. In particular, basic staples such as toothbrushes, white goods, and packaged food were all large market share gainers. To be sure, we still believe that GDP-per-capita growth will remain extremely robust (Exhibit 8); however, volume and price growth in many of these more traditional areas is now flat to down, driven by excess supply amidst saturated penetration levels.

Against this backdrop, we believe that the real opportunity is facilitating the transition from basic offerings to more sophisticated and differentiated ones, including aspirational brand items, in a technology-friendly way that allows shoppers to customize and/or enhance their experiences. In our view, it will mean creating aspirational products in a multi-channel format, including both physical stores and an online presence, that appeals to middle class and affluent customers who want to trade up. It also means moving into new local markets.

According to JD.com, more than 50% of shipping addresses in China are now outside of Tier 1 and Tier 2 cities.

**EXHIBIT 42**

With GDP-per-Capita Growing So Strongly, Total EM Consumption Is Now Growing 3x as Fast as Total DM Consumption

Global Household Consumption (US$ Trillions)

EXHIBIT 43

EM Share of Global Consumption Has Exploded in Recent Years, Despite a More Sluggish Growth Environment

Since 2003, EM’s share of global consumption has grown 16.2 ppt


EXHIBIT 44

$32 Billion Worth of Mobile Payments Will Be Made In 2021 — 10 Times That of 2013


EXHIBIT 45

Smartphone Ownership Rates in Emerging and Developing Nations Are Rising at an Extraordinary Rate, Having Already Climbed From a Median of 21% in 2013 to 37% in 2015

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>TOTAL %</th>
<th>18-34 %</th>
<th>35+ %</th>
<th>DIFFER.</th>
<th>LESS %</th>
<th>MORE %</th>
<th>DIFFER.</th>
<th>LOWER %</th>
<th>HIGHER %</th>
<th>DIFFER.</th>
</tr>
</thead>
<tbody>
<tr>
<td>AUSTRALIA</td>
<td>77</td>
<td>95</td>
<td>70</td>
<td>25</td>
<td>67</td>
<td>85</td>
<td>18</td>
<td>62</td>
<td>88</td>
<td>26</td>
</tr>
<tr>
<td>CHINA</td>
<td>58</td>
<td>85</td>
<td>43</td>
<td>42</td>
<td>40</td>
<td>86</td>
<td>46</td>
<td>49</td>
<td>75</td>
<td>26</td>
</tr>
<tr>
<td>INDIA</td>
<td>17</td>
<td>27</td>
<td>9</td>
<td>18</td>
<td>7</td>
<td>29</td>
<td>22</td>
<td>7</td>
<td>22</td>
<td>15</td>
</tr>
<tr>
<td>INDONESIA</td>
<td>21</td>
<td>39</td>
<td>7</td>
<td>32</td>
<td>7</td>
<td>42</td>
<td>35</td>
<td>10</td>
<td>31</td>
<td>21</td>
</tr>
<tr>
<td>JAPAN</td>
<td>39</td>
<td>77</td>
<td>31</td>
<td>46</td>
<td>31</td>
<td>52</td>
<td>21</td>
<td>21</td>
<td>54</td>
<td>33</td>
</tr>
<tr>
<td>MALAYSIA</td>
<td>65</td>
<td>88</td>
<td>46</td>
<td>42</td>
<td>26</td>
<td>79</td>
<td>53</td>
<td>44</td>
<td>75</td>
<td>31</td>
</tr>
<tr>
<td>PAKISTAN</td>
<td>11</td>
<td>13</td>
<td>7</td>
<td>6</td>
<td>5</td>
<td>22</td>
<td>17</td>
<td>5</td>
<td>14</td>
<td>9</td>
</tr>
<tr>
<td>PHILIPPINES</td>
<td>22</td>
<td>31</td>
<td>14</td>
<td>17</td>
<td>9</td>
<td>31</td>
<td>22</td>
<td>11</td>
<td>31</td>
<td>20</td>
</tr>
<tr>
<td>S. KOREA</td>
<td>88</td>
<td>100</td>
<td>83</td>
<td>17</td>
<td>80</td>
<td>95</td>
<td>15</td>
<td>79</td>
<td>95</td>
<td>16</td>
</tr>
<tr>
<td>VIETNAM</td>
<td>35</td>
<td>56</td>
<td>17</td>
<td>39</td>
<td>23</td>
<td>53</td>
<td>30</td>
<td>28</td>
<td>51</td>
<td>23</td>
</tr>
</tbody>
</table>

Data as at February 2016. Source: Pew Global Research.
Consistent with this view, we note that mobile devices have already dwarfed fixed Internet connectivity, including the traditional desktop; maybe more important, though, is the dawning reality that e-commerce trends in Asia are occurring in a radically different pattern than what we saw in the U.S. (i.e., large incumbents such as Target.com and Walmart.com poured billions of dollars into trying to protect their historical franchises against online start-ups, including Amazon). In EM Asia, by comparison, the shift towards online has been much more rapid and much more concentrated, as there were only a few major publicly traded competitors that had the wherewithal to invest in a sophisticated online strategy. As a result, it has been much more of a ‘winner take all’ mentality in places like China, with firms like Alibaba, Tencent, and JD.com essentially gaining Amazon-like stature in almost overnight fashion. All told, these companies have helped to create a $9 trillion mobile payments market, up sharply from just $15 billion in 2011, according to iResearch. The U.S. mobile payments market, by comparison, has increased to just $112 billion from $8.3 billion during the same period.

Importantly, the accelerating trend towards digital recognition, e-commerce, and mobile payments in Asia is not restricted to just China. Rather, we are seeing strong players across multiple verticals in India, Indonesia, and Vietnam. Interestingly, though, these markets are still wide open, as no local champion is being particularly favored. However, over time we do expect the eventual market leaders to create, similar to what we have seen in China, more of an economic virtuous circle.

EXHIBIT 47
When It Comes to Mobile Payments, China’s Activity Dwarfs That of the U.S.


Without question, these shifting trends in consumer buying behavior have profound implications well beyond traditional purchases. It extends notably into the footprint of the supply chain, including logistics, real estate, and transportation. Already, in mature markets such as South Korea, we see tangible examples of this shift; meanwhile, a similar pattern is now unfolding in large dynamic markets such as India. One can see this in Exhibits 48 and 49.

In EM Asia, the shift towards online has been much more rapid and much more concentrated, as there were only a few major publicly traded competitors that had the wherewithal to invest in a sophisticated online strategy.
Point #6: Asia’s Footprint Is Expanding. While the strong internal demand story in Asia is noteworthy, we would be remiss if we did not mention that Asia is also strengthening its inter-regional ties as well as expanding more into new markets. Importantly, we believe that the U.S. decision to pull out of the Trans-Pacific Partnership (TPP) will only accelerate this trend. Indeed, while the U.S. led TPP has faded into the background, the China-led RCEP (Regional Comprehensive Economic Partnership) has gained some momentum in recent months. Unlike TPP, RCEP covers many Asian countries, including both China and India. Together with China’s One Belt, One Road initiative, we think this endeavor will further bolster greater regional connectivity, particularly on the trade front.

EXHIBIT 50
Regional Trade Over Global Trade: TPPs Demise May Be RCEP’s Windfall

Somewhat uniquely, Asian companies are benefitting not only from surging domestic demand for higher value-added services, but also the opportunity to export their offerings abroad through a variety of channels, including M&A, joint-ventures, and de novo efforts.
Asia Trade Connectivity Will Likely Be More Important on a Go-Forward Basis

Countries in the TPP that are not in RCEP are Canada, Chile, Mexico, Peru and US. Countries in the RECP that are not in the TPP are China, India, Indonesia, South Korea, Cambodia, Laos, Myanmar, Philippines, and Thailand. Data as at December 2015. Source: IMF, UN, Haver Analytics.

EM Is Increasing Its Share of Global M&A

Beyond strengthening regional ties, we also expect Asian companies, particularly those firms that have moved up the value chain, to continue to expand abroad. Already, as we show below in Exhibits 54 and 55, respectively, China has ceded the lower value-added areas of its economy, so that it can expand its global reach. In our humble opinion, China will move beyond exporting high value-added products to consolidating global industries by expanding its footprint towards Europe, Asia, Africa, and Latin America. As we detail in Exhibit 55, China is now taking share in industries that were traditionally dominated by American, European, and Japanese manufacturers. We believe this trend is a secular one, and as such, will have significant implications on global pricing and inflation in sectors traditionally thought to be safe from the deflationary threat of China going global.

China Is Rebalancing Towards High Value-Added Exports...
EXHIBIT 55

...And Is Gaining Significant Market Share Across More Higher Value-Added Sectors

<table>
<thead>
<tr>
<th>China Exports as a % of Global Exports</th>
<th>2016</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electro-diagnostic eqp</td>
<td>7%</td>
<td>1%</td>
</tr>
<tr>
<td>Rails &amp; railway mat</td>
<td>4%</td>
<td>14%</td>
</tr>
<tr>
<td>Ships, boats etc</td>
<td>4%</td>
<td>18%</td>
</tr>
<tr>
<td>Electric Power M/c</td>
<td>10%</td>
<td>28%</td>
</tr>
<tr>
<td>Motorcycles &amp; cycles</td>
<td>12%</td>
<td>29%</td>
</tr>
<tr>
<td>Vapor boilers etc</td>
<td>4%</td>
<td>29%</td>
</tr>
<tr>
<td>Household type eqp</td>
<td>10%</td>
<td>34%</td>
</tr>
<tr>
<td>Telco Equipment</td>
<td>6%</td>
<td>34%</td>
</tr>
<tr>
<td>Optical instruments</td>
<td>8%</td>
<td>41%</td>
</tr>
</tbody>
</table>


Importantly, though, China is not the only country in Asia with global ambitions. Rather, we heard similar points of view regarding global expansion when we have visited with leading entrepreneurs in India, Indonesia, Vietnam, and South Korea. In our opinion, this desire for Asian companies to expand abroad represents a significant opportunity for global private equity firms to help facilitate entrance into new markets, including the U.S. and Europe. It also provides an opportunity for public equity investors to enjoy dramatic wealth creation in key strategic industries where Asian companies may need to buy their way into certain industries and/or markets.

"Moreover, both long and short investment opportunities linked to Asia’s ‘new economy’ are now exploding, as middle class consumers are dramatically shifting the way they do business across almost every sector we reviewed during our trip."
On the other hand, China has added an enormous amount of leverage in recent years. What some folks may not appreciate is that China became the world’s growth engine after the 2007 downturn by extending credit the same way the United States did with mortgage credit after the tragic events of 2001. As we show below in Exhibit 58, credit as a percentage of GDP has spiked to 260%, compared to a more modest 140% during the financial crisis. If credit growth continues in the mid-teens range, it would be on track to reach nearly 300% by 2021.

To be sure, while China can maintain strict capital controls in the short-term, it can’t do so forever. Moreover, if the country continues to run nominal credit growth above nominal GDP for an extended period of time, we believe that the currency will be forced to adjust.

EXHIBIT 58

If Credit Growth Slows to 12.5% and GDP Grows At 9%, China Debt-to-GDP Could Hit 300% in 2021

For our nickel, we actually believe that China is doing a lot of the right things to correct some of its past mistakes. In particular, as we show in Exhibit 59, the government has largely deflated the spike in financial services GDP growth. While short-term painful for the sector, we believe that the ongoing strength in other parts of the economy actually made the timing quite fortuitous. Also, the government is broadening and deepening the market by shifting credit growth towards mortgages and away from state-owned enterprises. In our view, this transition is a good one, and it should allow the country to increase debt as a percentage of GDP without the risk of a major overnight debt crisis.

#2: North Korea and Other Geopolitical Risks. Without question, the deepening crisis around North Korea is Asia’s most prominent flashpoint at the moment, driven by Pyongyang’s growing nuclear and ballistic missile capabilities. KKR Global Institute Executive Director Vance Serchuk believes that North Korea will continue to be a geopolitical roller coaster ride over the next 12-18 months. Interestingly, more important than the current volley of threats and insults being hurled between Washington and Pyongyang, in Vance’s view, is the intensifying U.S.-led campaign of economic warfare against North Korea’s illicit commercial networks, which Washington is pursuing in the hope of producing crippling pressure on North Korea that either yields meaningful negotiation or regime collapse.
Economic Sanctions Have Proved Ineffective in Dampening North Korean Real GDP Growth

Real GDP Growth Y/y, %

- South Korea
- North Korea

Data as at 2016. Source: Bank of Korea.

The Number of North Korean Provocations Has Increased Dramatically Since 2011

Cumulative Ballistic Missile and Nuclear Tests by Year

Kim Il-Sung 1984-1994
Kim Jong-II 1994-2011
Kim Jong-Un 2011-

Note: Accounts for full flight tests only and does not include partial tests of missile subsystems, tests of air defense systems or short range rockets and artillery firings. Data as at September 20, 2017. Source: CSIS Missile Defense Project.

In the months ahead, therefore, Vance expects a multiplication of U.S. Treasury Department designations towards companies, banks, and individuals that are facilitating unlawful business on behalf of the North in third countries, as well as ‘targeted warnings’ by Treasury about the need for intensified diligence around the risk of unintentionally doing business with any North Korean-linked entities. This viewpoint should not come as a major surprise, as we have already seen: 1) the Treasury Department designation in June of a Chinese bank as a ‘primary money-laundering concern’ for its ties to North Korea; 2) sanctions in August against ten Chinese and Russian firms for facilitating trade with North Korea; 3) a new executive order in September that significantly widens the Treasury Department’s authority to penalize any company or person doing business with North Korea by cutting off their access to the U.S. financial system and/or freezing their U.S. assets; 4) and the blacklisting of eight North Korean banks and 26 North Korean facilitators in four countries.

Despite Rising Geopolitical Tensions, Risk Premiums Have Actually Fallen in Many Parts of Asia

Risk Premium: LTM Earnings Yield – 10-year Bond Yield (ppt)

China
South Korea

Data as at September 15, 2017. Source: Bloomberg.

CDS Spreads Too Have Tightened; We Believe That the Opportunity for Them to Widen at Some Point Remains Quite High

5-year CDS Spread

China
South Korea
India

Data as at September 15, 2017. Source: Bloomberg.
Importantly, the U.S. unilateral pressure campaign is also likely to be a source of friction with Beijing, as many of the designated entities will be based in Chinese territory. However, our base view remains that we expect the U.S. will seek to moderate this fallout, as it did during the Iran sanctions push in 2010-2013, by carefully documenting how targeted entities are involved in illicit financial activity with Pyongyang, and by focusing fire on smaller, regional firms. In doing so, Washington will argue that it is going after criminal actors that threaten the integrity of the global financial system, rather than targeting the Chinese government.

Our bottom line: We do not anticipate the North Korea problem to be ‘solved’ in the foreseeable future; at best, intensifying pressure may lead to a diplomatic process in 12-18 months that in turn eventually produces an agreement imperfectly constraining the growth of Pyongyang’s weapons capabilities. But even that path will be strewn with elevated brinksmanship by the U.S. and North Korea, multiple rounds of start-stop diplomacy, increased U.S.-China tension, and worsening behavior by North Korea in order to prove that the U.S. pressure campaign is ineffective and counterproductive. If we are right, then it feels to us that investors may be underpricing near-term risk in the market. And even if we are wrong, our work shows the price to pay for insurance against this potential threat is surprisingly low (Exhibit 62 and 63, respectively).

#3: Slowing Global Trade. Another concern that we feel is growing in significance is the trajectory of global trade. We see several forces at work. First, China has begun a deliberate initiative to insource more of its intermediate goods, which has clearly affected the pace of imports. One can see this in Exhibit 64. Meanwhile, we have seen in major countries such as the U.S. and the United Kingdom a shift towards more nationalist agendas, many of which have the potential to derail growth rates, including in countries that populate the Asian growth miracle.

Our base case is that neither China nor the U.S. wants a full-fledged trade war, but we do think that global exports as a percentage of GDP have peaked. Consistent with this view, we also believe that global trade could also lag, not lead, global GDP during the next three to five years.

No doubt, this headwind is an important one to consider when allocating capital to Asia. In particular, we believe that China is committing substantial resources towards internalizing its semi-conductor and auto industries. If we are right, then excess capacity and potentially lower profits could lie ahead for certain global players that compete in these arenas.

That said, as we mentioned earlier, domestic consumption – compliments of robust demographics – remains outsized relative to other parts of the world. Moreover, with the U.S. backing out of TPP, we believe that Asia will become even more closely aligned, further fueling stronger bonds amongst the various players in the region. So, while we think that slower global trade will negatively impact certain areas of the global economy, we believe that Asia is best positioned to weather this shift in trade trends that we are envisioning.

"We believe that Private Credit is finally coming of age in Asia as an asset class, as both cyclical and secular tailwinds unfold."
Conclusion: Leaning In

Without question, this most recent trip across Asia supports our thesis that both cyclical and secular forces are now working in concert to create a favorable environment for capital deployment across a variety of asset classes in Asia. Key to our thinking is that the macro backdrop, including a more favorable currency environment as well as a more stable China, has turned more positive, particularly relative to the 2011-2015 period (i.e., when China’s nominal GDP collapsed to six percent from 20%). Beyond compelling macroeconomic conditions that we now see, Asia has now also emerged as an elegant play on some of our highest conviction investment themes, including corporate carve-outs, experiences over things, and the illiquidity premium.

EXHIBIT 66

We Believe That Asia Ex-Japan Is Now Finally Poised to Outperform. As a Result, We Have Boosted Our Exposure to this Region of the Global Capital Markets

Importantly, though, a more nuanced and thoughtful approach matters more than in the past. Specifically, we think that investors need to appreciate that rapid technological change is having a dramatic impact on which services and which service providers are flourishing in the new environment that we are envisioning. Moreover, given Asia’s current glut of excess savings, investors must learn to not only source compelling deals but also finance them in a way that takes advantage of today’s low rate environment.

Overall, though, in a world largely starved for structural growth, we believe that Asian equities and credits represent some of the best long-term value that we see across the global capital markets. Given this view, investors should consider ‘leaning in’ (i.e., increasing exposure) towards long-term thematic winners that we have identified in this article, including plays on aspirational brands, technological innovators, consumer financial services, and efficient healthcare providers. To be sure, there are risks associated with our positive outlook, but our base view is that the long-term investment profile is compelling enough to overcome short-term gyrations that could be caused by excess debt in China, rising geopolitical tensions on the Korean peninsula, and slowing global trade.

“

We believe that the real opportunity is facilitating the transition from basic offerings to more sophisticated and differentiated ones, including aspirational brand items, in a technology-friendly way that allows shoppers to customize and/or enhance their experience.

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Important Information

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