Outlook for 2018: You Can Get What You Need
TABLE OF CONTENTS

INTRODUCTION .......................................................... 3

SECTION I: MACRO BASICS ................................................. 11
Details on Global GDP .................................................. 11
United States Outlook .................................................. 12
European Outlook ..................................................... 15
Chinese Outlook ....................................................... 18
Brazilian Outlook ....................................................... 20
Equities Have More Potential Upside than Credit ................. 22
Oil Outlook ............................................................ 27
Where We Are in the Cycle/Expected Returns ...................... 29

SECTION II: KEY THEMES ................................................. 34
We Are in a Mid-cycle Phase of EM Recovery ....................... 34
Changing Preferences in Direct Lending ............................ 36
Buy Complexity, Sell Simplicity ...................................... 38
Deconglomeratization .................................................. 40
Experiences Over Things ............................................... 42
Central Bank Normalization .......................................... 44

SECTION III: RISKS/HEDGING ............................................ 46
Dependence on Technology and Financial Earnings ............. 46
A Very Optimistic Implied Default Rate ............................. 47
Stock/Bond Correlations Reverse .................................... 49
Buying Volatility/Hedges May Make Sense (Finally!) .......... 50
Social and Reputational Issues Will Remain Tail Risks in 2018 .. 51

SECTION IV: CONCLUSION ................................................. 52
Outlook for 2018: You Can Get What You Need

As we are poised to enter the 104th month of economic expansion amidst the second longest bull market on record in the United States, it is definitely harder to get ‘what you want’ when it comes to uncovering new and compelling investment opportunities. Credit spreads are tight, margins are elevated, volatility is low, and valuations are full in many instances. We are also adding stimulus to the U.S. economy at a time when it probably is not needed. The good news, however, is that our work shows that investors can still ‘get what they need’ in order to generate returns in excess of their liabilities. A major underpinning to our global macro and asset allocation viewpoint in 2018 is that the current investing environment in many ways increasingly feels like the late 1990s. Specifically, across many of the asset classes in which we invest on a global basis, it appears to us that overly optimistic investors are currently overpaying for growth and simplicity in many instances, while at the same time ignoring stories with complexity, uncertainty, and/or cyclicality. Therein lies a huge, long-tailed investment opportunity to arbitrage the notable bifurcation that has already begun to occur across many parts of the global markets, we believe.

“'You can’t always get what you want; but...you get what you need.'”

THE ROLLING STONES
As we are poised to enter the 104th month of economic expansion amidst the second longest bull market on record in the United States, it is definitely harder to get ‘what you want’ when it comes to uncovering new and compelling investment opportunities. Indeed, spreads are tight, margins are higher, volatility is low, and valuations are full in many instances. We are also adding stimulus to the U.S. economy at a time when it probably is not needed.

The good news, however, is that our work shows that investors can still ‘get what they need’ in order to generate returns in excess of their liabilities. A major underpinning to our global macro and asset allocation viewpoint in 2018 is that the current investing environment in many ways increasingly feels like the late 1990s. Indeed, as we show in Exhibit 3, Growth stocks are as expensive as they have been in nearly two decades (with top decile growth stocks trading at 18x book value), while the Russell 1000 Value Index is as cheap as it has been since the downturn in 2001. Make no mistake: We too are bullish on the technological change that is being ushered in during what we consider to be the Fourth Industrial Revolution, and we also appreciate many Growth companies today are actually generating cash flow (unlike in the late 1990s), but it does appear to us that overly optimistic investors are currently overpaying for growth and simplicity in certain instances, while at the same time ignoring stories with complexity, uncertainty, and/or cyclicalities. Therein lies a huge, long-tailed investment opportunity to arbitrage the normal bifurcation that has already begun to occur across many parts of the global markets, we believe.

Against this backdrop, the Global Macro & Asset Allocation team feels strongly that there are several actionable investment themes that multi-asset class investors should consider weaving into their portfolios in 2018 and beyond. They are as follows:

Our Asset Allocation Work Still Points to Equities Over Credit in 2018 When the KKR Global Macro & Asset Allocation team was first established in 2011, our initial big asset allocation call was to suggest that an investor could own Credit, High Yield in particular, and earn equity-like returns. Today, our top-down forecast shows that Liquid Credit – depending on the specific flavor – will earn three to six percent in 2018, while many Equities could earn seven to 10% this year. No doubt, Equities have more volatility inherent in their composition, but rates appear too low and spreads in Credit appear unusually tight, in our view. In fact, our proprietary model suggests that not only is the implied default rate on High Yield now close to zero, but also that the risk free rate is trading below its intrinsic value, particularly in Europe. Details below.

Stay Long: Our Emerging Markets Model Suggests that We Are Now Moving Towards Mid-Cycle, Despite Our View the Dollar Might Bounce at Some Point in 2018 After beginning to hook upwards in 2016, our proprietary Emerging Markets model now indicates that we are actually entering a mid-cycle outlook for EM, which is usually associated with solid, albeit more volatile, returns. Indeed, while valuation is no longer as compelling as it once was in EM, return on equity is improving, momentum is accelerating, and currencies are now appreciating. Importantly, we are constructive on both EM Equities and EM Local Government Debt but less so on EM Corporate Debt; at the sector level, we prefer Financials over Technology, which represents a change versus 2017. In terms of areas of focus, we favor Asia by a wide margin over Africa and/or Turkey, both areas where we see structural imbalances building.

New Macro Theme: Get Long Central Bank Normalization From our vantage point, 2018 will be the year that Quantitative Easing normalization amidst stronger global economic growth begins to actually impact portfolios. In our view, many investors appear to be underestimating this potential change in market technicals. In particular, we are very focused on the shift in G4 (Bank of Japan, Bank of England, Federal Reserve, and ECB) net supply that we will think will turn from deficit (i.e., shrinkage of available paper outstanding) to surplus in the second half of 2018 (Exhibit 106). If we are right, then the long end of the curve should finally start to move up in 2018 (we are using 3.00% target yield for U.S. 10-year, compared to 2.65% for the market). Meanwhile, we forecast five more U.S. rate hikes through the end of 2019, compared to just 2.5 for the market. These discrepancies in rate forecasts are noteworthy, in our view, as one thinks about asset allocation, sector positioning, and market volatility. See below for details, but we enter 2018 with a massive underweight to government bonds. For those with a penchant for pair trades, consider EM Sovereign Debt over developed market equivalent paper, German bunds in particular. Our proprietary model suggests that the ‘normal’ rate for the bund is closer to 140 basis points versus its current yield of 46 basis points. In the U.S., we see less of a mismatch, but our 3.00% forecasted year-end yield is up from 2.75% previously and the current level of 2.47%. Within Equities, we think that bank stocks, particularly in Europe, can benefit from our normalization thesis. We also think that areas such as mortgage servicing rights, which benefit from any upward stabilization in rates, should become more attractive on a go-forward basis. As part of this thesis, we also believe that asset allocators should look for ways to lock in what we view as artificially low cost, long-term liabilities. As a result, investors should be able to earn a healthy spread, even if overall asset returns are more modest in the future. Finally, given that Cash now actually yields something in the United States, we have boosted this position to overweight from underweight last year.

Notable Change in Our Thinking: Shifting Preferences in Private Credit Immediately following the Great Financial Crisis, Private Credit, Direct Lending in particular, was one of the most compelling investment opportunities that we uncovered across the global capital markets. Today, however, we view the opportunity set for Private Credit through a different lens. Key to our thinking is that robust pricing in the liquid credit markets is acting as credible competition to the traditional Direct Lending mandate; at the same time, there has been a lot of capital raised in the marketplace to meet the opportunity about which we have been speaking, particularly in the small deal size universe and in Europe (where we think that there are now more than 70 Direct Lending funds, many multiples of where we were just a few years ago). There has also been less supply from M&A recently. So, that’s the bad news. The good news is that we are seeing more and compelling opportunities in other areas of Private Credit, including the Asset-Based Finance part of the market. As we detail below, we like this opportunity set today, as we view it as one of our cyclicals plays on a recovering bank sector. We also see opportunities in the B-piece space of the Real Estate securities market (i.e., the lowest rating within the commercial mortgage debt stack), driven by retention rates that favor investors with long-duration capital. So,
as we detail below, we think now is the time to potentially tilt a little more towards Asset-Based Finance than Direct Lending in one’s asset allocation framework.

**Continued High Conviction Theme: Buy Complexity, Sell Simplicity** As we mentioned earlier, our base view is that market conditions are more akin to late-1990s than to the mid-2000s. Key to our thinking is that today, similar to what we saw in the 1998-2000 period, investors are willing to pay very high multiples for growth, both actual and potential. On the other hand, they feel uncomfortable holding positions that are currently underperforming or may have unprofitable subsidiaries or lines of business. As part of our ‘Buy Complexity’ thesis, we are currently constructive on certain MLPs, CCC-rated credits, and European Financials as well as a select number of beaten down Industrials, Healthcare, and Retail companies. On the other hand, many Growth companies – particularly on the private side of the ledger – appear fully valued; hence, we carry a 500 basis point underweight to Growth Investing within the Private Equity sub-segment of our target asset allocation. On the credit side, European High Yield, which now has a yields lower than the dividend yield of the Eurostoxx 600, feels mispriced. One can see this in Exhibit 1. Importantly, given the significant bifurcations that we are seeing across markets, we think that active management is finally poised to outperform again relative to passive benchmarking. In some instances we think that alpha generation could improve from being a negative drag to now adding 200-300 basis points of incremental return. This swing in alpha generation we are predicting is significant, as it could help to offset some of the lower forward return forecasts for many asset classes that we detail below in Section I.

**Continued High Conviction Theme: Experiences Over Things** We see a secular shift towards global consumers willing to spend more on experiences than on things these days. Leisure, wellness, and beauty represent important growth categories, all of which appear to be taking share from traditional ‘things.’ Our view is that mobile shopping and online payments are only accelerating this trend and our recent share from traditional ‘things.’ Our view is that mobile shopping and online payments are only accelerating this trend and our recent loss that ‘goods’ inflation has actually been negative on a year-over-year basis for the past 19 consecutive quarters and negative for developing countries. On the other hand, the work we lay out below shows that ‘goods’ inflation has actually been negative on a year-over-year basis for the past 19 consecutive quarters and negative for 53 of the last 72 quarters² since 2000. Not surprisingly, we view this deflationary pressure as a secular, not cyclical, issue for corporate profitability in several important parts of the global economy.

**Continued Theme: Our Paradigm Shift Framework Still Suggests a Different Kind of ‘Political Bull’ Market Has Arrived** Last year my colleague Ken Mehlman and I argued that coming public policy changes would be a market tailwind for most Equities (see Outlook for 2017: Paradigm Shift, January 2017), but for investors to watch closely for companies potentially being impacted by protectionism and populism. We anticipated the post-financial crisis combination of fiscal tightening and increased regulation was about to be replaced by more infrastructure spending, tax and regulatory reductions in the U.S., and tighter monetary policy. At the same time, we counseled investors to watch for increased trade restrictions and potential populist backlash against corporate power and industrial reputation. Importantly, we expect these trends to continue in 2018. Tax relief in the U.S. is now the law of the land, and Congress and the President will soon look for new ways to spur infrastructure spending. Regulations have been eased, but we see even further reforms coming in 2018. We also advise investors to anticipate even more scrutiny around trade and foreign direct investment in the U.S., the U.K., and other countries dealing with nationalistic movements. Finally, as we saw in this past year’s exposure of misconduct by leaders in media, government, entertainment, and business, the Internet’s radical transparency means more previously hidden personal and corporate misbehavior could be unearthed. These ‘discoveries’ will reinforce public distrust in many institutions, exposing organizations to heightened reputational and profitability risk. As such, investors – more than ever – need to diligence the governance, cultures, and potential reputational liabilities of companies in which they invest.

So, what do these high level macro investment themes mean for our specific target asset allocation recommendations this year? We note the following:

**We are reducing our Global Government Bond exposure back down to three percent from six percent.** As such, we are now a full 17% below our benchmark, which represents a massive underweight versus our 20% benchmark allocation. In both the U.S. and Europe, we forecast benchmark 10-year government bonds to generate losses of approximately two percent in 2018. Not surprisingly, this underweight is our largest asset allocation ‘bet’ in 2018. At current levels, our base view is that global government bonds can act neither as ‘Shock absorbers’ nor as meaningful income producers. Already, we note that the current 5-year trailing Sharpe ratio for U.S. long-term government bonds is 0.3, a 35-year low. Within our tiny three percent allocation, our advice is to allocate towards medium-duration local sovereign bonds, including those from India, Indonesia, and Mexico. Or, if an investor does need to own developed market bonds, very short-term government bonds in the U.S. seem like attractive relative value. See below for further details.

**We are raising Cash to four percent from one percent and a benchmark of two percent.** After being underweight Cash for 2017, we are now moving to overweight. We think allocating a little more to Cash makes sense at this point in the cycle for a couple reasons. First, it is actually starting to yield something, with U.S. overnight returns now on par with many long-duration, fixed income assets in both Europe and Asia. Second, we think increasing Cash exposure gives us some additional flexibility to lean in if and when market conditions turn bumpy, which we think they might in the second half of 2018 as central banks’ posture changes amidst a synchronous global recovery. Third, we want to start to bring down the beta of the portfolio at this point in the cycle.

Within Public Equities and Private Equity, we target an overweight position in Asia. See Exhibit 5 for details, but we hold a two hundred basis point overweight to both developed Asia (i.e., Japan) and developing Asia (e.g., Southeast Asia). As we detailed in our recent piece (see Asia: Leaning In, October 2017), we see both positive secular and cyclical forces at work. Asia too represents an attractive play on several of our key macro investment themes, including Deconglomeratization, Experiences Over Things, and the Illiquidity Premium in Private Credit. Overall, though, within Equities we retain our bias for Private Equity, where we still hold a 300 basis point overweight, compared to our benchmark weight across global Public Equities.

² See Exhibit 17.
Key to our thinking, as we show in Exhibit 82, is that Private Equity typically outperforms Public Equity in the later stages of market cycles. Not surprisingly, at a later stage in the business cycle, Private Equity often allows for more operational improvement as well as a more targeted approach in terms of sector and security selection.

Within Liquid Credit, we heavily favor Actively Managed Opportunistic Liquid Credit in 2018. See below for details in Exhibit 5, but we increase our allocation to 600 basis points this year versus 500 previously and a benchmark weighting of zero. By comparison, we hold a zero percent weighting in both traditional High Grade and High Yield bonds, compared to a benchmark weighting of 500 basis points in each asset class. Our logic for overweighting Actively Managed Opportunistic Credit at the expense of traditional Credit is predicated on our strong view that the way to generate outsized returns this late in the cycle is to 1) underwrite high conviction, idiosyncratic situations with deep industry expertise versus benchmark hugging/indexing; 2) leverage the ability to lean in periodically when the market dislocations do occur across any sub-segment of Liquid Credit (e.g., High Yield, Leveraged Loans, Structured Credit, etc.). Without question, from a top down perspective, we view our sizeable overweight to Actively Managed Opportunistic Credit as a direct play in 2018 on our Buy Complexity, Sell Simplicity thesis.

Within Private Credit, we are again reducing our Direct Lending exposure to two percent from five percent and down notably from a peak of 10% in January 2016. At the same time, however, we maintain our eight percent overweight in Asset-Based Finance versus a benchmark position of zero. Across Europe, the U.S., and Asia, we continue to see plentiful opportunities to deploy capital in areas such as residential construction, mortgages, locomotives, and other hard assets. We also favor some of the opportunities that we are seeing in the B-piece security space, which we view as an efficient way to harness the illiquidity premium against a challenging and complex regulatory environment.

We are boosting our Energy/Infrastructure allocation to seven percent from five percent and a benchmark of two percent. With oil prices finally stabilizing, we are now seeing more public and private resource companies selling ‘non-core’ assets at decent prices. In many instances these properties are producing assets that act somewhat as a ‘bond in the ground’ for investors, generating high single-digit cash-on-cash returns. Moreover, there is often the potential for development and efficiency upside, which can lead to a total return in the mid-teens in many instances. On the Infrastructure side, we also have a more constructive view, favoring areas such as mid-stream MLPs, towers, and other hard assets with contractual/recurring cash flows as well as the potential for restructuring and/or divestitures.

Overall, if we are right that governments around the world are now targeting improving growth in the real economy, not just boosting financial assets via monetary stimulus, then Real Assets should be a bigger part of one’s portfolio on a go-forward basis, we believe. We are making two modest asset allocation changes that provide guidance on where we think we are headed over the medium term.

First, we are trimming our long-held Leveraged Loan position to three percent from four percent. True, our 300 basis point position looks quite optimistic, compared to a benchmark weight of zero. However, by starting to trim our position weighting, we do want to suggest that even Levered Loans have gotten more expensive—and now with less compelling terms—at a later time in the cycle within our Liquid Credit universe. Previously, we have viewed Levered Loans as one of our safe haven assets. Meanwhile, despite lagging performance of late, we are adding that 100 basis points to our Distressed/Special Situations allocation, boosting it to three hundred basis points from two hundred basis points and relative to a benchmark of zero. Without question, generating outsized returns in the Distressed/Special Situations arena has been tough amidst substantial central bank easing. One can see this in Exhibit 85. However, the positive impact of quantitative easing (QE) is now likely to abate over the next 12-24 months; meanwhile, currently loose credit underwriting standards are already leading to capital misallocation in the corporate sector, we believe. Also, the recent changes around interest deductibility could accrue to this product area’s benefit. If we are right about these trends, then the backdrop for Distressed/Special Situations is likely to reward investors handsomely on a 12-36 month basis.

On the currency front, we think that, while the U.S. dollar is in the process of structurally peaking, it could bounce back a little in 2018 at some point. This view represents a tactical change in our thinking. A weaker dollar is now the consensus, and it comes at a time when the Fed is raising rates (and our forecast is two times more aggressive than what the consensus has priced in through 2019). At the same time, short-duration U.S. Treasuries are already attractively priced, and we also expect increased demand for dollars when corporations begin to repatriate capital under the new tax regime. Indeed, just consider that the dollar appreciated almost 13% around the time of the last repatriation in 2005. Given this backdrop, we see several actionable items to pursue within the currency market. First, we like the U.S. dollar against the GBP in 2018, given our more cautious view on Brexit. We also think the euro could weaken a little, and we remain cautious on the Turkish lira. Overall, though, we would view any dollar appreciation as a tactical reversal, and as such, we believe that many currencies, particularly within EM, still represent good long-term values for investors with a three-to seven-year outlook.

Therein lies a huge, long tailed investment opportunity to arbitrage the notable bifurcation that has already begun to occur across many parts of the global markets, we believe.
In terms of overall portfolio risks in 2018, we see several ones on which to focus. First, as we mentioned above and describe in more detail below, many markets have become increasingly bifurcated, which can be destabilizing to the global capital markets over time if these imbalances continue to widen further. Second, we see an increased dependence on the Technology sector to drive global earnings growth. In the Emerging Markets, for example, a full 32% of EPS growth is linked to the Technology sector in 2018. This sizeable dependence on one sector for earnings growth is noteworthy, as Technology is now a larger percentage of total EM market capitalization than Financial Services for the first time on record. Meanwhile, in the United States, Technology accounts for nearly 26% of total expected growth in 2018. Maybe more importantly, though, is that 50% of the total margin expansion in the S&P 500 since 2009 has come from the Technology sector, an influence we think many investors may currently underappreciate.

Third, geopolitical tensions around North Korea, according to my colleague Vance Serchuk, are likely to increase, not decrease, during the next six to 12 months. Coupled with what is going on in the Middle East, geopolitical tensions remain high at a time when market volatility is quite low. This discrepancy seems unsustainable, in our view.

Fourth, credit markets appear priced for perfection at a time of extraordinarily low global risk free rates. According to our KKR GMAA proprietary model, the implied High Yield default rate is now at 0.6% at the end of December 2017, compared to a historical average of 4.3% and a high of 8.3% as recently as February 2016. Meanwhile, in absolute terms, spreads on High Yield bonds are now at 358 basis points, well below the historical average of 580 basis points and just 23 basis points above the post-crisis lows. Duration too has been extended, though many bonds now trade well above par. In Europe, the situation appears even more over-heated; for the first time ever, the yield on local High Yield is trading well inside of the dividend yield that European Equities provide (Exhibit 1).

**Exhibit 1**
The Yearn for Yield Has Gotten Extreme, as European High Yield Now Offers Less Yield than Equities in Europe

---

**Exhibit 2**
There Has Been Strong Demand for High Yield and Growth Stocks. We Now See Better Opportunity in Other Areas of the Global Capital Markets

---

**Exhibit 3**
The Valuation Premium of U.S. Growth Stocks vs. U.S. Value Stocks Is Now the Most Extreme Since 2000

---

---
Finally (and maybe most importantly for long-term investors), were the current inverse relationship between stocks and bonds to break down (i.e., stocks sell off and bond prices decline, not appreciate) amidst stronger growth and less accommodative central bank policy, we believe that this shift in correlations could create a major dislocation that could catch many investors off-guard. This view is not our base case in the first half of 2018, but as we describe below in detail, it is one to which long-term investors should pay attention, particularly if the Fed is forced to accelerate its pace of tightening into a low unemployment, capex-constrained backdrop in the United States in late 2018 and/or early 2019.

Indeed, the opportunity set within many asset classes to generate alpha relative to passive indices is as large as we have seen in recent years, which helps support our overall approach to capital deployment in an environment where many index level gauges appear quite expensive relative to history.
Importantly, though, to be successful as an investor in 2018, one will need to be well versed beyond just trends in the global capital markets. Said differently, we also believe investors must watch for new controversies and developments involving key political ‘hotspots’ such as trade in 2018. Indeed, we expect a more confrontational tone between the U.S. and China around trade and intellectual property (IP). NAFTA also has the potential to become a worsening friction point in 2018, with the risk of even more disruption depending on how the Mexican election unfolds. However, President Trump is no ideologue. His rhetoric, often in service of negotiating a ‘better deal’, might differ from actual policy outcomes, and his approach can change based on other geopolitical events.

However, political saber rattling will not always be a negative. In fact, we also believe that intensifying rivalries and geopolitical events may also provide discrete upside to certain trade dynamics, which could actually be good for markets at times this year. Indeed, it was actually North Korea’s nuclear tests this past year that took the pressure off the US-South Korea FTA renegotiation. Similarly, a more confrontational dynamic with Beijing may eventually prove positive for U.S. trade relations with other Asian powers.

Looking at the bigger picture, we see today’s set up as one of mixed macro signals. One the one hand, we note that:

- Traditional valuation metrics for many liquid global indices generally appear full, particularly on the fixed income side. Meanwhile, on the equity side, market proxies for both Private and Public Growth investments seem to be trading at valuations that could lead to disappointing results in the future, we believe.
- Our forward-looking returns at the aggregate asset class level are collectively as low as they have been since we began publishing them at KKR (see Section I for details). Peak margins, full valuations, and low rates are all key drivers of our more modest forward-looking forecasts, which we detail in Exhibit 70.
- We are adding stimulus to the U.S. economy at a time when it is already performing quite well. Indeed, there is a growing risk that stronger-than-expected growth forces the Fed into action, particularly given low unemployment, increasing capital expenditures, and elevated financial asset prices. Consistent with this viewpoint, we have revised upward our forecast for both short- and long-term rates in the United States for the remainder of this cycle (see below for details).

On the other hand, our work below also shows that:

- Both cross-asset and intra-asset correlations have plummeted, and the case for active management to deliver significant alpha relative to passive investing has rarely been better. If we are right, then this backdrop could meaningfully offset the lower overall expected returns we are forecasting in many instances.
- Our proprietary economic models are still showing not only solid growth for the next 12-18 months but also that the cycle may extend for a bit beyond our original base case, which called for a 2019 economic slowdown in the U.S.
- Even at this later stage of the current bull market, several sizeable parts of the global capital markets appear fairly to attractively priced, given ongoing investor dissatisfaction with complexity and/or fear of value destruction caused by rapid technological change. Financials, in particular, still seem to be priced attractively, in our view.

So, as we enter 2018, our call to action is still to largely stay invested, albeit we are starting with a little more Cash (which was not our call last year, when we were underweight Cash). Said differently, we still think that thoughtful asset allocation, sound security selection, and tactical hedges will allow investors to get what they ‘need’ in terms of returns.

"
So, as we enter 2018, our call to action is still to largely stay invested, albeit we are starting with a little more Cash (which was not our call last year, when we were underweight Cash). Said differently, we still think that thoughtful asset allocation, sound security selection, and tactical hedges (which we describe in more detail below) will allow investors to get what they ‘need’ in terms of returns. However, we think that after a fast start to the year (which could enjoy strong EPS revisions, M&A activity, and buyback announcements), the second half of 2018 could prove to be a more challenging period.

Not surprisingly, within the macro construct we are describing, our advice is to definitely tilt away from things that seem expensive on both an absolute and relative basis (e.g., European High Yield and Growth Equity) and lean in towards areas where a complexity discount accrues to one’s favor, including Emerging Markets, Opportunistic Liquid Credit, Private Equity, Asset-Based Finance, and Real Assets with Yield and Growth. We also favor Cyclicals over Defensives on a global basis. As we showed earlier, valuation disparities today are as extreme as we have seen since the late 1990s; moreover, Sharpe ratios for U.S. stocks and traditional multi-asset class portfolios appear to be at unsustainably high levels (Exhibits 6 and 7). So, we are betting on some mean reversion to ‘get what we need’ in 2018. History rarely repeats itself, but it does often rhyme. In our view, now is again one of those times.

EXHIBIT 6
U.S. Equity Risk-Adjusted Returns Are Now Touching 17-Year Highs; We View this Performance as Unsustainable...

...A 60/40 Portfolio (60% Equity 40% Government Bonds) Has an Even Higher Risk Adjusted Return Ratio of 1.8. We Also Expect Some Performance Mean Reversion in this Area as Well, Particularly If Bond Prices Lag

Not surprisingly, within the macro construct we are describing, our advice is to definitely tilt away from things that seem expensive on both an absolute and relative basis (e.g., European High Yield and Growth Equity) and lean in towards areas where a complexity discount accrues to one’s favor, including Emerging Markets, Opportunistic Liquid Credit, Private Equity, Asset-Based Finance, and Real Assets with Yield and Growth. We also favor Cyclicals over Defensives on a global basis.
Our 2018 Asset Allocation Reflects Our Preferences for Emerging Markets Relative to Developed Markets, Opportunistic Liquid Credit, and Yield and Growth in the Private Markets

Data as at December 31, 2017. Source: KKR Global Macro & Asset Allocation analysis.

Section I: Macro Basics

In the following section we update several key top-down metrics, including not only our targets for GDP but also our outlook for earnings, rates, oil, cycle duration, and expected returns.

Details on Global GDP

Our base case is that 2018 is another year of decent global growth, though we see some notable contrasts versus 2017, particularly in what is driving growth across the various regions where KKR invests as a firm. Specifically, as we detail below, many of the drivers of our U.S. model are now becoming much more dependent on financial conditions, including net worth and credit spreads. In 2017, by comparison, almost all of the model’s indicators, both economic and financial, were positive, underscoring the breadth and easy comparisons each input faced last year. We also expect the Goods segment of the U.S. economy to outperform Services in 2018. This viewpoint represents a change in our thinking, but it is consistent with our forecast for stronger capital expenditures as well as ongoing growth in EM.

In Europe, meanwhile, our quantitative model, whose outputs we detail below, suggests that central bank policy remains the single largest driver of GDP growth. We anticipate that the European Central Bank (ECB) will remain quite dovish in 2018, given that Europe’s unemployment rate is still quite elevated relative to the U.S. (8.8% in the Eurozone versus 4.1% in the U.S.). Finally (and as we show below in Exhibit 9), China remains the most influential driver of global GDP growth. China, coupled with the rest of EM, explains fully 78% of total global growth in 2018.

EM Countries Are Expected to Account for More than Three-Quarters of Total Global Growth in 2018

Given such strong returns of late, we fully understand why an investor might feel that a cautionary outlook for 2018 is warranted. However, bull markets tend to end with a bang, not a whimper.

"
Unlike in Prior Years, Our GDP and Inflation Forecasts Are Generally In Line with the Consensus in 2018

### 2018 GROWTH & INFLATION BASE CASE ESTIMATES

<table>
<thead>
<tr>
<th>Country</th>
<th>GMAA Target Real GDP Growth (%)</th>
<th>Bloomberg Consensus Real GDP Growth (%)</th>
<th>KKR GMAA Target Inflation (%)</th>
<th>Bloomberg Consensus Inflation (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>2.7</td>
<td>2.6</td>
<td>2.2</td>
<td>2.1</td>
</tr>
<tr>
<td>Euro Area</td>
<td>2.0</td>
<td>2.1</td>
<td>1.6</td>
<td>1.5</td>
</tr>
<tr>
<td>China</td>
<td>6.5</td>
<td>6.5</td>
<td>2.3</td>
<td>2.3</td>
</tr>
<tr>
<td>Brazil</td>
<td>2.5</td>
<td>2.5</td>
<td>4.1</td>
<td>3.9</td>
</tr>
</tbody>
</table>

GDP = Gross Domestic Product. Bloomberg consensus estimates as at December 31, 2017. Source: KKR Global Macro & Asset Allocation analysis of various variable inputs that contribute meaningfully to these forecasts.

In the following section we break down global growth into the various regions that the KKR Global Macro & Asset Allocation team consistently tracks.

**United States Outlook** In terms of the U.S., my colleague Dave McNellis remains upbeat on growth again in 2018. Specifically, his bottom-up estimate for 2018 U.S. GDP is 2.7%, which is a tick above consensus of 2.6%, and at the same level suggested by our proprietary statistical model. In terms of what is driving his thinking, we would note the following:

- We see the backdrop for equipment capex, inventories, net exports, and government spending all potentially improving in 2018. Importantly, however, we envision Personal Consumption Expenditures (which are 70% of GDP) on a slowing trend, particularly given the recent decline in the U.S. consumers’ savings rate all the way back down towards 2.9% (Exhibit 123).

- We estimate the 2018 GDP tailwind from tax reform to 1) be modest (approximately 40 basis points) and 2) be already largely incorporated into our proprietary leading indicator variables such as equity prices, credit spreads, business confidence, consumer confidence, etc.

### EXHIBIT 10

**Unlike the Broad-Based Expansion We Forecasted Last Year, We See Fewer Drivers of U.S. GDP Growth in 2018**

<table>
<thead>
<tr>
<th>Forecast</th>
<th>1.7%</th>
<th>0.3%</th>
<th>0.1%</th>
<th>0.2%</th>
<th>2.7%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baseline</td>
<td>0.4%</td>
<td>0.1%</td>
<td>0.1%</td>
<td>0.1%</td>
<td></td>
</tr>
</tbody>
</table>

Our GDP leading indicator is a combination of eight macro inputs that in combination we think have significant explanatory power regarding the U.S. growth outlook. Data as at December 31, 2017. Source: Federal Reserve, Bureau of Labor Statistics, Nat’l Association of Realtors, ISM, Conference Board, Bloomberg, KKR Global Macro & Asset Allocation analysis.

### EXHIBIT 11

**U.S. Financial Conditions Are Actually Hovering Near 10-Year Lows, Despite 125 Basis Points of Fed Hikes Since December 2015**

The GS Financial Conditions Index is calculated as a weighted average of a policy rate, a long-term riskless bond yield, a corporate credit spread, an equity price variable, and a trade-weighted exchange rate. Bond yields and corporate bond spreads are the most important variables for the U.S., accounting for 85% of the index weight. Data as at December 31, 2017. Source: Bloomberg.
Our U.S. GDP Indicator Suggests that Growth Is Becoming More Dependent on Supportive Financial Market Conditions and Less Underpinned by Key Economic Fundamental Inputs Such as Housing Activity and Oil Prices

<table>
<thead>
<tr>
<th></th>
<th>DEC-17E as of June 30, 2017</th>
<th>DEC-18E Current</th>
<th>CHANGE 2018e vs. 2017e</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Conditions</td>
<td>0.3%</td>
<td>1.1%</td>
<td>0.8%</td>
</tr>
<tr>
<td>Household Wealth</td>
<td>0.2%</td>
<td>0.3%</td>
<td>0.1%</td>
</tr>
<tr>
<td>Global Policy Rates</td>
<td>0.1%</td>
<td>0.1%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Intercept</td>
<td>1.7%</td>
<td>1.7%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Graying Workforce</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Other Factors</td>
<td>0.2%</td>
<td>0.2%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Home Sales</td>
<td>0.2%</td>
<td>-0.1%</td>
<td>-0.3%</td>
</tr>
<tr>
<td>Oil Price Environment</td>
<td>0.3%</td>
<td>-0.4%</td>
<td>-0.7%</td>
</tr>
<tr>
<td>Total</td>
<td>2.8%</td>
<td>2.7%</td>
<td>-0.1%</td>
</tr>
</tbody>
</table>

Data as at December 31, 2017. Our GDP leading indicator is a combination of eight macro inputs that in combination we think have significant explanatory power regarding the U.S. growth outlook. Source: Federal Reserve, Bureau of Labor Statistics, National Association of Realtors, ISM, Conference Board, Bloomberg, KKR Global Macro & Asset Allocation analysis.

In terms of inflation, we expect headline CPI inflation of 2.2% in 2018, essentially unchanged versus 2017 and just a hair above the consensus of 2.1%. Given that Food and Energy are excluded from Core CPI, we think it will likely remain stuck at or below two percent in 2018. Core inflation trends continue to be dominated by services-related factors such as shelter, healthcare, and education, as well as secular core goods deflation. One can see this in Exhibit 17.

"From our vantage point, 2018 will be the year that Quantitative Easing normalization amidst stronger global economic growth begins to actually impact portfolios.

Meanwhile, our Fed Funds outlook continues to envision rate hikes above what the market is pricing, but below the Fed ‘dots plot,’ which shows the projections of all the members of the Federal Open Market Committee. Specifically, Dave’s view is that the Fed hikes three times in 2018 and two more times in 2019. Importantly, though, our forecast is meaningfully above current futures market pricing, which embeds just two hikes in 2018 and just a 50% chance of any additional hike in 2019. (Exhibits 18 and 20).
In terms of 10-year yields, we see them grinding higher and hitting 3.00% this year and 3.25% at our expected cycle peak in 2019. As such, our forecast remains above current market pricing (Exhibit 19), but quite mild versus history. We think a U.S. 10-year yield target of 3.00% - and not something higher - makes sense for 2018, given relative value dynamics versus European rates (Exhibit 105). Similarly, we think 3.25% represents a reasonable high end of the range for this cycle, given our views on inflation, demographics, and technological change.

EXHIBIT 16

Putting All the Pieces Together, We Expect Headline CPI of 2.2% in 2018, Just a Tick Above Consensus of 2.1%

Full-Year 2018e U.S. CPI Inflation

<table>
<thead>
<tr>
<th>Component</th>
<th>Weighting</th>
<th>2018e</th>
</tr>
</thead>
<tbody>
<tr>
<td>Headline CPI</td>
<td>2.2%</td>
<td></td>
</tr>
<tr>
<td>Core CPI (79% of Total CPI)</td>
<td>1.9%</td>
<td></td>
</tr>
<tr>
<td>Food (13% of Total CPI)</td>
<td>1.1%</td>
<td></td>
</tr>
<tr>
<td>Energy (8% of Total CPI)</td>
<td>8.0%</td>
<td></td>
</tr>
</tbody>
</table>


EXHIBIT 17

U.S. Core Inflation Trends Are Heavily Influenced by Areas Where We See Little to No Pricing Pressure

% Weighting Within Core CPI

- 'Core Core' Goods 20.4%
- 'Core Core' Services 18.3%
- Shelter 42.9%
- Telecom 2.9%
- Education 3.9%
- Health Care 10.8%

* 'Core core' goods = goods ex food, energy, tobacco, and healthcare commodities. 'Core core' services = services ex shelter, healthcare services, education, and telecom. Data as at November 30, 2017. Source: Bureau of Labor Statistics, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 18

Our Fed Funds Outlook Continues to Envision Rate Hikes Above What the Market Is Pricing, but Below the Fed ‘Dots Plot’

Current Expected Fed Funds Rates

- FOMC
- GMAA
- Futures Mkt


EXHIBIT 19

We Look for the U.S. 10-Year to Reach 3.00% in 2018 and 3.25% at Cycle Peak

U.S. 10-Year Yield Target

<table>
<thead>
<tr>
<th>Year</th>
<th>KKR GMAA</th>
<th>Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>3.00%</td>
<td>2.65%</td>
</tr>
<tr>
<td>(Cycle Peak)</td>
<td>3.25%</td>
<td>2.77%</td>
</tr>
</tbody>
</table>

Data as December 20, 2017. ‘Market’ expectation is as per interest rate forward market pricing. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.
We Are Well Above the Market in Cumulative Expected Fed Hikes in 2018 and 2019

![Number of Fed Hikes Expected Thru 2019](chart)

Interest Rate Futures Market | KKR GMAA Forecast
---|---
2.5 | 5.0


European Outlook My colleague Aidan Corcoran is looking for another solid year of GDP growth in the Eurozone (EZ), with a base case of two percent growth, compared to a consensus estimate of 2.1%. Importantly, this growth is finally being shared across almost the entire EZ area. In fact, the cross-country variation in GDP growth rates within the Eurozone is now at or near the lowest point since its founding, aided by the ECB’s aggressive quantitative easing. One can see this improvement in Exhibit 21. We are also seeing more sectors participate in the recovery. Even Eurozone industrials firms, which have suffered from an energy cost disadvantage versus their U.S. peers, now report hiring intentions at all-time highs (Exhibit 22).

EXHIBIT 21
Cross-country Variation in GDP Growth Rates Is Near All-time Lows; this Data Point Underscores Our View that the Entire Eurozone Is Recovering this Time

![Cross-country variation in GDP growth rates is falling](chart)

Standard Deviations of Real GDP Growth Divergence, Eurozone, %

Data as at 3Q17. Source: Eurostat, KKR Global Macro & Asset Allocation analysis.

What is fueling this strong momentum? Without a doubt, the ECB’s QE has been a key driver. This heavy reliance on the ECB may give pause to some investors (given the ECB is now in the midst of tapering), but we believe that the outlook is actually still quite constructive. Key to our thinking is that, while the rate of change is slowing, the ECB is still on track to add about a third of a trillion euros to its balance sheet in 2018. One can see this in Exhibit 23. Moreover, as we show in Exhibit 24, the lion’s share of the buying will still occur in the sovereign market, which should be supportive of an ongoing technical bid in the market in the first half of 2018.

EXHIBIT 22
Eurozone Industrials’ Employment Expectations in the Eurozone Are Now at All Time Highs

![Industrials firms are hiring aggressively](chart)

Industrials Employment Expectations, Next Three Months, % of Balance Positive Minus Negative Respondents

Data as at 3Q17. Source: Eurostat, Haver Analytics.

EXHIBIT 23
The ECB Is Still Set to Add Over a Third of a Trillion Euro-Dominated Bonds to Its Balance Sheet in 2018

![Size of ECB Balance Sheet, 2017e vs. 2018e, Euro Billions](chart)

Data as at 3Q17. Source: ECB, KKR Global Macro & Asset Allocation analysis.
So, then what is the key risk facing Eurozone investors in 2018? In our humble opinion, even with QE remaining a solid tailwind, we continue to feel that the price of the German bund is too rich in the context of the robust Eurozone recovery that we have described above. The easiest way to see this is to note that five-year ahead EZ inflation is, on average, less than one percent per year below U.S. inflation. At the same time, however, the price of the bund is still more like two percent below the U.S. Treasury (Exhibit 25).

Our quantitative bund price forecasting model tells a similar story. Specifically, as we show in Exhibit 26, it indicates that a rate of 1.4% on the 10-year bund would be an appropriate yield for the Eurozone today. While we do not think we get a sell-off to 1.4% in 2018, we do look for a normalization to one percent in 2018, with a significant risk of a more substantial bear market in European rates over time.

In our humble opinion, even with QE remaining a solid tailwind, we continue to feel that the price of the German bund is too rich in the context of the robust Eurozone recovery.
Interestingly, our quantitative GDP model, which we detail in Exhibit 27, actually points to a deceleration in Eurozone growth to 1.6% in 2018, from above two percent in 2017. Last year, by comparison, our model was well above consensus growth forecast for the entire year. As we look through the model’s drivers of growth for this year, the major drags come from a strengthening euro currency and a still-weak housing recovery. However, the qualitative indicators that Aidan and the KKR European Real Estate team monitor suggest that the housing recovery will not actually be as weak as our model assumes; also, if the dollar bounces in 2018 as we suspect it might, some of its increase will likely be at the expense of the euro, which could be good for local European exports in the near term. As such, we feel comfortable with our two percent GDP call – but will be watching this area of the economy particularly closely. On inflation, we think there is more weakness ahead, or at least through the first half of 2018. Specifically, as we show in Exhibit 29, we forecast inflation to fall to 1.2% in March 2018; thereafter, however, we do expect it to rise modestly to 1.6% by December 2018.

**EXHIBIT 27**

Our Real GDP Leading Indicator Shows Growth Slowing by the Second Half of 2018 in Europe

![Eurozone Real GDP Leading Indicator, Y/y](image)

Data as at December 31, 2017. Source: KKR Global Macro & Asset Allocation analysis.

**EXHIBIT 28**

Housing (e.g., Residential Mortgages and Residential Permits) Are Still Not Yet Fully Contributing to the Eurozone Recovery

![Elements of 2018e Eurozone GDP Forecast](image)


**EXHIBIT 29**

We Expect a Weaker Eurozone Inflation Outlook in the Immediate Future, but then Rising by the End of 2018

![Headline CPI Inflation With Forecasts In Blue](image)

Data as at December 31, 2017. Source: ECB, KKR Global Macro & Asset Allocation analysis.
Our Base Case Calls for a Normalization of EZ Rates to 100 Basis Points from 46 Basis Points in 2018, Not the 140 Basis Points Our Theoretical Model Currently Predicts

Turning to the U.K., Brexit remains the dominant theme, and on this front events are unfolding at a rapid pace. Cutting through the sound and fury, our belief is that progress is finally being made in the Brexit negotiations. So, given the recent momentum, our base case is that the U.K. economy will continue to post positive GDP growth in 2018 and 2019. However, we remain sensitive to the downside risks, particularly as the U.K. has a history of long and deep recessions. In fact, as Exhibit 31 shows, the average duration of U.K. recessions is a little over four quarters of negative growth, with an average peak to trough fall of 4.4 percentage points of GDP.

To be clear, such a recession is not in our base case. We believe that ultimately the U.K. will come to mutually beneficial trading arrangements with the EU, U.S., China and its other key trading partners. However, a meaningful recession is a realistic downside case that we plan for in all our investments with U.K. exposure. This is because the U.K. is not just vulnerable to Brexit mishaps, but also has its own domestic vulnerabilities. To pick just one of these, Exhibit 32 shows U.K. non-bank consumer credit outstanding, which has increased aggressively in recent years, and is still growing at double-digit rates. Given this viewpoint, we remain quite cautious in our underwriting of U.K. risk assets.

Nominal GDP in China fell 68% from 2011 to 2015; as such, China’s economy has already crashed, in our view.

Chinese Outlook For China, my colleague Frances Lim believes that real GDP growth will decelerate 30 basis points to 6.5%, driven by a cooling housing market, more modest infrastructure spending growth, increased anti-pollution measures, and additional supply side reforms. These headwinds, we believe, will be partially offset by a resilient consumer as the job market is tight, wages are rising, and consumer confidence remains strong. Furthermore, stronger U.S. growth could lift local export demand in China, we believe.
Nominal GDP in China Fell 68% from 2011 to 2015; as Such, China’s Economy Has Already Crashed, in Our View

EXHIBIT 33

By Shrinking Capacity in the Industrial Sector, China Has Enabled Profits to Increase; This Development Is an Important One, We Believe

Importantly, our recent trip to China leads us to believe that the overall pace of growth feels more sustainable, a goal that the government again recently underscored as a key priority. There are several factors that influence our thinking. First, industries that faced sales downturns related to corruption investigations now benefit from easier year-over-year comparisons. Second, Chinese locals feel not only more confident in the government’s command of the domestic economy, but also the country’s role in the global economy, particularly as the U.S. shifts towards more of a nationalistic agenda. Finally, many ‘new economy’ sectors are booming with fresh sources of funding, more innovation, and job creation, which are all collectively helping to offset weaknesses in stagnant parts of the ‘old economy.’

EXHIBIT 36

China Financial Conditions Have Tightened Most Visibly in M2 and the Shadow Banking Sector

**EXHIBIT 37**

**Services, Not Manufacturing, Now Drive Growth in China**


---

**EXHIBIT 38**

**With Both Headed Higher This Year, Chinese Core and Headline Inflation Should Begin to Converge**


---

In terms of inflation, we think China headline inflation will trend upward towards core inflation’s higher level in 2018. This convergence is noteworthy because, as we show in Exhibit 38, headline inflation has been running well below core inflation for quite some time. So, why will this finally happen? Our view is that food price inflation, which was a 35 basis points drag to headline inflation in 2017, will normalize this year, while higher oil prices could add another 35 basis points to overall CPI in 2018, we believe.

Overall, while we expect growth to cool in China, we do not expect a sharp deceleration, and while inflation will rise, it will remain within the government’s comfort zone. Macro prudential measures will remain in place to restrain credit growth in the shadow banking sector and control capital outflow pressures, and as such, it should allow the People’s Bank of China to keep the benchmark interest rate steady in the coming year.

**Brazilian Outlook** My colleague Brian Leung and I are forecasting 2.5% real GDP growth for Brazil this year, compared to just 0.7% growth in 2017 and a consensus forecast of 2.5% for 2018. This re-acceleration is a big deal, in our view. Indeed, after the 11-quarter long recession, Brazil’s economy is finally gaining traction (Exhibit 39). Our call for a cyclical recovery will be underpinned by sharply lower interest rates, declining inflation, higher real wages, and a continued rebound in consumer/business confidence.

**EXHIBIT 39**

We Believe Brazil’s Real GDP Could Grow 2.5% Year-over-Year in 2018, Which Would Represent a Notable Improvement

Data as at December 31, 2017. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

After the 11-quarter long recession, Brazil’s economy is finally gaining traction. Our call for a cyclical recovery will be underpinned by sharply lower interest rates, declining inflation, higher real wages, and a continued rebound in consumer/business confidence.
EXHIBIT 40
The 725 Basis Points of Central Bank Rate Cuts Since 2016 Could Serve as a Major Tailwind for Brazil’s Economy in 2018

EXHIBIT 41
Brazil Real GDP Turned Positive in 2017 After Eight Quarters of Negative Growth; We Expect the Rebound to Continue in 2018

EXHIBIT 42
As Reflected by Its CDS, Brazil’s Financial Conditions Have Eased Considerably

In terms of inflation, we expect the headline IPCA inflation to stay benign in 2018, rising to ‘just’ 4.1% in 2018 from a low of 2.7% in 2017. In terms of specifics, we believe that the bulk of the inflation increase will likely be driven by food price inflation normalization after plummeting to negative 4.2% in 2017. While we are forecasting a notable increase in inflation, our 2018e inflation forecast of 4.1% will still be a full 40 basis points below the central bank’s target of 4.5%. Importantly, with inflation expectations well anchored and the output gap still sizable, we believe the central bank can afford to keep the Selic rate near the record-low levels of seven percent throughout 2018. If we are right, then Brazilian financial conditions should remain accommodative, helping to lower consumer debt servicing costs. One can see this in Exhibit 44.

EXHIBIT 43
With Inflation Recently Falling to 19-Year Lows, Brazil Has Been Able to Aggressively Cut Interest Rates


Data as at December 31, 2017. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Data as at December 31, 2017. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Data as at December 31, 2017. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.
EXHIBIT 44
Aggressive Monetary Easing Should Continue to Lower Consumer Debt Servicing Costs in Brazil

So, against an improving macro backdrop, what are the risks that investors should consider? Well for starters, Brazil’s fiscal fragility remains noteworthy. All told, Brazil’s public sector deficit is currently a sizable 8.5% of GDP, which is a big reason why it is still running with twin deficits (fiscal and current account). Until there is notable improvement in these areas, the country’s public load will continue to worsen. Already, debt-to-GDP has surged to 74% of GDP, compared to 55% just three years ago (Exhibit 46).

We also believe that current political distractions associated with the October 2018 general elections will likely prevent the Temer administration from passing comprehensive social security reform in the near term. As a result, we do have some concerns that lack of progress on fiscal consolidation could derail the nascent recovery in consumer and business confidence, reignite fears of Brazilian real depreciation, and again lead to higher inflation expectations. Were this scenario to unfold, we believe that the central bank would likely have to tighten monetary policy sooner than expected, which would likely dent the constructive base case we are currently forecasting.

As our target asset allocation framework suggests, we still view Public Equities as a more compelling asset class than Liquid Credit at this point in the cycle.
bonds were yielding 19.5% versus 8.5% for the S&P 500; moreover, as recently as December 2015, High Yield bonds were yielding 8.8% versus 6.2% for the S&P 500. One can see the progression of the change in relative value across asset classes in Exhibit 47.

**EXHIBIT 47**

The Earnings Yield on the S&P 500 Is Now Almost on Par With Yield on U.S. High Yield Bonds

<table>
<thead>
<tr>
<th>Year</th>
<th>S&amp;P 500 Earnings Yield</th>
<th>U.S. HY Effective Yield</th>
<th>10yr UST Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>6.2%</td>
<td>2.2%</td>
<td>2.4%</td>
</tr>
<tr>
<td>2015</td>
<td>8.8%</td>
<td>2.3%</td>
<td>5.7%</td>
</tr>
<tr>
<td>2017</td>
<td>19.5%</td>
<td>5.5%</td>
<td>2.2%</td>
</tr>
</tbody>
</table>

Earnings yield based on 12-month forward EPS. Data as at December 31, 2017. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

**EXHIBIT 48**

However, Earnings Need to Come Through in 2018, as Traditional Valuation Metrics for Stocks Now Appear Somewhat Expensive

S&P 500 Valuation Relative to History (Since 1990)

- Trailing PE
- Fwd PE
- EV / EBITDA
- P/B
- P/S
- EV / Sales

Left - handscale

Right - hand scale

Data as at December 31, 2017. Source: Factset.

From a cyclical perspective, we still see several important macro tailwinds to bolster S&P 500 earnings growth in 2018, including rising home prices, robust consumer confidence, and strong ISMs. One can see the importance of all the various macro inputs we track in our Earnings Growth Leading Indicator (EGLI), which we decompose in Exhibit 50. If we are right, then Equities could enjoy more upside from current levels, we believe. The other big positive, which we describe in more detail below, is tax reform.
To this end, we note that President Trump’s tax reform agenda provides the biggest potential boost to earnings, of which about $1.1 trillion is cash. As such, we estimate that much of this $1.1 trillion will be brought back onshore and taxed at 15.5% and the remainder (approximately $1.5 trillion permanently invested abroad) will be taxed at eight percent. The tax is expected to be payable over a period of eight years, so we estimate the hit to 2018 EPS will likely be around four dollars per year for the next eight years. However, we do note that the analyst community may opt to adjust their EPS figures for this item as a one-time charge and/or put the expense below the line. As such, we will continue to monitor and update our forecasts accordingly.

- **Repatriation / Buybacks:** We assume that the aforementioned $1.1 trillion of accumulated cash earnings will be brought back onshore at a one-time tax rate of 15.5%. We then assume that 50% of the after-tax proceeds are used for share buybacks in the first year. If we are right, then this addition could add two to three dollars, we believe, to 2018 EPS.

- **Capping of Interest Expense Deductibility:** Our base case assumes a capping of interest expense deductibility to 30% of EBITDA for four years, then to 30% of EBIT thereafter. Under such a provision, the impact on overall EPS looks to be negligible. In fact, our work shows that less than five percent of U.S. companies in the Russell 1000 are likely to be affected. In this light, while this provision could be a material headwind for highly levered companies, in aggregate we expect an EPS headwind of only about one dollar to S&P 500 companies.

So, when we bring it all together, our 2018 EPS forecast for the S&P 500 is now $154, compared to our prior 2018 forecast of $141 (which included a more modest tax cut), a bottom’s-up consensus forecast of $148 (which we think will increase as sell-side analysts fully adjust for the new tax code), and a top-down consensus forecast of $153 (with a range of $145 to $164). Overall, we believe that we are more optimistic than the sell-side analyst community, but in-line with top-down views in key areas such as revenue growth, operating leverage, etc.

Importantly, embedded in the forecast is our belief that net profit margin will peak at a record 11.1% this year, which is higher than our original assumptions for both 2018 and 2017 (Exhibit 52). As one might expect, the lion’s share of the 2018 margin expansion will be driven by the anticipated lower tax rate boost to EPS growth, not significant operating leverage at the business unit level. Thereafter, we do expect margins to decline modestly from such high levels as late-cycle pressures lead to higher labor and input costs; in addition, as we mentioned earlier, we do expect some of the initial boost from tax reform to get competed away over the next few years.

We think that investors are underestimating the incremental return on capital for the financial services industry, which is part of our U.S. base case forecast.

In terms of our specific EPS outlook for 2018, we are forecasting organic earnings growth of eight percent for the S&P 500, which is roughly 30% lower than the 11.8% implied by our Earnings Growth Leading Indicator (EGLI). We are using a lower organic growth estimate because we assume that our EGLI indicator, particularly the more cyclical components of consumer confidence, ISM and credit spreads, has already incorporated some boost/optimism from corporate tax reform (Exhibits 49 and 50, respectively).

Meanwhile, we prefer to treat the impact of corporate tax reform as a separate and distinct earnings driver. To this end, we note that President Trump’s tax reform agenda provides the biggest potential boost to our EPS estimate. All told, we think that – with all its moving pieces – it could collectively add an additional $11.20 to 2018 EPS in 2018. We note the following inputs to our model:

- **Lower Corporate Tax Rate:** Our 2018 base case incorporates a 21% corporate tax rate. Previously, we had assumed the tax rate would fall to 25% from 35%. All told, we now estimate the gross boost to EPS is approximately $13-$14 in year one, though we caution folks that some notable portion of the gross tax benefit could quickly be competed away under certain potential scenarios.

- **One-time Tax on Foreign Cash and Earnings:** U.S. multinationals have accumulated approximately $2.6 trillion in foreign retained earnings, of which about $1.1 trillion is cash. As such, we esti-
In terms of sector trends, there are several noteworthy ones on which to focus. First, while the lower corporate tax rate should significantly boost Consumer Discretionary earnings in 2018, we worry that highly competitive and commoditized industries within the sector (e.g., consumer durables and apparel, retailing, and consumer services) will struggle to retain the entire benefit of the tax cut beyond 2018. It seems likely that a large portion of the excess profits could be passed on to consumers via lower prices and workers via higher wages as many of these companies lack pricing power and need to compete for both market share and labor.

Probably more noteworthy is that around 50% of the total margin expansion since 2009 has come from just the Technology sector, with Apple accounting for a full 20% of total margin expansion during this same period. So, with Technology margins already at 20-year highs (20%) and a full 1000 basis points higher than overall S&P 500 margins, any deterioration in technology company margins would have a disproportionate effect on overall S&P 500 net margins. This view is not our base one at the moment, but as we describe below in our Risks/Hedging section, we think Tech’s disproportionate contribution to earnings growth does warrant investor attention.

“Probably more noteworthy is that around 50% of the total margin expansion since 2009 has come from just the Technology sector, with Apple accounting for a full 20% of total margin expansion during this same period.”
Our 2018e S&P 500 EPS Forecast Is Approximately $154 per Share, Compared to a Bottom-Up Consensus of $148 and a Top-Down Consensus of $153. 

From a valuation standpoint, we think that the S&P 500 can trade around an 18-19x P/E multiple, which appears reasonable relative to history at this point in the cycle. Without question, the market will look more attractive on forward earnings than on trailing (given the notable bump from tax cuts that will be enacted this year). However, we believe that some of this step-up in earnings will be discounted by investors worried about whether the current windfall will be competed away in the form of higher wages, increased operational costs, and intensified pricing schemes. Ultimately, though, our research shows that multiples tend to stay constant or even improve in the later stages of a bull market, and as such, we are confident that no significant multiple degradation is likely in 2018.

With oil prices finally stabilizing, we are now seeing more public and private resource companies selling ‘non-core’ assets at decent prices. In many instances these properties are producing assets that act somewhat as a ‘bond in the ground’ for investors, generating high single-digit cash-on-cash returns.

We Think the S&P 500 Can Trade Around a 18-19x P/E Multiple...

...Which Implies a 7-13% Total Return (Including Dividends)
Based on these inputs, the S&P 500 could provide a total return of around seven to 13% in 2018, with two percent of that return coming from the dividend. In our view, this return would still represent a superior one to Credit instruments such as High Yield. As we show in Exhibit 57, our total return expectation for U.S. High Yield is in the three to four percent range over the next 12 months. Our base case assumes that credit spreads will stay relatively flat in 2018, compared to the notable tightening we have seen in prior years. As a result, the current coupon yield of 6.4%, once adjusted for approximately 370 basis points of expected credit and capital losses from a rising five-year U.S. Treasury yield, will only get us to a return of about 2.6%. So, our bottom line is that we continue to favor owning Equities over Credit at this point in the cycle.

EXHIBIT 57

We Expect U.S. High Yield Bonds to Generate Three to Four Percent Total Return in 2018

<table>
<thead>
<tr>
<th>2018 TOTAL RETURN FORECAST ASSUMPTIONS</th>
<th>U.S. HY</th>
<th>5-YEAR UST</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current spread (yield) (basis points)</td>
<td>358</td>
<td>221</td>
</tr>
<tr>
<td>Target (basis points)</td>
<td>358</td>
<td>280</td>
</tr>
<tr>
<td>Predicted Change (basis points)</td>
<td>0</td>
<td>59</td>
</tr>
<tr>
<td>Effective Duration</td>
<td>3.9</td>
<td></td>
</tr>
<tr>
<td>(1) Capital Gain (via spreads) (basis points)</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>(2) Capital Loss (via rates) (basis points)</td>
<td>-232</td>
<td></td>
</tr>
<tr>
<td>(3) Credit Loss (basis points)</td>
<td>-144</td>
<td></td>
</tr>
<tr>
<td>(4) Current Coupon Yield (basis points)</td>
<td>637</td>
<td></td>
</tr>
<tr>
<td>TOTAL RETURN (1) + (2) + (3) + (4)</td>
<td>2.6%</td>
<td></td>
</tr>
</tbody>
</table>

Data as at December 31, 2017. Source: ICE Bond Indices, Global Macro & Asset Allocation analysis.

We think WTI oil has bottomed, but we believe that excess inventories and optimistic positioning still leave the commodity exposed to periodic drawdowns over the medium term. However, on a three to five-year basis, we are more constructive than the consensus.

EXHIBIT 58

Longer Term, We See the Potential for Oil Price Upside as the Need to Sanction New Conventional Projects Reemerges and Services Prices Move Into Recovery...

Oil Outlook: We Are Using a Bottoming in Oil Prices to Lean in to Real Assets

While we continue to view oil as likely range-bound in the near term, we are a bit more constructive over the longer term. Specifically, our base case is that we see the potential for prices to head above $60 during the next few years. As such, this forecast places us a bit above current market consensus for 2021 and beyond (Exhibit 59), which is important because energy asset valuations are generally most sensitive to out-year commodity price assumptions. This optimistic view helps to support our decision to increase our overweight to Real Assets, including Energy and Energy-Related Infrastructure.

Despite our longer-term optimism on oil, there are still two key factors that we perceive as risks to the near-term commodity price outlook. First is sentiment. As we show in Exhibit 60, large speculator positioning in crude futures has reached excessively bullish territory, now standing at 1.5 standard deviations above trend. This optimism is significant, we believe, as swings in sentiment of this magnitude have served as a reliable contrarian signal in recent years (i.e., too much optimism is bearish for near-term prices).
...And As Such, Our Base Case Reflects More Upside than the Expectation of the Forward Curve Longer Term

WTI Forward Curve vs. KKR GMAA Base Case

Data as at December 31, 2017. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Large Speculator Positioning in Crude Futures Is Extended, Triggering a Tactical ‘Sell’ Signal

CFTC: Crude (WTI+Brent) Large Speculators Net Long as a % of Total Open Interest

Data as at December 20, 2017. Source: Bloomberg, CFTC, KKR Global Macro & Asset Allocation analysis.

Regarding inventories, crude oil stocks in developed markets have declined in recent months but remain elevated on an absolute basis (Exhibit 61). Based on current production forecasts, the market will be undersupplied by only a modest 360,000 barrels per day in 2018. At that moderate level of deficit, it would take until the early 2020s to normalize global stockpiles, which is what we think is required to sustainably tighten the market in our base case.

Many investment professionals — hungry to do deals — now appear to be over-paying for quality assets with stable cash flow streams; at the same time, however, many of these same investors are not willing to pay a fair price for assets that may have stumbled and/or require some fixing to achieve their potential.
EXHIBIT 62
Energy Services Pricing Looks Unsustainably Low at Current Levels

S&P Supercomposite Energy Equipment & Services Industry Return on Equity, %


2 8 16 26 29 20 9 11 13 12 11 6 4 6 -3


EXHIBIT 63
Based on Current Rig Counts, We Believe the Consensus for 2018 U.S. Production Growth Could Prove a Bit Too High; Our Estimate Is for Approximately 857k Barrels per Day by Mid-2018

U.S. Crude Oil Production, Y/y Growth, Thousands of Barrels Day

Actual Predicted

R² = 93%

Consensus closer to 1.0mm Bbl/day in our view

= Predicted line is as per KKR GMAA regression model based on oil rig count and price trends. Data as at November 30, 2017. Source: Bloomberg, Baker Hughes, KKR Global Macro & Asset Allocation analysis.

However, looking out longer-term, we think current futures pricing—which embeds prices hovering around $50—could ultimately prove too pessimistic. The two important factors in our thinking are break-even prices and shale productivity. Regarding break-even prices, the oil analysts we’ve surveyed tend to forecast current shale break-even pricing to average around $40-50 per barrel, which we think explains why deferred oil futures assume prices stuck around that level. What we think the market could be missing however, is that break-even prices are not static, but rather significantly influenced by input costs such as labor, acreage, and services costs, which have come down in most instances of late. So, when the oil market ultimately rebalances, we would expect input costs to rise, pushing up break-evens. As one rough indication of the significant deflation that has flowed through the oil ecosystem, consider that the Oilfield Services industry is expected to have a return on equity of just six percent in 2018 (Exhibit 62). Such compressed economics do not seem sustainable on a long-term basis, in our view.

Finally, regarding U.S. shale productivity: we believe the innovation and growth of this sector is indeed formidable, but our work suggests that the market could potentially be slightly overestimating U.S. production growth in 2018. Specifically, our statistical model (Exhibit 63) suggests that the current rig count and oil price backdrop looks consistent with U.S. production growth of 800-900 thousand barrels per day next year, whereas we view the consensus as being closer to one million barrels per day. If U.S. supply growth were to undershoot expectations, we think it could cause the market to consider whether a higher long-term price environment could ultimately be required to incentivize the long-term U.S. production growth that the world requires.

Bottom line: We think WTI oil has bottomed, but we believe that excess inventories and optimistic positioning still leave the commodity exposed to periodic drawdowns over the medium term. However, on a three- to five-year basis, we are more constructive than the consensus for the reasons cited above (i.e., rising break-even costs and productivity headwinds), and such, we are focusing on opportunities within the Oil Patch that offer solid returns in the current environment, good downside protection, and asymmetric upside skew if our more constructive outlook does in fact play out.

Where Are We in the Cycle/Expected Returns

As many of our readers will know, our base case for some time has been that a modest economic slowdown will occur in 2019. However, with tax cuts taking effect in 2018, the chance of a near-term recession appears quite remote. Consistent with this viewpoint, our proprietary recession model, which we show in Exhibit 64, suggests a limited chance of recession during the next 12 months. According to the model, high interest coverage, tight High Yield spreads, low delinquencies, and a modest consumer obligations ratio all appear to be favorable tailwinds that should sustain economic growth through 2018.
Benefitting from Easier Financial Conditions, the Growth Outlook Over the Next 12 Months Remains Healthy

Our proprietary recession model suggests a limited chance of recession during the next 12 months.

Interestingly though, when we extend the model from 0-12 months to 24 months, the risk of recession increases materially. One can see this in Exhibit 65. We link the uptick in the model’s cautionary outlook in late 2019 and beyond to a structurally peaking U.S. dollar, a flattening yield curve, higher unit labor costs, and some reversion to the mean in both consumer confidence and home building expectations.

However, We Do Believe that Risks Begin to Increase 24+ Months Out, Which Could Make the Economy More Susceptible to Recession.
Importantly, irrespective of where we are in the cycle, we believe that – compliments of central bank intervention – the current prices of many financial assets appear more cyclically elevated than current economic conditions might otherwise support. Indeed, as we show in Exhibit 67, the S&P 500 has been up for nine consecutive years, despite a U.S. economic recovery that has been lackluster by most standards. This performance feat by the U.S. equity market is quite extraordinary, as it has occurred only one other time on record – the 1991-1999 period.

**EXHIBIT 66**

We Are Quite Long in the Tooth in Terms of Pure Cycle Duration at 103 Months

<table>
<thead>
<tr>
<th>Duration of U.S. Economic Expansions (Months)</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 2009 Current (Jan-18)</td>
</tr>
<tr>
<td>November 2001 - December 2007</td>
</tr>
<tr>
<td>March 1991 - March 2001</td>
</tr>
<tr>
<td>November 1982 - July 1990</td>
</tr>
<tr>
<td>July 1980 - July 1981</td>
</tr>
<tr>
<td>March 1975 - January 1980</td>
</tr>
<tr>
<td>November 1970 - November 1973</td>
</tr>
<tr>
<td>February 1961 - December 1969</td>
</tr>
<tr>
<td>April 1958 - April 1960</td>
</tr>
<tr>
<td>May 1954 - August 1957</td>
</tr>
<tr>
<td>October 1949 - July 1953</td>
</tr>
<tr>
<td>October 1945 - November 1948</td>
</tr>
<tr>
<td>June 1938 - February 1945</td>
</tr>
<tr>
<td>March 1933 - May 1937</td>
</tr>
<tr>
<td>November 1927 - August 1929</td>
</tr>
<tr>
<td>July 1924 - October 1926</td>
</tr>
<tr>
<td>July 1921 - May 1923</td>
</tr>
<tr>
<td>March 1919 - January 1920</td>
</tr>
<tr>
<td>December 1914 - August 1918</td>
</tr>
<tr>
<td>January 1912 - January 1913</td>
</tr>
<tr>
<td>June 1908 - January 1910</td>
</tr>
<tr>
<td>August 1904 - May 1907</td>
</tr>
</tbody>
</table>

Median = 37


**EXHIBIT 67**

Nine Years of Consecutive Positive Performance for the S&P 500 Is Highly Unusual; We Are Now Entering Our 10th Year

<table>
<thead>
<tr>
<th># OF CONSECUTIVE YEARS OF POSITIVE RETURNS</th>
<th>START</th>
<th>END</th>
<th>CUMULATIVE RETURN</th>
<th>CAGR</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>1904</td>
<td>1906</td>
<td>67%</td>
<td>19%</td>
</tr>
<tr>
<td>3</td>
<td>1954</td>
<td>1956</td>
<td>111%</td>
<td>28%</td>
</tr>
<tr>
<td>3</td>
<td>1963</td>
<td>1965</td>
<td>60%</td>
<td>17%</td>
</tr>
<tr>
<td>3</td>
<td>1970</td>
<td>1972</td>
<td>40%</td>
<td>12%</td>
</tr>
<tr>
<td>4</td>
<td>1942</td>
<td>1945</td>
<td>143%</td>
<td>25%</td>
</tr>
<tr>
<td>4</td>
<td>1958</td>
<td>1961</td>
<td>102%</td>
<td>19%</td>
</tr>
<tr>
<td>5</td>
<td>2003</td>
<td>2007</td>
<td>83%</td>
<td>13%</td>
</tr>
<tr>
<td>6</td>
<td>1947</td>
<td>1952</td>
<td>148%</td>
<td>16%</td>
</tr>
<tr>
<td>8</td>
<td>1921</td>
<td>1928</td>
<td>435%</td>
<td>23%</td>
</tr>
<tr>
<td>8</td>
<td>1982</td>
<td>1989</td>
<td>291%</td>
<td>19%</td>
</tr>
<tr>
<td>9</td>
<td>1991</td>
<td>1999</td>
<td>450%</td>
<td>21%</td>
</tr>
<tr>
<td>9</td>
<td>2009</td>
<td>2017</td>
<td>259%</td>
<td>24%</td>
</tr>
</tbody>
</table>

Avg. CAGR 20%


Importantly, irrespective of where we are in the cycle, we believe that – compliments of central bank intervention – the current prices of many financial assets appear more cyclically elevated than current economic conditions might otherwise support.
EXHIBIT 68

The Multiple Expansion Achieved This Cycle Is Now More Consistent With Historical Norms

<table>
<thead>
<tr>
<th>DATE OF TROUGH</th>
<th>DATE OF PEAK</th>
<th>DURATION TROUGH TO PEAK (MONTHS)</th>
<th>% CHANGE TROUGH TO PEAK</th>
<th>P/E MULTIPLE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apr-42</td>
<td>May-46</td>
<td>49</td>
<td>157.1%</td>
<td>177%</td>
</tr>
<tr>
<td>Jun-49</td>
<td>Dec-52</td>
<td>42</td>
<td>96.2%</td>
<td>87%</td>
</tr>
<tr>
<td>Sep-53</td>
<td>Aug-56</td>
<td>35</td>
<td>119.0%</td>
<td>51%</td>
</tr>
<tr>
<td>Dec-57</td>
<td>Jul-59</td>
<td>19</td>
<td>53.8%</td>
<td>45%</td>
</tr>
<tr>
<td>Oct-60</td>
<td>Dec-61</td>
<td>14</td>
<td>38.9%</td>
<td>39%</td>
</tr>
<tr>
<td>Jun-62</td>
<td>Jan-66</td>
<td>43</td>
<td>79.8%</td>
<td>2%</td>
</tr>
<tr>
<td>Sep-66</td>
<td>Nov-68</td>
<td>25</td>
<td>48.0%</td>
<td>35%</td>
</tr>
<tr>
<td>Jun-70</td>
<td>Jan-73</td>
<td>31</td>
<td>73.5%</td>
<td>32%</td>
</tr>
<tr>
<td>Oct-74</td>
<td>Dec-76</td>
<td>26</td>
<td>72.5%</td>
<td>57%</td>
</tr>
<tr>
<td>Mar-78</td>
<td>Nov-80</td>
<td>32</td>
<td>61.7%</td>
<td>21%</td>
</tr>
<tr>
<td>Aug-82</td>
<td>Aug-87</td>
<td>60</td>
<td>228.8%</td>
<td>166%</td>
</tr>
<tr>
<td>Dec-87</td>
<td>Jul-90</td>
<td>31</td>
<td>64.8%</td>
<td>18%</td>
</tr>
<tr>
<td>Oct-90</td>
<td>Mar-00</td>
<td>112</td>
<td>417.0%</td>
<td>113%</td>
</tr>
<tr>
<td>Oct-02</td>
<td>Oct-07</td>
<td>60</td>
<td>101.5%</td>
<td>-1%</td>
</tr>
<tr>
<td>AVERAGE</td>
<td></td>
<td>41.3</td>
<td>115.0%</td>
<td>56%</td>
</tr>
<tr>
<td>MAR-09</td>
<td>DEC-17</td>
<td>106</td>
<td>295.0%</td>
<td>42%</td>
</tr>
</tbody>
</table>

Performance on a monthly basis, peak to trough. PE Multiple as of nearest month end. Data as December 31, 2017. Source: Standard & Poor’s, Omega Advisors.

Overall, though, as we peer around the corner today on what returns look like tomorrow, we can’t help but have a more conservative view. Indeed, our work around margins, multiples, and cycle duration all lead us to forecast more modest forward returns for many asset classes.

EXHIBIT 69

Bull Markets End with Bangs, Not Whimpers; Given Our Models Are Still Constructive, Our Base Case Is to Stay Largely Invested in the First Half of 2018

Average Returns and Length of the S&P 500 One Year Before and During a Bear Market Since the 1960s (ex 1998)

Given such strong returns of late, we fully understand why an investor might feel that a cautionary outlook for 2018 is warranted. However, as we show in Exhibit 69, bull markets tend to end with a bang, not a whimper. In fact, according to some quality work done by Peter Oppenheimer and his team at the investment bank Goldman Sachs, there is often an underappreciated penalty for selling early at the end of a bull market. Specifically, they note that an investor who sells the equity market just three months before its peak misses about the same amount (roughly seven percent on average) as an investor loses in the first three months of a bear market. Moreover, there is nearly always a bounce after the initial decline, providing investors with another opportunity to reduce risks.
We See Expected Future Returns for the Investment Management Industry Headed Lower During the Next Five Years

Past and Future Expected Returns by Asset Class, CAGR, %


EXHIBIT 71
Given Low Bond Yields, the Opportunity to Beat a 60/40 Portfolio Is Now Extremely High, We Believe

Performance: 5-Year CAGR of a Traditional 60% Equities/40% Bond Portfolio, %


Overall, though, as we peer around the corner today on what returns look like tomorrow, we can’t help but have a more conservative view. Indeed, our work around margins, multiples, and cycle duration all lead us to forecast more modest forward returns for many asset classes, which one can see in Exhibit 70. We also believe that interest rates have structurally bottomed for the first time in several decades, which represents a noteworthy shift in our thinking.

While we believe that the ability to generate absolute returns will be harder, we do think that the opportunity to generate returns that exceed a benchmark (e.g., a 60/40 split as shown in Exhibit 71) is quite compelling. Consistent with this view, we note that pairwise correlations for the S&P 500, which measures how closely stocks in the index move relative to one another, have fallen to 23-year lows of 8.8%, which is down sharply from 52% two years ago. Likewise, pairwise correlations for the Russell 2000 have fallen to 17-year lows of 10.8%. Both of these measures imply that stock movements are increasingly driven by company/sector-specific factors rather than macroeconomic factors moving all stocks up and down in concert. Without question, this backdrop is bullish for security selection.

Meanwhile, correlations across asset classes have also plummeted over the past 12 months, with the MS Global Cross-Asset Correlation Index back near post-crisis lows as Equities have become less correlated with rates, FX, oil and vice versa. One can see this notable improvement in Exhibit 73. From what we can tell, as global central bank policies become increasingly desynchronized (e.g., the Federal Reserve unwinding its monetary easing, while Bank of Japan and ECB stimulus continues), we believe that linkages amongst assets, regions, and stocks are giving way to more company and/or sector-specific drivers.
Globally, Cross-Asset Correlations Are Back Near Post-Crisis Lows; This Is Bullish for Asset Allocators and Macro Investors

EXHIBIT 73

MS Global Cross Asset Correlation, Rolling 6-Months, %

Jan-03  Jan-05  Jan-07  Jan-09  Jan-11  Jan-13  Jan-15  Jan-17


In sum, we think that forward returns are likely to be notably lower than in the past. In particular, we believe that spreads in Credit are at their tights at a time when risk-free rates are too low, and we believe that equity multiples as well as corporate margins could be approaching their peak in 2018.

The good news is that returns-wise, active managers across equity, fixed income, commodities, and currencies should finally find it easier to outperform passive index strategies as alpha opportunities can now be more readily extracted from macro trends. This change in the investing environment is a big deal, in our view. Case in point, 48% of U.S. large-cap active managers outperformed their benchmarks in 2017, which is the highest hit rate since 2009. In our view, this is not an aberration but the beginning of a longer-term trend. Our bottom line: If we are right on our strong belief that the gap between Complexity and Simplicity is poised to narrow, then we believe that asset allocators and macro investors are poised to generate substantially larger excess returns across both up and down markets than passive investors as this markets anomaly narrows over the next few years.

Section II: Key Themes

#1: Emerging Markets Rules of the Road Suggest We Are Already Entering a ‘Mid-Cycle’ Phase of Recovery. Consistent with our view that China has bottomed in nominal terms amidst tighter supply side reforms as well as increasing demand from EM consumers, our overall Emerging Markets model continues to send upbeat signals. These signals are important, in our view, as both EM outperformance as well as underperformance cycles tend to last years, not months. One can see this pattern in Exhibit 75.

With EM appreciating 38% in 2017, we fully acknowledge that last year was a huge year for EM performance. As such, we do expect some backfilling during parts of 2018, particularly if our more aggressive Fed Funds forecast is right. That said, we think that this bull market is secular, not cyclical, and we are willing to endure some short-term period of underperformance to stay invested in what we believe is one of the more compelling macro themes that we see.

Consistent with this view, our proprietary EM model, which we detail in Exhibit 75, continues to deliver mostly positive signals, albeit ones that are now more mid-cycle in nature. We note the following:

- Valuation is now just neutral, no longer cheap. In fact, EM now trades at a 5.6 point discount to DM, which is attractive, but definitely less compelling than the 7.3 point discount that prevailed at the end of 2015 when this factor triggered a buy signal in our work.
- 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. 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 upturn, reinforcing our view that commodity prices must remain on a recovery trajectory for our EM dashboard to remain positive.
- Meanwhile, when we look at the two other components of the 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.
- 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 we think prospects are good that FX will not be as much of an obstacle to EM equity returns in the future (even with the dollar bounce we are expecting at some point during 2018).

Despite the recent strength in EM, we think that Emerging Markets outperformance still has three to five years more of running room.
consumption stories are accelerating in many areas of EM, which we believe will continue to drive a sustained period of overall economic growth. Meanwhile, smaller deficits and higher real rates give us additional confidence that the EM tailwind can withstand macro shocks, including a tactical rebound in the dollar, along the way. Finally, we still think that investors are under-invested in EM, which should continue to attract flows as retail and institutional investors are poised to reposition their portfolios.

EXHIBIT 74

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

Our recent travels lead us to believe that domestic consumption stories are accelerating in many areas of EM, which we believe will continue to drive a sustained period of overall economic growth. Meanwhile, smaller deficits and higher real rates give us additional confidence that the EM tailwind can withstand macro shocks, including a tactical rebound in the dollar, along the way.

EXHIBIT 75

EM Is Now Entering the ‘Mid-Cycle’ Phase of Its Recovery Wherein Relative Valuation Is No Longer Compellingly Cheap, but 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 backdrop recently also helps bolster our conviction in the sustainability of this EM cycle.

Data as at December 31, 2017. Source: KKR Global Macro & Asset Allocation analysis.

Within EM, we generally favor economies with large domestic consumption stories and/or an increasing value-added services franchises. At the moment, India, Indonesia, Vietnam, and even parts of China appear compelling. By comparison, we are more cautious on much of Africa as well as capital dependent countries such as Turkey.
While We Think the Dollar Could Bounce Tactically in 2018, We Believe that the USD Is Structurally in the Process of Peaking

EXHIBIT 76

Real Major Trade-Weighted U.S. Dollar REER: % Over (Under) Valued


EXHIBIT 77

Except for the Philippines, All EM Countries Appear Less Financially Vulnerable Than They Were During the Taper Tantrum of 2013

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

#2: Changing Preferences in Direct Lending. As many of our readers know, we have been a notable champion of the Private Credit opportunity since 2011. Our top down view gave us high conviction that over-regulation of the banks as well as insufficient supply of capital would create a compelling void that would have to be funded by non-traditional lending. All told, we estimated that Wall Street’s balance sheets had shrunk the equivalent of five Morgan Stanley’s. The final underpinning of our thesis rests on the fact that overall Credit as an asset class appeared more attractive than Equities – and with less volatility.

Today, however, we see the environment much differently. Capital inflows into the space have intensified, traditional global wholesale banks are now taking more risks, and credit spreads are extraordinarily tight on both an absolute and relative basis for most asset classes. Also, M&A activity has – to date – not been as active as we would like, which is denting Direct Lending product supply.

To be fair, we still see room for lucrative returns in this market, particularly at the large end of the market, but we do believe that the prudent approach at this point in the cycle is to dial back exposure. That’s exactly what we have been doing, as one can see in Exhibit 78.

EXHIBIT 78

After Peaking at 10% in 2016, Our Exposure to Direct Lending Has Begun to Shrink

Data as at December 31, 2017. Source: KKR Global Macro & Asset Allocation analysis.
Non-Traditional Lending Has Grown Significantly as a Percentage of GDP Since the Global Financial Crisis; We Are Now Being More Selective in This Area

On the other hand, as economic and financial conditions have improved, our desire to increase exposure in the Asset-Based Finance arena of Private Credit has actually grown. In particular, as book values have again begun to grow in the banking sector, publicly traded financial intermediaries have finally started to ‘reposition’ their portfolios, including selling performing hard assets with onerous capital charges as well as seeking out capital-relieving joint ventures with third party investors, including alternative asset managers. ‘Last mile’ residential construction in areas such as Spain and Ireland has been a particular focus of ours of late within Asset-Based Finance. We also view Asset-Based Finance as an elegant play on our desire to lock in low-cost liabilities in today’s QE-driven market, allowing investors to earn above average spreads. Finally, we are seeing an increased opportunity set in the B-piece segment of the commercial mortgage market, driven by ‘new’ retention rules that notably favor investors with long duration liabilities who value the benefits of cash flowing hard assets.

We view Asset-Based Finance as an elegant play on our desire to lock in low-cost liabilities in today’s QE-driven market, allowing investors to earn above average spreads.

Despite Increased Competition in the Direct Lending Market, the Illiquidity Premium Has – to Date – Remained Fairly Constant Across a Variety of Environments

We Feel More Optimistic About Some of the Trends in the Asset-Based Finance, Particularly Around Hard-Asset Lending Arena
#3: Buy Complexity, Sell Simplicity; Active Management Performance to Rebound. Given that global central bank balance sheets have expanded by $14 trillion in recent years, investor access to cheap capital has skyrocketed. As a result, many investment professionals — hungry to do deals — now appear to be over-paying for quality assets with stable cash flow streams; at the same time, however, many of these same investors are not willing to pay a fair price for assets that may have stumbled and/or require some fixing to achieve their potential. In our view, it is these types of disparate behavior patterns that have created such a bifurcation in the market, inspiring our call to arms to ‘Buy Complexity and Sell Simplicity.’

From our macro perch at KKR, we see lots of opportunities across global Private Equity to implement this thesis, including roll-ups, dispositions, and joint-ventures, and as such, it remains one of the reasons that we favor more operationally intensive Private Equity stories over Public Equity ones at this later point in the cycle (Exhibit 82). We also think that certain parts of Energy, including MLPs, appear attractive. Our work shows that this asset class is one of the few high yielding asset classes that have not compressed with the dramatic decline in interest rates that we have seen in recent years. To be sure, there are some broken business models in the sector (particularly the roll-up stories), but we have also been able to find some cheap cash-flowing assets that we believe will create substantial long-term value for shareholders. We also expect European Financials to deliver outperformance again in 2018. All told, earnings per share, which expanded 11.2% in 2017, are expected to grow another 11.7% in 2018 against valuations that we do not deem as demanding.

EXHIBIT 82

Private Equity Typically Outperforms Public Equities in Lower Return Environments

U.S. Private Equity Average Relative Returns in Various Market Environments, %

<table>
<thead>
<tr>
<th>S&amp;P 500 Total Return</th>
<th>&lt; 0%</th>
<th>0-10%</th>
<th>10-20%</th>
<th>&gt; 20%</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Private Equity</td>
<td>10.2</td>
<td>11.6</td>
<td>6.3</td>
<td>-7.5</td>
</tr>
</tbody>
</table>


EXHIBIT 83

After Nine Full Years of a Bull Market, 41% of Russell 2000 Companies Still Have EV/EBITDAs of Less than 10x

EV/EBITDA of U.S. Stocks With EVs of $500 Million-$5 Billion

EV to Next Twelve Months Estimated EBITDA, based on consensus EBITDA estimates per Bloomberg. Universe = 1,070 Russell 3000 stocks with EVs of $500mm-$5bn and EBITDA estimates available in Bloomberg. Data as at December 21, 2017. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 84

Performance in the Energy Sector Has Been Abysmal; We Now Believe there Are Significant, Near Term Value-Creation Opportunities in the Energy Sector

Energy Upstream & Royalties and Private Equity Energy Five Year Average Annualized Return, %

Data as at 1Q2017. Source: Cambridge Associates, KKR Global Macro & Asset Allocation analysis.

We also think that certain parts of Energy, including MLPs, appear attractive.
The Reduction in QE, Coupled With Potential Misallocation of Capital From Loose Credit Underwriting Standards, Will Ultimately Lead to Opportunities Across the Distressed/Special Situations Universe

Consistent with this view to Buy Complexity, we have begun to increase our allocation to both Real Assets and Distressed/Special Situations (Exhibit 5). In Real Assets, we are finally seeing buyers and sellers get matched on price in the Energy sector, particularly as publicly traded companies are increasingly looking to jettison non-core assets in areas such as the Eagle Ford basin. These deals are complex, but they provide private investors with high single digit cash flows and a total return in the mid-teens if structured properly without having to take material commodity risks.

Within Liquid Credit markets, we have again boosted our long-standing allocation towards Actively Managed Opportunistic Credit to even higher levels (600 basis points versus 500 previously and a benchmark weighting of zero). Without question, many parts of the CCC-rated universe for Loans actually look quite interesting relative to history. One can see this in Exhibit 89. To be sure, not every CCC credit is worthy of investor attention, but we do feel strongly that looking for these types of anomalies makes sense in a market that generally does not offer that much relative value, in our view.

In Real Assets, we are finally seeing buyers and sellers get matched on price in the Energy sector, particularly as publicly traded companies are increasingly looking to jettison non-core assets in areas such as the Eagle Ford basin.

Meanwhile, we believe that there is an increasing chance for Investment Grade credits to become ‘Fallen Angels’ during the next 12-24 months. We also see opportunity amongst potential divestitures and roll-ups in beaten-down sectors such as Telecom and Healthcare. We also believe that current changes in the tax code could create higher cost of capital for leveraged entities whose interest expense exceeds 30% of EBITDA. In our view, investors have not focused enough on this subtle but important change, and as such, we think that it could potentially represent a secular opportunity for investors in both Distressed and Actively Managed Liquid Credit funds.
There Are Very Few Asset Classes Offering Above Average Yields. MLPs Are Currently One of Them

Indicated Yield by Asset Class, %, December 2007 to December 2017

MLPs are One of Few Asset Classes that Currently Offer Above-Average Yields

Given the Flight to Quality, Individual Credit Picking and Understanding Relative Value Across All Spread Assets Can Add Material Alpha in Today’s Market, We Believe

On the other hand, there are several areas that appear expensive. For example, as we show in Exhibit 86, the Defensive segment of the European equity market still appears quite richly priced. On the debt side, we note that many areas of the traditional liquid markets appear expensive, particularly bonds. Indeed, as the left hand side of Exhibit 89 shows, BB less BBB spreads are at multi-decade lows relative to trend, underscoring our view that investors are willing to overpay for quality in today’s market. As we mentioned earlier, we also think that government bonds in Europe represent particularly poor value.

Finally, in-depth discussions during our recent travels lead us to believe that Core Real Estate appears expensive, particularly in certain gateway cities like London, Hong Kong, and New York.

#4: Deconglomeratization: Corporates Shedding Assets Creating Opportunities Across Energy, Infrastructure, and Private Equity.

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 cross-border returns are falling for many multinational companies, which one can see in Exhibits 90 and 91.

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

Corporates shedding assets has created opportunities across Energy, Infrastructure, and Private Equity. In our view, this idea is a big one; it is global, and it has duration.
Local and Regional Competitors Are Increasingly Challenging the Returns of the Multinational Firms

Top 500 Global Companies Return on Equity, LTM as at 2016, %

-5% 0% 5% 10% 15% 20% 25%

Energy
Media & Communication
Basic Materials
Diversified
Financial
All Sectors
Utilities
Cyclical Consumer
Industrial
Other Consumer
Technology


Exhibit 92
Europe and Asia Have Seen the Most Dramatic Increase in the Number of Companies Targeted by Activists...

Number of Companies Publicly Subject to Activist Demands

Source: 2017 Activist Insight Annual Review.

Exhibit 93
Companies Across All Sectors Now Face Higher Level of Scrutiny by the Activist Community

Sector Breakdown of Global Activist Targets in 2016

Source: 2017 Activist Insight Annual Review.

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. Without question, the macro backdrop is compelling for at least three reasons. 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. All told, as we show in Exhibit 94, at least a quarter of the Nikkei 400 has 100 or more subsidiaries.

Second, the deposit-to-GDP ratio in Japan is 135.5%, underscoring that banks have lots of excess capital to lend to acquirers of these subsidiaries. In many instances, a private equity firm can get at least 7x leverage, with an all-in cost of funds that is below two percent. Finally, enterprise value-to-EBITDA multiples in Japan are often at or below historical averages, a set-up that we can’t find in many other markets around the world.

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.

"
Japan Has Emerged as One of the Most Compelling Pure Play Examples on Our Thesis About Corporations Shedding Noncore Assets and Subsidiaries

<table>
<thead>
<tr>
<th>NUMBER OF LISTED COMPANIES BY NUMBER OF CONSOLIDATED SUBSIDIARIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Comp.</td>
</tr>
<tr>
<td>Nikkei 400</td>
</tr>
<tr>
<td>TSE First Section</td>
</tr>
<tr>
<td>TSE Second Section</td>
</tr>
<tr>
<td>Mothers</td>
</tr>
<tr>
<td>JASDAQ</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Data as at 2017. Source: Macquarie.

We also note that we are seeing a lot of corporate ‘streamlining’ occurring outside of the traditional multinational sector. Indeed, after several quarters of inactivity, we are finally seeing U.S. energy companies rightsizing their footprints, as Wall Street encourages many of these companies to shed slower growth assets in favor of ‘hot’ shale basins. While this activity may not necessarily be long-term bullish for the stocks of publicly traded energy companies, it is creating significant, near term value-creation opportunities for the buyers of these properties, particularly for players with expertise in the production and midstream segments of the oil and gas markets.

Also, within the Infrastructure sector, we have seen a notable number of divestitures of hard assets, particularly those with contractual revenue set-ups, in recent quarters. From our perch, it appears that Europe has emerged as the most active region for Infrastructure carve-outs, but trend lines in both the United States and Asia are firming too. Importantly, this carve-out opportunity is in addition to some of the structural increases in infrastructure investment that we think will occur as governments rely more on fiscal spending than monetary stimulus to bolster growth in the years ahead. All told, McKinsey Consulting estimates that the global economy will need to spend $3.7 trillion annually, or 4.1% of global GDP, from 2017-2035 to cover basic infrastructure needs across key markets such water, roads, telecom, and rail (Exhibit 96).

EXHIBIT 95

U.S. Upstream Now Seems to Be in Consolidation Mode

EXHIBIT 96

The World Needs to Invest an Average of $3.7 Trillion in Infrastructure Assets Every Year Through 2035 in Order to Keep Pace With Projected GDP Growth

EXHIBIT 97

#5: Experiences Over Things. While this theme is not a new one for us, the pace of implementation appears to have accelerated in recent months. Importantly, as we describe below, we do not think the trend towards experiences is just the ‘Amazon’ effect. Rather, we believe that key influences such as increased healthcare spending, heightened rental costs, and rising telecommunications budgets (e.g., iPhones) are leaving less and less discretionary income for traditional
items, particularly mainstream retail. Recent trips to continental Europe as well as Asia lend support to our view that this trend towards experiences is global in nature and cuts across a variety of demographics. For example, in Japan and Germany, aging demographics are boosting the use of later stage healthcare offerings, while younger individuals in the U.S. are embracing more health, wellness and beautification.

**EXHIBIT 97**

Disposable Income Available for Traditional ‘Things’ Is Waning at a Time of Significant Change in Consumer Spending

---

We do not think the trend towards experiences is just the ‘Amazon’ effect. Rather, we believe that key influences such as increased healthcare spending, heightened rental costs, and rising telecommunications budgets are leaving less and less discretionary income for traditional items, particularly mainstream retail.

---

**EXHIBIT 98**

The Trend Towards Greater Spending on ‘Experiences’ Is Accelerating in Europe Too

Eurozone Consumer Spending by Category, 1995 = Indexed to 100

Experiences Includes Recreation and Culture, Other Recreational Items and Equipment, Gardens and Pets, Package Holidays, Restaurants and Hotels, Personal Care, Personal Effects n.e.c. Data as at December 31, 2016. Source: Eurostat, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Meanwhile, in the Emerging Markets, as countries move up the GDP-per-capita curve, we continue to see demand for basic healthcare offerings, including private insurance and specialized surgery care, especially in fast-growing consumer markets such as Brazil, China, Indonesia, and India. Importantly, the trend towards services extends well beyond just the Healthcare sector. Recreation, travel, and leisure all appear to be market share gainers versus basic ‘things’ that consumers traditionally bought with their disposable income. Moreover, consumers are more willing to use the Internet to price shop, making them more fickle in some instances.

**EXHIBIT 99**

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

Spending Breakdown China Overall vs. Chinese Millennials

We See Growing Demand for Healthcare Offerings in Both Developed and Developing Markets

Exhibit 100

We See Growing Demand for Healthcare Offerings in Both Developed and Developing Markets

<table>
<thead>
<tr>
<th>Country</th>
<th>Public</th>
<th>Private</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>2.8</td>
<td>4.1</td>
<td>6.9</td>
</tr>
<tr>
<td>Thailand</td>
<td>4.2</td>
<td>4.7</td>
<td>8.9</td>
</tr>
<tr>
<td>Malaysia</td>
<td>4.7</td>
<td>4.9</td>
<td>9.6</td>
</tr>
<tr>
<td>India</td>
<td>5.5</td>
<td>7.1</td>
<td>12.6</td>
</tr>
<tr>
<td>Singapore</td>
<td>7.4</td>
<td>8.3</td>
<td>15.7</td>
</tr>
<tr>
<td>Vietnam</td>
<td>9.1</td>
<td>9.4</td>
<td>18.5</td>
</tr>
<tr>
<td>Korea</td>
<td>10.2</td>
<td>10.2</td>
<td>20.4</td>
</tr>
<tr>
<td>U.K.</td>
<td>7.1</td>
<td>7.1</td>
<td>14.2</td>
</tr>
<tr>
<td>Australia</td>
<td>8.3</td>
<td>8.3</td>
<td>16.6</td>
</tr>
<tr>
<td>Japan</td>
<td>9.4</td>
<td>9.4</td>
<td>18.8</td>
</tr>
<tr>
<td>U.S.</td>
<td>17.1</td>
<td>17.1</td>
<td>34.2</td>
</tr>
</tbody>
</table>


Exhibit 101

Japan Is Experiencing a Shift Towards Services as the Population Ages

Japan: Household Expenditure By Age of Head of Household as a % of Total

<table>
<thead>
<tr>
<th>Age Group</th>
<th>Services</th>
<th>Food &amp; Beverage</th>
<th>Goods</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;30</td>
<td>15%</td>
<td>45%</td>
<td>40%</td>
</tr>
<tr>
<td>30-39</td>
<td>17%</td>
<td>41%</td>
<td>41%</td>
</tr>
<tr>
<td>40-49</td>
<td>19%</td>
<td>41%</td>
<td>40%</td>
</tr>
<tr>
<td>50-59</td>
<td>19%</td>
<td>31%</td>
<td>46%</td>
</tr>
<tr>
<td>60-69</td>
<td>23%</td>
<td>31%</td>
<td>47%</td>
</tr>
<tr>
<td>70+</td>
<td>24%</td>
<td>28%</td>
<td>28%</td>
</tr>
</tbody>
</table>

Data as at 2015. Source: Cabinet Office of Japan, Haver Analytics.

Exhibit 102

Asia Pacific Tourists Accounted for More than 25% of Total International Arrivals in 2016

<table>
<thead>
<tr>
<th>Year</th>
<th>International Arrivals by Asia Pacific Tourists, Millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>59</td>
</tr>
<tr>
<td>1995</td>
<td>86</td>
</tr>
<tr>
<td>2000</td>
<td>114</td>
</tr>
<tr>
<td>2005</td>
<td>153</td>
</tr>
<tr>
<td>2010</td>
<td>206</td>
</tr>
<tr>
<td>2014</td>
<td>272</td>
</tr>
<tr>
<td>2015</td>
<td>294</td>
</tr>
<tr>
<td>2016</td>
<td>317</td>
</tr>
</tbody>
</table>

Data as at 2016. Source: UNWTO.

The downside of the environment we are describing is that many traditional retailers, malls, and product providers are likely to see waning demand for their offerings. Moreover, pricing power in many areas of the ‘goods’ market is negative. All told, ‘core core’ U.S. goods inflation, which we define as goods inflation ex-food, energy and tobacco, has been negative on a year-over-year basis for the past 19 consecutive quarters and negative for 53 of the last 72 quarters since 2000. These trends are noteworthy, because a lot of infrastructure has already been built to support consumer expenditures. As a result, if we are right that the shift towards experiences over things is more secular than cyclical (which we believe it is), many companies across the global supply chain may need to reconsider their existing footprints to better accommodate the preferential shifts that we are highlighting.

#6: Central Bank Normalization. With the global economy now on sound footing, we think central banks will finally try to normalize financial conditions. What does this mean? We see two considerations worthy of investor attention. First, as we show in Exhibit 103, Tier I capital ratios are extremely high, and second, the much-anticipated changes to Dodd Frank to roll back the implementation of certain regulations likely mean not only more ways to make money but also more flexibility in returning capital to shareholders. Said differently, we view this set-up in the banking sector as somewhat of an ‘in the money’ call option for investors. As such, we think that the potential for banks and other important financial intermediaries to return more capital to shareholders is significant.

Second, we think that investors are underestimating the incremental return on capital for the financial services industry from any part of our U.S. base case forecast (i.e., recall that we are at five hikes versus the markets’ 2.5 through the end of 2019). Our prior work has shown that margin pick-up from rising rates at certain deposit-taking institutions could be as high as 90%. This uplift could be substantial, as we show in Exhibit 103.
**EXHIBIT 103**

Tier 1 Capital Ratio Requirements Have Risen Dramatically at a Time of Shrinking Net Interest Margin. We Expect Some Reversal Ahead in Both Areas

MSCI U.S. Banks Weighted-Average Net Interest Margin and Tier One Capital Ratio Comparison, %

Data as at 3Q2017. Source: Factset.

**EXHIBIT 104**

Net Interest Margin Has Been Squeezed in Recent Years, but This Metric Is Now Set to Improve, in Our View

Net Interest Margin, Equal-Weighted Average, U.S. Large-Cap Banks

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Net Interest Margin</th>
<th>Y/Y % Change</th>
<th>Central Bank Purchases</th>
<th>Y/Y % Change</th>
<th>Net Issuance Less QE</th>
<th>Y/Y % Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>3.40%</td>
<td></td>
<td>1,032</td>
<td></td>
<td>1,414</td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td>3.34%</td>
<td>-16%</td>
<td>508</td>
<td>-51%</td>
<td>1,556</td>
<td>10%</td>
</tr>
<tr>
<td>2013</td>
<td>3.31%</td>
<td>-8%</td>
<td>1,063</td>
<td>109%</td>
<td>826</td>
<td>-47%</td>
</tr>
<tr>
<td>2014</td>
<td>3.27%</td>
<td>-22%</td>
<td>809</td>
<td>-24%</td>
<td>674</td>
<td>-18%</td>
</tr>
<tr>
<td>2015</td>
<td>3.23%</td>
<td>-30%</td>
<td>1,091</td>
<td>35%</td>
<td>-48</td>
<td>-107%</td>
</tr>
<tr>
<td>2016</td>
<td>3.14%</td>
<td>-22%</td>
<td>1,477</td>
<td>35%</td>
<td>-514</td>
<td>-971%</td>
</tr>
<tr>
<td>2017</td>
<td>3.04%</td>
<td>-1%</td>
<td>1,104</td>
<td>-25%</td>
<td>-150</td>
<td>-71%</td>
</tr>
<tr>
<td>2018</td>
<td>3.00%</td>
<td>33%</td>
<td>706</td>
<td>-36%</td>
<td>561</td>
<td>474%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>12,110</td>
<td>7,791</td>
<td>4,320</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


**EXHIBIT 105**

European Rates Appear Expensive Relative to Both U.S. Rates as Well as European GDP, We Believe

U.S. - Germany 10-Year Rate Spread, %

Data as at December 31, 2017. Source: Bloomberg.

**EXHIBIT 106**

G4 Sovereign Issuance Less Central Bank Purchases Shows that Net Issuance Is Now Actually Negative. However, this Trend Will Change Notably in 2H18

In the near term we expect U.S. banks to benefit the most, but over time, the upside gearing in the European financial services community is substantial – more than many investors are likely to appreciate. Just consider that, on the front end, European financials are now enduring negative deposit rates; moreover, the German bund, as a proxy for the long end of the curve, is yielding just 0.46%, compared to our theoretical value of closer to 140 basis points, underscoring our view that there is substantial upside to European Financial profits over time (Exhibit 107).

EXHIBIT 107

Any Increase in Rates Could Materially Bolster Banks Earnings

<table>
<thead>
<tr>
<th>Bank</th>
<th>+100bps</th>
<th>+50bps</th>
<th>+10bps</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commerzbank</td>
<td>8%</td>
<td>39%</td>
<td>78%</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>6%</td>
<td>30%</td>
<td>60%</td>
</tr>
<tr>
<td>Credito Emiliano</td>
<td>4%</td>
<td>19%</td>
<td>37%</td>
</tr>
<tr>
<td>Caiza Bank</td>
<td>3%</td>
<td>15%</td>
<td>31%</td>
</tr>
<tr>
<td>Societe Generale</td>
<td>3%</td>
<td>14%</td>
<td>29%</td>
</tr>
<tr>
<td>Intesa Sanpaolo</td>
<td>3%</td>
<td>13%</td>
<td>25%</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>2%</td>
<td>12%</td>
<td>25%</td>
</tr>
<tr>
<td>BBVA</td>
<td>3%</td>
<td>13%</td>
<td>23%</td>
</tr>
<tr>
<td>Credit Agricole</td>
<td>2%</td>
<td>11%</td>
<td>19%</td>
</tr>
<tr>
<td>Royal Bank of Scotland</td>
<td>2%</td>
<td>9%</td>
<td>19%</td>
</tr>
<tr>
<td>Barclays</td>
<td>2%</td>
<td>8%</td>
<td>17%</td>
</tr>
<tr>
<td>UBS</td>
<td>2%</td>
<td>8%</td>
<td>16%</td>
</tr>
</tbody>
</table>

Data as of September 6, 2017. Source: Goldman Sachs Investment Research.

EXHIBIT 108

In Our View, Europe Will Actually Be Ground Zero for Any Change in Global Rates

![Graph showing real 10-year govt yield for various countries]

Real 10-Year Govt Yield, %

- Brazil: 13.1
- Indonesia: 5.8
- India: 3.9
- China: 1.3
- Australia: 1.0
- Spain: 0.5
- U.S.: 0.0
- France: -0.3
- Japan: -0.3
- Canada: -0.6
- Euro Area: -0.9
- Germany: -1.1
- U.K.: -1.3

Data as at December 31, 2017. Source: Bloomberg.

Section III: Risks/Hedging

In the following section we detail some market concerns that we have identified as well as potential mitigants to protecting against issues in these market “soft spots.”

#1: Increasing Dependence on Technology and Financial Earnings

Given our view that there are not a lot of multiple expansion stories left in this market, we think that investors should focus on what is driving earnings. In 2018, the answer to that question is fairly straightforward: Technology and Financials. All told, these two sectors are expected to account for slightly more than 50% of EPS growth in the U.S. and nearly 57% across the Emerging Markets. In Europe, there is not really a significant publicly traded Technology sector, though Financials are expected to fully account for over 32% of total earnings growth.

Given these views, we suggest an overweight to both European and U.S. banks. We also believe that buying performing assets off these banks, particularly in Europe, is a good way to play this thesis. Given the high leverage in European banks, rising stock prices mean a greater propensity to sell assets that have gotten stale or are under-managed. As part of our normalization thesis, we also favor owning financial assets like mortgage servicing rights, which become even more valuable cash flow assets if and when rates increase (assuming unemployment does not spike, which is our base view).

Two other considerations that we think warrant investor attention include being notably underweight government bonds across portfolios and liability management. At current levels, we think that government bonds can no longer provide decent yield. Second, we think that stock market performance is not as likely to be as correlated with bond market performance as it has been during the past two decades. Given this viewpoint, we feel strongly that investors should seek to extend liabilities at the fund level, or at portfolio company level. At present, our two favorite markets to perform this task would be Europe (where bunds look quite expensive versus U.S. Treasuries) and Japan (where bank deposits as a percentage of GDP are still north of 130%).

Given these views, we suggest an overweight to both European and U.S. banks. We also believe that buying performing assets off these banks, particularly in Europe, is a good way to play this thesis. Given the high leverage in European banks, rising stock prices mean a greater propensity to sell assets that have gotten stale or are under-managed. As part of our normalization thesis, we also favor owning financial assets like mortgage servicing rights, which become even more valuable cash flow assets if and when rates increase (assuming unemployment does not spike, which is our base view).

Two other considerations that we think warrant investor attention include being notably underweight government bonds across portfolios and liability management. At current levels, we think that government bonds can no longer provide decent yield. Second, we think that stock market performance is not as likely to be as correlated with bond market performance as it has been during the past two decades. Given this viewpoint, we feel strongly that investors should seek to extend liabilities at the fund level, or at portfolio company level. At present, our two favorite markets to perform this task would be Europe (where bunds look quite expensive versus U.S. Treasuries) and Japan (where bank deposits as a percentage of GDP are still north of 130%).
Financials and Tech Make Up Slightly More Than 50% of 2018 S&P 500 EPS Growth

So, if we either see something that dents current earnings trends in Technology (e.g., government intervention, pricing pressure, etc.) or a flattening yield curve amidst accelerating credit losses across Financials, then we think it would be overall bearish for the market. For those that want to hedge out this risk on a proactive basis, our colleague Phil Kim suggests using simple 25 delta put options on QQQ (the Nasdaq 100 Index). As a refresher, delta measures the rate of change of the theoretical option value with respect to changes in the underlying asset’s price. With a strike of 144 versus an underlying value of 156, the option costs 220 basis points upfront.

From almost any vantage point, the global risk free rate is unusually low relative to both history as well as current global growth trends. This backdrop was not the case in prior years, and as such, it could create significant price risk across most bond portfolios. Moreover, spreads across Credit appear tight amidst a time of booming consumer and investor confidence. Our favorite measure for quantifying potential over-optimism in the credit markets is to assess the implied default rate that the liquid High Yield market appears to be discounting. As we show in Exhibit 111, our model is currently suggesting an implied default rate of 0.6%, well below the historical average and a far cry from levels seen as recently as the first quarter of 2016. In terms of absolute yield levels, High Yield spreads also feel compressed, trading now at 358 basis points above the risk-free rate (which we also think is almost priced for perfection). In the past, this spread has averaged closer to 600 basis points.

Tech and Financials Make Up Nearly 57% of 2018 Emerging Market EPS Growth

So, if we either see something that dents current earnings trends in Technology (e.g., government intervention, pricing pressure, etc.) or a flattening yield curve amidst accelerating credit losses across Financials, then we think it would be overall bearish for the market. For those that want to hedge out this risk on a proactive basis, our colleague Phil Kim suggests using simple 25 delta put options on QQQ (the Nasdaq 100 Index). As a refresher, delta measures the rate of change of the theoretical option value with respect to changes in the underlying asset’s price. With a strike of 144 versus an underlying value of 156, the option costs 220 basis points upfront.

From almost any vantage point, the global risk free rate is unusually low relative to both history as well as current global growth trends.
High Yield Spreads Have Tightened Significantly and Are Now Well Below Average

Data as at December 27, 2017. Source: Bloomberg.

Relative value within and across the High Yield asset class also feels somewhat disconnected from reality. For example, despite being further down in the capital structure, High Yield spreads are now trading 48 basis points tighter, on average, than bank loans (Exhibit 113). In our view, this type of relative compression seems unsustainable.

EXHIBIT 113
High Yield Spreads Appear Mispriced Relative to Those of Bank Loans at This Point in the Cycle

Data as at December 20, 2017. Source: Bloomberg.

Another area within Credit that we are watching closely is the Investment Grade Debt market. Key to our thinking is that, as we show in Exhibit 115, gross leverage and net leverage are both re-approaching levels not seen since the late 1990s, a period that led to a sudden surge in ‘Fallen Angels.’ All told, the BBB segment of the Investment Grade market is now 49% of the entire IG market, compared to 38% in 2007; moreover, the size of the IG market has doubled during this same period, according to Adam Richmond of the investment bank Morgan Stanley.

EXHIBIT 115
Investment Grade Leverage Risk Is Quietly Testing Record Levels Again...

Data as at October 31, 2017. Source: Morgan Stanley.
EXHIBIT 116

Particularly in the Energy, Healthcare, and TMT Sectors

Change in Leverage from Trough in 2Q11 to 2Q17

Data as at June 30, 2017. Source: Morgan Stanley.

In terms of hedging for these aforementioned risks, we are running with huge underweights to both Government Bonds and traditional Credit. In addition, we suggest Investment Grade CDX payer swaptions for full tail risk insurance. Despite skew being wider in Investment Grade bonds, the overall level of volatility is still very low, resulting in less premium spend per unit of expected payout. Also, Investment Grade spreads tend to move more in multiples of original spread than High Yield in risk-off scenarios (i.e., it’s easier for a company that trades at 20 basis points to widen to 80 basis points in a risk-off event rather than a company to go from 300 basis points to 1,200 basis points). A six month 25 delta payer swaption (80 basis points strike versus 57 basis points forward) costs 15.5 basis points upfront. This compared to the equivalent 25 delta High Yield option cost of 752 basis points, so the gap in pricing definitely favors hedging Investment Grade over High Yield, we believe.

#3: Stock/Bond Correlations Reverse Amidst Stronger Growth and Central Bank Normalization, Pressuring Levered Portfolios

While the macro concerns that we mentioned above are more cyclical in nature, there is also one secular risk that we think is worthy of investor consideration. It relates to the relationship between stocks and bonds. As we show in Exhibit 117, prior to the collapse of Long Term Capital Management in the late 1990s, stocks and bonds tended to move in opposite directions, creating notable bouts of volatility along the way (e.g., 1994). However, after Fed Chairman Greenspan intervened in 1998, stocks and bonds tended to be more supportive during periods of stress. Specifically, as stocks sold off, bonds actually rallied – essentially lowering the cost of capital for corporations. At the same time, levered entities, including risk parity players, benefitted from the stability that bonds provided. In many instances these portfolios actually enjoyed gains.

This relationship has been quite lucrative for the investment management industry in recent years, and in our view, we believe that it has bred complacency. To this end, if we do enter an era where long duration fixed income does not act as a positive carry hedge, it will represent a major change in how both corporations and investors behave during periods of crisis. Specifically, portfolio managers will have not only to sell bonds at a loss but also reduce their leverage, which we believe could exacerbate more selling and more de-leveraging, at even lower prices.

EXHIBIT 117

Stock and Bond Volatilities Are Now on Par; This Seems Unsustainable, in Our View

At current levels, our base view is that global government bonds can act neither as ‘shock absorbers’ nor as meaningful income producers.

“}

Stock Bond Correlations Have Actually Been Positive Since the Tech Bubble Peak in 2000, But this Isn’t the Norm Over a Longer Time Period

At the moment, we do not see this type of systematic and permanent reversal in equity/bond correlations as a material threat to the market. However, this risk is rising as we add stimulus to a global economy that is now already enjoying a synchronized recovery. As such, we view this risk as the one that could structurally impair the extremely compelling macro backdrop that has existed for multi-asset class investors in recent years.

To hedge against this potential shift in the macro environment, we believe that investors should be fully embracing our ‘Central Bank Normalization’ thesis, which includes – among other things – an underweight to government bonds, an overweight to mortgage services, and an extension of long duration liabilities. We also believe that some of the hedges mentioned earlier (e.g., Nasdaq and/or S&P 500 puts) would make sense were correlations to reverse (finally) amidst stronger growth and central bank normalization.

**#4: Complacency Is Beginning to Set in; Buying Volatility/Hedges May Make Sense (Finally!)**

While the junk heap for capital wasted on buying volatility in recent years is large and growing, our work points towards a more volatile second half of 2018. Key to our thinking is that the macro landscape could be changing by 2H18. In particular, we expect U.S. earnings growth to decelerate, and our work shows that central bank QE flows could begin to reverse in absolute terms at a time when we think that the Fed will be hiking rates for much faster than the market currently expects. Importantly, this set-up is about to occur at a time when dispersions for most of the macro data we track have collapsed to record lows. Indeed, as we show in Exhibits 119-122, there is now very little debate amongst investors around key macro forecasts such as inflation expectations, earnings trends, and term premium.


---

**EXHIBIT 118**

36-Month Correlation: S&P 500 Index vs. US 10-Year Yield, %

Up until 2000, the stock price vs bond yield correlation was negative


---

**EXHIBIT 119**

Inflation Expectations Have Narrowed Relative to History


---

**EXHIBIT 120**

We Believe that Term Premium Has Fallen to Unsustainably Low Levels, and as Such, We See It Headed Higher

Data as at November 14, 2017. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

---

While the junk heap for capital wasted on buying volatility in recent years is large and growing, our work points towards a more volatile second half of 2018.
Synchronized Improvements in Economic Surprises Have Helped to Foster a Benign Environment for Global Capital Markets; We Believe this Could Change Within the Next 12-24 Months

EXHIBIT 121

Dispersion of EPS Has Also Dropped to Levels that We View as Too Low. As Such, We Look for Some Mean Reversion in 2018

EXHIBIT 122

So, our call is to spend a little money to protect against the aforementioned tightness in macro dispersions that have accumulated during the past few years. In our humble opinion, downside protection across Equities, Rates, and Credit makes sense these days, particularly given 1) how low volatility has trended in recent quarters and 2) how confident investors have become that greener investment pastures lie ahead.

#5: Social and Reputational Issues Will Remain Tail Risks in 2018

My colleague Ken Mehlman is watching for more behavioral controversies to upend companies over the coming year. The exposure of widespread sexual harassment— and worse— has ended careers and damaged numerous institutions across a wide swath of industries. In addition to reflecting a welcomed change in behavior, these revelations and public outrage also reflect the transformative power of the Internet to uncover misbehavior. We see multiple dynamics at work. First, the Internet and social media turn previously powerless individuals with a story to tell into de facto investigative journalists. Second, social media builds community among otherwise random individuals with similar experiences—making it more likely these individuals will tell their stories. Third, social media’s immediacy spreads and accelerates these stories at a rapid clip.

Without question, social media is not just about reputational issues; the aforementioned concerns can impact a company’s bottom line, result in termination of top talent, and otherwise impair brand. In this environment, there is no easy hedge; rather, investors must carefully assess company culture, risk management practices, and personnel risks.

Without question, social media is not just about reputational issues; the aforementioned concerns can impact a company’s bottom line, result in termination of top talent, and otherwise impair brand. In this environment, there is no easy hedge; rather, investors must carefully assess company culture, risk management practices, and personnel risks.
Section IV: Conclusion

As we enter 2018, our base view is to become over-invested in areas of the market that offer upside relative to traditional benchmarks. To this end, we favor the operationally intensive segments of Private Equity, Real Assets, and Asset-Based Finance within the Private Markets, all of which are reflected in our target asset allocation in Exhibit 5. In the Public Markets, we favor Emerging Markets Public Equities (with a focus on Asia), Opportunistic Liquid Credit, and global Financial Services stocks. Not surprisingly, these investment opportunities underscore many of our key macro investment themes:

- Deconglomeratization
- Illiquidity Premium
- EM Bull Market
- Experiences Over Things
- Central Bank Normalization
- Complexity Over Simplicity

On the other hand, there are several parts of the market where we think valuations and sentiment have gotten too extreme. Specifically, within the Private Markets we think Growth Equity is expensive, and as such, we have zero exposure to this asset class, compared to a benchmark weighting of 500 basis points. We also view High Yield and Investment Grade debt as expensive, and as such, we have minimized our exposure to these areas. As we indicated, however, our largest underweight is to Government Bonds. Interestingly, one can now own Cash in the U.S. and earn more than what an investor could get in longer-duration government bonds in Europe and Japan.

However, to be successful as an investor in 2018, one will need to be well versed beyond just the global capital markets. Looking ahead, we believe investors must watch for new controversies and developments involving key political hotspots such as trade. Indeed, we expect a more confrontational tone between the U.S. and China around trade and intellectual property (IP). NAFTA also has the potential to become a worsening friction point in 2018, with the risk of even more disruption depending on how the Mexican election unfolds. However, President Trump is no ideologue. His rhetoric, often in service of negotiating a ‘better deal’, might differ from actual policy outcomes, and his approach can change based on other geopolitical events.

Interestingly, though, we also believe that intensifying rivalries and geopolitical events may also provide discrete up sides to certain trade dynamics, which could actually be good for markets. Indeed, it was actually North Korea’s nuclear tests this past year that took the pressure off the US-South Korea FTA renegotiation. Similarly, a more confrontational dynamic with Beijing may eventually prove positive for U.S. trade relations with other Asian powers.

With all these aforementioned considerations at play, our base view, particularly for the first half of the year, remains that 2018 could emerge as another decent performance period for many financial assets. As we transition into 2019, however, we believe that financial assets may not perform as well as real economy prices. Indeed, some form of mean reversion is likely at the end of this cycle, as we show in Exhibit 122. Importantly, we think this viewpoint dovetails with our belief that politicians will continue to implement global policies that try to tackle the growing inequality that we now see on a global basis.

EXHIBIT 123

U.S. Consumer Are Now Spending, Not Saving

We think that forward returns are likely to be notably lower than in the past. In particular, we believe that spreads in Credit are at their tights at a time when risk-free rates are too low, and we believe that equity multiples as well as corporate margins could be approaching their peak in 2018.
There Is a Wide Dispersion Between Financial Asset Prices and Real Economy Prices

If we are wrong and financial assets perform poorly throughout 2018, we believe that it will actually be tied to stronger—not weaker—growth as well as a more hawkish Federal Reserve and/or ECB. Indeed, we are now adding significant stimulus amidst a period of both rising consumer confidence and financial asset prices. Against this more robust growth, central banks will likely have to start removing ‘emergency’ monetary conditions, a decision that we believe could dent the significant outperformance that we have seen of financial assets relative to real assets since the Global Financial Crisis (Exhibit 124).

In the interim, however, we believe that investors can still ‘get what they need’ in 2018 by embracing many of the global macro investment themes that we have laid out in this year’s outlook piece. Consistent with this view, we continue to see today’s market as a bifurcated one that rewards investors seeking to Buy Complexity as well as to Sell Simplicity. Moreover, unlike in prior years, the opportunity set today extends well beyond making good asset allocation decisions. Indeed, the opportunity set within many asset classes to generate alpha relative to passive indices is as large as we have seen in recent years, which helps support our overall approach to capital deployment in an environment where many index level gauges appear quite expensive relative to history.

"As we enter 2018, our base view is to become over-invested in areas of the market that offer upside relative to traditional benchmarks. To this end, we favor the operationally intensive segments of Private Equity, Real Assets, and Asset-Based Finance within the Private Markets."

EXHIBIT 124
Financial and Real Economy Prices Total Return Performance in Local Currency Since January 2009

Data as at December 31, 2017. Source: Factset.
The views expressed reflect the current views of Mr. McVey as of the date hereof and neither Mr. McVey nor KKR undertakes to advise you of any changes in the views expressed herein. Opinions or statements regarding financial market trends are based on current market conditions and are subject to change without notice. References to a target portfolio and allocations of such a portfolio refer to a hypothetical allocation of assets and not an actual portfolio. The views expressed herein and discussion of any target portfolio or allocations may not be reflected in the strategies and products that KKR offers or invests, including strategies and products to which Mr. McVey provides investment advice to or on behalf of KKR. It should not be assumed that Mr. McVey has made or will make investment recommendations in the future that are consistent with the views expressed herein, or use any or all of the techniques or methods of analysis described herein in managing client or proprietary accounts. Further, Mr. McVey may make investment recommendations and KKR and its affiliates may have positions (long or short) or engage in securities transactions that are not consistent with the information and views expressed in this document.

The views expressed in this publication are the personal views of Henry McVey of Kohlberg Kravis Roberts & Co. L.P. (together with its affiliates, “KKR”) and do not necessarily reflect the views of KKR itself or any investment professional at KKR. This document is not research and should not be treated as research. This document does not represent valuations with respect to any financial instrument, issuer, security or sector that may be described or referenced herein and does not represent a formal or official view of KKR. This document is not intended to, and does not, relate specifically to any investment strategy or product that KKR offers. It is being provided merely to provide a framework to assist in the implementation of an investor’s own analysis and an investor’s own views on the topic discussed herein.

This publication has been prepared solely for informational purposes. The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this document has been developed internally and/or obtained from sources believed to be reliable; however, neither KKR nor Mr. McVey guarantees the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision.

There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Target allocations contained herein are subject to change. There is no assurance that the target allocations will be achieved, and actual allocations may be significantly different than that shown here. This publication should not be viewed as a current or past recommendation or a solicitation of an offer to buy or sell any securities or to adopt any investment strategy.

The information in this publication may contain projections or other forward looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Performance of all cited indices is calculated on a total return basis with dividends reinvested. The indices do not include any expenses, fees or charges and are unmanaged and should not be considered investments.

The investment strategy and themes discussed herein may be unsuitable for investors depending on their specific investment objectives and financial situation. Please note that changes in the rate of exchange of a currency may affect the value, price or income of an investment adversely.

Neither KKR nor Mr. McVey assumes any duty to, nor undertakes to update forward looking statements. No representation or warranty, express or implied, is made or given by or on behalf of KKR, Mr. McVey or any other person as to the accuracy and completeness or fairness of the information contained in this publication and no responsibility or liability is accepted for any such information. By accepting this document, the recipient acknowledges its understanding and acceptance of the foregoing statement.

The MSCI sourced information in this document is the exclusive property of MSCI Inc. (MSCI). MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.