INSIGHTS
GLOBAL MACRO TRENDS

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New Playbook Required

KKR GLOBAL INSTITUTE

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New Playbook Required

From a macro and asset allocation perspective, we think we may be on the cusp of a secular shift where a new playbook for investing may be required. Most importantly, we now see a significant 'baton hand-off' in many of the markets that we cover from monetary policy towards fiscal stimulus — perhaps the most important shift in the last decade. This change in policy leads us to favor investments with greater linkages to the real economy — versus purely financial assets — than in the past. We also continue to see nationalist agendas supplanting more global ones. Against this backdrop, we now favor more upfront yield in the portfolio, we advocate shortening duration, and we place a premium on low-cost liabilities. We also continue to view Asia as the world's incremental growth engine.

"The problem with fiction, it has to be plausible. That's not true with non-fiction."

THOMAS K. WOLFE
AMERICAN AUTHOR AND JOURNALIST

One quick glance at the newspaper headlines these days, and I am left thinking that the events of 2018 would be difficult for someone even as creative as the late Tom Wolfe to imagine. Indeed, recent trips to Mexico City, Rome, London, Spain, and Washington, D.C. all confirm my view that we are truly living in unprecedented times – times that might likely have seemed 'implausible' for the legendary, Virginia-born, author who penned such literary classics as *Bonfire of the Vanities, The Right Stuff,* and *Electric Kool-Aid Acid Test.*

The good news is that uncertainty almost always breeds opportunity for those who are not only prepared but also willing to adapt. We would like to think we are both, and as such, we are using this mid-year update to lay out some important changes to our asset allocation framework. See below for details, but – to some degree – we think that a new playbook may be required. To this end, we note the following mega macro trends:

One must now invest through the lens of fiscal policy accommodation, not monetary policy accommodation. Without question, this shift within many markets we cover could be the most important one in a decade, driven by governments shifting their emphasis away from monetary policy, which has dominated the landscape since the Global Financial Crisis (GFC), towards fiscal policy. At the moment, the U.S. is clearly leading the pack, but many countries, including Italy, Spain, and Mexico, are trying to use fiscal stimulus to help not only stimulate growth but also to thwart the growing socioeconomic divide that has been created in the GFC's aftermath. See below for more details, but we think that this 'baton hand-off' may likely require a different investment playbook than what worked during the 2009-2017 period. Specifically, it could favor assets with greater linkages to the real economy than purely to the financial markets *(Exhibit 69).* It also means that equity multiples have likely peaked, something we have not previously been saying (*Exhibit 47*). By comparison, during the past few years sluggish economic growth meant above normal policy accommodation from global central banks, which was a boon for owners of most financial assets, including long duration debt and equity (i.e., growth stocks). We also believe this change from monetary to fiscal stimulus reinforces our strong desire to lock in low cost liabilities, one of the key themes from our January 2018 outlook piece (see *You Can't Always Get What You Want*).

Nationalist agendas are now aggressively being emphasized over global ones. My colleague Ken Mehlman and I laid this theme out in detail in our January 2018 piece (*You Can't Always Get What You Want)*, but the speed and the magnitude of recent actions have caught even us off guard. Without question, President Trump in the United States is ushering in a different era as it relates to global trade. At the moment, we estimate roughly 40% of the United States' total trade deficit is derived from three areas: transportation (Mexico), apparel (China), and technology (China). In terms of specifics, we estimate that over 100% of the U.S. trade deficit with Mexico is in one category, transportation, while nearly two-thirds of the trade deficit with China is centered in the apparel and computer categories. So, if one is to focus on the signal and not the noise, then we believe any attempt to narrow the deficit will have to involve significant changes in these three areas (*Exhibit 103*). As such, we advocate a heightened scrutiny on capital deployment across these three sectors – at a minimum – of the global economy. Our bigger picture conclusion, which we detail below in *Exhibit 104*, is that global trade actually peaked around 2008 after a multi-decade upward run. Hence, our view is that President Trump's trade negotiations may just further accelerate a global growth headwind that has actually been with us for some time, particularly as China insources production of more intermediate goods. It could also lead to further volatility in the currency market, as trade-affected countries try to regain competitive advantage through potential devaluations.

We remain bullish on the Yearn for Yield, but we are further turning our focus towards hard assets that benefit more from nominal GDP running so hot relative to nominal interest rates. Both the demographic work done my colleagues Paula Roberts and Ken Mehlman (see *What Does Population Aging Mean for Growth and Investments,* February 2018) as well our recent insurance piece (see *New World Order,* April 2018) supports our view that the structural bid for yielding assets remain outsized. However, given our high conviction view that governments are committed to driving higher nominal GDP at a time of low nominal interest rates (which has traditionally been the cure for deflation/disinflation), we want to continue to increase our allocation to yielding assets backed by nominal GDP. This call is a big one, we believe; we think it has legs in terms of duration, and we believe it warrants a notable overweight position from an asset allocation perspective.

Similar to the late 1990s, we think that the market is giving investors a wonderful opportunity to buy complexity at a discount. Importantly, for investment managers with operational expertise, there is potentially a lucrative opportunity to buy companies at a discount, reposition or restructure them, and sell them back into the public markets at a significant valuation increase. Consistent with this view, our quant work shows that *Momentum and Growth* are the two most coveted strategies by equity investors over the last three years. At the same time, *Value and Dividend* are the two least preferred. From our perch at KKR, this arbitrage is an extremely compelling one. A similar story is playing out in Credit, which supports our heavy overweight to Opportunistic Credit over High Grade Debt. So, overall, though many headline indexes across the equity and debt markets appear full, we continue to identify some good values if one is willing to not follow the herd, lean into complexity, and originate capital structures that are not subject to short-termism.

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> **One must now invest through the lens of fiscal policy accommodation, not monetary policy accommodation. Without question, this shift within many markets we cover could be the most important one in a decade.**
> "

We remain bullish on our 'Deconglomeratization' thesis. This theme is not new, but it is a powerful one that is accelerating the pace of corporate restructurings across the global capital markets. To some degree, outsized activism in the public markets is forcing CEOs to refine their global footprints, which has been a boon to private equity investors. In addition, there are key markets, particularly in Japan, where in our view there are just too many companies with too many subsidiaries. All told, a full 25% of the Nikkei 400 has 100 or more subsidiaries, and many have more than 300 divisions below the parent company. We have seen a similar burst of corporate carve-out activity across Europe in recent quarters, a trend that we believe will continue. The catalysts for this acceleration, in our view, are the rising cost of capital (which is forcing CEOs to revisit their global footprints), increasing global competition (where locals are reclaiming share), and a surge in in activist dollars (which are aggressively advocating for change).

Experiences Over Things 2.0 We continue to be bullish on our *Experiences Over Things* thesis, but we believe that there are some larger forces at work within the consumer segment of the global economy that warrant investor attention. For example, as detailed by a recent piece from the Council on Foreign Relations (see *The Work Ahead: Machines, Skills, and U.S. Leadership in the Twenty-First Century*), we are increasingly struck by how fast overall consumer behavior patterns are changing. See below for further details, but our bottom line is it is not business as usual in the global consumer arena. Specifically, we think that there are several structural forces at work, including technology, demographics, and education, that are radically changing how, when, and where consumers are spending their time and money against a backdrop of stagnant real wages in many economies. Importantly, these changes are now occurring at a time when savings rates are falling sharply in large markets like the United States.

We continue to favor EM over DM, but we acknowledge that our mid-cycle pause thesis is playing out more intensely than we originally envisioned. As such, we continue to advocate more selectivity in the second phase of this secular bull market in EM. After beginning to hook upwards in 2016, our proprietary Emerging Markets model now indicates that we are actually entering a mid-cycle phase for EM, which is usually associated with solid, albeit more volatile, returns. In particular, valuation is no longer as compelling as it once was in EM, but return on equity is improving, as margins are expanding in Technology as well as many 'old economy' sectors. The bottoming in commodities is also important, according to our model. At the moment, we are constructive on both EM Public Equities and EM dollar-based Government Debt but less so on EM Corporate Debt. Implicit in what we are saying is that we think the recent appreciation in the dollar is not the beginning of the second leg of a dollar bull market after the currency's strong run from 2011-2015. In terms of areas of focus within EM, we favor Asia by a wide margin over Africa and/or Turkey, both areas where we see structural imbalances building. We also remain notably underweight Latin America, which has served us well so far in 2018. On the sector front, we are currently most concerned by the sharp decline that we are seeing in the margins within the EM Consumer Discretionary sector (*Exhibit 94*).

EXHIBIT 1

KKR GMAA 2H18 Target Asset Allocation Update

ASSET CLASS	KKR GMAA JUNE 2018 TARGET (%)	STRATEGY BENCH-MARK (%)	KKR GMAA MARCH 2018 TARGET (%)
Public Equities	**53**	**53**	**53**
U.S.	16	20	15
Europe	17	15	17
Turkey	-1	0	0
All Asia ex-Japan*	10	7	10
Japan	7	5	7
Latin America	4	6	4
Total Fixed Income	**24**	**30**	**22**
Long Duration Global Government	0	20	3
Short-Duration U.S. Bonds	3	0	0
Asset-Based Finance	8	0	8
High Yield	0	5	0
Levered Loans	3	0	3
High Grade	0	5	0
Emerging Market Debt	0	0	0
Actively Managed Opportunistic Credit	6	0	6
Global Direct Lending	2	0	2
Real Estate Credit (B-piece)	2	0	0
Real Assets	**11**	**5**	**10**
Real Estate	3	2	3
Energy / Infrastructure	7	2	7
Gold	0	1	0
Grains (Corn)	1	0	0
Other Alternatives	**11**	**10**	**11**
Traditional PE	8	5	8
Distressed / Special Situation	3	0	3
Growth Capital / VC / Other	0	5	0
Cash	**1**	**2**	**4**

*Please note that as of December 31, 2015 we have recalibrated Asia Public Equities as All Asia ex-Japan and Japan Public Equities. Strategy benchmark is the typical allocation of a large U.S. pension plan. Data as at June 15, 2018. Source: KKR Global Macro & Asset Allocation (GMAA).

Based on these key investment themes, we are providing the following updates to our asset allocation framework.

We are shifting our three percent position in long-duration global government bonds to short-duration U.S. government securities. Previously, we had a zero weighting to the short end of the global curve. In making this change, we are now 20% underweight long-term government bonds (i.e., 2,000 basis points underweight relative to the benchmark, which is the maximum amount allowable). Simply stated, we don't want to own long-duration government bonds when governments around the world have shifted their tool kits from monetary stimulus to fiscal. We also believe that long-term bonds at their current prices with such low yields cannot satisfy their traditional roles in an asset allocation framework as either a 'shock absorber' and/or relevant income stream. For our nickel, we continue to believe that this cycle is different: Long-duration bonds will not rally materially when stocks sell-off in the next downturn. This call is a major one, but one we are comfortable making. Also, as we describe below, we see much more value in the short-end than the long-end, given the flatness of the yield curve. So, if we are wrong and bonds do rally in the second half of 2018, *then we believe that two-year notes in the U.S. provide a positive carry hedge with significant upside convexity, which is extremely hard to find in today's markets*.

We are adding further to our Real Assets with Yield thesis. To review, we already have an 800 basis point overweight to Asset-Based Finance versus a benchmark of zero percent, and we target a 700 basis point weighting in Energy/Infrastructure, compared to a benchmark weighting of 200 basis points. We certainly appreciate that this puts a lot of investment eggs in one basket, but given our view on the movement towards fiscal stimulus from monetary stimulus as well as the consequences from running nominal GDP over nominal interest rates, we think that our major overweight position is warranted. In fact, we are using this mid-year update to further increase the size of this bet by adding a two percent position to the B-piece of our Real Estate Credit portfolio. All told, we think this investment can return 11-14% annually, with around 10% of that total in the form of cash coupon. We also believe that this asset class satisfies our desire to gain more upfront coupons as well as to hold assets that benefit from rising nominal GDP.

Within Global Equities, we remain notably underweight Latin America, and we are using this opportunity to sell a one percent position in Turkey. By comparison, we remain overweight All Asia ex-Japan by three hundred basis points. Overall, we are still constructive on EM, but we do think that weaker players – particularly those with both current and fiscal account deficits will face a more challenging road ahead (*Exhibit 98*). Meanwhile, we remain overweight Europe and Japan, both areas where we feel that monetary policy is likely to stay loose amidst structurally low inflation. Within Europe, we favor Germany, France, and Spain, at the expense of the U.K. and Italy. In Japan, we favor active management and a focus on value creation strategies. Finally, we hold an underweight in U.S. Public Equities, but we are using this update to add back one percentage point to the U.S. (going to 16% from 15% versus a benchmark of 20%).

Within Private Equity, we remain 300 basis points overweight traditional Private Equity and 500 basis points underweight Growth Investing. As we describe below in more detail, we want more 'ball control' on our investments later in the cycle, which is typically when PE outperforms Public Equities. By comparison, given that we think Growth Investing has been awarded too much money to deploy at a time when valuations appear full, we continue to underweight this asset class, particularly in Asia (where our travels lead us to believe that sentiment is now on par with the late 1990s in the U.S.).

We retain a notable underweight to both traditional High Grade Debt and High Yield. All told, as we show in *Exhibit 1*, we are collectively underweight these asset classes by 1000 basis points. In lieu of these positions, we continue to favor Opportunistic Credit (six percent) and Asset-Based Finance (eight percent). We view the former as a play on our *Buy Complexity* thesis, while we view the latter as a defensive vehicle to protect against higher nominal GDP and higher nominal interest rates.

We are adding a one percentage point positon in Grains, Corn in particular. As any Bloomberg terminal will attest, the price of corn has been in a structural downtrend, with what we believe finally culminated in a cathartic move down in price during late June. However, at today's levels, we believe the current risk-reward is quite compelling. Key to our thinking is that the long-term fundamentals will prevail, as there is large and growing demand for protein across both developed and developing markets, and corn is a key component in the animal feedstock. Moreover, if trade does become an issue and China fails to import U.S. soybeans, then Brazil will increase its supply of soybeans at the expense of corn. If we are right, then this would further tighten the market for corn. Finally, we think Corn is an interesting inflation hedge against nominal GDP growing materially faster than what we are currently forecasting.

Our Cash balance drops to one percent from four percent. However, don't get us wrong; we still like Cash in the U.S. We are merely redeploying our excess Cash into tactical areas like Grains and CMBS B-Piece, where we see near-term market mis-pricings. Indeed, unlike in the past, Cash is increasingly becoming a competitive asset class in markets like the U.S. Moreover, given our view that multiples in Public Equities have peaked and that credit spreads can't tighten further, we think the ability to earn one to two percent in U.S. dollars with no duration risk is increasingly becoming compelling. Also, Cash has a zero correlation with the other asset classes in which we traffic, and as such, our one percent position gives us a little flexibility to add to risk assets if markets pull back meaningfully in the second half of 2018.

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Our bigger picture conclusion is that global trade actually peaked around 2008 after a multi-decade upward run.

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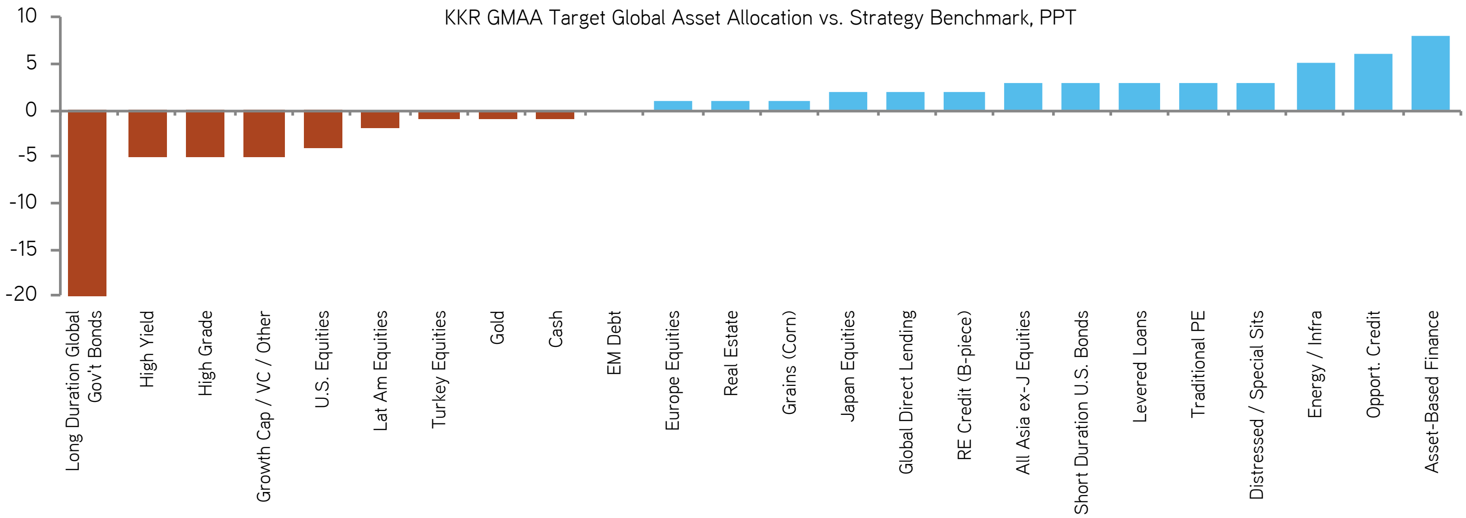
EXHIBIT 2

Our Asset Allocation Reflects Our Preference for Yield and Growth Assets That Are Linked to Nominal GDP Relative to Government Bonds, Asia Over Latin America, and Private Equity Over Growth Equity



Data as at June 20, 2018. Source: KKR Global Macro & Asset Allocation analysis.

While we feel confident about our preferred macro and asset allocation strategies, we are fully cognizant that there are risks to our portfolio positioning. First, there is growing risk that, given the movement away from monetary stimulus toward fiscal initiatives, including investments that may require more savings, interest rates move sharply upward in a path that is well beyond what either we and/or the futures markets are suggesting. *This shift would not only create losses in the fixed income investments, but we also believe that it would, as we describe below in more detail, dent equity multiples more than we are already anticipating.* We hedge this concern by our massive underweight to long duration Government Bonds as well as our *Buy Complexity* thesis, which tends to favor Value stocks and bonds over Growth securities at this point in the cycle.

Second, credit conditions could deteriorate faster than we are currently forecasting. At the moment, our work shows that the second half of 2019 is the period when both top line growth and margins should begin to come under pressure. If it happens earlier than we expect, then we believe it will be linked to rising financing costs and higher wages. It could also be linked to surging input costs, compliments of either heightened trade tensions or over-stimulation of the 'old economy' by fiscal stimulus late in the cycle, which could cause more of a boom-bust cycle than we are currently envisioning.

Third, as we mentioned at the outset, there are material geopolitical risks, including the recent sparring between the U.S. and China (which we expect to continue), to consider. We generally do not make explicit overweight sector or country calls based specifically on geopolitical tensions, but today's political landscape is being dominated by a handful of unconventional politicians, many of whom have less traditional diplomatic strategies. So, against this backdrop, we do believe that our underweight to select parts of EM, Mexico and Turkey in particular, is a potentially thoughtful approach to the conundrum that many investors now face. Our heavy overweight to Real Assets also gives us some additional downside protection.

Finally, the Technology sector could come under pressure. For our nickel, we believe that a fall-off in this sector would be significant, as it currently represents nearly 26% of S&P 500's market capitalization as well as 46.5% of the U.S. equity return during the last three years (and 99.4% YTD in the U.S.). In EM, it is now the largest sector by market capitalization in 2018 for the first time ever *(Exhibit 45)*. At the moment, we think that capital expenditures, particularly Tech spend, are booming in many parts of the world. So, while Tech's growing influence is now worthy of investor attention, we do not yet see any immediate signals that its trajectory is about to turn down.

Looking at the big picture, we think that an investor can distill our macro calls down to two important themes. First, many governments around the world are beginning to turn towards an increasing use of fiscal stimulus at the expense of traditional monetary tools. The significance of this transition may not be fully appreciated, in our humble opinion. Moreover, the stark reality is that very few investors in today's market have deployed capital into an environment when rates are structurally rising, not falling.

Second, we believe that more fiscal stimulus will likely drive nominal GDP well in excess of nominal interest rates. This shift represents a major change, as today's politicians look for innovative ways to provide economic relief to a growing number of discontented voters, many of whom have not seen their wages increase in years. It also reflects a decision by governments to control more of their own economic destiny via a more nationalistic approach versus being too reliant on global connectivity to succeed. In our view, this new reality is likely to unsettle the global capital markets for some time. So, in this environment, the investment 'playbook' feels all but certain: capture upfront yield, own more hard assets, shorten duration, lock in low cost liabilities, and avoid countries with large current account deficits.

Ultimately, the two swing factors in the global macro outlook that determine whether the shift towards fiscal impulses from monetary ones as well as the move towards nationalist agendas from global ones work are productivity growth and confidence. Specifically, If central banks are not forced to tighten more quickly than they want and heightened trade tensions do not derail sentiment, then current supply side reforms such as lower taxes and increased fixed investment could prove to a be a boon for both the real economy and the global capital markets. If not, we will look back a few years from now and wonder why political leaders were adding stimulus and granting subsidies at this time in the cycle. In the interim, however, we think that our current asset allocation recommendations are likely to produce strong risk adjusted returns in a world where – inspired by unorthodox fiscal policy amidst a rising populist bent – volatility is going up at the same time that absolute returns across many traditional asset classes are likely going down.

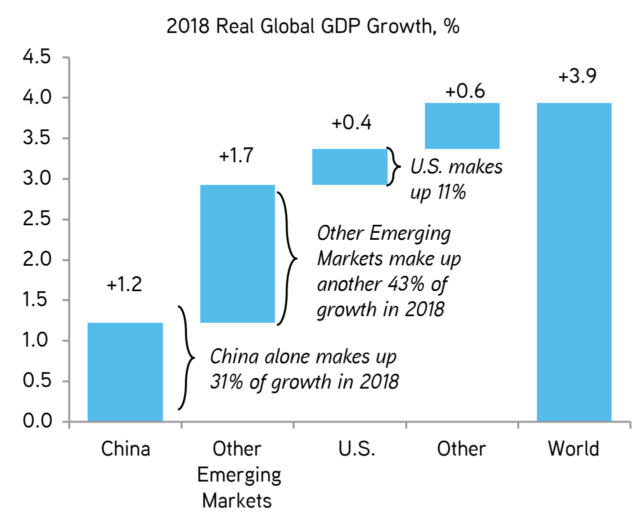
Section I: Global Economic Outlook

As many folks know, we huddle the KKR Global Macro & Asset Allocation team together several times a year to update our outlook. We recently held one of these get-togethers, in mid-June in New York, and it was a wonderful opportunity to update our regional growth forecasts as well as to mark-to-market our views on important macro topics such as oil and interest rates.

So, when we left Boardroom A in KKR's New York headquarters that June day, we came to the conclusion that we remain above consensus for GDP growth around the globe in every region except Europe. One can see this in *Exhibit 4*. Importantly, contrary to public opinion, we still think that China's economy crashed during the 2011 to 2015 period when nominal GDP fell to six percent from roughly 20%. As such, we think that the risk of a major global slowdown in China – and for the global economy overall – is now quite low. Hence, our base case remains that the potential for continued global growth during the next 12 months, particularly in the U.S., is the most likely scenario.

EXHIBIT 3

China Remains the 'Swing Factor' in Global Growth Again This Year



Data as at April 8, 2018. Source: IMFWEO, Haver Analytics.

EXHIBIT 4

We Are Generally More Bullish On Global Growth But Now More In Line With Others on Inflation

2018 GROWTH & INFLATION BASE CASE ESTIMATES

	GMAA TARGET REAL GDP GROWTH	BLOOMBERG CONSENSUS REAL GDP GROWTH	KKR GMAA TARGET INFLATION	BLOOMBERG CONSENSUS INFLATION
U.S.	3.0%	2.8%	2.7%	2.5%
Euro Area	2.1%	2.3%	1.6%	1.6%
China	6.6%	6.5%	2.2%	2.2%
Mexico	2.3%	2.2%	4.4%	4.4%

GDP = Gross Domestic Product. Bloomberg consensus estimates as at June 15, 2018. Source: KKR Global Macro & Asset Allocation analysis.

Another noteworthy insight from our global team was that, despite stronger global growth, we are seeing some strange behavior patterns that we think warrant investor attention. For starters, within the Emerging Markets complex, our work shows that higher oil prices, higher rates, and weaker currencies in many instances are denting consumer buying patterns in markets such as Indonesia. As a result, operating profits within the EM Consumer Discretionary sector are tanking – likely more than many folks may currently appreciate (*Exhibit 94*). Second, in Europe, corporate loan growth has actually slowed materially into the face of better than expected GDP growth. One can see this in *Exhibit 11*. A similar trend is playing out in many parts of the U.S. as well, which also seems inconsistent with better than expected growth. Third, our data shows that global trade tensions are already causing uncertainty around sourcing, investments, and hiring. At the moment, we have trimmed U.S. GDP by 10 basis points to account for rising tensions, but this estimate could prove to be low.

Finally, in terms of economic forecasting, we do want to highlight that we are shifting our economic 'proxy' for Latin America to Mexico from Brazil. All told, KKR has deployed more than two billion dollars of capital in Mexico during recent years, and the Firm now either directly or through its portfolio companies employs more than 10,000 individuals across a variety of business in Mexico. So, not surprisingly, we are spending more time assessing macroeconomic and political trends in Mexico than in the past, especially given the significance of the upcoming election in early July.

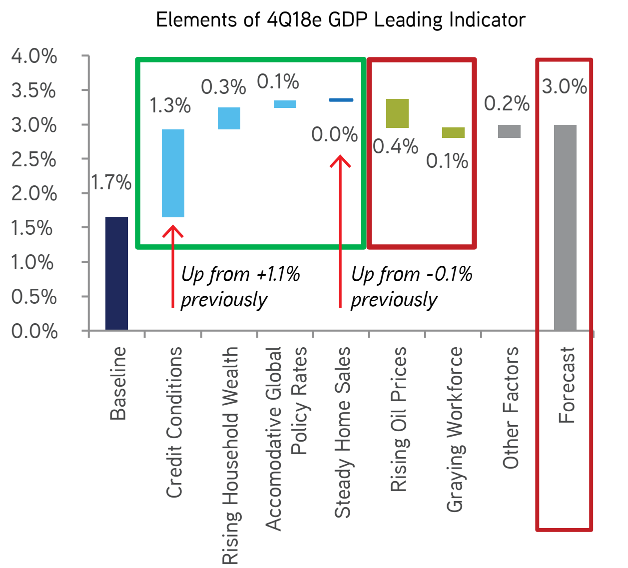
U.S. Outlook: A Stronger Outlook

In the U.S. my colleague Dave McNellis is boosting his U.S. GDP growth forecast up to 3.0% from 2.7% previously. By comparison, the consensus is now at 2.8% growth, compared to 2.6% at the beginning of the year.

As we show in *Exhibit 5*, a key insight from our U.S. GDP model is that it is now more reliant on financial conditions, including credit conditions, rising household net worth, and accommodative global policy rates. Improved housing activity relative to our original expectations in January has also become a modest tailwind. In contrast, higher oil prices are becoming a notable headwind in our model, and we now expect them to increasingly weigh on indications through at least late 2019. Interestingly, a 'graying' workforce is now a fairly consistent issue for GDP, which we believe speaks volumes about the importance of immigration to overall economic growth in the United States.

EXHIBIT 5

Our GDP Model Has Become More Positive on the Outlook for 2018, Though Underlying Variables Are No Longer Universally Supportive

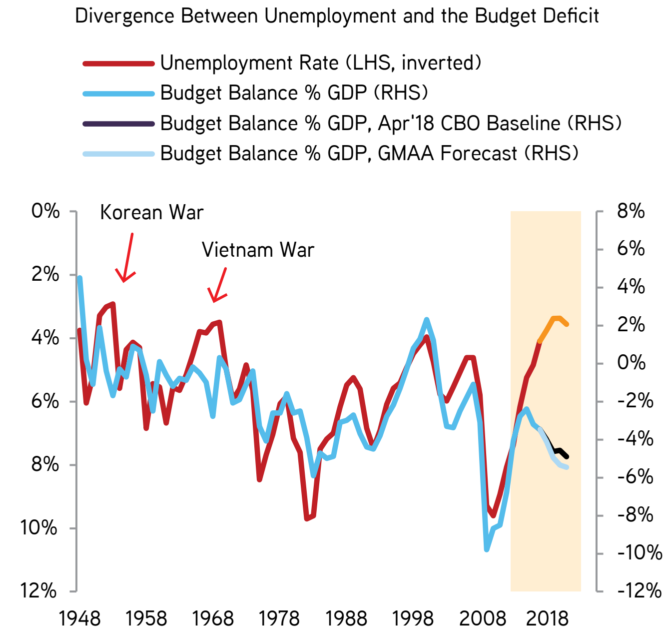


Data as at June 15, 2018. Source: KKR Global Macro & Asset Allocation analysis.

> **Our U.S. GDP model is now more reliant on financial conditions, including credit conditions, rising household net worth, and accommodative global policy rates.**

EXHIBIT 6

The Combination of Tax Cuts and the Recent Budget Deal Could Increase the Deficit to 5.5% of GDP in 2019

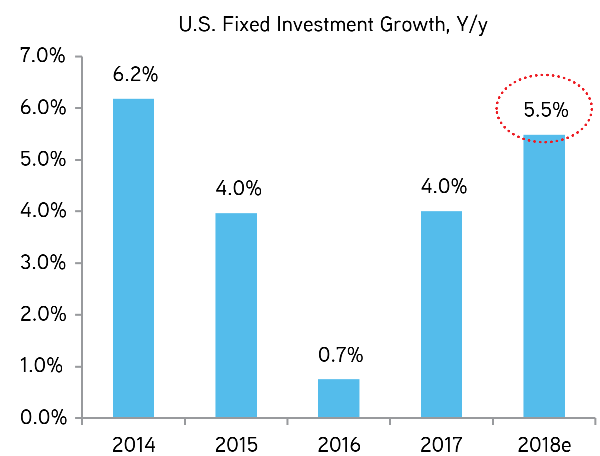


Data as at April 23, 2018. Source: Department of Labor, Department of Commerce, CBO, Goldman Sachs.

Importantly, Dave does not rely just on his quantitative model to forecast growth; he also forecasts GDP growth from a fundamental perspective in an attempt to drive the most accurate results between the two methodologies. So, what's changed on the fundamental side since the beginning of year? Well, we have boosted our forecast for Real Personal Consumption Expenditure (PCE) to 2.6% from 2.4%, and we also now expect Fixed Investment to grow fully 5.5% this year, compared to 4.0% last year and just 0.7% in 2016.

EXHIBIT 7

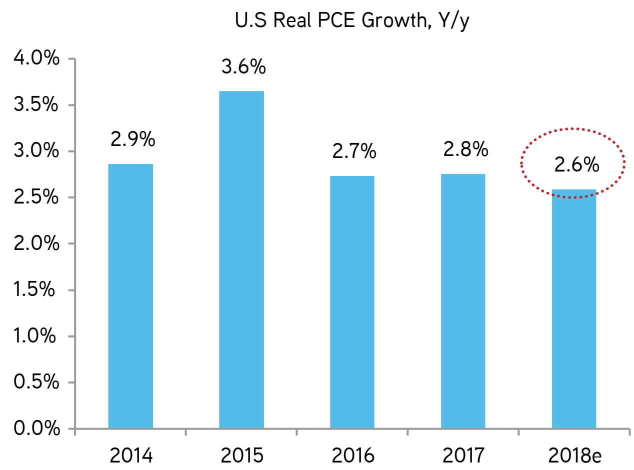
We Think An Upturn in Fixed Investment Spending Will Be One of the Key Drivers of GDP Growth in 2018



Data as at May 31, 2018. Source: Bureau of Economic Analysis, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 8

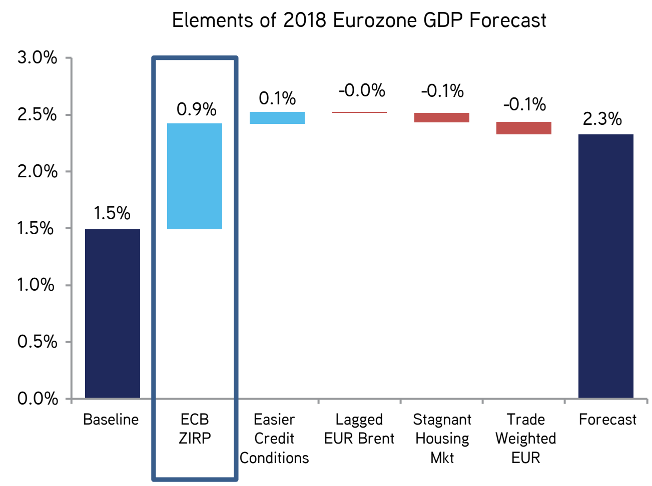
Personal Consumption Growth Is Moderating Relative to Recent Years, But Still Robust in an Absolute Sense



Data as at May 31, 2018. Source: Bureau of Economic Analysis, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 9

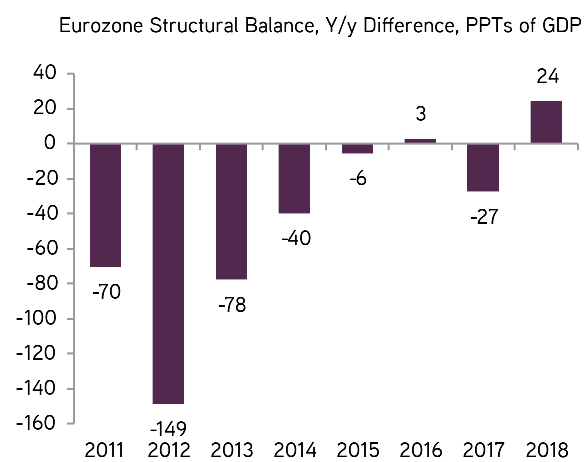
The ECB Remains a Powerful Force of Economic Growth in Europe



Data as at June 15, 2018. Source: Eurostat, European Commission, Statistical Office of the European Communities, Haver Analytics.

EXHIBIT 10

Europe Too Is Finally Seeing Positive Fiscal Stimulus After Years of Belt Tightening



Data as at May 3, 2018. Office of the European Communities, Haver Analytics.

Overall, despite heightened uncertainty around trade policies, growth trends in the U.S. remain quite favorable, and as we look ahead, we are particularly focused on whether increased fixed investment will lead to a boost in productivity. If it does, then it would go a long way towards reducing stress within the investment community about the aggressive fiscal stance taken by President Trump and his administration. If it does not, however, then we likely have too big an exposure to Global Equities at our current equal weight position.

Euro Area Outlook: We Remain Constructive, But Below Consensus

My colleague Aidan Corcoran is now forecasting 2.1% GDP growth for 2018, up 10 basis points from his January estimate. By comparison, the consensus for growth in Europe is 2.3% for 2018, up from 2.1% in January 2018. Interestingly, our quantitative model, which we show below in *Exhibit 9*, points to strong real GDP growth that is more in line with the consensus. To Aidan's credit, however, his fundamental work showed that we should be more conservative than the model in the first half of 2018, an insight that served us well during the spring slowdown.

As we have shown in the past, the powerful influence of the ECB's monetary policy is still acting as an important tailwind to our model. To put this in perspective, we estimate that QE from the ECB accounted for nearly two-thirds of total growth in Italy in recent years. For Spain, we think that the percentage contribution to growth from the ECB's activities is one-third of total growth.

On the other hand, the recent appreciation of the euro as well as less robust housing conditions act as modest headwinds to the model at this point in the cycle. Importantly, though, recent trips to Spain and France suggest that housing is turning more constructive, and as such, we feel confident this variable could turn from negative to positive during the next 12-18 months.

"

Overall, despite heightened uncertainty around trade policies, growth trends in the U.S. remain quite favorable, and as we look ahead, we are particularly focused on whether increased fixed investment will lead to a boost in productivity.

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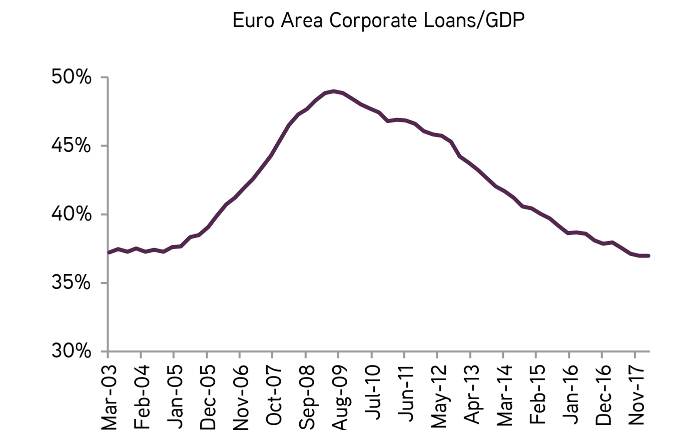
EXHIBIT 11

Credit Growth in the Euro Area Has Generally Been Disappointing, Despite Heavy Central Bank Intervention



Data as at June 1, 2018. Source: Haver Analytics.

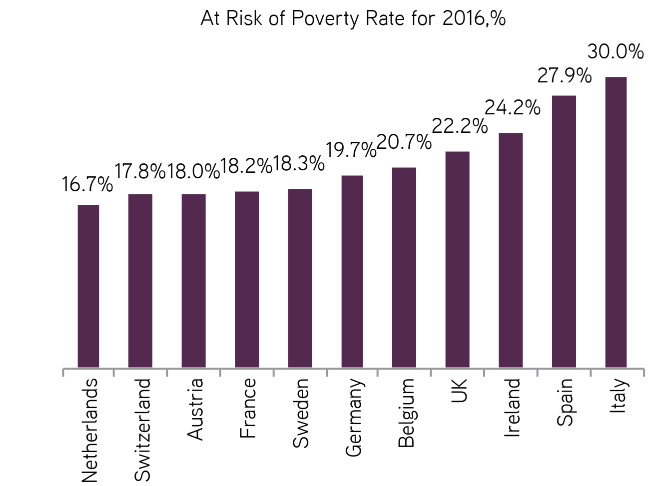
Also, as we show in *Exhibit 10*, fiscal policy has moved from a major overhang to a tailwind. Our instincts tell us that actual fiscal support will likely be greater than this, as more fiscal stimulus is sorely needed to address the populist concerns that continue to impact the political environment all around Europe. Meanwhile, high debt loads are clearly a structural problem in Europe, an issue that goes hand-in hand with slower growth and the inability to fund new social programs for the less fortunate. Not surprisingly, this macroeconomic backdrop only further encourages social discord and populist tilts.

Without question, immigration is a significant component of the current populist tension. True, immigration could actually be an important part of the solution to Europe's demographic challenge, but the numbers can be daunting, particularly on a forward-looking basis. Consider, for example, that Africa's population, which is increasingly turning towards Europe as a migratory destination, is set to increase from 1.3 billion today to 2.5 billion by 2050, which would be about five times the current EU population. So, if we assume that five percent of Africa's projected population migrates towards Europe by 2050 (which is not a totally crazy number, we believe), it would lead to an African population in Europe of nearly 126 million (note: we keep EU borders constant and count only new immigrants versus existing or second generation immigrants, so it could actually be higher). At 126 million people, the population of Africans in Europe would also be a significantly greater number than the largest EU country by population, Germany, which is projected to total 83 million people per the EU's projections for 2050.

"Our instincts tell us that more fiscal support is likely needed to address the populist concerns that continue to impact the political environment all around Europe."

EXHIBIT 12

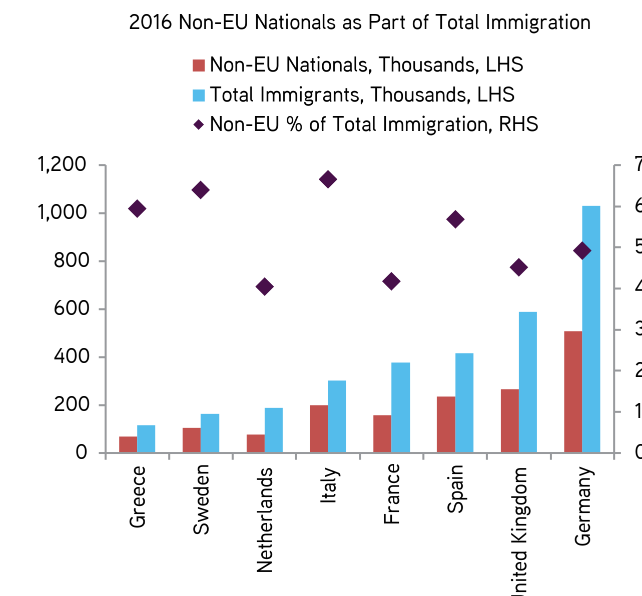
Higher Debt Countries Have Greater Risk of Poverty for Their Citizens



Data as at April 30, 2018. Source: Statistical Office of the European Communities, Haver Analytics.

EXHIBIT 13

Many Countries Have Also Had to Absorb Waves of Non-EU Immigrants

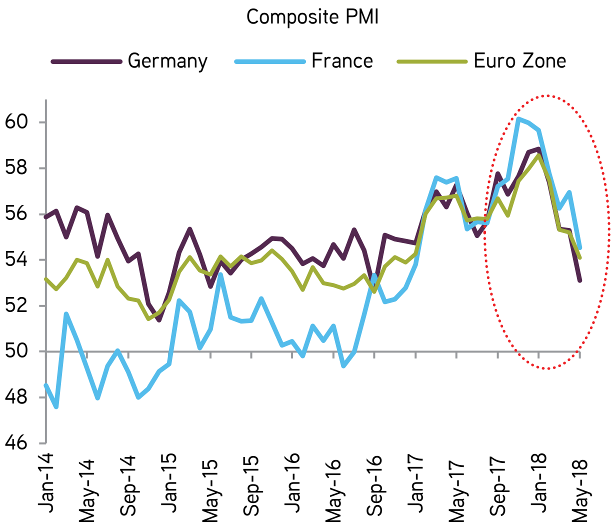


Data as at April 30, 2018. Source: Statistical Office of the European Communities, Haver Analytics.

Another key finding from our recent trip is that Europe's growth has slowed more significantly than what we have seen in Asia and the U.S. of late. One can see this in *Exhibit 14*. However, we currently view the slowdown as a move back towards potential growth, not a signal that any recessionary conditions are fast approaching. The one exception to this viewpoint is the United Kingdom, as we continue to believe that the U.K. consumer is now really feeling the pressure of several macro headwinds, including lower availability of credit *(Exhibit 15)*.

EXHIBIT 14

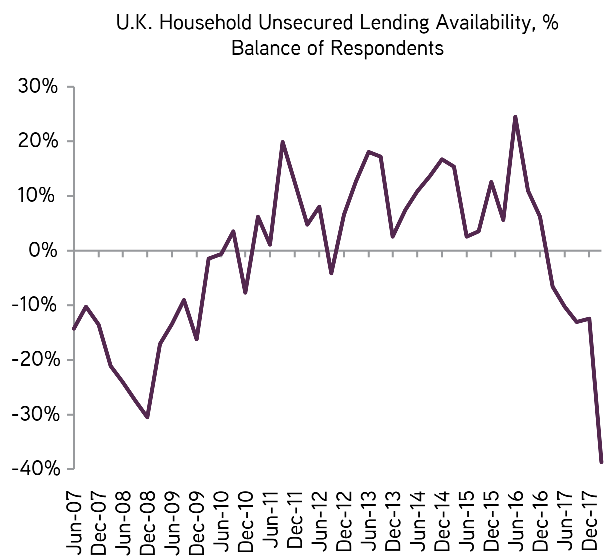
Growth Indicators in Both Manufacturing and Services Have Deteriorated Across Europe



Data as at April 30, 2018. Source: Statistical Office of the European Communities, Haver Analytics.

EXHIBIT 15

There Has Been a Sharp Fall in Consumer Credit Availability in the U.K.



Data as at April 30, 2018. Source: Statistical Office of the European Communities, Haver Analytics.

China: The Balancing Act Continues

My colleague Frances Lim is boosting her 2018 GDP forecast to 6.6% from 6.5%. A major driver of the increase is the reality that first quarter 2018 GDP came in much stronger than we expected at 6.8% versus our original view that growth was poised to decelerate from recent levels. Without question, deleveraging of the financial services industry has been significant. One can see this in *Exhibit 19*. While deleveraging has also impacted fiscal spending and infrastructure growth negatively, the government has employed counter cyclical measures to ease liquidity conditions. For example, interest rates have actually fallen in China versus increasing in the U.S. In fact, the current period is the first time since late 2016 that the PBoC did not raise the reverse repo rate when the Fed raised interest rates. At the same time, Frances is lowering her inflation forecasts to 2.2% from 2.3% previously. Higher oil prices versus last year will push headline inflation up; however, we expect this increase will be more than offset by lower food price inflation.

EXHIBIT 16

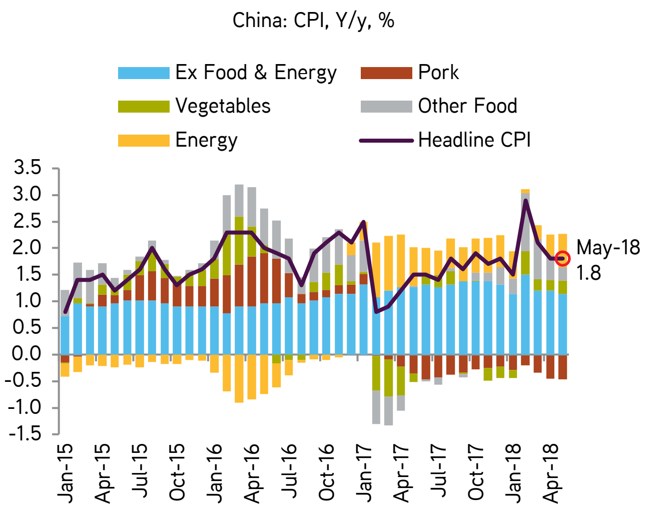
After a Stronger Start to the Year, We Are Boosting Our 2018 Real GDP Growth Forecast for China to 6.6% From 6.5%...

Data as at June 10, 2018. Source: China Bureau of National Statistics, KKR Global Macro & Asset Allocation analysis.

> "In trying to eradicate deflationary pressures from the country, China's government has forced capacity to come out of many 'old economy' sectors."

EXHIBIT 17

...But We Are Lowering Our Full Year 2018 CPI Forecast in China Based on Recent Softness

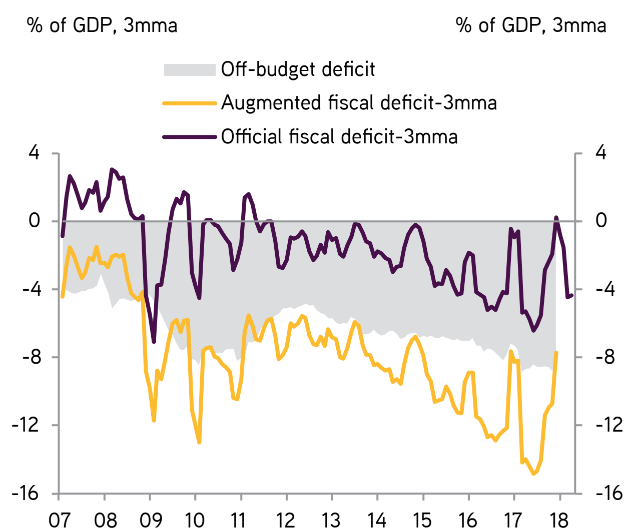


Data as at June 10, 2018. Source: China Bureau of National Statistics, KKR Global Macro & Asset Allocation analysis.

This year China's official budget deficit is targeted to shrink by 40 basis points to 2.6% from 3.0%. Furthermore, off-balance sheet fiscal expenditures are also likely to be constrained by ongoing deleveraging initiatives. So, unlike many of the other countries where KKR does business, China is not aggressively loosening its fiscal policy. Why? Because it already has in past years (*Exhibit 18*), and now the government believes it is time to have a more disciplined approach to capital allocation.

EXHIBIT 18

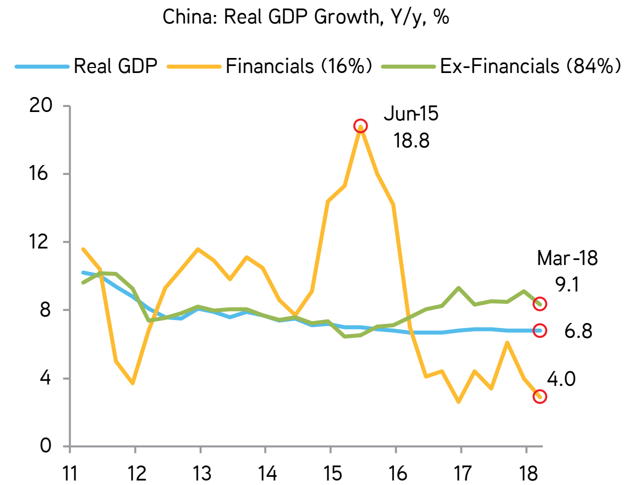
China Has Already Used Fiscal Stimulus to Drive Growth



Data as at March 31, 2018. Source: Goldman Sachs Research.

EXHIBIT 19

While China's GDP Appears Stable, There Have Been Some Substantial Changes Occurring as Financial De-leveraging Occurs

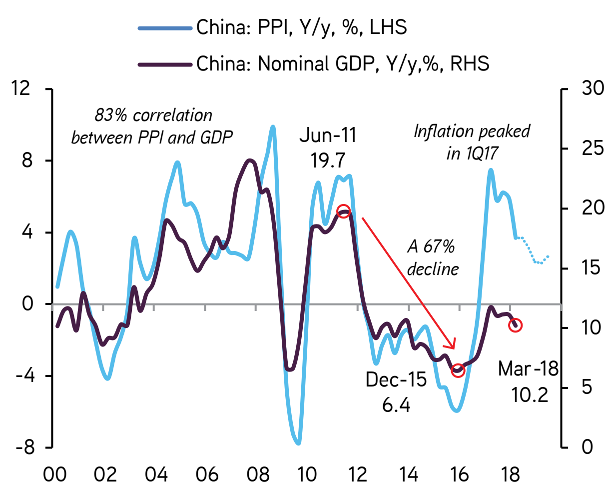


Data as at April 2018. Source: Ministry of Finance of China, China National Bureau of Statistics, Haver Analytics.

Importantly, our base view remains that China has already crashed as an economy. One can see this in *Exhibit 20*, which shows that nominal GDP actually fell 67% from 2011 to 2015. Subsequently, with the country's producer price index (PPI) jumping back into positive territory, nominal GDP has actually rebounded 100% or so to around 12%. Moreover, in trying to eradicate deflationary pressures from the country, China's government has forced capacity to come out of many 'old economy' sectors. This decision has been instrumental in returning profitability to not only China's major industrial producers, but we heard a sigh of relief from commodity producers in other markets such as India too.

EXHIBIT 20

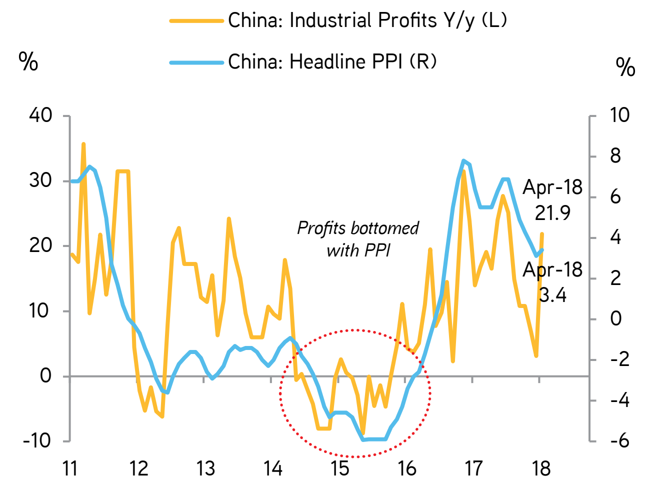
Nominal GDP in China Fell 67% from 2011 to 2015; As Such, We Think that China's Economy Has Already Crashed



Data as at March 31, 2018. Source: China National Bureau of Statistics, Haver Analytics.

EXHIBIT 21

With Supply Being Rationalized, Chinese Industrial Profits Appear to Have Bottomed



Data as at April 30, 2018. Source: China National Bureau of Statistics, Haver Analytics.

Looking ahead, we expect the Chinese government to balance ongoing growth initiatives in important areas like environmental protection while continuing ongoing reform in other areas that need purging, particularly within the shadow banking arena. The good news is that a tight labor market, less available square footage in housing, stable wage growth, and strong U.S. and European growth all help to provide President Xi Jinping with additional 'air cover' to make the changes necessary to transition the Chinese economy towards a more sustainable trajectory in the quarters ahead, we believe.

Mexico: Prevailing Amidst Uncertainty

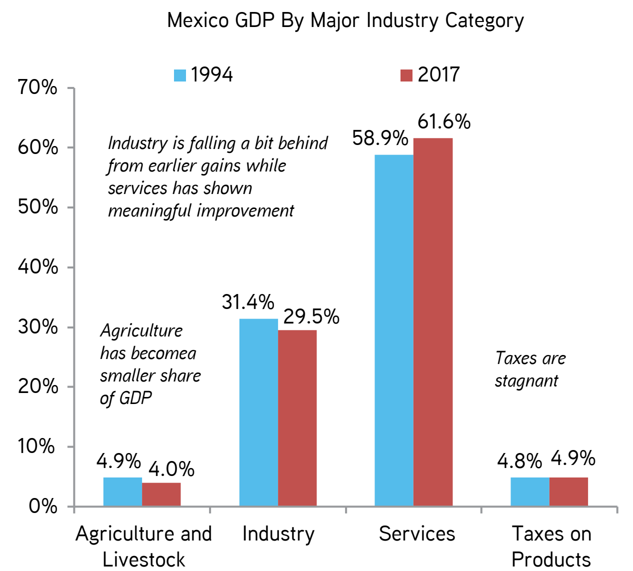
Despite all the headwinds the country has faced of late (e.g., higher inflation, rising interest rates, trade tensions, and no investment growth over the last 12 months), the Mexican economy is actually doing quite well. Unemployment is at 3.4%, compared to a natural unemployment rate of 4.7% according to the OECD. Meanwhile, most economists believe that the economy's output gap is essentially zero, formal sector jobs are growing at 4.5% year-over-year, and real wages are rising again. Most impressive to us, though, is that the economy has weathered the massive downturn in energy prices in recent years (remember that Pemex used to account for 30% of total tax receipts). Without question, the economy has proved to be more flexible and dynamic than in the past.

Looking ahead, we are forecasting 2.3% real GDP growth for Mexico this year, compared to 2.0% growth in 2017 and a consensus forecast of 2.2% for 2018 *(Exhibit 4)*. However, the risks are skewed to the downside in our view due to the ongoing uncertainty associated with NAFTA negotiations negatively impacting — in addition to trade — both investment and private consumption.

We expect headline inflation to moderate towards 3.8% year-over-year by the end of 2018, essentially in-line with Banxico's forecasts. Recent meetings in Mexico City confirm our thesis that the central bank remains vigilant, particularly given the multitude of domestic and external risk factors that could now reignite inflation expectations. As such, we believe that the central bank will likely intervene aggressively above 20 pesos to the dollar to prevent higher inflation, corporate margin degradation, and slower consumer imports.

EXHIBIT 22

The Mexican Economy Remains Heavily Skewed Towards Services, Including Trade



Data as at December 31, 2017. Source: Instituto Nacional de Estadística Geografía e Informática, Haver Analytics.

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Despite all the headwinds the country has faced of late (e.g., higher inflation, rising interest rates, trade tensions, and no investment growth over the last 12 months), the Mexican economy is actually doing quite well.

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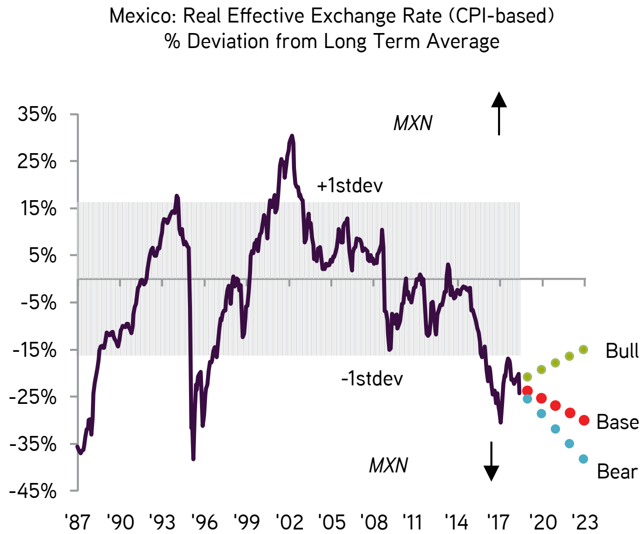
EXHIBIT 23

The Mexican Currency Is Now at a Critical Juncture, We Believe



Data as at May 31, 2018. 2018 thru 2023 KKR Global Macro & Asset Allocation estimates. Source: Instituto Brasileiro de Geografia e Estatística, Instituto Nacional de Estadística Geografía e Informática, Haver Analytics.

EXHIBIT: 24

Both Trade and Politics Will Dramatically Affect the Outlook For Mexico

Scenario Analysis Based Upon Andrés Manuel López Obrador Victory or Defeat in the Mexican Presidential Election and NAFT Outcomes

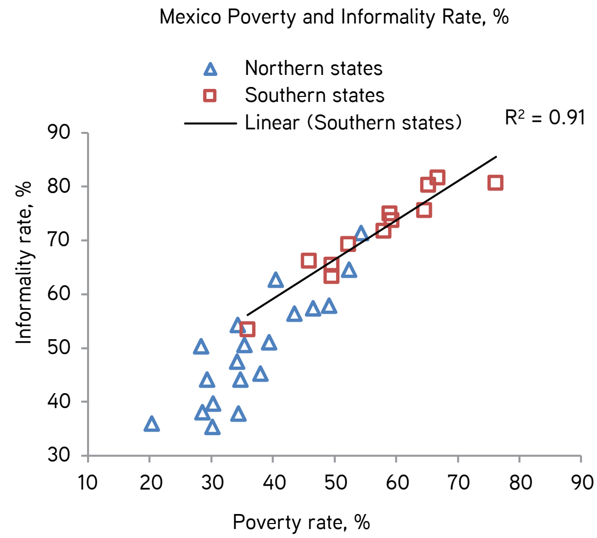
	AMLO wins	AMLO loses
NAFTA Agreement Reached	↓ MXN = Growth (but ↓ Potential) ↑ Inflation ↑ Risk Premium	↑ MXN ↑ Growth ↓ Inflation ↓ Risk Premium
U.S. Withdraws from NAFTA	↓↓ MXN ↓↓ Growth (via Investment) ↑↑ Inflation ↑↑ Risk Premium	↓ MXN ↓↓ Growth (via Investment) ↑ Inflation ↑ Risk Premium

Data as at May 31, 2018. Source: KKR Global Macro & Asset Allocation analysis.

Despite better-than-expected economic resilience of late, our bigger picture conclusion is that Mexico will continue to face a structural productivity growth issue relative to other EM countries. In particular, we find it hard to believe that Mexico will be able to get GDP growth much above three percent, which is usually the threshold required to be considered an elite EM growth story. We link the drag to lack of productivity gains, a large informal economy, worsening security, and corruption/rule of law – all issues that have plagued it for some time and show no signs of turning the corner in any electoral scenario.

EXHIBIT: 25

The Informality Rate and the Poverty Rate Go Hand in Hand in Mexico, Both of Which Are Higher in Southern States



Data as at May 1, 2018. Source: Bloomberg, Haver Analytics, OECD.

Interest Rates Outlook: More of the Same

Consistent with our above consensus GDP forecast back in January, we also entered the year more hawkish than the consensus and the Federal Reserve on the path of interest rates. As we update our forecasts at mid-year 2018, not much has actually changed in our view for either the long-end or the short-end of the U.S. yield curve. Specifically, we continue to look for a 10-year yield of 3.25% in December 2018, while our short-end call remains that the Federal Reserve will boost rates four times this year.

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Interestingly, Chairman Powell explicitly mentioned during his June press conference that fiscal stimulus is one of the important factors pushing up his assessment of rates, which is consistent with our theme regarding the increasing primacy of fiscal policy over monetary policy.

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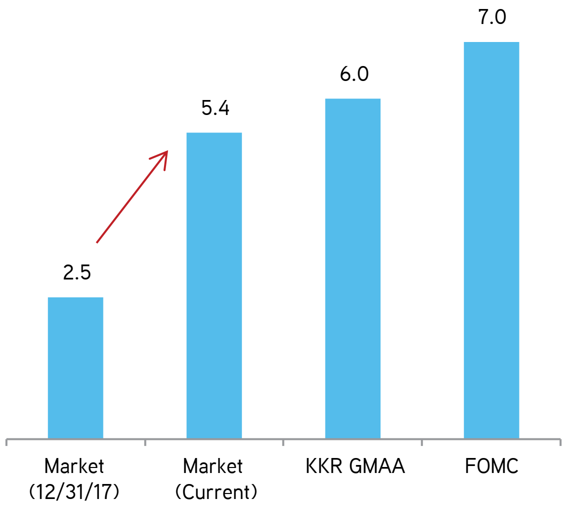
EXHIBIT 26

There Is No Change to Our Fed Funds Outlook. The Fed and Markets Have Gravitated Increasingly Towards Our Point of View

Expected Total Number of Fed Hikes in 2018 and 2019

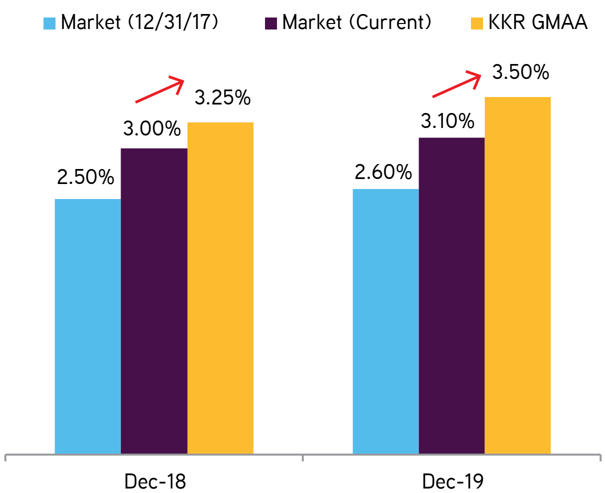


Data as at June 13, 2018. Source: FOMC, Bloomberg, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 27

We Continue to Expect the U.S. 10-Year Yield to Push Towards the Mid-Three Percent Range by the Peak of This Cycle

Expected U.S. 10-Year Yield Forecast



Data as at June 13, 2018. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

However, the same consistency of approach cannot be said for either the Federal Reserve or other market participants. In fact, during the most recent FOMC meeting on June 13, 2018, the Federal Reserve raised its total rate hike expectations in 2018 to four from three, bringing it in line with our in-house forecast. It also upgraded its assessment of economic activity across a wide range of variables, including inflation, unemployment, and GDP.

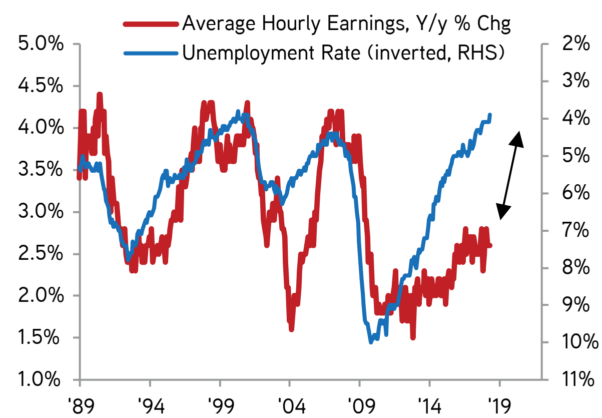
Moreover, the Fed now forecasts that it will raise rates another three times in 2019 to reach 3.125%. Put another way, the FOMC now believes that by the end of next year, rates will be in the restrictive territory above its 2.875% long-run target. For our part, we believe the Fed will hike only two times next year, as we expect it will ultimately feel pressure not to tighten financial conditions too drastically via pressuring the yield curve too much lower or the dollar too much higher.

Interestingly, Chairman Powell explicitly mentioned during his June press conference that fiscal stimulus is one of the important factors pushing up his assessment of rates, which is consistent with our theme regarding the increasing primacy of fiscal policy over monetary policy. This point is significant because it underscores our strong view that the Federal Reserve and current administration are rooting for very different outcomes in terms of some key economic metrics. On the one hand, President Trump has made it clear that he wants to boost both wages and the participation rate. On the other hand, the Federal Reserve feels uncomfortable with unemployment at such low levels. Moreover, the threat of higher wages may force it to accelerate even further the pace of tightening. One can see the different dynamics at play in *Exhibits 28 and 29*, respectively.

EXHIBIT 28

President Trump Would Like to See Wages Increase More Meaningfully. We Are Not Sure the Fed Feels as Strongly

Unemployment Rate and Average Hourly Earnings

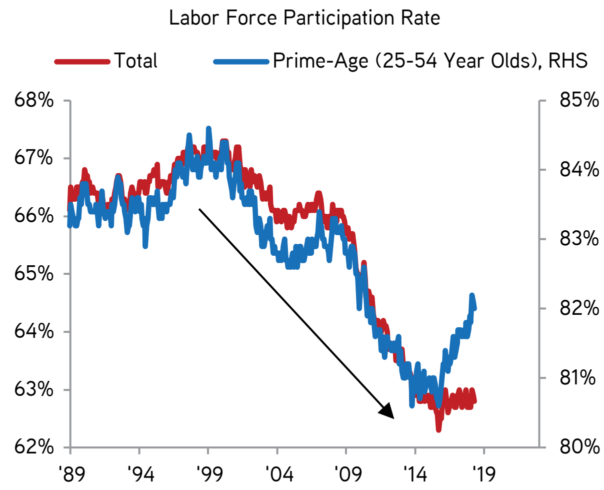


Data as at May 4, 2018. Source: Bloomberg.

> "Further out, we think the gap resolves itself with German bunds selling off more than U.S. Treasuries from current levels."

EXHIBIT 29

While the Fed Seems Happy With the Recent Increase in the Prime Age Participation Rate, the Trump Administration Would Like to See a More Broad-Based Expansion of the Work Force

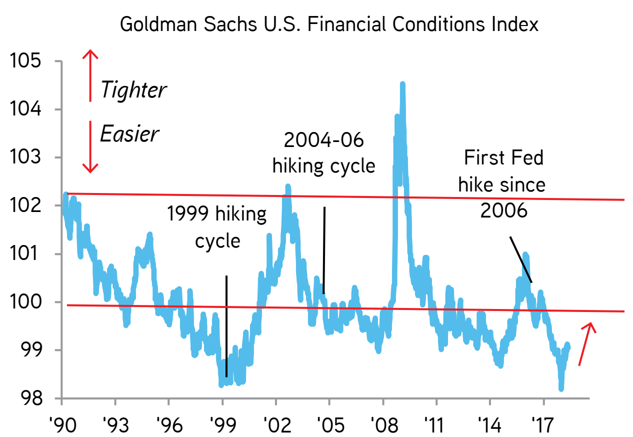


Data as at May 4, 2018. Source: Bloomberg.

As we mentioned above, we think that the Fed continues on a gradual hiking pace. In the near-term, we do not think this campaign will derail the economy because financial conditions are still quite loose (*Exhibit 30*). However, we are more concerned about 2019. Key to our thinking is that, coupled with the end of QE in the U.S., financial conditions will begin to become much more restrictive by 2019 if money supply growth begins to wane. One can see this rising threat in *Exhibit 31*.

EXHIBIT 30

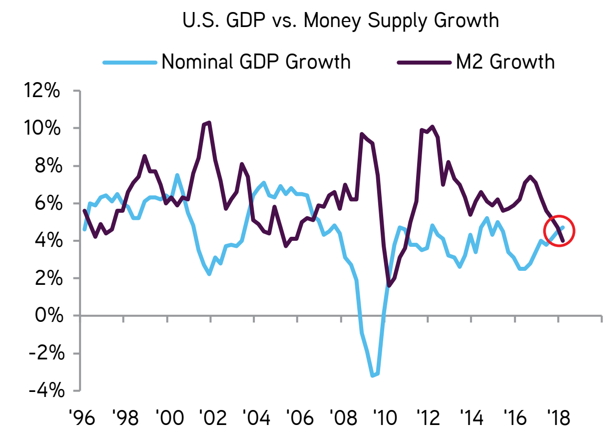
Despite Several Fed Hikes, Financial Conditions Are Still Quite Accommodative



Data as at June 8, 2018. Source: Goldman Sachs, Bloomberg.

EXHIBIT 31

Money Supply Growth Is Now Running Below Nominal GDP Growth



Data as at June 14, 2018. Source: BEA, Haver Analytics.

Given our conviction around higher rates in the U.S., we spent some time thinking through the relationship between long-term rates in the U.S. and Europe. Interestingly, as we show in *Exhibit 33*, the difference between the U.S. and German 10-year rate has now recently reached nearly 250 basis points, which we view as a truly monumental divergence in the supposedly integrated capital markets.

Looking ahead, we believe the gap will remain wide in the near term, as the ECB has signaled a high degree of patience in applying stimulus to ensure inflation returns to target. In fact, at its June 2018 conference, the ECB made the unusual move of committing itself to no rate hikes before summer of 2019, at the earliest.

Further out, we think the gap resolves itself with German bunds selling off more than U.S. Treasuries from current levels. In fact, our quantitative bunds model calls for it to close quite dramatically, with a spike in the German 10-year to 1.2% by the end of December 2018, a full 85 basis points increase over the next six months, followed by another 110 basis points rise over the subsequent twelve months *(Exhibit 32)*. While this model accurately captures the purely quantitative pressures, it misses the huge pressure on the ECB to close the last few basis points of inflation shortfall, after many years of failing to meet its mandate.

So, although capital market pressures are significant, we are not yet breaking the glass on European rates, and we now change our call on the bund. Specifically, we had been calling for the 10-year bund to reach one percent by the end of 2018, but now believe it will be 2019 before this happens, for the reasons outlined above. Moreover, in the interim, investors in Europe should get ready for even greater participation in European markets by U.S. domiciled investors, as the forward curve is pricing in euro appreciation making it attractive for USD investors who can lock in the euro, hedging FX risk at a profit.

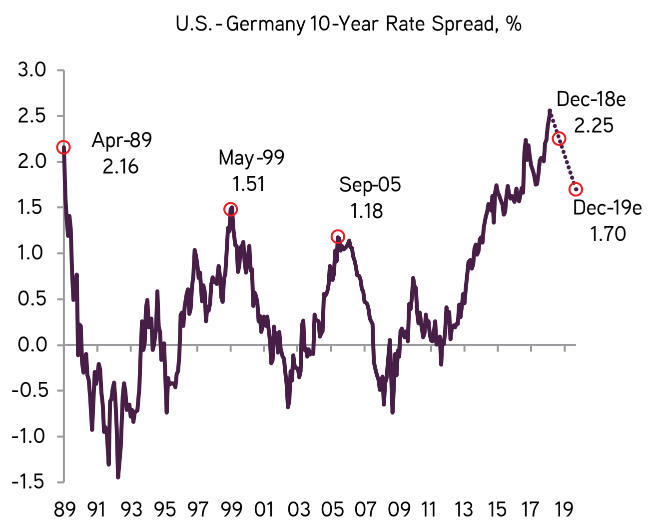
EXHIBIT 32

Our Quantitative Bund Model Indicates a 2.3% Yield By 4Q19, Though We Believe the ECB's Dovish Stance Will Prevent that From Occurring in the Near-Term

Data as at June 15, 2018. Source: ECB, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 33

We Think the Gap Between the U.S. Treasury and the German Bund Begins to Narrow



Data as at June 12, 2018. Source: Statistical Office of the European Communities, Haver Analytics.

Overall, our views on global rates are admittedly less divergent relative to consensus than they once were, as markets have converged towards our thinking. Regardless, we continue to position for an upward drift to rate expectations in coming quarters, which supports our call for investors to lock in low cost liabilities and/or own businesses that benefit from the structural bottoming in rates that we are suggesting is underway.

Global EPS and Valuation Update

From almost any vantage point, 2018 has emerged as one of the most unusual periods for earnings revisions that we have seen in years. What happened? Well, after essentially ignoring the Trump tax cuts through the fourth quarter of 2017, the sell-side community was forced to crank up their earnings revisions in January 2018 as full year guidance was given. According to our work, earnings revisions for the U.S. hit a 30-year high in the first quarter of 2018.

However, it was not enough, as first quarter EPS results were very strong with 72% of companies beating on EPS, 73% beating on sales and 57% beating on both – the highest proportion of EPS and sales beats since 2000[1]. Driving the huge overage in first quarter 2018 were the following considerations:

- All told, first quarter 2018 earnings results beat analysts' expectations by five percent, while pre-tax profits beat expectations by three percent. The overall beat was led by Technology, Financials and Industrials, three sectors that combine to contribute almost 60% of 2018e EPS growth for the S&P 500.

- Average Brent crude prices in the first five months of the year have been about 34% higher than comparable prices a year ago. We estimate that every 10% increase in average oil prices increases S&P 500 earnings by approximately 1.3%. Importantly, though, while energy companies are clear beneficiaries of higher oil prices, there are some notable offsets that actually weight on EPS growth. For example, the recent 20% increase in gasoline/heating oil costs is akin to a $61 billion 'tax hike' on the consumer, which negates about 80% of the income boost from personal tax cuts. Also, higher energy input costs are a drag on the margins of transportation stocks. We are not sure how this cycle will play out, but we do know that during the last two late cycle commodity price surges (in 1999 and 2007), their operating margin fell by fully two and four percentage points, respectively (*Exhibit 100*).

"

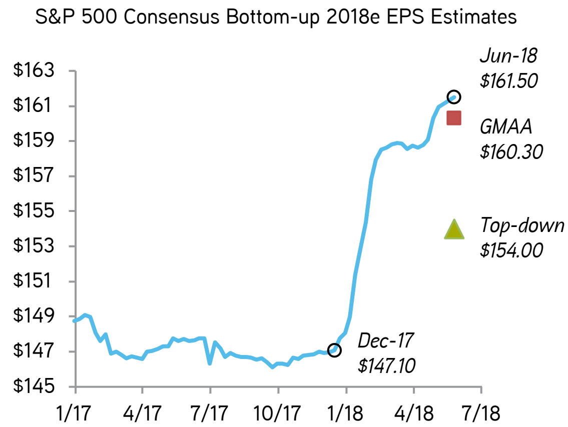
From almost any vantage point, 2018 has emerged as one of the most unusual periods for earnings revisions that we have seen in years.

"

1 Data as at May 24, 2018. Source: IBES, Factset.

EXHIBIT 34

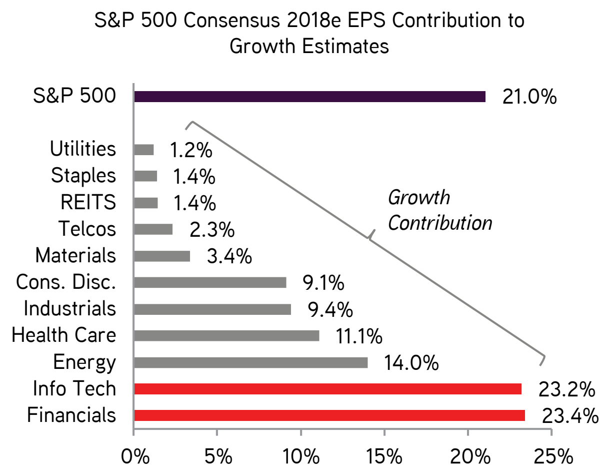
Full Year S&P 500 2018 Bottom-Up EPS Estimates Have Climbed to $161.50 on the Back of a Very Strong First Quarter 2018 Earnings Season



Data as at May 24, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics, S&P, IBES.

EXHIBIT 36

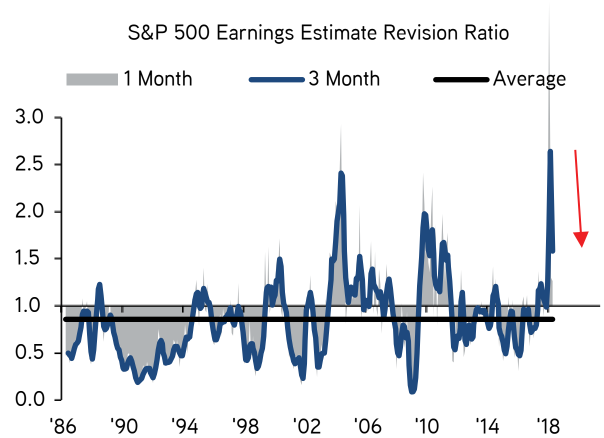
Financials and Technology Still Make Up Close to 50% of the 2018e S&P 500 EPS Growth



Data as at May 24, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics, S&P, IBES.

EXHIBIT 35

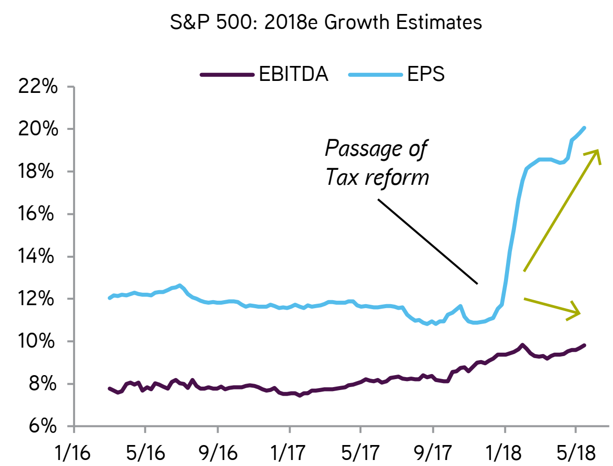
The Downturn in Revisions Supports Our View That the Rate of Change in U.S. Earnings Is Now Moderating



The 3-month revision ratio is defined as the total number of earnings estimate increases divided by total number of earnings estimate decreases during the last three months. Data as at May 24, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics, S&P, IBES, BofAML.

EXHIBIT 37

EBITDA Growth Forecasts Have Not Kept Pace With the Surge in EPS Growth Expectations



Data as at May 24, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics, S&P, IBES.

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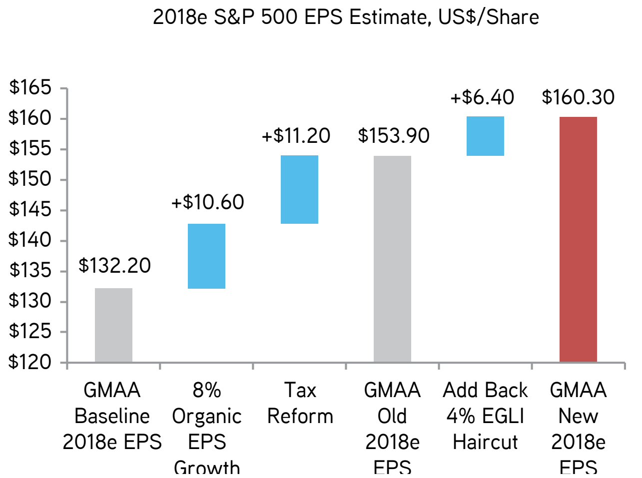
Outside of the U.S., we see a different picture, as Europe and EM earnings growth is expected to trail that of the U.S. in 2018.

"

Against this backdrop of strong first quarter 2018 results and robust oil prices after the recent OPEC meeting, we are raising our 2018 EPS forecast for the S&P 500 to $160.30, compared to our prior forecast of $153.90 (now implying 21.3% growth in 2018 versus 16.5% previously). As we show in *Exhibit 40*, this new forecast is now roughly in line with what our Earnings Growth Leading Indicator (EGLI) model has been suggesting (excluding the one-time bump). As reference, the bottom-up consensus forecast is now at $161.50 (22.3% expected growth), compared to $147.10 in December 2017 (11.3% growth). Meanwhile, the top-down consensus forecast is at $154.00 or so, little changed from around $153.00 back in December 2017. From what we can tell, not all the top-down strategists have fully adjusted their earnings outlook for the recent Trump corporate tax cuts.

EXHIBIT 38

We Have Boosted Our S&P 500 EPS to $160.30, Which Is More In Line With What Our Quantitative Model Is Suggesting

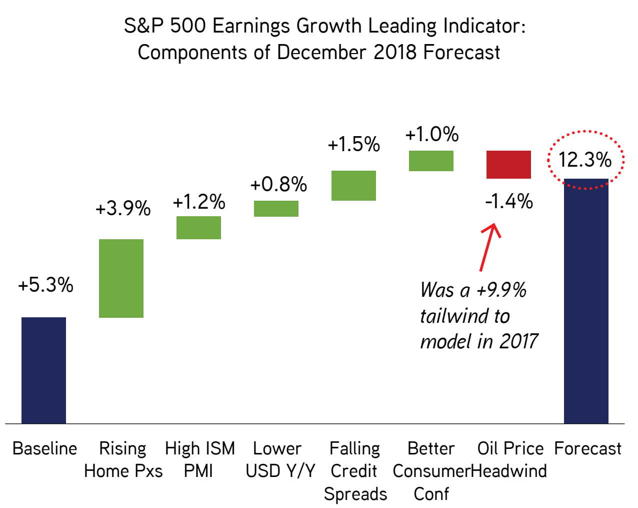


Data as at June 15, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics, S&P, IBES.

While not as bullish as our fundamental outlook (because a model can't explicitly capture a tax cut), our quantitative EGLI remains quite constructive in the near-term. One can see this in *Exhibit 39*, which shows that essentially every input into the indicator except oil is currently positive.

EXHIBIT 39

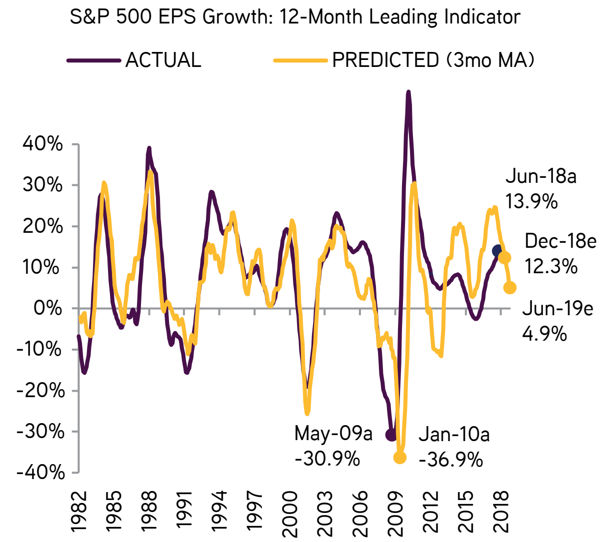
Most Inputs to Our Proprietary U.S. Earnings Growth Lead Indicator (EGLI) Are Still Positive in 2018



Data as at June 15, 2018. Source: KKR Global Macro & Asset Allocation analysis.

EXHIBIT 40

Our U.S. Earnings Growth Lead Indicator (EGLI) Points to a Strong 12.3% Expansion in 2018, Followed by More Modest Momentum in 2019



Data as at June 15, 2018. Source: KKR Global Macro & Asset Allocation analysis.

Looking out to 2019, our preliminary EPS estimate is $168.30 for the S&P 500, which is roughly five percent year-over-year growth (and in line with the 2019 deceleration in EGLI). Our more conservative EPS outlook for 2019 reflects four areas of concern in our assumptions: a) tougher comps versus 2018; b) higher cost of capital; c) continued tightening of financial conditions; and d) late-cycle pressures, including higher input costs and wages. Our EPS slowdown is also consistent with both our EGLI (which shows growth slowing by 2019) and our recession model (*Exhibits 65 and 66*), as our work shows that the U.S. could face a mild economic slowdown by 2020.

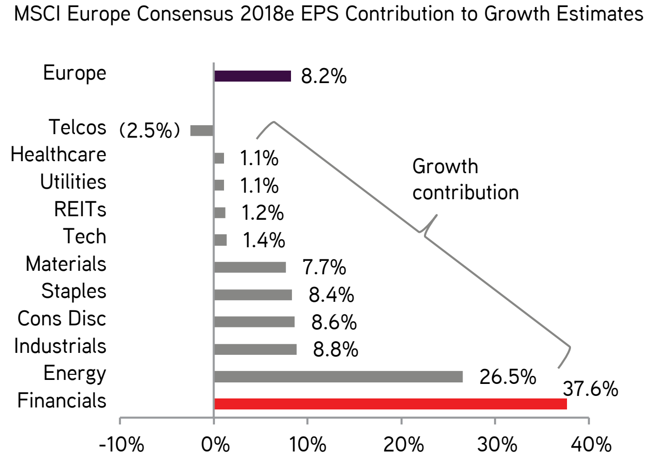
Outside of the U.S., we see a different picture, as Europe and EM earnings growth is expected to trail that of the U.S. in 2018. In Europe, for example, 2018 earnings growth estimates have declined to 8.2% from 9.1% in the beginning of the year. A 10% appreciation in the trade-weighted euro in 2017, coupled with Euro Area PMI momentum tumbling to five-year lows, has largely been responsible for the softness in earnings trends. But the FX headwind will likely fade in coming quarters and we continue to expect global growth to accelerate to 3.7% in 2018e, which should lend support to European earnings.

Probably more important, though, is that *Financials are now responsible for an incredible 38% of expected growth this year*. Lower loan losses, improved trading results, and less punitive interest rates are all helping, a trend we expect to continue. The other notable area of earnings upside is Natural Resources. We note that 2018 Energy earnings estimates have been revised up by more than 17 percentage points year-to-date to 26.5% year-over-year. In fact, beyond Natural Resources and Financials, there have been downgrades in all other sectors of the European capital markets.

Likewise, in Emerging Markets, 2018 earnings growth estimates have decelerated on the margin to 14.6% year-over-year from a high of 16.5% back in February. With that said, estimates are still up 1.3 percentage points from 13.3% at the beginning of the year. *Notably, Technology and Financials combined are expected to make up almost 50% of expected growth this year*. Meanwhile, similar to Europe, Energy and Materials have seen some of the strongest earnings revision trends year-to-date, up 8.7 percentage points and 11.2 percentage points, respectively. In our view, rising yields, a stronger U.S. dollar, and intensifying U.S.-China trade tensions are the key headwinds to monitor going forward, as they could put a damper on the commodities-led earnings growth story.

EXHIBIT 41

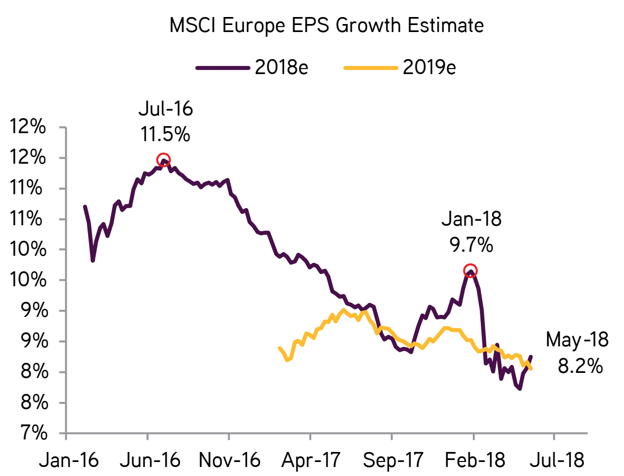
Financials Are Now Responsible for an Incredible 38% of Estimated European Earnings Growth this Year



Data as May 24, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics.

EXHIBIT 42

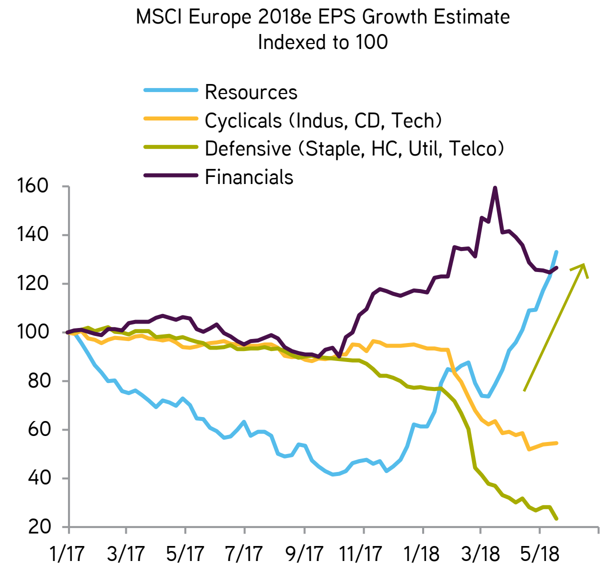
2018 European Earnings Growth Estimate Has Declined to 8.2% from 9.1% at the Beginning of the Year



Data as at May 24, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics.

EXHIBIT 43

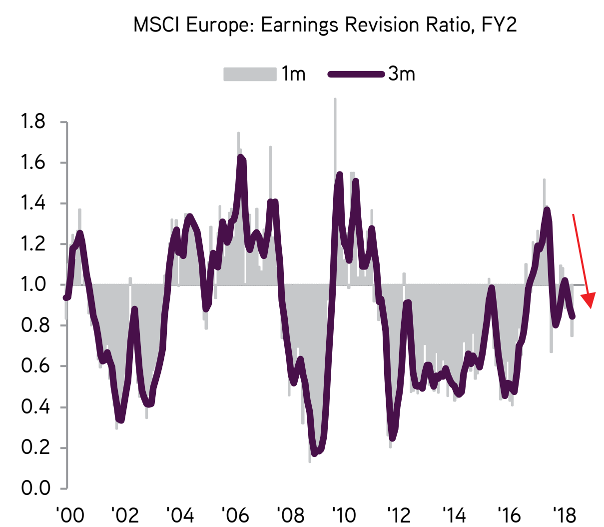
There Has Been a Significant Divergence Between Earnings Growth Upgrades in Resources and Financials Versus Downgrades in Cyclicals and Defensive Sectors



Data as May 24, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics.

EXHIBIT 44

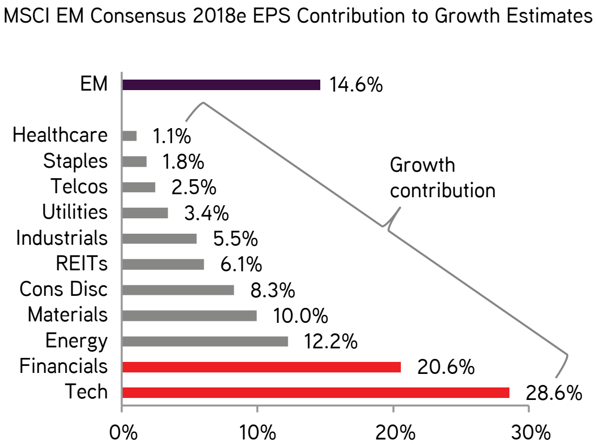
Earnings Revision Trends Show that Europe Has Been Stuck in a Downgrade Cycle (i.e., More Downgrades than Upgrades)



Data as May 24, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics.

EXHIBIT 45

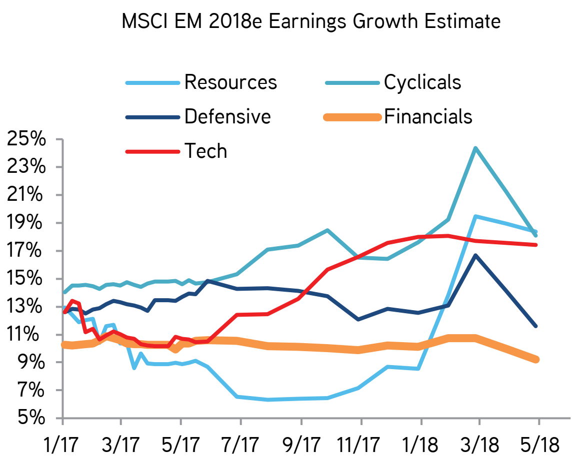
2018 EM Earnings Estimates Have Decelerated On the Margin to 14.6% from a High of 16.5% Back in February



Data as May 24, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics.

EXHIBIT 46

Cyclicals and Resources Stocks Are Enjoying the Strongest EPS Revisions in EM



Data as May 24, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics.

So, what does this all mean for valuation and returns relative to our prior forecasts? To review, in January our base case assumed that the S&P 500 could trade at 18-19x our 'old' 2018 EPS estimate of $153.90 for a total return with dividends of 7-13%. Today, by comparison, given that we are further along in the tightening cycle, we now believe that some multiple compression is warranted. Our forecast for a lower multiple should actually not be all that surprising, we believe, given that earnings multiples have actually contracted in every one of the last eight prior cycles. Indeed, as one can see in *Exhibit 47*, the average P/E decline has been about 2.5 multiple points on average. For this cycle (which began in December 2015), the forward P/E has 'only' declined by approximately 0.7 multiple points. However, as certainty about the magnitude of the Fed's tightening campaign has gained momentum in 2018, the de-rating has been more exaggerated, with the forward P/E declining year-to-date by a full 3.0 multiple points already (to 16.9x from 20.0x).

EXHIBIT 47

P/E Multiples Have Declined in Eight of the Past Eight Fed Tightening Cycles and Are Now On Track to Make It Nine of Nine

CHANGE IN FORWARD P/ES DURING A FED TIGHTENING CYCLE									
Rate Hike Cycle									
Start	2/29/72	2/28/74	11/30/76	4/29/83	11/28/86	1/31/94	5/31/99	5/31/04	12/16/15
Stop	8/31/73	7/31/74	4/30/80	8/31/84	5/31/89	2/28/95	5/31/00	7/31/06	Present
Trailing P/Es									
Start	19.4x	12.2x	11.0x	12.5x	12.5x	14.9x	23.5x	16.5x	17.6x
Stop	15.1x	9.9x	7.0x	10.7x	11.0x	12.6x	22.2x	14.0x	16.9x
Change	-4.29	-2.3	-4.06	-1.85	-1.46	-2.36	-1.31	-2.48	-0.7

Data as at May 31, 2018. Source: Cornerstone Macro.

So, when we pull it all together, we estimate that the S&P 500 could achieve a total return of approximately 7.8%, which would be about 2,829 on the S&P 500. In absolute numbers, this price target assumes a multiple of 17.7 times an earnings number of $160.30. Of the 7.8% total return we forecast, two percent comes from dividend yield and 20% from earnings growth, partially offset by 12% in multiple compression. To be sure, though, predicting short-term stock market returns is a difficult at best, and as such, we have provided a range of four to 12% using assumptions that under different scenarios, we think could be reasonable this year. One can see the range of outcomes in *Exhibits 48* and *49*, respectively.

> "Today, by comparison, given that we are further along in the tightening cycle, we now believe that some multiple compression is warranted."

EXHIBIT 48

We Now Think the S&P 500 Can Trade in the 17x-18x Range in 2018...

S&P Price Index at Various P/E and EPS Levels

EPS	16.2x	16.7x	17.2x	17.7x	18.2x	18.7x	19.2x
$152	2,459	2,535	2,612	2,688	2,764	2,840	2,916
$154	2,492	2,569	2,646	2,723	2,800	2,877	2,954
$156	2,524	2,602	2,680	2,758	2,836	2,915	2,993
$158	2,556	2,635	2,714	2,794	2,873	2,952	3,031
$160	2,589	2,669	2,749	2,829	2,909	2,989	3,069
$162	2,621	2,702	2,783	2,864	2,945	3,027	3,108
$164	2,653	2,735	2,817	2,900	2,982	3,064	3,146
$166	2,685	2,769	2,852	2,935	3,018	3,101	3,184
$168	2,718	2,802	2,886	2,970	3,054	3,138	3,223

Data as at May 24, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics.

EXHIBIT 49

...Which Implies Four to 12% Total Return (Including Dividends) for Full Year 2018

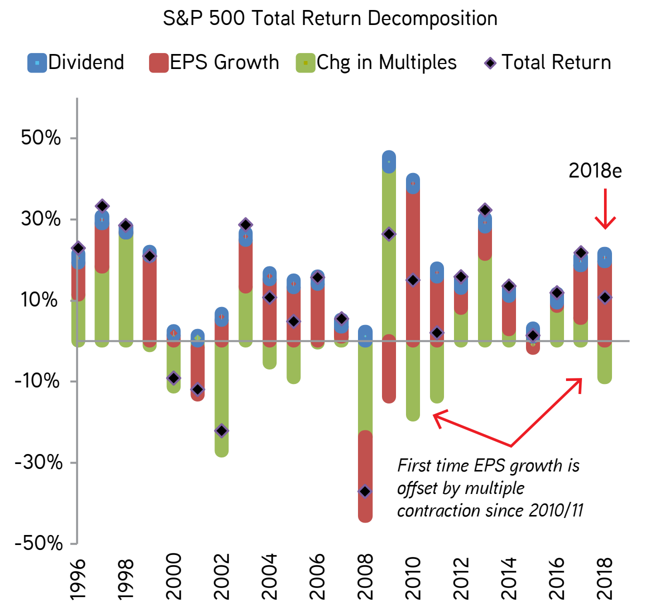
S&P Total Return at Various P/E and EPS Y/y Levels

EPS y/y	16.2x	16.7x	17.2x	17.7x	18.2x	18.7x	19.2x
15.3%	(6.0%)	(3.2%)	(0.3%)	2.5%	5.4%	8.2%	11.1%
16.8%	(4.8%)	(1.9%)	1.0%	3.8%	6.7%	9.6%	12.5%
18.3%	(3.6%)	(0.7%)	2.2%	5.2%	8.1%	11.0%	13.9%
19.8%	(2.4%)	0.6%	3.5%	6.5%	9.4%	12.4%	15.4%
21.3%	(1.2%)	1.8%	4.8%	7.8%	10.8%	13.8%	16.8%
22.8%	0.0%	3.1%	6.1%	9.1%	12.2%	15.2%	18.2%
24.3%	1.2%	4.3%	7.4%	10.5%	13.5%	16.6%	19.7%
25.8%	2.4%	5.6%	8.7%	11.8%	14.9%	18.0%	21.1%
27.4%	3.7%	6.8%	9.9%	13.1%	16.2%	19.4%	22.5%

Data as at May 24, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics.

EXHIBIT 50

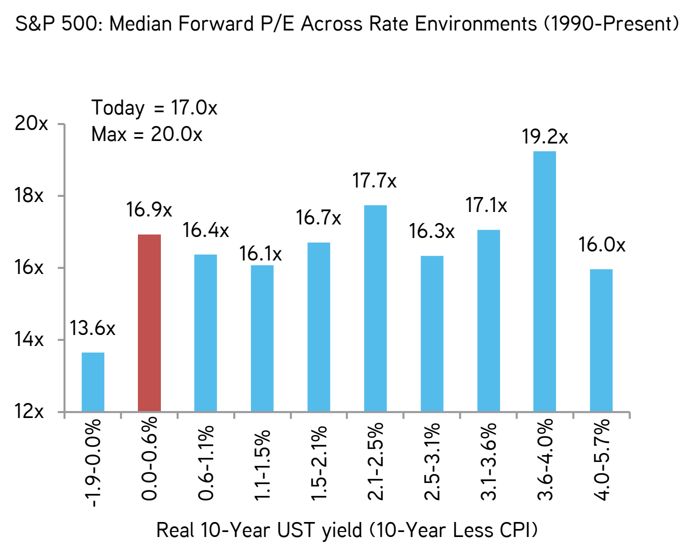
Assuming Eight Percent Total Return for the S&P 500, It Will Be Driven by About 20% EPS Growth, Plus Two Percent of Dividend Income, Offset by 12% of Multiple Contraction



Data as at May 24, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg.

EXHIBIT 51

With Real 10-Year Yields in the 0.0-0.6% Range, Today's S&P 500 Forward PE of 17.0x Is Actually In Line With Its Long-Term Median of 16.9x



Note: Real yields proxied with 10-Year UST yield less U.S. headline inflation. Data as at May 31, 2018. Source: KKR Global Macro & Asset Allocation analysis,, Bloomberg.

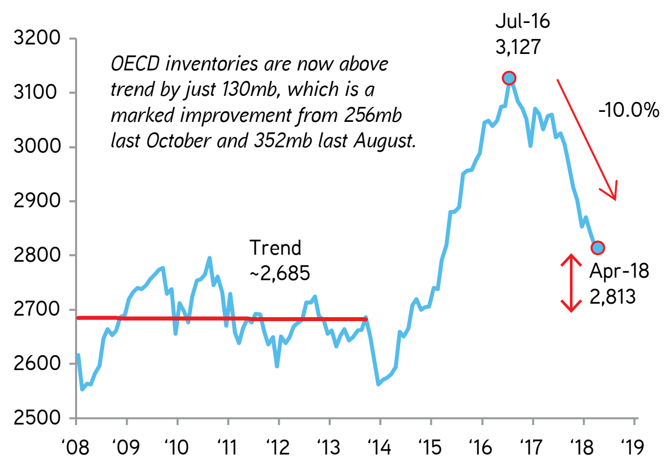
Oil Update: Stronger for Longer

As our asset allocation targets suggest, we retain a notable overweight to Energy/Infrastructure. To review, two things have been driving our thinking in 2018. First, the massive oil inventory glut that fuelled the commodity bear market of 2014-16 is now almost fully corrected. As we show in *Exhibit 52*, OECD inventories have fallen fully 10% since mid-year 2016, and they are now on pace to revert to pre-crisis levels within the next year in our view. Admittedly, OPEC will add some supply back to the market in coming months, but we expect the OPEC additions will only offset the Venezuelan and Iranian supplies that are falling offline. All told, we suspect inventories will continue declining at the recent pace, and as such, we believe official forecasting agencies such as the U.S. Energy Information Administration (EIA) and the International Energy Agency (IEA) may need to further upgrade their inventory estimates (*Exhibit 53*).

EXHIBIT 52

The Supply Normalization Story in Oil Continues as OECD Inventories Are Just 130 Million Barrels Above the Pre-4Q14 Levels, a Big Improvement from 352 Million Barrels Last August

OECD Total Commercial Inventories, Millions of Barrels, vs. Trend



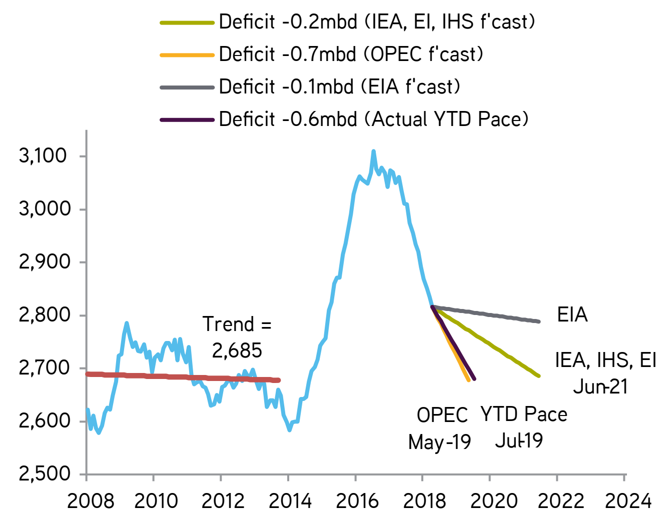
Data as at May 21, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics, IEA, EIA, Energy Intelligence.

Second, we also think the oil market is entering an important new phase of its recovery, as long-dated oil futures have finally started moving higher in recent weeks. This change is significant because energy equities are tied much more closely to long-dated (e.g., 5-Year forward) prices than to spot prices. As a result, it has only been in recent weeks that energy equities have started outperforming global benchmarks.

EXHIBIT 53

On a Seasonally-Adjusted Basis, the YTD Rate of Draws Suggests OECD Inventories Could Normalize to Pre-2014 Levels in 14 months

OECD Total Commercial Inventories, Millions of Barrels, Seasonally Adjusted



Data as at May 21, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics, IEA, EIA, Energy Intelligence.

What's driving long-dated futures and energy equities higher these days, we believe, is a shift in the oil story from one of outsized global demand growth (the key feature of the second half of 2017, in our view) to one of lackluster non-U.S. supply growth *(Exhibit 56)*. Importantly, while we expect demand growth to wax and wane in coming years, we see the supply issue as a much more durable theme. To be sure, some of the big events that tightened supply in recent months—including Venezuela's melt-down and the Iran sanctions—are non-recurring items. That said, we do not see those issues going away anytime soon. Maybe even more importantly, we are now seeing

"

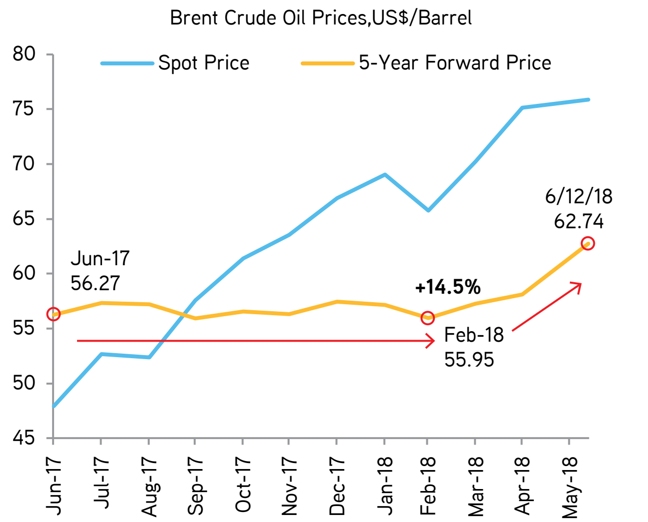
What's driving long-dated futures and energy equities higher these days, we believe, is a shift in the oil story from one of outsized global demand growth (the key feature of the second half of 2017, in our view) to one of lackluster non-U.S. supply growth.

"

evidence of lackluster conventional oil production growth in regions outside of OPEC *(Exhibit 57)*, which we suspect will be a persistent issue in coming years as a lack of new project sanctioning starts to impact the flow of volumes coming online *(Exhibit 58)*.

EXHIBIT 54

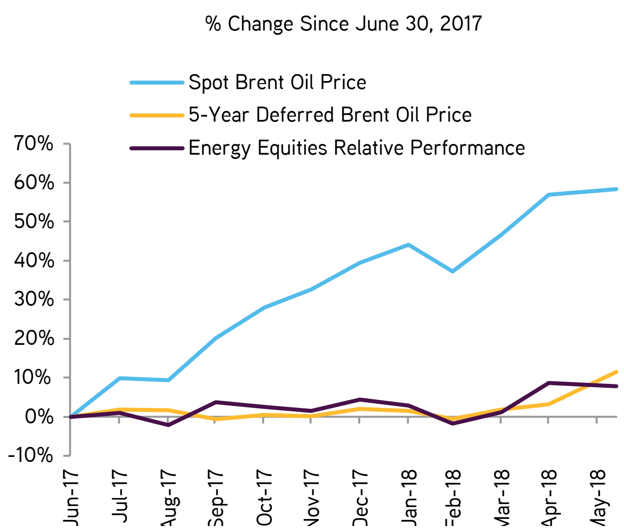
While Spot Oil Prices Have Been Recovering for Over a Year, Long-Dated Prices Have Only Started Increasing Recently



Data as at May 22, 2018. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 55

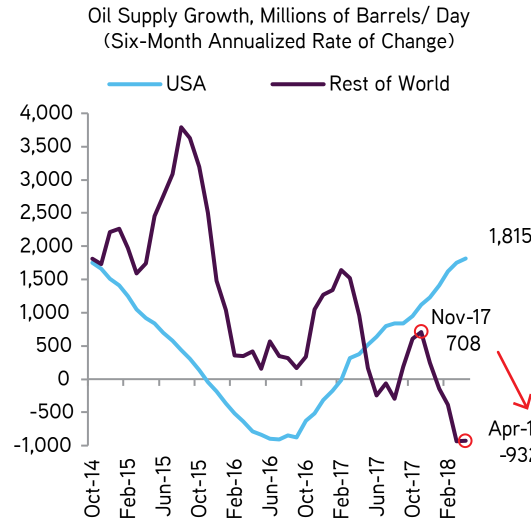
Energy Equities Are Tied Much More Closely to Long-Dated Prices than to Spot Prices



Energy equities relative performance = MSCI ACWI Energy Relative to MSCI ACWI. Data as at May 22, 2018. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 56

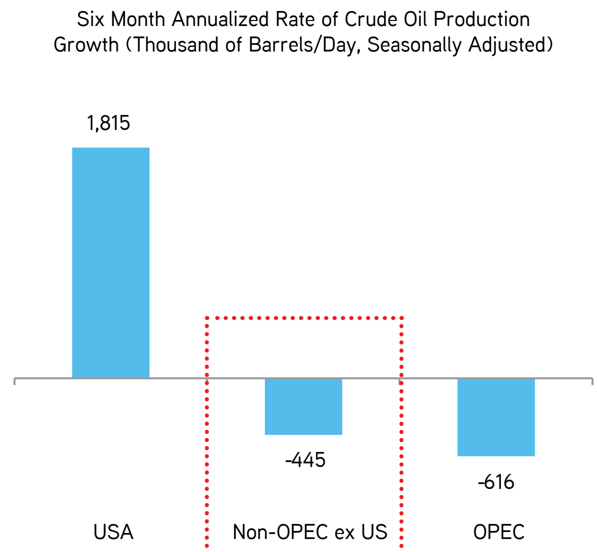
Declines in Conventional Oil Supply Are Now Substantially Offsetting Surging U.S. Shale Production



Data as at May 22, 2018. Source: Energy Intelligence, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 57

We Are Now Seeing Evidence of Lackluster Conventional Oil Production Growth Outside of OPEC

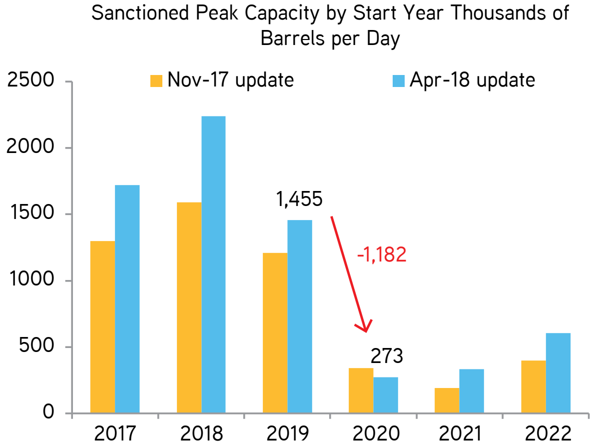


Data as at April 30, 2018. Source: Energy Intelligence, Haver Analytics, KKR Global Macro & Asset Allocation.

In sum, despite the recent move up in oil prices, we still like our overweight position in the sector. Fundamentals are strong, inventories are getting lean, and we see upside to the long-dated oil futures prices that govern energy equity values. In the private markets, we also think this is an attractive time for investors to acquire producing assets, hedge current production at today's attractive spot prices, and benefit from longer-term upside if our thesis on long-dated pricing plays out as we expect.

EXHIBIT 58

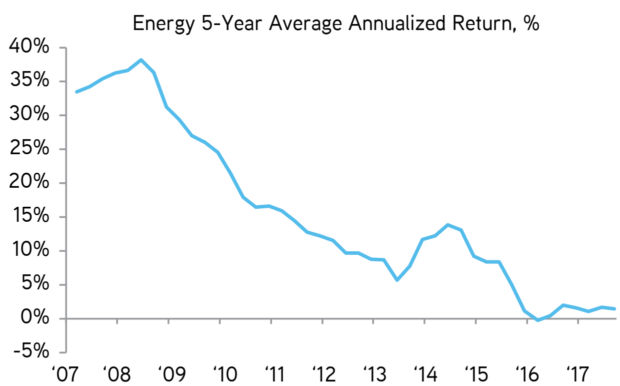
The Pipeline of Projects Set in Motion Prior to the Oil Price Collapse Will Sustain Sanctioned Production Growth Through 2019



Data as at April 30, 2018. Source: Cambridge Associates, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 59

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



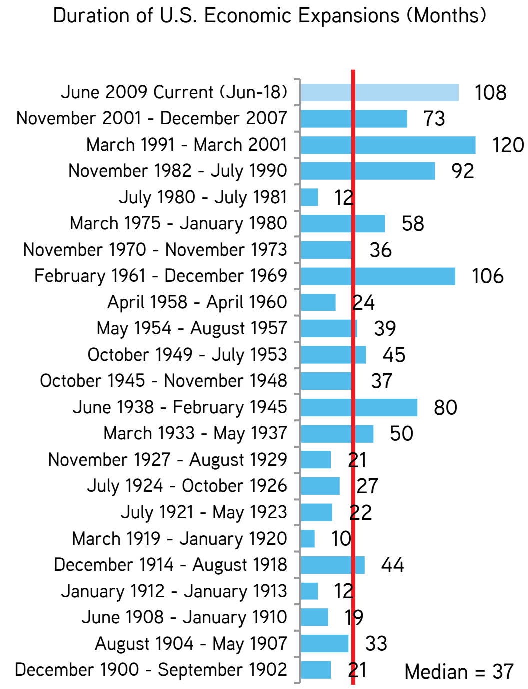
Data as at 4Q17. Source: Cambridge Associates, KKR Global Macro & Asset Allocation analysis.

Where Are We in the Cycle?

Similarly to many of the folks with whom we speak, we too are spending a lot of time assessing where we are in the cycle. From our perch at KKR, our work suggests that the financial markets cycle in the U.S. is more mature than the economic one. One can see this in both *Exhibits 60 and 61*, respectively, which show that both the duration of the expansion and the consistency of the capital markets performance are largely unmatched.

EXHIBIT 60

We Are Quite Long in the Tooth in Terms of Pure Cycle Duration at 108 Months



Data as at June 12, 2018. Source: National Bureau of Economic Research (NBER), KKR Global Macro & Asset Allocation analysis.

EXHIBIT 61

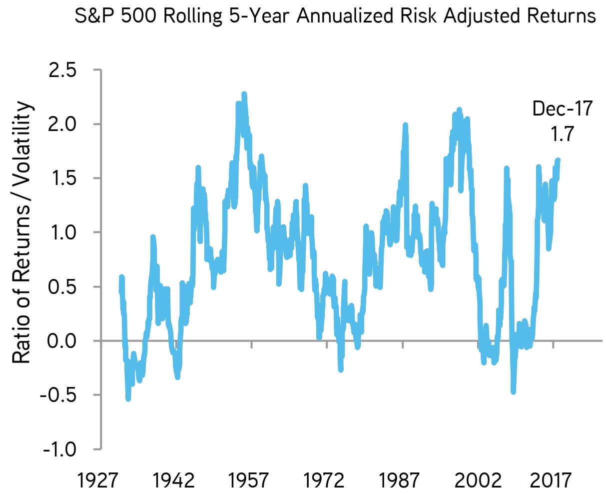
Nine Years of Consecutive Positive Performance for the S&P 500 Is Highly Unusual; We Are Now Halfway Through Our 10th Year

# OF CONSECUTIVE YEARS OF POSITIVE RETURNS	START	END	CUMULATIVE RETURN	CAGR
3	1904	1906	67%	19%
3	1954	1956	111%	28%
3	1963	1965	60%	17%
3	1970	1972	40%	12%
4	1942	1945	143%	25%
4	1958	1961	102%	19%
5	2003	2007	83%	13%
6	1947	1952	148%	16%
8	1921	1928	435%	23%
8	1982	1989	291%	19%
9	1991	1999	450%	21%
9	2009	2017	259%	24%
			Avg. CAGR	20%

Cumulative total return on an annual basis. Data as at December 31, 2017. Source: http://www.econ.yale.edu/~shiller/, Bloomberg.

EXHIBIT 62

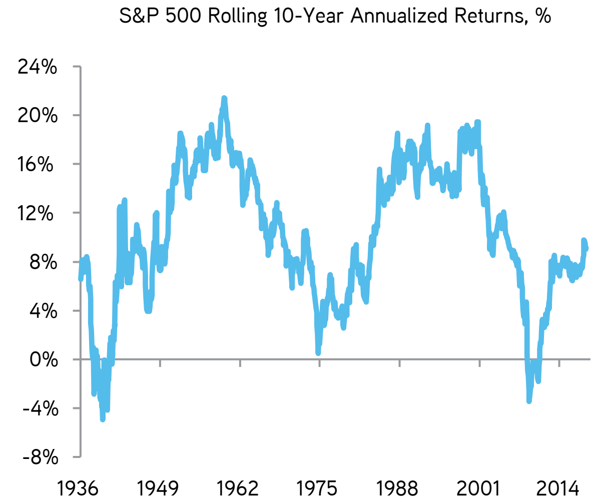
5-Year Annualized Risk-Adjusted Returns in the U.S. Are Approaching Peak Levels



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

EXHIBIT 63

10-Year Cumulative Equity Returns Are Now Beginning to Look More Full Too



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

EXHIBIT 64

Our Cycle Dashboard Suggests That Many Asset Classes at the Aggregate Level Are Now Fairly to Fully Valued; As Such, More Investment Creativity Will Be Required

		Equity Valuation Metrics						Economic and Credit-Related Metrics			
	Avg. Across All Metrics	Avg. Across Equity Metrics	EV/ EBITDA	Fwd P/E	Market Cap % of GDP	Embedded EPS Growth (Rate-Adj. Equity Valuation)	Shiller P/E	Avg. Across Credit and Cycle-Related Metrics	Unemp. Rate (inverse)	Credit Spreads (inverse)	Trailing 5yr Equity Mkt Return
U.S.	0.8	0.8	1.5	0.5	1.5	-0.6	0.9	0.8	1.4	0.8	0.3
Europe	0.2	-0.1	0.1	0.1	0.9	-1.3	0.0	0.7	1.6	0.7	-0.1
EM	0.1	0.0	1.1	-0.3	0.2	-0.5	-0.5	0.3	0.5	0.7	-0.4
Japan	-0.1	-0.5	-1.1	-1.0	1.5	-1.3	-0.9	0.7	1.2	-0.2	1.1

NOTE: Table above represents Cycle Metrics - Number of Standard Deviations Rich/Cheap. Data as at May 31, 2018. Source: Bloomberg, Factset.

In Europe and China, by comparison, we believe that both their economies and markets are in more catch-up mode relative to the U.S. Not surprisingly, this viewpoint drives our overweight positions in both Europe and Asia, compared to our modest underweight position in the United States.

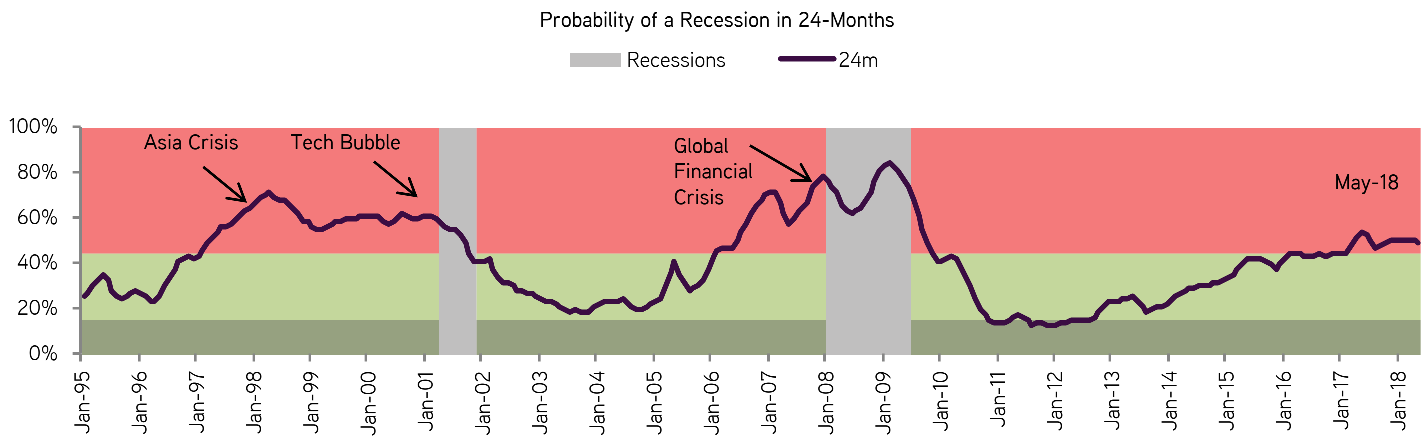
Importantly, regardless of region, the key variable on which every investor must have a strong view is interest rates. Why? Because as we show in *Exhibit 64*, markets around the world are quite expensive on a market capitalization-to-GDP basis. Indeed, only if one adjusts for interest rates (which is what we do in the column to the right of market capitalization to GDP in *Exhibit 64*), do valuations actually appear more reasonable. For our nickel, we think that rates have structurally bottomed, but will only head higher over time. So, when all the various macro inputs we watch are aggregated together, we do not view markets at levels that are flashing a danger zone. What we have recommended, though, as a safety precaution, is to lock in low cost liabilities and/or own businesses that benefit from the structural bottoming in rates that is now under way, we believe.

Another reason that we have not shifted our asset allocation to a notably more defensive stance is that our proprietary recession model is not suggesting an economic slowdown in imminent. In fact, the model in *Exhibit 65*, which was originally devised by Paula Roberts and Nishant Kachawa, suggests that the risk of recession is benign over the next 12 months with only a modestly elevated risk of recession over 24 months. Were the model to turn more long-term cautious, we believe the cause would be linked to the overall health of the consumer. At present, however, given tax cuts and low unemployment, we are not yet ready to lead the leading indicators in the model. That said, as the model also shows, there are some variables that have turned more cautious. Specifically, heightened levels of risk two years out is currently being driven by potentially tightening financial conditions, as interest rates rise, stock market performance moderates, and corporate interest coverage declines.

So, for those that follow our asset allocation framework closely, our core view is to not yet massively pull back from risk-assets. Rather, we continue to advocate a diversified portfolio that now benefits more from an improvement in nominal GDP. It also favors yield-oriented investment strategies that are shorter in duration, tilts more towards Asia than the Americas, and attempts to harness the illiquidity premium in key areas such as Asset Based Lending and Private Equity.

EXHIBIT 65

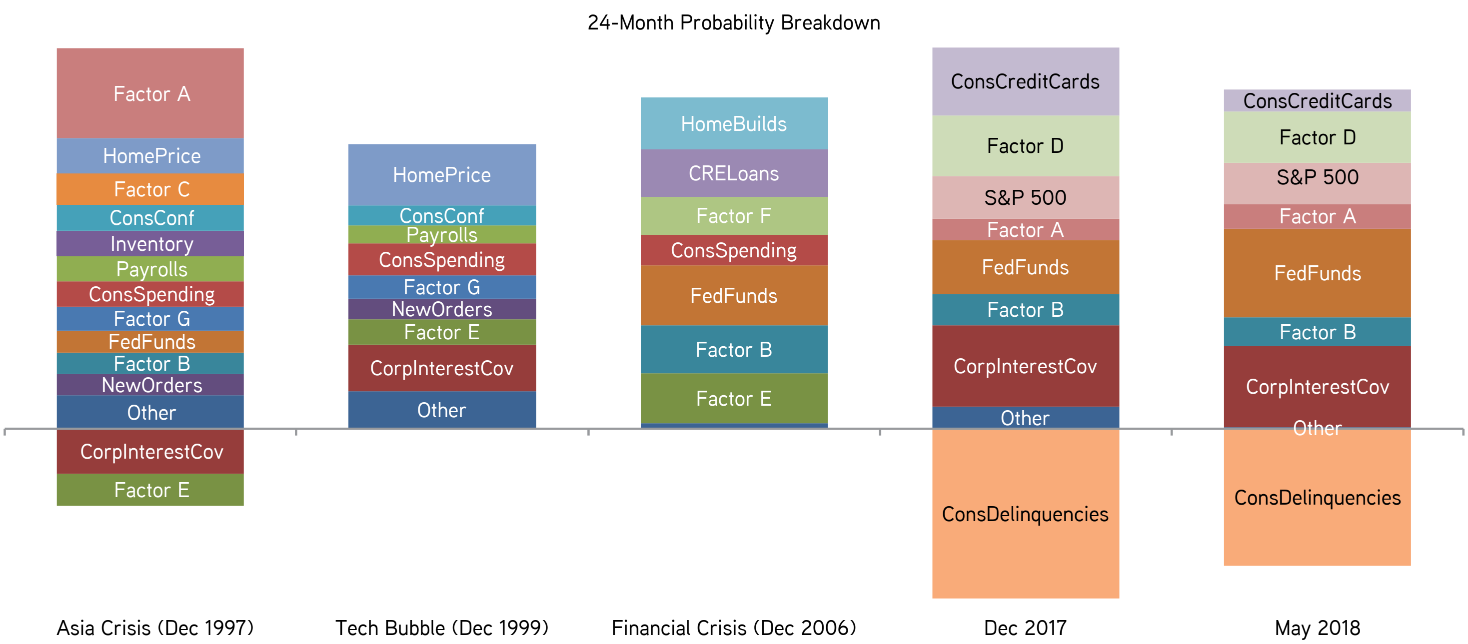
Our Quantitative Model Suggests that Tightening Financial Conditions Are Leading to Increased Levels of Risk for the U.S. Economy Over the Next 24 Months, Potentially Foreshadowing a Mild Economic Downturn in 2020



Green to red variance corresponds to likelihood of a recession. Data as at June 1, 2018. Source: KKR Global Macro & Asset Allocation analysis.

EXHIBIT 66

The Most Important Positive Offset to the Growing Storm Clouds Is the Health of the U.S. Consumer



Data as at June 1, 2018. Source: KKR Global Macro & Asset Allocation analysis.

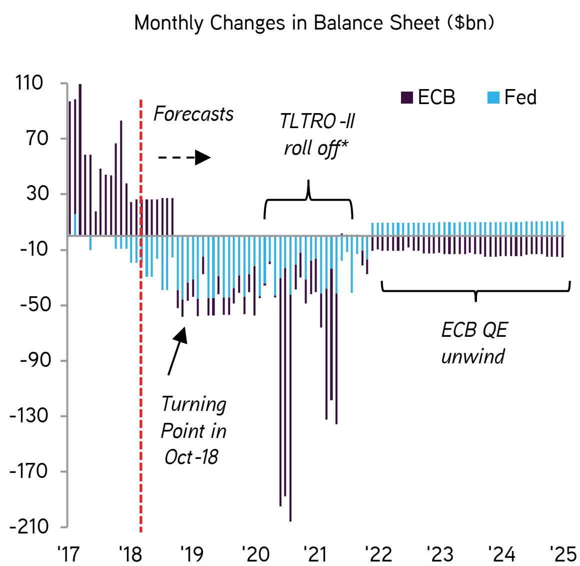
Section II: Key Investing Themes

#1: The Shift From Monetary Stimulus to Fiscal Stimulus Has Emerged As a Big Call For Investors

As part of our *Paradigm Shift* thesis, which we laid out in January 2017 (see *Outlook for 2017: Paradigm Shift)*, we argued that growing socioeconomic tension would inspire governments around the world to shift their focus towards fixing the underwhelming growth rates in the nominal economy relative to financial assets (*Exhibit 69).* In doing so, the change in emphasis would ease the positive technical bid that investors have enjoyed in recent years. One can see this transition starting to play out in *Exhibits 71* and *72*, respectively.

EXHIBIT 67

QE Technicals will Turn into a Modest Headwind (Net Selling) Beginning in October 2018, Driven Largely By the Fed



*Maturity of each of the four operations is fixed at four years. But we smoothed out the "lump-sum" repayments over the calendar year for illustrative purposes. Data as at February 28, 2018. Source: KKR Global Macro & Asset Allocation analysis. Federal Reserve, European Central Bank.

Whether we have been lucky or good, our *Paradigm Shift* playbook is gaining further momentum, and it now extends well beyond places like the U.S. to many countries these days, including Italy and Mexico. At its core, the strategy is for the 'Authorities' to run nominal GDP well in excess of nominal interest rates to not only help pay off the debt created by the fiscal stimulus but also to create some inflation in the system to inspire faster revenue growth – and with it, some pricing flexibility around key metrics such as wage growth.

EXHIBIT 68

G4 Sovereign Issuance Less Central Bank Purchases Shows that Net Issuance Will Expand Notably in 2H18

	Net Issuance	Y/y % Change	Central Bank Purchases	Y/y % Change	Net Issuance Less QE	Y/y % Change
2011	2,446		1,032		1,414	
2012	2,064	-16%	508	-51%	1,556	10%
2013	1,890	-8%	1,063	109%	826	-47%
2014	1,482	-22%	809	-24%	674	-18%
2015	1,044	-30%	1,091	35%	-48	-107%
2016e	964	-8%	1,477	35%	-514	-971%
2017e	964	0%	1,132	-24%	-167	-68%
2018e	1,453	51%	775	-32%	677	506%
Total	12,306		7,888		4,419	

G4 = BoJ, BofE, Fed, Eurozone. QE = Quantitative easing. Data as at June 14, 2018. Source: National Treasuries, Morgan Stanley Research.

"

At its core, the strategy is for the 'Authorities' to run nominal GDP well in excess of nominal interest rates to not only help pay off the debt created by the fiscal stimulus but also to create some inflation in the system to inspire faster revenue growth – and with it, some pricing flexibility around key metrics such as wage growth.

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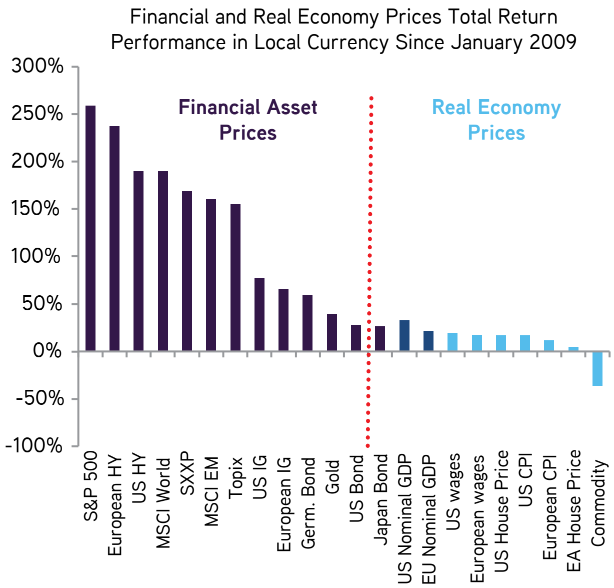
EXHIBIT 69

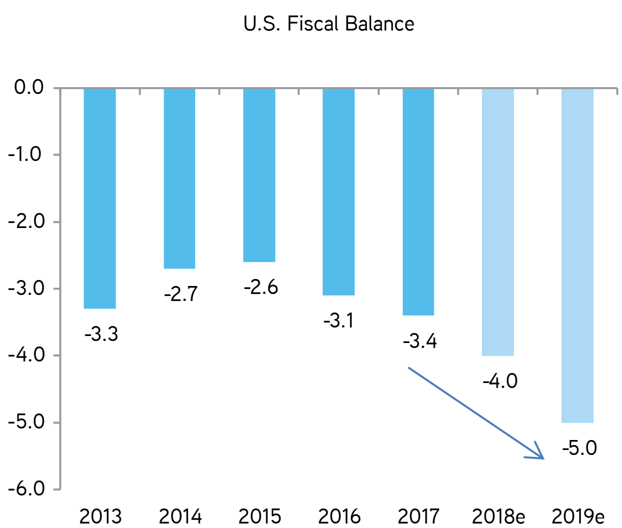
We Think That Governments Are Now Focused on Driving Better Returns in the Real Economy Relative to the Financial Economy



Data as at December 31, 2017. Source: Goldman Sachs.

EXHIBIT 70

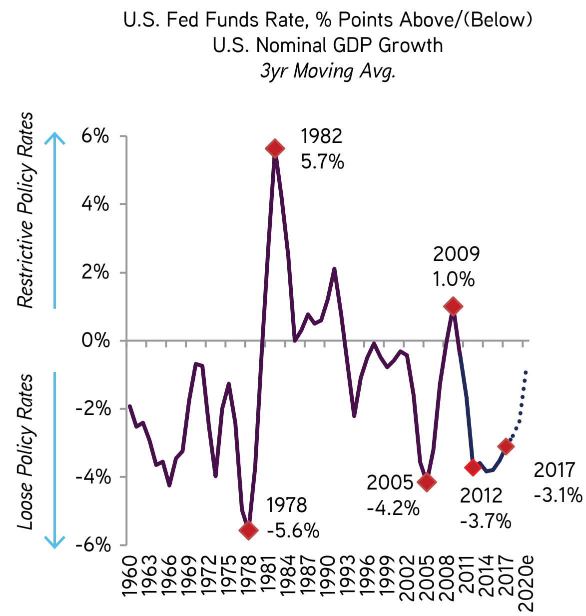
The U.S. Government Has Likely Ushered in a Period of Rising Fiscal Imbalances



e = Consensus estimates per Bloomberg. Data as at May 31 2018. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 71

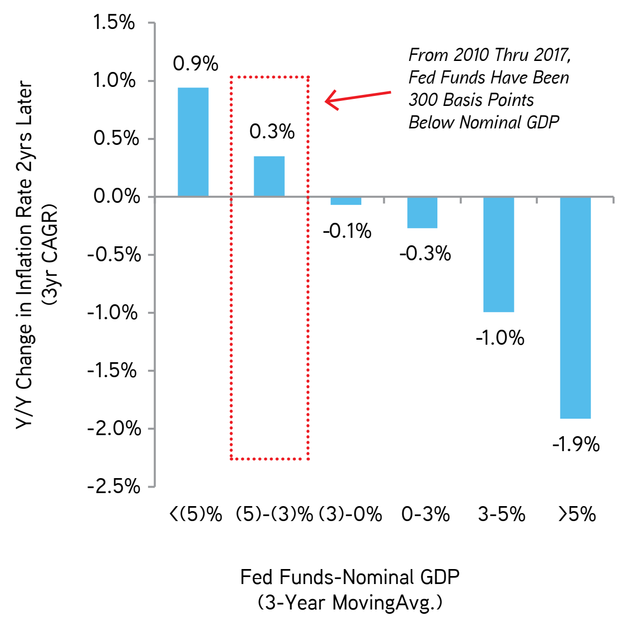
The Government Has Focused On Stimulating Nominal GDP in Today's Low Interest Rate Environment...



Data as at May 31, 2018. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 72

...Which Often Leads to an Increase in the Rate of Inflation

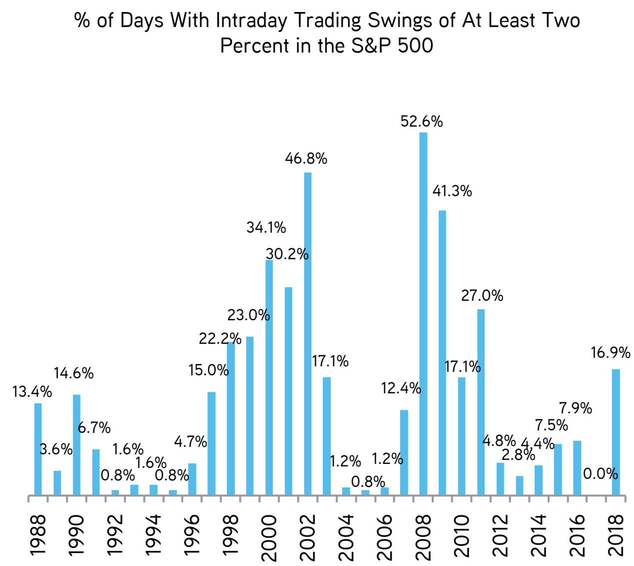


Data as at May 31, 2018. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

So, what does this mean for investors? For starters, it likely means lower expected returns for financial assets. It is also likely to lead to more volatility in the global capital markets, something that is now increasingly becoming apparent to investors, particularly in the equity markets. One can see this in *Exhibit 74*.

EXHIBIT 73

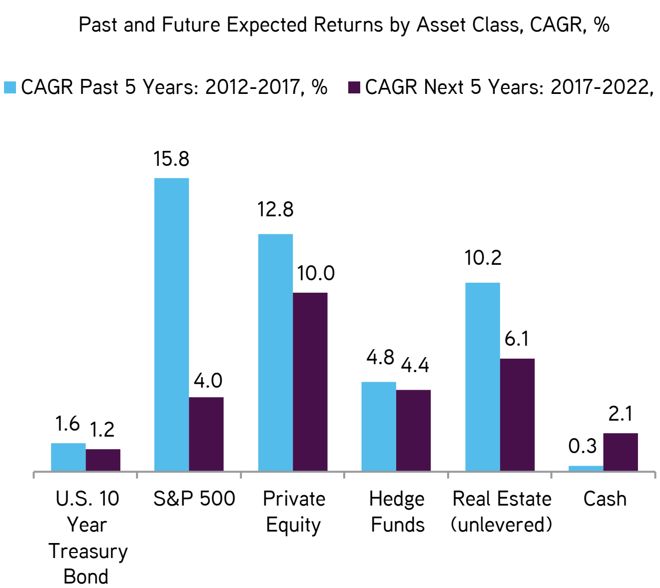
As Governments Shift From Monetary to Fiscal Stimulus, We Expect More Volatility



Data as at May 1, 2018. Source: Bloomberg.

EXHIBIT 74

We See Expected Future Returns for the Investment Management Industry Headed Lower During the Next Five Years

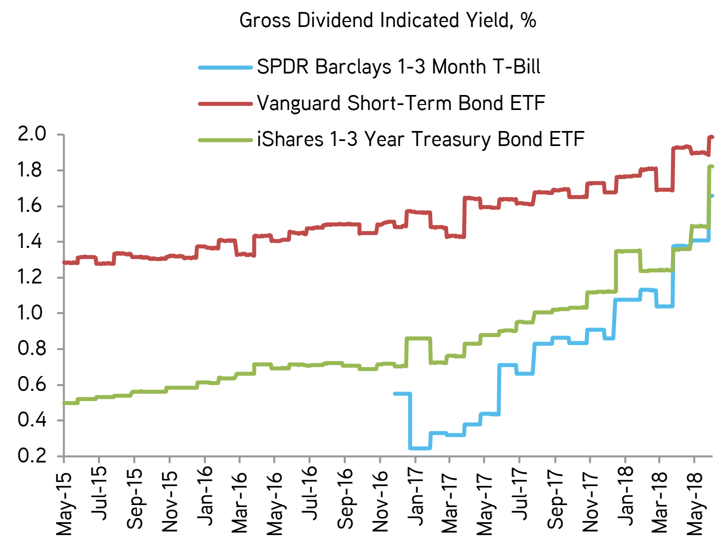


Data as at December 31, 2017. Source: Bloomberg, Cambridge Associates, NCREIF, HFRI Fund Weighted Composite Index (HFRIFWI Index), KKR Global Macro & Asset Allocation.

From an asset allocation and positioning standpoint, we believe our message is quite clear on what not to own. Specifically, our strong view is that investors should move away from longer-duration global government bonds, which is why we have a 2,000 percentage point – yes 2,000 percentage point - underweight to Long-Duration Government Bonds. We also think that our nominal GDP over nominal interest rate thesis means that investors should continue to lock in low cost liabilities, which is a theme we have been touting for some time. Finally, if we are right, then Cash will increasingly become a more formidable asset class. Already in the U.S., the 1-3 month T-Bills are above or at least competitive with what a global investor can earn after going five- to 10-years out on the duration curve in many other parts of the world. Finally, we like select global Financials, particularly those levered to rising rates and lower credit losses.

EXHIBIT 75

Cash Will Increasingly Become a More Competitive Asset Class in the United States



Data as at June 6, 2018. Source: Bloomberg.

#2: Yearn for Yield: Own More Cash Flowing Hard Assets

In recent years the Global Macro & Asset Allocation team has done a substantial amount of work around the high net worth (see *The Ultra High Net Worth Investor: Coming of Age,* May 2017) and insurance markets (see *New World Order,* April 2018). My colleagues Paula Roberts and Ken Mehlman have also supplemented this industry work with some detailed, top down analysis on demographics (see *What Does Population Aging Mean for Growth and Investments?,* February 2018). Across all cases, we continue to believe that the *Yearn for Yield* thesis is a multi-year theme with significant structural tailwinds behind it.

Consistent with this view, KKR's asset allocation framework in recent years has over-weighted sectors and themes where we felt investors would be rewarded with solid cash flow without too much leverage. However, given that we now have higher conviction that governments around the world are more committed to running nominal GDP above nominal interest rates, we want to make sure that we are further migrating even more towards assets that appreciate nicely when nominal GDP increases at a healthy clip.

To this end, we are adding a two percent position to the strategy of owning the B-piece stack of CMBS mortgages. This instrument acts like a zero coupon bond in terms of accretion, and we believe that it can offer investors an approximate 10% cash-on-cash return with an all in target gross return of 11-14% annually. Unlike the CLO segment of the market, the retention rules around the B-piece have not changed, supporting our view that an excess of capital will not pour into this space as many bank regulation rules are relaxed.

Importantly, though, our biggest overweight to our *Yearn for Yield* thesis remains our eight percent overweight to Asset-Based Finance. Indeed, 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. Importantly, as bank 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.

Meanwhile, our decision to boost our Energy/Infrastructure allocation to seven percent from five percent and a benchmark of two percent in January 2018 has served us well. Today we feel equally as enthusiastic. In particular, 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 improved growth in the real economy, not just boosting financial assets via monetary stimulus, then we believe Real Assets should be a bigger part of one's portfolio on a go-forward basis.

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Importantly, though, our biggest overweight to our Yearn for Yield thesis remains our eight percent overweight to Asset-Based Finance.

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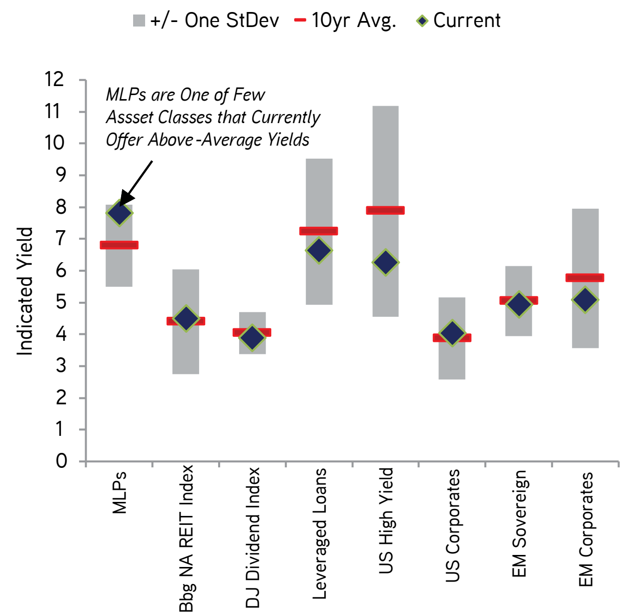
EXHIBIT 76

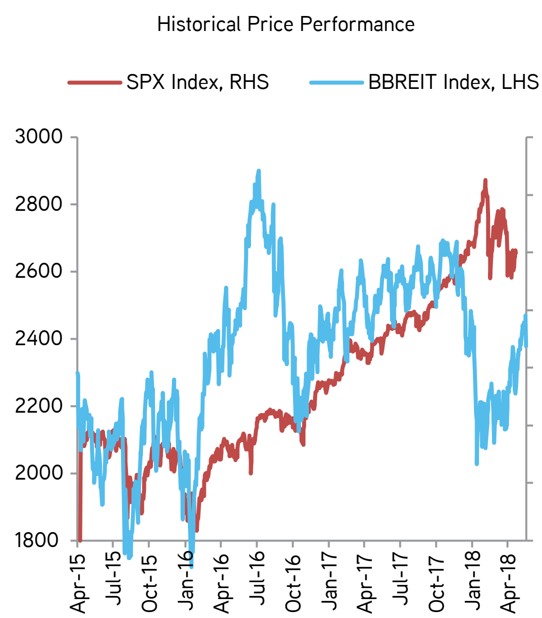
MLPs Are One of the Few Assets With Above Average Yields



Data as at June 12, 2018. Source: Bloomberg.

EXHIBIT 77

With Public REITs Now Badly Lagging the S&P 500, We Think an Interesting Investment Opportunity Is Being Created



Data as at June 12, 2018. Source: Bloomberg.

In sum, we are bullish on cash-flowing, hard assets that can be modestly levered to deliver investors a 12-14% return. Interestingly, given that banks are being encouraged to lend more these days, one can actually buy collateralized assets linked to nominal GDP from banks looking for capital relief and then borrow from the same bank at attractive terms to lock in what we view as a durable spread. To be sure, this option is not available everywhere, but key markets in Ireland, Australia, and the United States have yielded compelling opportunities of late.

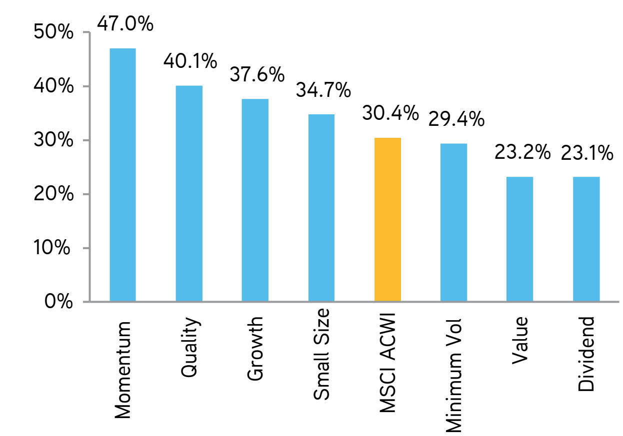
#3: Buy Complexity, Sell Simplicity

While this thesis is not a new one for us, it remains an extremely profitable play on what current market conditions are offering investors with 1) longer duration liabilities and/or 2) the ability to facilitate operational improvements. As we show below, the best performing strategies of the past three years have been *Momentum, Quality, and Growth*. In many instances, investors follow these strategies yet they fail to adequately incorporate valuation into their investment processes. Yet, at the same time the market is shunning *Value and Dividend Yield*. We like this arbitrage a lot, particularly given that we believe markets often only get this bifurcated later in an economic expansion (when what is working continues to work until it can't).

EXHIBIT 78

Over the Past Three Years Momentum Strategies Have Meaningfully Outperformed the Broader Market...

Global Investment Styles: Total Return, 3-Year, %



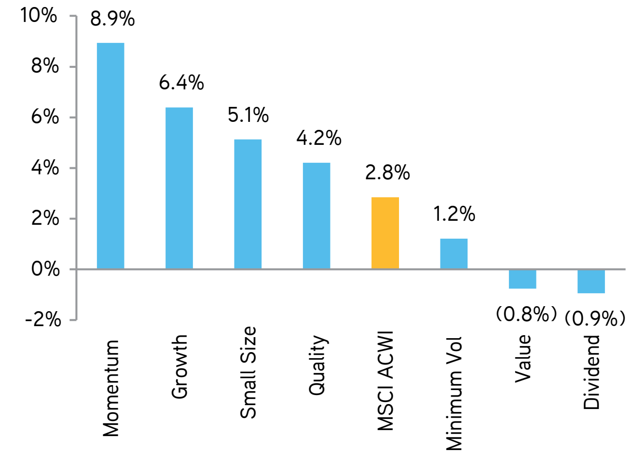
Data as at June 12, 2018. Source: Bloomberg, BAML Research.

> **We are bullish on cash-flowing, hard assets that can be modestly levered to deliver investors a 12-14% return.**

EXHIBIT 79

...And These Trends Continue in 2018. We Believe These Dynamics Are Creating an Interesting Arbitrage for Private Equity

Global Investment Styles: Total Return, YTD, %



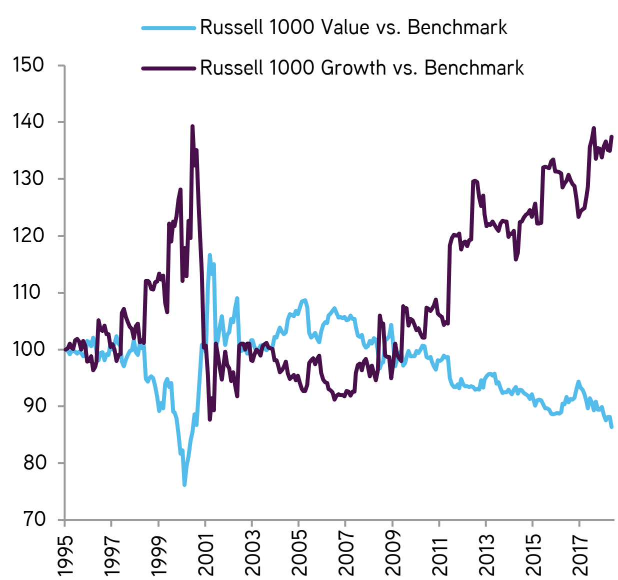
Data as at June 12, 2018. Source: Bloomberg, BAML Research.

On the credit side, a similar set-up of Haves versus Have-Nots has unfolded, according to my colleague Chris Sheldon. One can see this in *Exhibit 81*. Interestingly, though, performance year-to-date has favored more risky credits, a trend that we believe is likely to continue.

EXHIBIT 80

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

Price to Book, Indexed to 100

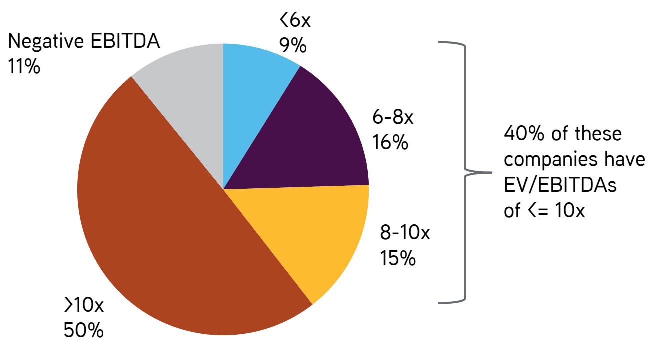


Data as at May 31, 2018. Source: Bloomberg.

EXHIBIT 82

After Nine Full Years of a Bull Market, 40% of Russell 2000 Companies Still Have EV/EBITDAs of Less than 10x

EV/EBITDA of U.S. Stocks With EVs of $500mm-$5bn



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 May 31, 2018. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

So, while we fully acknowledge that several key metrics, U.S. employment trends in particular, suggest we are late cycle, we take significant comfort in the large bifurcations that the global capital markets are presenting. Specifically, we like the bifurcations that we now see extending across both Equities and Credit. This backdrop is especially compelling for investment managers who can buy into complex situations at a discount, provide a meaningful degree of operational improvement or expertise, and then sell them back out into the capital markets at a notable premium to what they paid. This arbitrage will not last forever, in our opinion, but while it does, asset allocators should lean in aggressively.

#4: Deconglomeratization: Corporations Are Increasingly Shedding Assets

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 83 and 84, respectively.*

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We like the bifurcations that we now see extending across both Equities and Credit.

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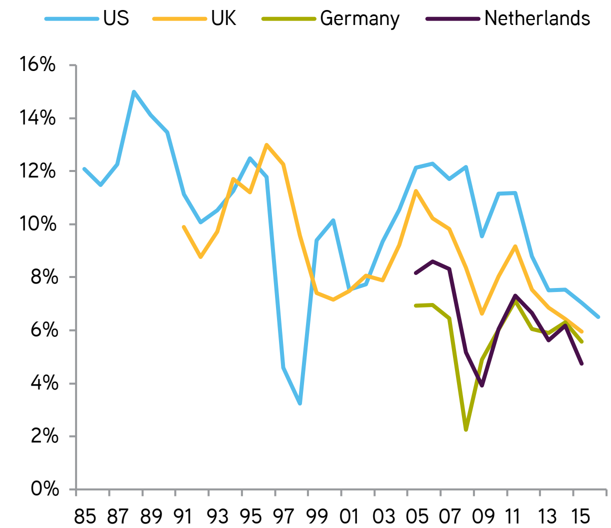
EXHIBIT 83

The Rate of Return On FDI Is Declining

Rate of Return on Foreign Direct Investment, %

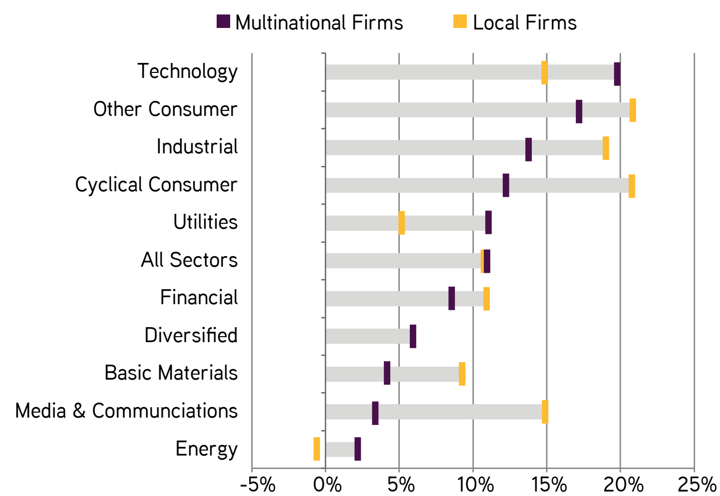


Data as at January 2017. Source: National Statistics, OECD, Haver Analytics.

EXHIBIT 84

Intensifying Local Competition Has Dented the Return Profile of Global Multinationals

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



Data as at January 2017. Source: The Economist, Bloomberg.

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 for this phenomenon 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 have increasingly been identified as potential sources of value creation. All told, as we show here in *Exhibit 85*, at least a quarter of the Nikkei 400 has 100 or more subsidiaries.

Second, the deposit-to-GDP ratio in Japan is 135.5%. This high level underscores our view that banks have plenty 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. Third, enterprise value-to-EBITDA multiples in Japan are often at or below historical averages, a set-up that we do not find in many other markets around the world.

EXHIBIT 85

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

NUMBER OF LISTED COMPANIES BY NUMBER OF CONSOLIDATED SUBSIDIARIES

	NUMBER OF COMP.	UNDER 10	10 -49	50 -99	100 -299	300 OR MORE
Nikkei 400	400	51	157	91	77	24
TSE First Section	1,956	882	802	155	90	27
TSE Second Section	539	467	71	1	0	0
Mothers	239	226	13	0	0	0
JASDAQ	773	693	79	1	0	0
Total	**3,507**	**2,269**	**964**	**154**	**91**	**28**

Data as at 2017. Source: Macquarie.

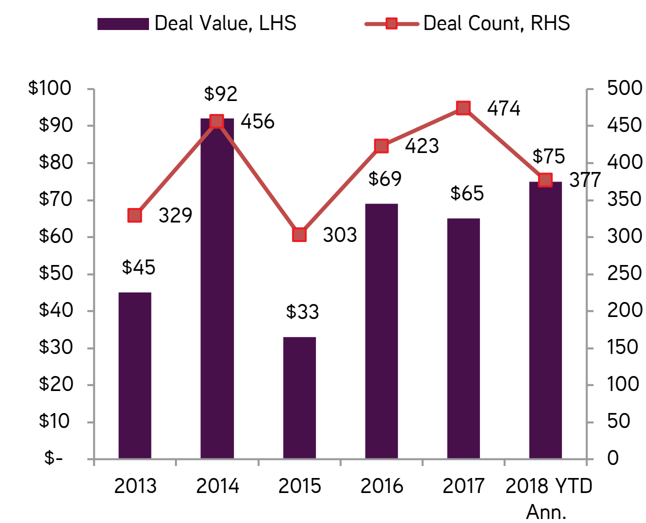
We also note that we are seeing a lot of corporate 'streamlining' occurring outside of the traditional multinational sector. Indeed, after several quarters of inactivity, we are finally seeing U.S. energy companies rightsizing their footprints, as Wall Street encourages many of these entities to shed 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 in recent quarters, particularly those with contractual revenue set-ups. It appears that Europe has emerged as the most active region for Infrastructure carve-outs, though 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, in 2017, McKinsey Consulting estimated 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 as water, roads, telecom, and rail (*Exhibit 87*).

EXHIBIT 86

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

U.S. Upstream Transactions: Deal Value and Count by Year, US$ Billions



2018 YTD is annualized. Data as at May 31, 2018. Source: PLS.

EXHIBIT 87

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

THE NETWORK INFRASTRUCTURE NECESSARY TO SUPPORT GLOBAL ECONOMIES PROJECTED GDP GROWTH, 2017-2035

	AVERAGE ANNUAL NEED, 2017-2035, USD TRILLIONS	ANNUAL SPENDING AS A % OF GDP	AGGREGATE SPENDING, 2017-35, USD TRILLIONS
Ports	0.1	0.1	1.6
Airports	0.1	0.1	2.1
Rail	0.4	0.4	7.9
Water	0.5	0.5	9.1
Telecom	0.5	0.6	10.4
Roads	0.9	1.0	18.0
Power	1.1	1.3	20.2
Total	**3.7**	**4.1**	**69.4**

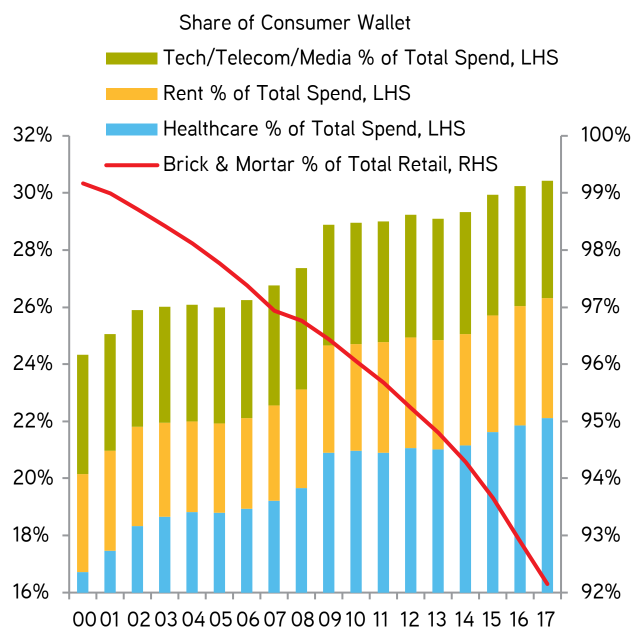
Data as at June 2017. Source: McKinsey *Bridging Infrastructure Gaps: Has The World Made Progress?*

#5: Experiences Over Things 2.0

For several quarters we have been highlighting the secular trend by consumers away from 'Things' and towards 'Experiences' — think posting a delicious meal on Instagram versus adding another sweater to the wardrobe. As we travel around (particularly in Asia), technology has made the trend towards *Experiences Over Things* a secular trend with far ranging implications in major sectors such as Healthcare/Wellness, Leisure, Financial Services, and Entertainment. In the U.S., consumers are earmarking an ever increasing amount of their paychecks for what we are increasingly viewing as 'fixed charges' such as healthcare, rental expenses, and iPhone maintenance. One can see this in *Exhibit 88*.

EXHIBIT 88

Discretionary Purchases in Key Areas Such As Shelter, Healthcare, and Technology Are Becoming More Fixed in Nature, We Believe



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

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As many as one-third of American workers may need to change occupations and acquire new skills by 2030 if automation adoption is rapid.

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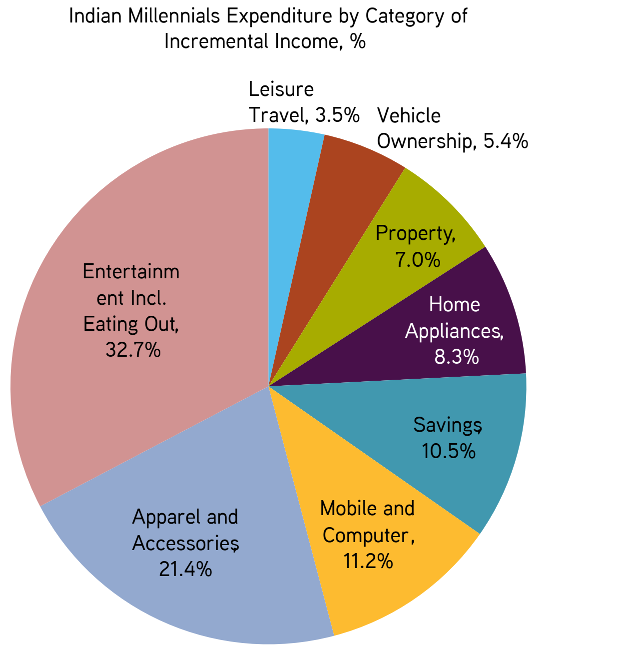
EXHIBIT 89

Indian Millennials Spend More than 36% of Their Incremental Income on Entertainment and Travel



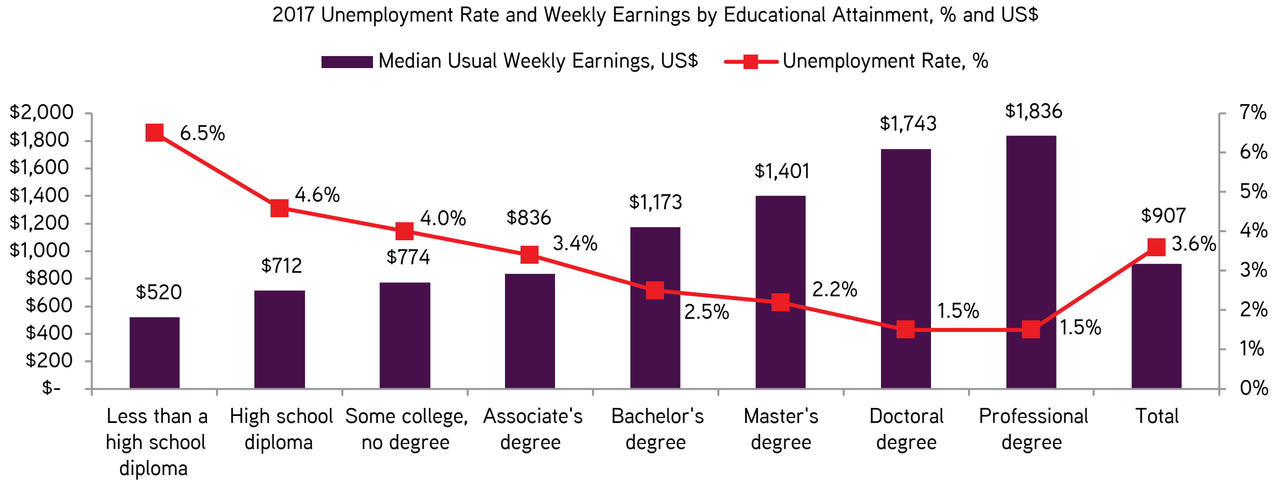
Note: incremental income is money remaining after monthly essentials (rent, utilities) and education. Data as at February 2018. Source: Deloitte Database (Thomson One) and Analysis, *Trend-setting Millennials Redefining the Consumer Story*.

Not surprisingly, the trend towards *Experiences Over Things* is a global one. In particular, we see it unfolding in large, key EM markets such as China and India (*Exhibit 89*). Recent visits to Indonesia and Mexico confirm a similar phenomenon, though we do think that China's strong position in e-commerce as well as its more sophisticated infrastructure is creating a more rapid increase in experiential spending relative to some other EM countries we have visited in recent quarters.

Yet, perhaps what is most important to us these days may be what is driving this change in consumer preferences amongst the masses. For example, the more we travel the more we are struck by the extent to which education drives the choices consumers make. One can see the profound impact of education on U.S. citizen's employment and income opportunities in *Exhibit 90*. However, while the U.S. example is extreme, it is not isolated, and we see similar consumer backdrops across Europe, Latin America, and Asia.

EXHIBIT 90

The U.S. Unemployment Rate and Education Levels Go Hand-in-Hand



Data as at December 31, 2017. Source: Bureau of Labor Statistics.

The other major influence on consumer behavior is technological change and how it is affecting the consumer experience/well-being, particularly around employment trends. To this end, we note the following from the Council on Foreign Relations report entitled *The Work Ahead: Machines, Skills, and U.S. Leadership in the Twenty-First Century*:

- Nearly two-thirds of the 13 million new jobs created in the U.S. since 2010 required medium or advanced levels of digital skills.
- As many as one-third of American workers may need to change occupations and acquire new skills by 2030 if automation adoption is rapid. The average worker will journey through over a dozen separate jobs during his or her lifetime while education will become a lifelong affair, not something completed prior to entering the workforce, with retraining becoming the new normal.
- The United States spends roughly one-fifth of what the average European country spends on active labor market programs, which are designed to provide individuals who lose their jobs with the training, skills, and job counseling needed to return to the job market.

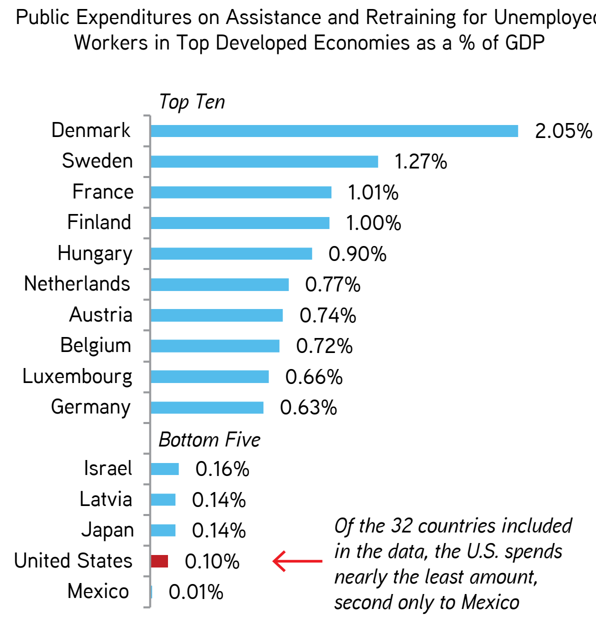
"

We think fully understanding the influences of education and technology on today's consumers are now prerequisites for success. If we are right, then both the upside and downside an investor now faces has never been more extreme, in our view.

"

EXHIBIT 91

Public Expenditures On Assistance and Retraining for Unemployed Workers in the U.S. Remains Quite Low



Data as at April 2018. Source: Council on Foreign Relations.

So, our bottom line is that it is not business as usual in the large and growing global consumer arena. To be sure *Experiences Over Things* continues to gain momentum, and we want to play this trend in size. However, as we detailed above, we think fully understanding the influences of education and technology on today's consumer are now prerequisites for success. If we are right, then both the upside and downside an investor now faces in this area of the global economy has never been more extreme, in our view.

#6: Emerging Markets: Stay Selective in EM, But Stay Invested

With EM having appreciated 38% in 2017[2], we highlighted in our January 2018 piece that a mid-cycle slowdown might occur in 2018, particularly if we got a tactical dollar rally (which we have). Well, that back-filling is now occurring, and we would advocate using any further weakness to add to positions in higher quality EM markets, particularly in Asia. Indeed, though it is not fully flashing an 'All In' signal, our proprietary EM model, which we detail in *Exhibit 93*, continues to deliver mostly positive signals. We note the following:

- When we do a simple DuPont analysis to decompose return on equity, our work shows that operating margins are now solidly improving across much of EM after a five-year bear market, which is now boosting return on equity. This notable improvement, particularly in the Technology, Energy, Materials, and Industrials sectors, has led the ROE factor in our dashboard to finally send a a 'buy' signal.

- Another positive for Emerging Markets these days is the ongoing improvement in commodity prices. Historically, a strong commodities backdrop has provided an uplift not only for EM commodity exporting countries, but also an incremental uplift for commodity importers such as India and Turkey, which actually stand to benefit from improved inbound investment from the commodity exporting countries with whom they do business. As a result, higher commodity prices often help to sustain the current account deficits of the importing countries.

- In terms of emerging complications to the EM story, valuations are now just neutral, no longer cheap. In fact, EM now trades at a 4.7 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.

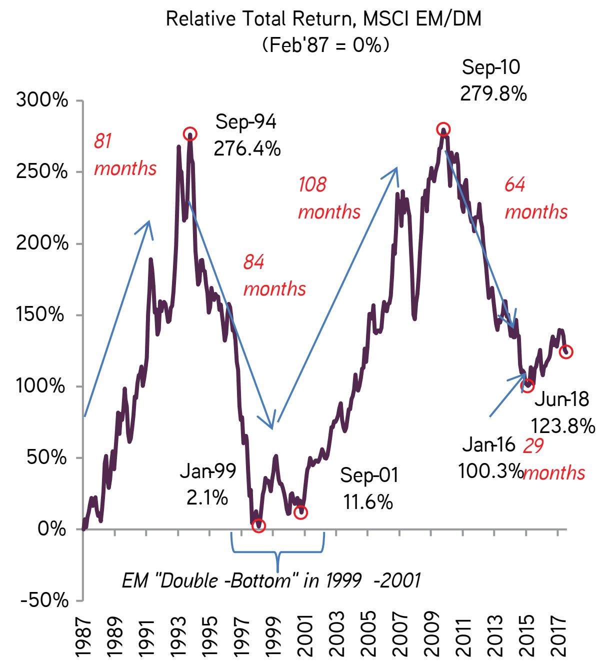
- Another consideration is that our signal 'EM FX Follows EM Equities' has turned back to neutral again, compared to a positive reading in January 2018. The underperformance of EM currencies has been led by a 'fat tail' of currencies that run significant current account and/or fiscal deficits such as Argentina, Brazil, and Turkey. Despite the sell-off, we are finding it difficult these days to make the case for sustained upside in EM FX, as real interest rates in much of the region are not yet at compelling levels (*Exhibit 96*), and real effective exchange rates look only average relative to history.

Bottom line: Despite the recent weakness in EM, we think that Emerging Markets outperformance still has three to five years more of running room. To be sure, we could face a double bottom situation for the overall group, which is similar to what happened during the 1999-2001 period, and we do expect a narrower ascent for EM in Phase II of this bull market.

However, our longer-term conviction is undeterred for several reasons. For starters, as we detailed in the GDP outlook section, we believe that China has already bottomed. This viewpoint is key to not only our overweight to Asia but also to our central thesis that EM is an attractive play on rising GDP-per-capita in less developed markets. 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, after such strong dollar-based returns in the U.S. during recent years, we still think that investors are now under-invested in EM. If we are right, then this tailwind should continue to attract flows as retail and institutional investors reposition their portfolios towards key growth markets like China, India, and Vietnam in the coming years.

EXHIBIT 92

We Some Risk that EM Ultimately Experiences a 'Double Bottom' Similar to What Happened in 1999-2001



Data as at June 12, 2018. Source: MSCI, Bloomberg, Factset, KKR Global Macro & Asset Allocation analysis.

> **"Despite the recent weakness in EM, we think that Emerging Markets outperformance still has three to five years more of running room."**

2 Data as at June 15, 2018. Source: Bloomberg.

EXHIBIT 93

EM Is Now Entering the 'Mid-Cycle' Phase of Its Recovery. While Relative Valuation Is No Longer As Compelling, Return on Equity Is Rising Nicely and Higher Commodity Prices Are Helpful

	'RULE OF THE ROAD'	MAY '15	JAN '16	AUG '16	MAY '17	SEP '17	JUN '18
1	Buy When ROE Is Stable or Rising	↔	↔	↔	↗	↗	↗
2	Valuation: It's Not Different This Time	↔	↗	↗	↗	↔	↔
3	EM FX Follows EM Equities	↘	↘	↔	↔	↗	↔
4	Commodities Correlation in EM Is High	↔	↔	↔	↔	↔	↗
5	Momentum Matters in EM Equities	↘	↘	↗	↔	↗	↔

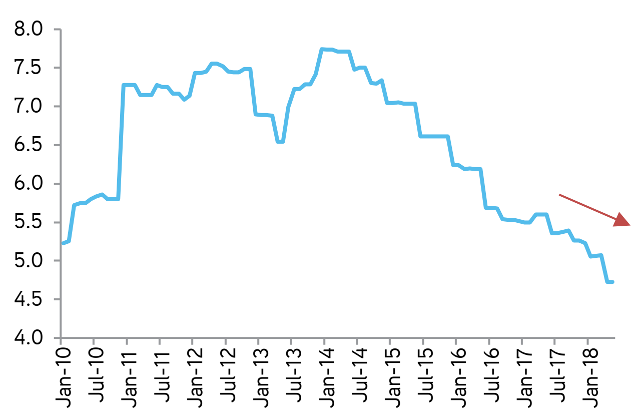
Overall: EM now seems to be entering a more 'mid-cycle' phase of its recovery, wherein country performance will be more differentiated. Valuation is no longer compellingly cheap, but fundamentals are improving. This is particularly true for domestically-focused economies where debt and deficits are under control, and local companies are moving up the value chain, helping to sustainably raise standards of living. A firmer commodity backdrop recently also helps bolster our conviction in a tradeable EM cycle.

Data as at June 12, 2018. Source: KKR Global Macro & Asset Allocation analysis.

EXHIBIT 94

Margins in the Consumer Discretionary Sector in EM Are Falling, Despite Stronger Global Growth

MSCI EM Consumer Discretionary Sector Margins

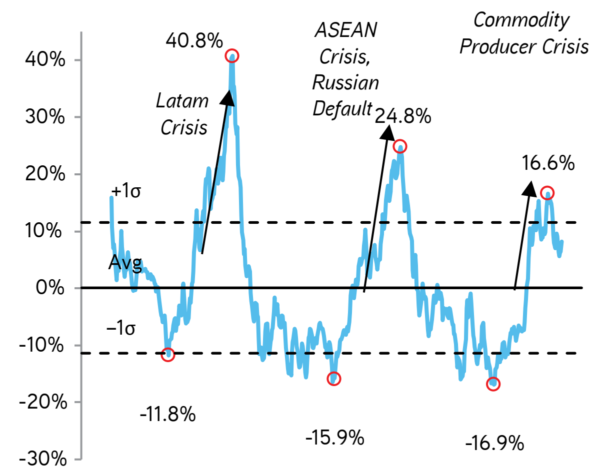


Data as at May 31, 2018. Source: MSCI, Factset.

EXHIBIT 95

For Our EM Call to Work, We Need to Be Right that the Dollar Has Peaked

Real MajorTrade-Weighted US Dollar REER: % Over (Under) Valued

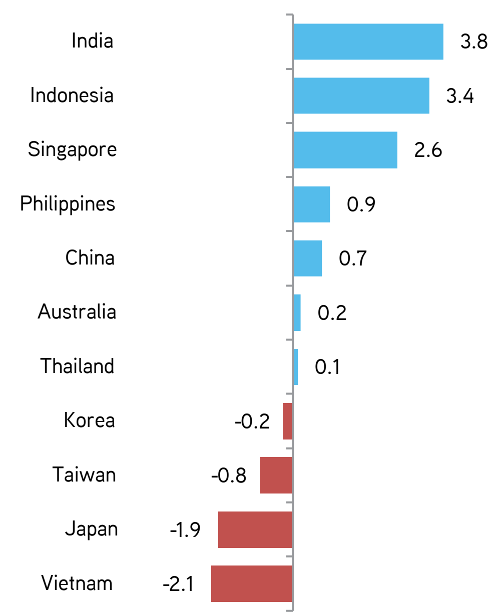


Data as at May 31, 2018. Source: Federal Reserve, Bloomberg.

EXHIBIT 96

Real Rates Have Improved in Some Asian Countries, But They Have Also Fallen in Other Ones

Change in Real 10-Year Yields: Current vs. Pre-Taper, PPT

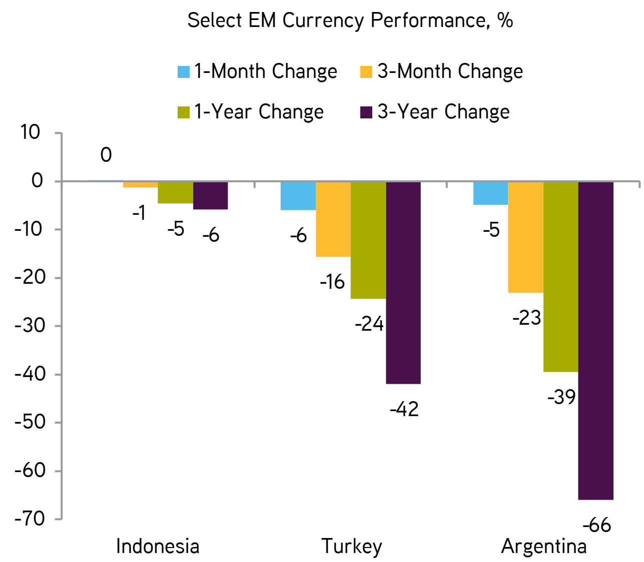


Data as at June 15, 2018. Source: Bloomberg.

If we do have areas of concern in EM, it is really around countries that are aggressively using other people's money to finance their growth. To date, the market has largely agreed with our line of thinking. To this end, we note that the some of the largest declines in local currencies have coincided with those countries that are running the largest current account deficits and fiscal account deficits. One can see this graphically in *Exhibits 97 and 98*, respectively, which shows the vulnerability of countries like Turkey and Argentina. In our view, the issues that many of these countries are facing are likely to increase, not decrease, as the adverse impact of global quantitative easing becomes more recognizable in the second half of 2018 and beyond.

EXHIBIT 97

Countries That Rely on Foreigners to Finance Themselves Are Likely to Stay Under Pressure



Data as at June 13, 2018. Source: Bloomberg.

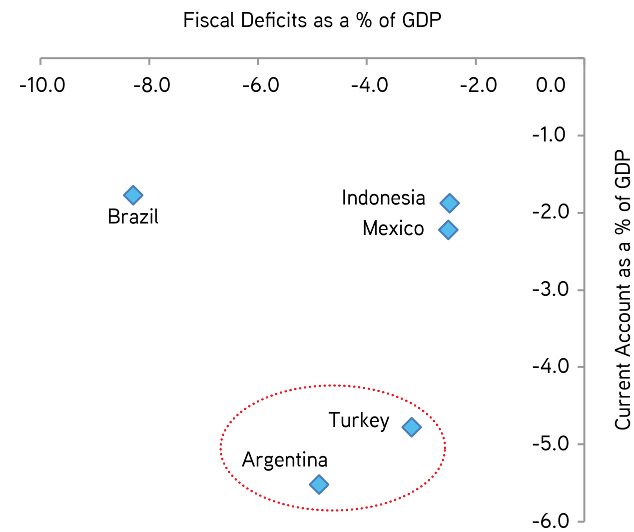
"

Given our strong views that fiscal policy is supplanting monetary policy in many instances and that nominal GDP is now running well in excess of nominal interest rates in several key economies, we think that the risk to margins across multiple sectors, particularly companies that lack pricing power, is quite significant in the new regime that we are envisioning.

"

EXHIBIT 98

As Liquidity Dries Up, Large Fiscal and Current Account Deficits Are Becoming Headwinds



Data as at April 8, 2018. Source: IMF, Haver Analytics.

Section III: Risks to Consider

In the following section we detail many of the key risks on which we think investors should focus.

#1: Input Costs Rising/Margin Degradation Likely Means Avoid Price Takers

Given our strong views that fiscal policy is supplanting monetary policy in many instances and that nominal GDP is now running well in excess of nominal interest rates in several key economies, we think that the risk to margins across multiple sectors, particularly companies that lack pricing power, is quite significant in the new regime that we are envisioning. Surge buying ahead of tariff implementations is also creating headwinds in key industrial markets such as steel and aluminum. Already, our channel checks suggest that input costs, including steel, aluminum, and compensation, are creating headwinds. To this end, we note the following quotes from the last three ISM reports in the U.S[3]:

"Much concern in the industry regarding the steel and aluminum tariffs recently [imposed]. This is causing panic buying, driving the near-term prices higher and [leading to] inventory shortages for non-contract customers." (Machinery)

"Significant price increases in the steel commodity due to 232 [the tariffs]. The price increases will begin to impact our company's performance." (Primary Metals)

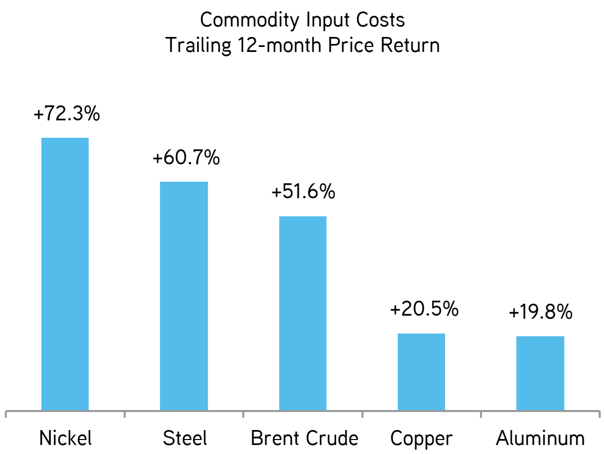
"The recent steel tariffs have made it difficult to source material, and we have had to eliminate two products due to availability and cost of raw material." (Fabricated Metal Products)

3 March, April and May 2018 ISM Reports on Business. Source: Institute for Supply Management.

Importantly, these trends are occurring at a time when operating margins are already quite high. One can see this in *Exhibit 100*.

EXHIBIT 99

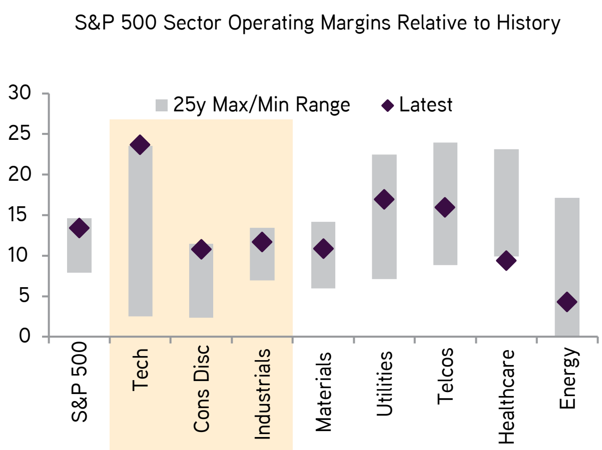
Rising Commodity Input Costs Could Be a Drag on Operating Margins...



Data as at May 31, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg.

EXHIBIT 100

...Which Are Already Quite High For Sectors Like Technology, Consumer Discretionary and Industrials



Data as at May 31, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg.

Somewhat surprisingly against a backdrop of strong employment growth, we are also seeing higher input costs adversely impact the global consumer. For example, in Indonesia, the local consumers are now facing the difficult consequences of higher interest rates, higher input costs, and a weaker rupiah. On a real basis, home prices are negative, so there is no boost from a housing wealth effect. Consumer concern over finances has also risen, which could partly be due to higher fuel and electricity prices as well as fear of yet higher prices to come.

Meanwhile, in the United States, the savings rate has come under significant pressure, despite a near record low unemployment rate and improved wage growth. Moreover, as we show in *Exhibit 101*, many consumers are running in place as faster wage growth is being offset by higher costs in many critical areas, including healthcare and shelter.

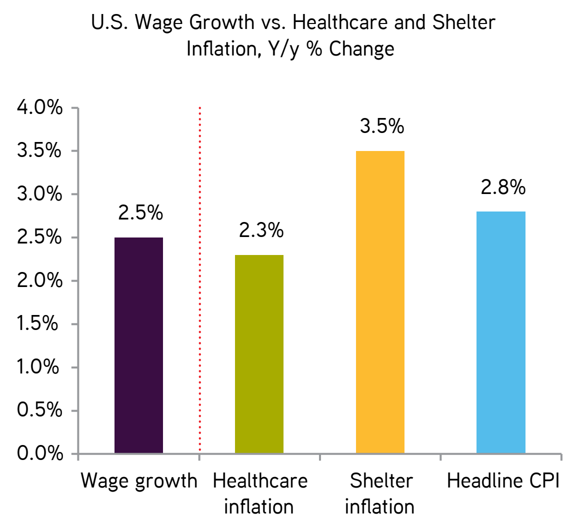
EXHIBIT 101

U.S. Consumers Are Spending Rather than Saving

Data as at April 30, 2018. Source: BLS, Haver Analytics.

EXHIBIT 102

Despite Stronger Economic Growth, the U.S. Consumer Is Still Facing Headwinds



Data as at June 12, 2018. Source: Bureau of Labor Statistics, Haver Analytics.

In sum, we think we are late enough in the earnings cycle that rising input costs could begin to dent momentum by third quarter 2018 reporting season. Moreover, if President Trump pushes harder on the trade front, international tariffs could be an issue across the Americas, Europe, and Asia. Meanwhile, the global consumer is not in as great a shape as one might expect, given where unemployment levels are. So, if input costs do remain high and employment trends slow, we believe investors could be surprised by the downward operating leverage that consumer results display this cycle relative to prior ones.

#2: Rising Geopolitical and Socioeconomic Tensions

Without question, my colleagues Ken Mehlman and Travers Garvin expect that economic and nationalist populist movements will continue to gain strength — trends that will lead to even stronger anti-establishment sentiment. If they are right, then market participants should brace for more frequent periodic market shocks in the coming months. Already, we have seen this type of 'shock' play out in the Italian bond market, as investors initially underestimated the strength of the populist movement. Meanwhile, the surprise electoral defeat on May 9, 2018 of Malaysia's Barisan Nasional which had ruled for over 61 years demonstrates that Asia is not immune from its own versions of political populism.

Investors should pay attention to the upcoming elections in Mexico and the U.S. Congress later this year as important bellwethers. Over the second half of the year, we expect that major geopolitical risks including the uncertainty around the Iran nuclear agreement and Iran's regional malfeasance, U.S.-China tensions, Venezuela's economic implosion, and North Korean nuclear talks will continue, unresolved, and with continuing undulation in political rhetoric and speculation.

We also expect trade to remain a major headline issue. As expected, the Trump administration announced recently that it will proceed with 25% tariffs on roughly $50 billion in Chinese goods. There were revisions to the tariffs announced in April 2018, with roughly $16 billion of previously announced tariff goods being removed from the list and replaced with new items. The $16 billion of 'new' replacement tariff goods are subject to a comment period in coming weeks, while the $34 billion of previously announced items will go into effect on July 6, 2018. China responded with its own tariffs/duties of 'equal strength' starting July 6, 2018 as well. Furthermore, as a reminder, the Treasury is expected to announce its 'investment reciprocity regime' limiting Chinese investment into the U.S. on June 30, 2018.

> "
> **Without question, we expect that economic and nationalist populist movements will continue to gain strength — trends that will lead to even stronger anti-establishment sentiment. If we are right, then market participants should brace for more frequent periodic market shocks in the coming months.**
> "

What was not expected was President Trump's decision to escalate tensions further with the threat of up to $450 billion in tariffs, if China does not back down. The situation obviously remains fluid, but our base case is that the U.S. is not looking to start a major trade war, though it will remain vigilant around key areas such as intellectual property.

EXHIBIT 103

A Large Percentage of the U.S. Trade Deficit Can Be Explained by Auto and Computer Imports From China and Transportation Imports From Mexico

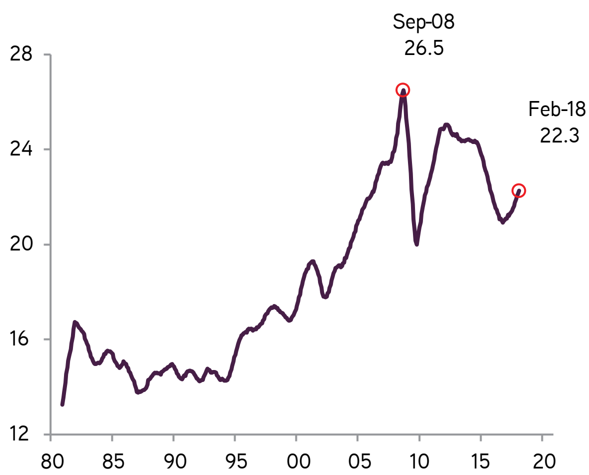
BALANCE OF GOODS IN 2017, BY TRADING PARTNER, US$ BILLIONS	CANADA	MEXICO	CHINA	ALL COUNTRIES
Agriculture	0.2	-6.0	15.6	17.0
Oil, Gas, Minerals	-48.6	-4.0	8.4	-85.8
Food	-2.0	2.8	-0.5	3.2
Beverages, Tobacco	1.6	-4.4	0.1	-15.7
Textile	1.4	2.6	-13.5	-17.3
Apparel	2.3	-4.1	-49.4	-113.0
Paper	-10.4	4.3	-2.7	-7.7
Petroleum	-1.6	20.1	0.6	34.5
Chemical	6.2	17.9	-3.0	-24.9
Plastics	1.9	5.2	-15.6	-20.0
Nonmetallic Minerals	1.5	-1.1	-7.0	-11.2
Primary Metals	-10.7	1.6	-2.2	-35.6
Fabricated Metals	5.2	2.3	-20.3	-24.4
Machinery	12.7	2.3	-25.7	-35.4
Computer	18.7	-17.1	-167.3	-192.7
Electrical Equipment	8.3	-11.5	-40.0	-54.0
Transportation	-0.4	-76.0	10.5	-107.3
Furniture	-0.5	-2.1	-23.4	-36.4
Misc. Manufacturing	5.7	-3.5	-38.6	-41.6
All Goods	-8.9	-70.6	-373.7	-768.3

Note: Limited to top 30 trading partner of each country. Data as at December 31, 2017. Source: Goldman Sachs.

EXHIBIT 104

We Believe Global Trade Momentum Actually Peaked in 2008

Global Merchandise Exports as a % of Global GDP

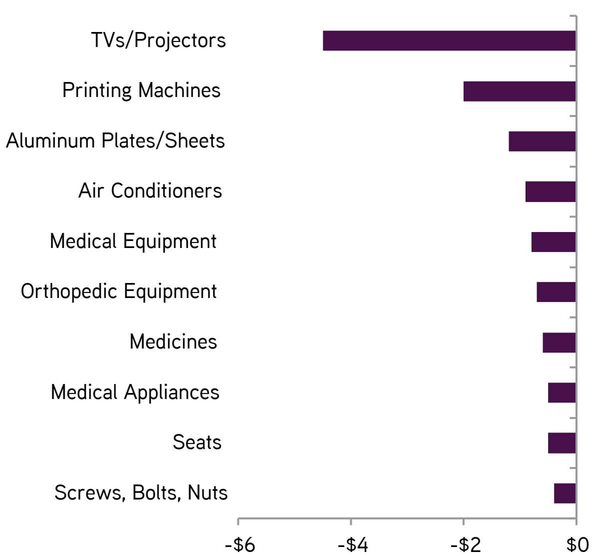


Data as at February 28, 2018. Source: IMFWEO, Haver Analytics.

EXHIBIT 105

The Most Recent Trade Announcement by the U.S. Government Dialed Back its Emphasis on Consumer Goods...

Change in Exposure, US$ Billions

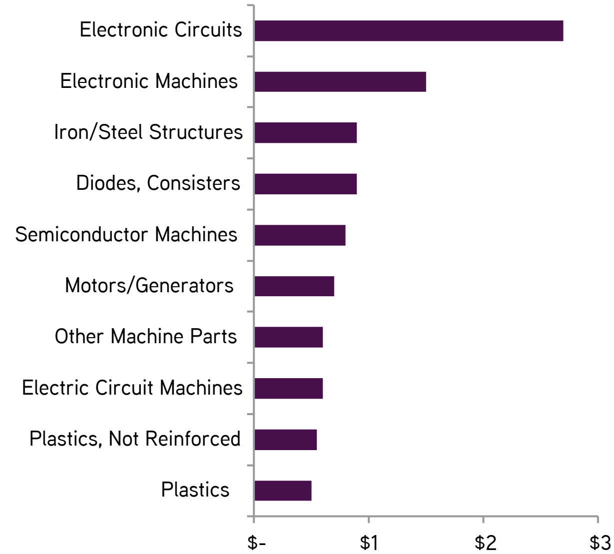


Based on 2017 imports. Calculated as difference between the amounts of products within each category targeted in the final versus initial tariff product lists. Data as at June 15, 2018. Source: USITC, USTR, Nomura.

EXHIBIT 106

...While Increasing Its Focus on High-Tech Capital Goods

Change in Exposure, US$ Billions



Calculated as difference between the amounts of products within each category targeted in the final versus initial tariff product lists. Based on 2017 imports. Data as at June 15, 2018. Source: USITC, USTR, Nomura.

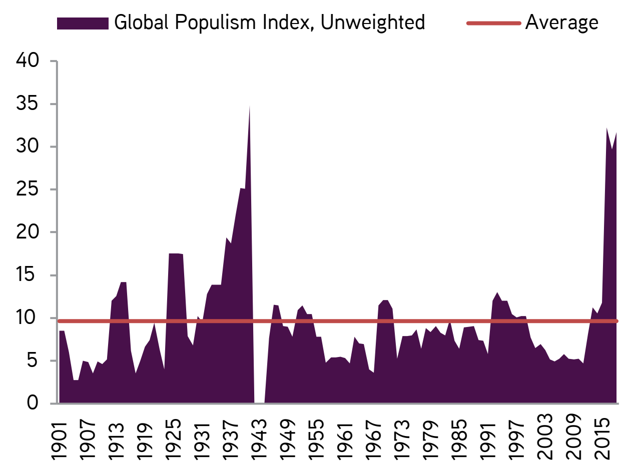
So, with respect to China in particular, investors should not expect a return to the 'strategic partners' approach any time soon. Critics across the U.S. political spectrum and in many European and Asian nations are skeptical of China's economic and regional ambitions, technological theft, and the uneven playing field for non-Chinese companies. While negotiations may produce some 'deals', a world where technological know-how and data are strategic assets and where China's continued rise will inevitably produce more systematic and consistent trade tensions. Further, China has land and maritime disputes with multiple countries on its periphery which, along with heighted tensions over North Korea and the East and South China Seas, creates the risk of a geopolitical event that could unsettle Asian and global markets.

There are also technological shocks to consider. For example, as Europe imposes the GDPR to protect privacy, calls for more oversight of technology companies in the U.S. have grown—particularly following the Facebook/Cambridge Analytica scandal. Yet, new regulation in the U.S. is far from certain, in part because the same populist forces that generate unprecedented distrust of business and government also stymie policy change. Furthermore, millions of consumers/voters simply appear willing to trade their privacy for convenience and connection.

The NFL and Starbucks have learned the hard way that a world where everyone has a smart phone is also one in which everyone is a journalist and potential activist. The radical transparency of the Internet exposes all and creates a new consciousness focused on whether companies 'do the right thing' not just whether they do things right. Against this backdrop, it is critical for investors to understand the underlying cultures of the companies in which they invest and whether these companies are prepared for this new world of radical transparency.

EXHIBIT 107

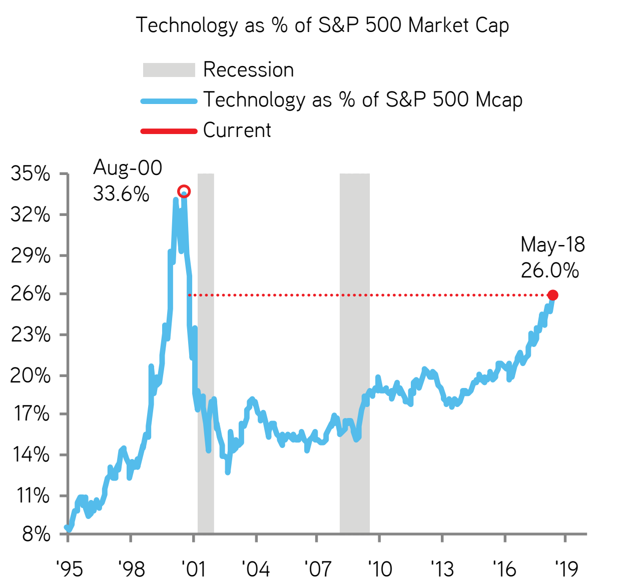
Global Populism Is Now Close to Highs Not Seen Since Right Before the Second World War



Data as at May 2018. Source: Deutsche Bank.

EXHIBIT 108

Technology Stocks Are Now 26% of the S&P 500 Market Cap, the Highest Proportion Since October 2000



Data as at May 31, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg.

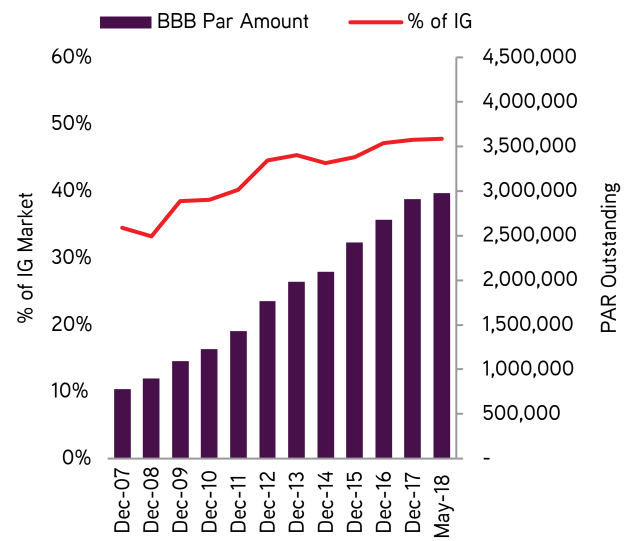
So, our bottom line is that the combination of income equality, technological transparency, and migratory tensions are creating an unsettled backdrop that is likely to persist for some time. As such, our call to action is to structure portfolios that are overweight upfront yield relative to duration, have enough flexibility to add capital into market weakness, and provide enough idiosyncratic cash flow streams to endure periods when asset class correlations are likely to spike. As we mentioned earlier, we are also prone to underweight geopolitical 'hot spots' where capital could be impaired if local government policies shift more inward. To date, politicians have not yet interfered in the capital markets, but if history is any guide, it is not unthinkable, given the heightened trade tensions of late.

#3: Growing Credit Market Concerns

Without question, many CIOs feel that there has been a notable decline in the quality of the Investment Grade Debt market. Indeed, as we show below in *Exhibit 109*, the BBB segment of the market has grown ten times to USD three trillion since 1998, and it now represents almost half of the entire Investment Grade market versus a more modest 30% in 1998. In our view, this dramatic increase in size of the total market is notable not only in absolute terms but also relative to history (when BBBs were a much smaller part of a much smaller overall market).

EXHIBIT 109

The Investment Grade Market Has Also Grown Rapidly with BBB Now Nearly 48% of Investment Grade

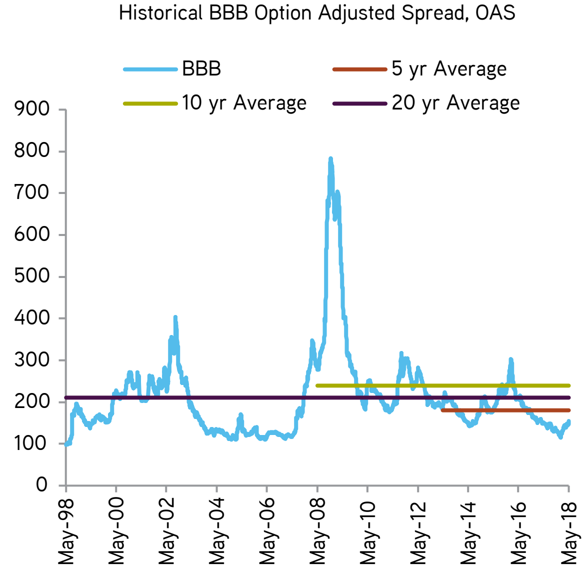


Data as at May 31, 2018. Source: ML Corporate Index, Bloomberg.

"Our call to action is to structure portfolios that are overweight upfront yield relative to duration, have enough flexibility to add capital into market weakness, and provide enough idiosyncratic cash flow streams to endure periods when asset class correlations are likely to spike."

EXHIBIT 110

Spreads Are Now Extraordinarily Tight in the BBB Market On Both an Absolute and Relative Basis



Data as at May 31, 2018. Source: ML Corp Index, Bloomberg.

Meanwhile, as we show in *Exhibit 110*, BBB spreads relative to Treasuries are just 154 basis points, which is extraordinarily tight relative to history. Potentially more concerning is that, with spreads this tight, duration has actually been extended to 7.2 years, compared to around 5.8 years in 2009, according to my colleague Kris Novell in our Liquid Credit team. Importantly, this duration extension comes at a time when the interest, or coupon on BBB securities, has essentially been cut in half during the same period.

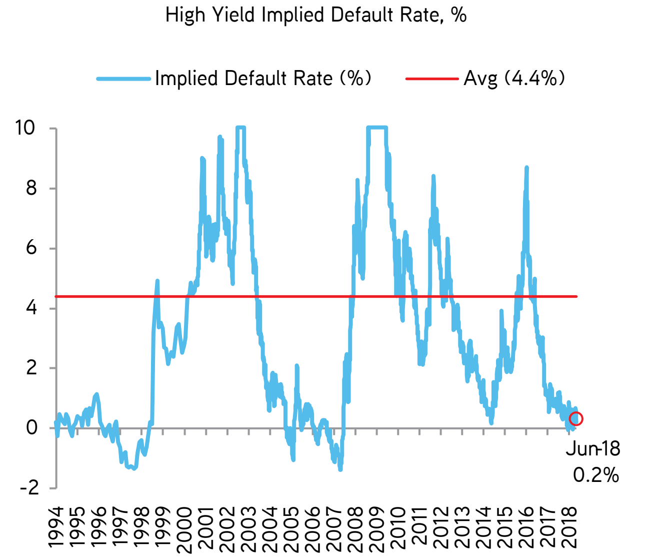
So, our bottom line with the BBB market is that we agree with our CIOs: Things are not necessarily as they seem. In particular, there is a growing risk that the traditional IG market, the BBB segment in particular, will prove to be a weak link during the next market downturn. If we are right, then the current size and breadth of this market could serve as a major headwind to most investors if they do not remain extremely vigilant around credit quality in this now sizeable part of the credit markets. We note that of the 10% of the total Investment Grade market on negative watch from Moody's, 83% were given negative watch in 2017 and into 2018.

Yet, when we updated our favorite measures for quantifying potential over-optimism in the credit markets, they still appear quite optimistic. Indeed, see *Exhibit 111* for details, but our model is currently suggesting an implied default rate of 0.2%, well below the historical average of 4.4% and a far cry from levels seen as recently as the first quarter of 2016 (i.e., around eight percent).

Importantly, we do not think this optimistic implied default rate is isolated to the High Yield market. In fact, our colleagues in Credit are actually more concerned about the BBB market than the 'traditional' High Yield market (as measured by the BB market, which is the highest quality segment of the High Yield market). Indeed, as we show below, the BB segment of the High Yield is now 46.6% (i.e., the highest rated bonds now represent the largest portion of the index). By comparison, as we showed earlier in *Exhibit 109*, the most speculative part of the Investment Grade market is now the largest at just under 50% of what is a much larger market in absolute dollars ($6.4 trillion in size for Investment Grade Debt versus $1.3 trillion in size for High Yield).

EXHIBIT 111

The Implied Default Rate for High Yield, Which We View as a Proxy for Credit Conditions, Is Suggesting that We Are Now Back to Levels Not Seen Since Just Before the Global Financial Crisis

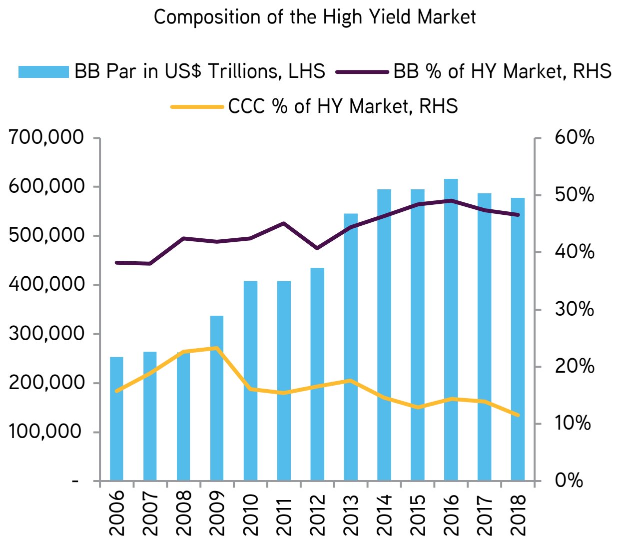


Data as at June 12, 2018. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

> "There is a growing risk that the traditional IG market, the BBB segment in particular, will prove to be a weak link during the next market downturn. If we are right, then the current size and breadth of this market could serve as a major headwind to most investors if they do not remain extremely vigilant around credit quality in this now sizeable part of the credit markets."

EXHIBIT 112

However, Unlike the Investment Grade Market, the Composition of the High Yield Has Been Improving, Not Deteriorating



Data as at March 31, 2018. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Perhaps more importantly, though, is that we think that this optimism towards the credit cycle has extended into the Private Credit markets as well. In fact, similar to several CIOs with whom we have spoken, we have more consternation about the underwriting standards that we see in the small segment of the Private Lending market than we currently see in the High Yield market.

To hedge these concerns, my colleague Phil Kim suggests options on the IG Credit Default Swap Index. Key to his thinking is that, with 1) a full 69% of IG CDX 30 composed of BBB bonds; 2) the low level of implied volatility; and 3) the historical success of these structures in 2015/early 2016, we believe both outright payers and payer spreads are effective and tactically attractive at current levels. In fact, in many instances the upfront cost is less than 20 basis points.

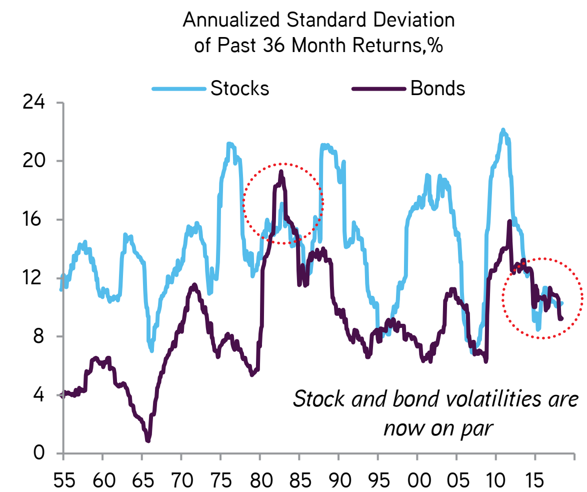
The downside of these structures is that CDX does not incorporate interest rate movements, and liquidity in the CDX options market is limited to six months, so incremental duration would need to be managed by a rolling hedge program. Or one can underweight longer-duration government bonds, as we previously suggested.

#4: Regime Change for Stocks and Bonds?

As we mentioned earlier, we believe that we recently entered an important regime change, with many governments now targeting reflation via fiscal impulses versus simply more monetary stimulus. This shift in policy focus is a big deal for asset allocation professionals. Hopefully it means that stocks and bonds may no longer be as positively correlated in the future, which could meaningfully dent, or even reverse, some of the outsized positive risk adjusted returns that a traditional 60-40 fund (60% stocks and 40% bonds) has enjoyed in recent years. To put this outperformance in perspective, just consider the five-year rolling return for a traditional 60/40 portfolio at the end of 2017 was 10.8%, a full 250 basis points above the long-term historical average.

EXHIBIT 113

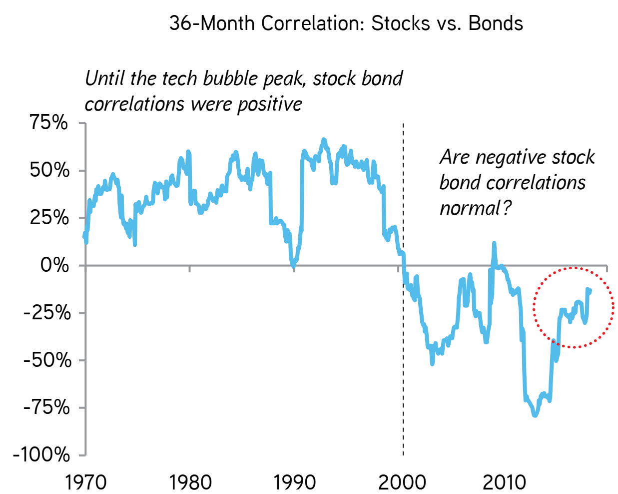
Stock and Bond Volatilities Are Now on Par. This Relationship Does Not Make Sense to Us



Data as at May 31, 2018. Source: Morgan Stanley Research, Bloomberg.

EXHIBIT 114

We Find Stocks and Bonds Have Similar Sensitivity to Real Inflation-Adjusted Policy Rates and Inflation



Data as at May 31, 2018. Source: Morgan Stanley Research, Bloomberg.

Too often in the past, these types of regime changes have not transitioned smoothly. So, consistent with this concern, we still suggest a substantial underweight position in government bonds, particularly those of longer duration. We also believe that global financial stocks, many of which have been chronic underperformers in recent years, could continue to stage a significant multi-year rally. Finally, we continue to advocate locking in low-cost liabilities, which helps to ensure a lower cost of capital relative to one's peer group amidst what could be a notable shift in the relationship between stocks and bonds.

Conclusion: New Playbook Required

We feel confident that a 'new playbook' is now required in today's investment environment. Key to our thinking is that the developed markets are leading the charge towards fiscal stimulus – stimulus that will be required to not only offset the slowdown in money supply that QE withdrawals are creating but also to help pacify the increasingly disgruntled voters who are calling for nationalistic agendas. No doubt, fiscal stimulus can come in many forms that extend beyond traditional tax cuts; for example, within EM countries like Indonesia we are now seeing a visible push by politicians to provide enhanced subsidies, particularly around rising fuel costs, to their core voting base. Against this backdrop, our 'call to arms' is clear: Macro investors and asset allocators should shorten duration, focus more on upfront yield, and own more assets linked to nominal GDP.

Beyond the macroeconomic and geopolitical trends identified in this paper, we also have high conviction around our major investment themes. In particular, our preference for *Deconglomeratization, Experiences Over Things*, and *Asset-Based Lending* in the private credit markets all represent compelling opportunities for asset allocators to generate additional alpha during what we believe will be more modest returns on a go-forward basis.

That said, we should all acknowledge that portfolio risks are rising. The financial markets, Investment Grade Credit in particular, looks more stretched than the current economic cycle might indicate, and we see the shift away from monetary stimulus beginning to restrict financial conditions more than the consensus may believe over the next 12- to 24-months. As such, corporate earnings must continue to be solid for 2018 to support our current asset allocation strategy.

Looking at the big picture, our decision to run a largely pro-risk portfolio at the expense of government bonds for the past few years have served us well. We have also benefitted from consistently overweighting Alternatives as well as taking advantage of periodic dislocations across the various regions in which we invest.

However, by the end of fourth quarter 2018, we do want to foreshadow to our investors that we are likely to take a more conservative approach heading into 2019. Key to our thinking is that we are quite far along in capital markets cycle, valuations appear largely full, and our growth models seem to indicate that overall growth will peak in the next 12-24 months.

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