

INSIGHTS

GLOBAL MACRO TRENDS

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Hot Spots



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Hot Spots

We recently journeyed to Beijing and London, two of the most important geopolitical “hot spots” for global investors these days. Both China and the United Kingdom are enduring long, drawn-out discussions around their roles as trading partners as well as destinations for foreign capital. In the case of China, our trip confirmed that there is already a structural shift occurring across supply chains and global footprints. While the road ahead will be a bumpy one for most market participants, we view this transition as an opportunity for China-centric firms that are willing to adapt their business models. In particular, there are now big growth themes emerging in areas like insourcing and logistics that should be pursued, we believe. Technological change, particularly amongst Chinese millennials, remains a powerful investment consideration as well. In the United Kingdom, the situation remains extremely difficult too, and despite recent weakness in the currency, we think that more patience is required. Overall, we believe that we are living in an increasingly complicated world—one that requires more investment flexibility, including operational expertise as well as the ability to move up and down the capital structure at different points in the cycle. Disinflationary forces, accompanied by strong central bank intervention, are also at work. As such, we continue to argue that lack of yield and reinvestment risks are huge issues with which many global asset allocators are now just coming to grips. Finally, given the sizeable bifurcations we are seeing across almost all markets, we think that forming capital around complex situations that require deep industry expertise makes a lot of sense at this point in the cycle.

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A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty.

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WINSTON CHURCHILL

BRITISH POLITICIAN, ARMY OFFICER, AND WRITER

Section I: Introduction

Almost a year ago, following a deep-dive research trip to Beijing focused on global trade tensions and China's slowing growth trajectory, we penned a piece entitled "*China: A Visit to the Epicenter*," dated August 2018, that summarized what we had learned. Our conclusion was that we had clearly hit an inflection point in the U.S.-China relationship and, as part of that shift, globalization as we historically knew it, including traditional outsourcing of global supply chains, was materially changing. Well, given that the situation has gotten more – not less – complex in recent quarters (including President Trump's announced tariff increase on August 1, 2019), we returned to Beijing again this summer striving to – as Winston S. Churchill once quipped – "see the opportunity in every difficulty" that now appears to have emerged.

Importantly, though, in terms of visiting global "hot spots," we did not limit ourselves to Beijing this summer. In fact, we actually continued our journey on from Beijing to London, immersing ourselves in the Brexit debate. As we detail below, Brexit remains frustratingly uncertain, and that uncertainty is clearly weighing heavily on not only capital expenditures but also on CEO confidence.

So, what should investors know about what we learned during our journey to key "hot spots" around the globe in 2019, and what does it mean for our asset allocation framework?

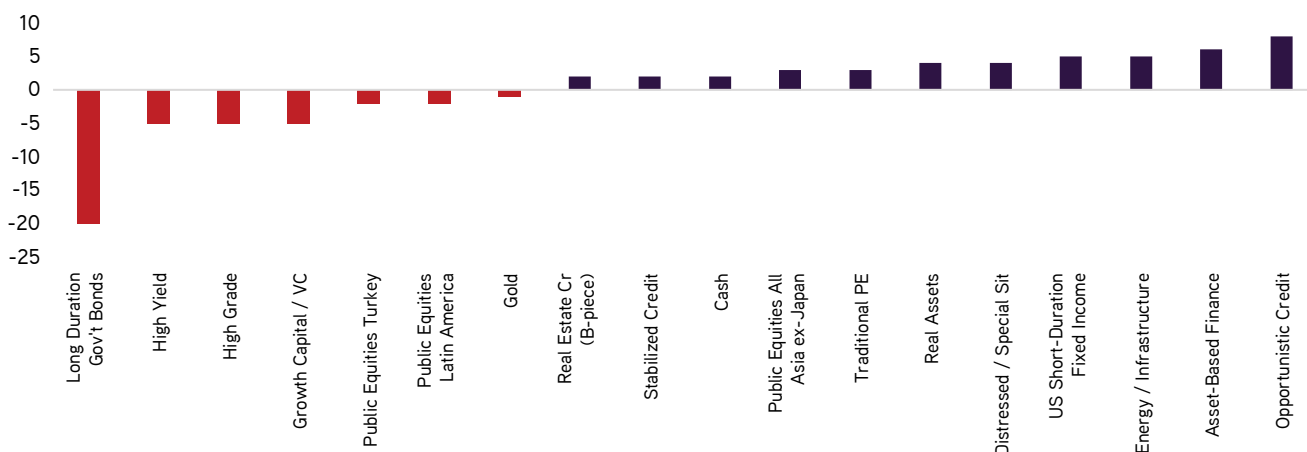
1. As one might expect, trade was the *topic du jour* across both continents. Our key takeaway was that there may or may not be a headline win around trade eventually, but the global competitive landscape has shifted permanently, in our view. From what we can tell, there is a growing nationalist movement amongst politicians to usher in a collective disarmament of the World Trade Organization. In many instances supporting national champions is now more important than sourcing the lowest cost supply chains. It is one of the reasons that we have always believed that President Trump would threaten to implement Round IV of tariffs (see mid-year outlook *Stay the Course* for full details). Consistent with this view, we see a Berlin Wall-type scenario now unfolding across global technology standards – one that flies in the face of what the WTO and other organizations that promote open standards have attempted to achieve for nearly three decades. Already, Western players such as Google, Facebook, Twitter, and WhatsApp have had difficulty in China, and in their places, Baidu, Ren Ren, Weibo, and WeChat are now thriving. Not surprisingly, we see 5G as the next chapter in this global bifurcation of technology standards/providers. Meanwhile, several foreign firms with whom we spoke during our time in Beijing indicated some sort of an acceleration in supply chain diversification away from China in order to reduce operating risks. Thailand, Vietnam, Mexico, and even the United States and Europe, were all mentioned during our visits as key beneficiaries of this rerouting, a migration pattern my colleague Frances Lim has been arguing for some time. At the same time, the trend towards insourcing within China is now a very viable one for investors to consider backing with their capital. The decision-makers with whom we spoke in Beijing confirmed that the trend towards insourcing is broad-based, spanning the industrial, technology, and healthcare sectors. So, our bottom line is that, even if there is positive headline

news around trade negotiations (e.g., China buying more oil or soybeans) in the coming months, rule of law and national security concerns represent longer-term issues that are not easily fixable, particularly as the geopolitical and strategic importance of technological prowess across industries increases. If we are right, then a different investment playbook than what worked for the last 25 years is now required.

- 2. In terms of the global inflation outlook, our travels lead us to believe that we are stuck somewhere between disinflation and deflation.** As a team at KKR, we are firmly in the camp that demographics, technological change, and excess capacity are likely to keep a lid on inflationary trends for the near future. Consistent with this view, we now estimate that the Federal Reserve needs to engineer 40-50 basis points of inflation annually just to keep inflation stable, given that deflation is actually playing out in many key sectors such as Autos, Technology, and Consumer Goods. Hence, as we describe below in more detail, we remain of the view that rates are likely to stay lower for longer, which has huge investment implications for both individual and institutional savers. In the world we envision, upfront yield becomes more important to credit allocators, while pricing power becomes more important to investors in equity securities. Importantly, China's recent decision to let its currency weaken only strengthens our conviction in our thesis.
- 3. China continues to be the most innovative technology market that we visit each year, while Europe is trying to close the gap.** Driven by 330 million millennials that are coming of age, the opportunity around Big Data, Artificial Intelligence, and 5G remains outsized within both the consumer and corporate segments of China. From our vantage point, it is hard to overstate how important getting up to speed on Chinese technological innovation is to any global investor who allocates capital to the Technology and/or Consumer sectors. This knowledge base is also critical to a better understanding of the current U.S.-China trade debate, and why we believe this debate is much more significant than just the world's two largest economies arguing about terms of trade. Meanwhile, in Europe we think that Berlin has clearly emerged as the Continent's Silicon Valley, and the significant opportunity set that we see across private Technology investments in the region make us even more bullish that European Private Equity can handily outperform European Public Markets. Further details below.
- 4. We expect more geopolitical volatility ahead, and we now assign a 50% probability to a Hard Brexit.** The potential temporary dysfunction from a disorderly departure, particularly as it relates to business uncertainty in the private sector, likely deserves more attention than it is getting from investors. Therefore, we are of the mindset that U.K. investments should demand one of the highest risk premium of any developed economy today, and as such, we are encouraging hedging the majority of one's positions in the currency market.
- 5. Given the uncertainty, we think that the opportunity to buy complexity at a discount remains outsized.** Interestingly, though, Asia seems to be gaining on Europe in terms of the ability to transact. Beyond just acquiring positions through the public

We Favor Upfront Yield, Collateral and Mandate Flexibility as We Enter a New Phase of This Cycle

KKR GMAA Target Asset Allocation, % Over / Under Weight



Data as at May 31, 2019. Source: KKR Global Macro & Asset Allocation analysis.

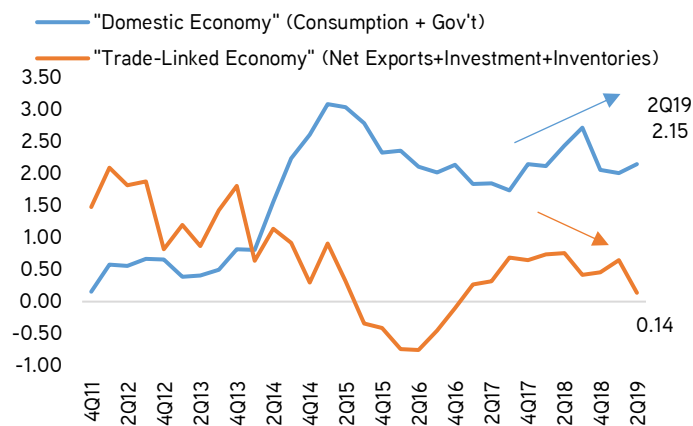
markets (which is becoming a more relevant opportunity set for PE firms), our conversations in Beijing with senior executives now lead us to believe that there is a forthcoming wave of deconglomeratization in China that could soon rival what we are seeing in Europe these days. Simply stated, multinationals are increasingly of the mindset that doing business in China as a foreigner is getting tougher, not easier. If we are even partially right, this opportunity could be quite meaningful to Private Equity, Real Estate, Credit, and Infrastructure over the next five to seven years, we believe.

Looking at the bigger picture, our asset allocation tilts towards investments that are linked to nominal GDP, have collateral against them, and generate upfront cash flow. As a result, we remain overweight Real Assets, Global Infrastructure in particular. We also remain constructive on more flexible mandates across both liquid and illiquid investments, and as such, maintain our increased allocations to both Actively Managed Opportunistic Credit and Special Situations. Finally, we continue to overweight Private Equity in size (300 basis points), as our work shows that the value of private investments grows more important later in the cycle.

EXHIBIT 2

Weakness in the Trade-Linked Economy Is Being Offset by Fiscal Spending and Consumption

Contribution to U.S. LTM GDP Growth (Percentage Points)



Data as at June 30, 2019. Source: BEA, Haver Analytics.

In terms of risks worth watching, we think that a continued slow-down in capital expenditures could ultimately bleed into unemployment. As one can see from *Exhibit 2*, consumption and fiscal spending are holding up well at a time when exports, inventories, and fixed investment are all just above recessionary levels. The good news is that the banking system is not overly levered, and with central banks back in the game, traditional savers are encouraged to put their risk assets where they can generate returns beyond what liquid sovereign debt can offer these days.

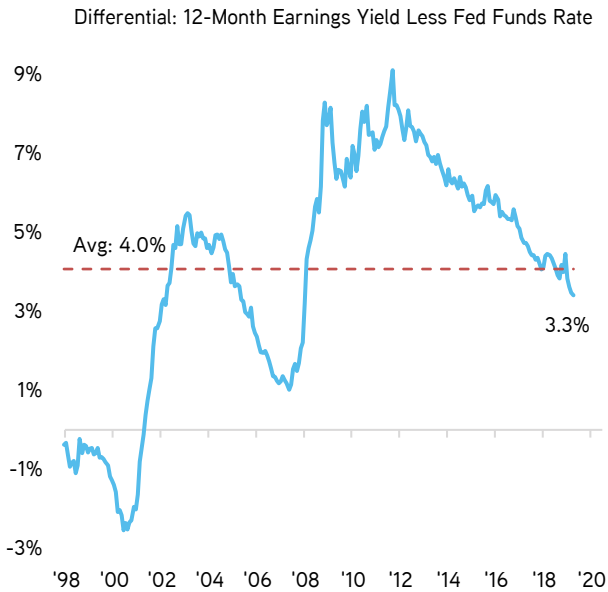
Overall, we still adhere to our call that most parts of the global capital markets are somewhat “stuck” in a modestly upward trending range of trading through mid-year 2020. On the one hand, interest rates

“**As a team at KKR, we are firmly in the camp that demographics, technological change, and excess capacity are likely to keep a lid on inflationary trends for the near future.**”

remain low, particularly relative to cash flows, and this arbitrage should prevent any long sustained, 2007-like downturn in risk assets (*Exhibit 3*). On the other hand, corporate margins are high, valuations are generally full, and earnings power is slowing. Importantly, these headwinds are intensifying at a time when the global trade tensions now definitely require a higher risk premium, we believe.

EXHIBIT 3

The Earnings Yield Arbitrage Relative to the Risk-Free Rate Is Still Positive in the U.S., But It Has Narrowed Meaningfully in Recent Years



Data as at May 20, 2019. Source: Bloomberg.

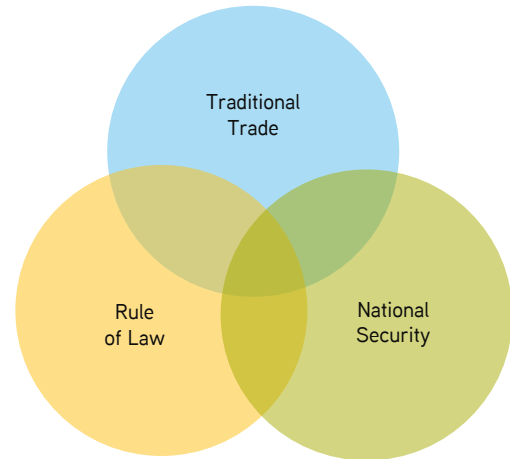
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Looking at the bigger picture, our asset allocation tilts towards investments that are linked to nominal GDP, have collateral against them, and generate upfront cash flow. As a result, we remain overweight Real Assets, Global Infrastructure in particular

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EXHIBIT 4

National Security Issues Are Now Being Bundled with Rule of Law and Trade Negotiations



Data as at May 29, 2019. Source: KKR Global Macro & Asset Allocation analysis.

Section II: The View From China

GDP Growth: Bringing both the gasoline and the fire extinguisher to the party. As we landed in Beijing in mid-July, it was reported that growth for 2Q19 hit 6.2%¹, the lowest level since 1990. However, we actually do not view this downshift as a surprise, given weakening trade trends, a secular slowdown in fixed investment, and dented corporate confidence amongst local CEOs. That said, while things are clearly slow, we do not ascribe to the idea that China's GDP growth is poised to roll over materially from current levels. Real GDP growth showed an acceleration in 2Q19 to 1.6% quarter-over-quarter, from 1.4% in 1Q19², and the year-over-year comparisons for the second half of 2019 will be more favorable, we believe. Our meetings with local business leaders and government officials confirmed that there is a lot of stimulus in the system, and our quantitative and fundamental work confirms that the Chinese government has implemented north of 75 easing measures since the U.S.-China trade tensions began to bubble up. To be sure, the multiplier effect of government-enacted stimulus measures has shrunk materially in recent years, but the absolute level of fiscal and monetary push by the government should serve as an important deterrent to many of the country's current macro headwinds, including Round IV of President Trump's tariffs (*Exhibit 5*).

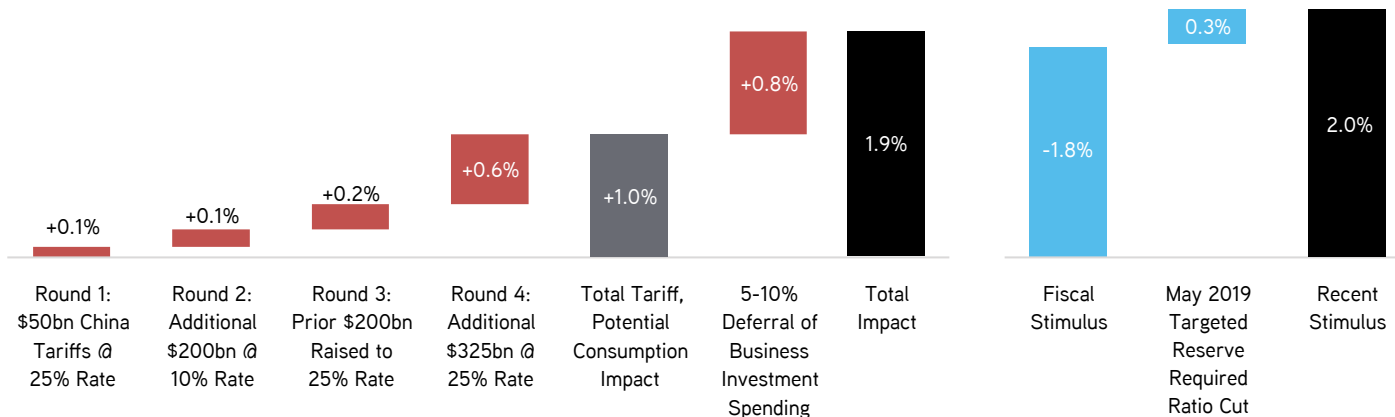
¹ Data as at June 30, 2019. Source: China National Bureau of Statistics.

² *Ibid.*

China Has Enacted More Than 75 Easing Measures Using a Variety of Both Fiscal and Monetary Tools. As Such, We Think the Chance of a Major Downside Surprise to Growth Is Limited

Approximate Cumulative Potential Tariff Impacts as a % of China GDP

Approximate Recent Stimulus as a % of China GDP



Fiscal stimulus includes value added tax cuts, personal income tax cuts, personal income special deductions, social insurance reduction, infrastructure spending, and other various tax cuts implemented since May 2018. The targeted reserve required ratio cut refers to the May 2019 policy response to the latest escalation in tariffs. On August 1, 2019 President Trump announced that the U.S. will impose a 10% tariff on \$300B of goods effective September 1, 2019. The above chart from our mid year outlook assumes, a 25% tariff impact on \$325B of goods. Data as at May 31, 2019. Source: KKR Global Macro & Asset Allocation analysis.

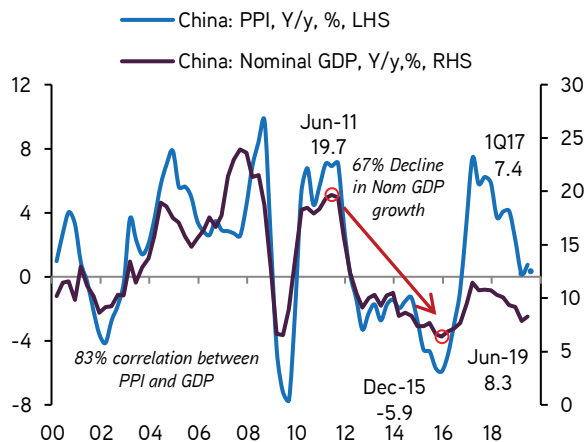
So rather than a bust – or a boom for that matter – we continue to believe that Chinese GDP growth will continue to be a series of rolling cyclical highs and lows during the next few quarters. For example, when things are slow and there are growing concerns around employment, we should expect the government to pour gasoline in the form of new stimulus to refuel an economic fire. If there is good news within this strategy, it does appear that they are now using more ‘unleaded’ gas in the form of supply side cuts and regional rail investment versus the prior ‘leaded’ strategy of just bluntly stoking Real Estate, Infrastructure, and Plant/Equipment. On the other hand, when the economy gains an unexpected tailwind, there is still plenty of desire at the central government level to slow growth via corporate deleveraging and heightened regulation of shadow bank lending.

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With the Structural Slowdown in Fixed Investment and Exports, Nominal GDP Growth in China Has Fallen Materially



Data as at June 30, 2019. Source: China National Bureau of Statistics, Haver Analytics.

Ultimately, though, China’s growth rate is now in structural decline. One can see this trend in *Exhibit 7*, which shows our longer-term projection for Chinese GDP growth. Importantly, the slowdown in growth is actually being amplified, as both real and nominal GDP are slowing commensurately (*Exhibit 6*). Given that China accounts for nearly one third of global growth, the knock-on effect from a slower China has implications for every region of the world in which KKR deploys capital.

Real GDP Growth in China Is Expected to Continue to Decline Meaningfully in the Years Ahead as Consumption Becomes the Single Largest Driver of Growth



Data as at March 31, 2019. Source: China National Bureau of Statistics, OECD, Haver Analytics.

Underneath the surface, however, the incremental drivers of Chinese growth now rest largely on consumption. Fixed asset investment is for the most part being discouraged, and exports are now just 18% of GDP, down by half from 36% a decade ago. On the other hand, the rate of growth for consumption, which now accounts for 39.4% of GDP is quite strong, as evidenced by the upside surprise to Chinese retail sales in 2Q19. Specifically, retail sales for June came in at fully 9.8% Y/y, well above both consensus of 8.5% and the month-prior level of 8.6%. In our view, these strong consumer numbers, particularly relative to growth in fixed investment and exports, are not an aberration but the beginning of a secular shift in growth drivers of GDP³.

Within consumption, we used our trip to continue to dig even deeper on several key areas of existing investments at KKR, particularly within our Private Equity franchise. Healthcare, wellness, and food safety all continue to grow at rates well above GDP, and our time with the management team at COFCO (which is China's largest food and agriculture company with a global footprint in 35 countries) reinforced our strong beliefs around key consumer related themes such as rising GDP-per-capita, the shift towards more protein-based diets (remember that China accounts for 50% of the world's pork consumption), and improved food safety⁴. Meanwhile, on the technology front, we spent time with ByteDance's management (ByteDance is an Internet technology company operating multiple machine learning content platforms), and despite lofty assumptions by investors, we think that the company's AI effort as well as its creative offerings signal significant market share and profitability gains in the years ahead. Our visit with ByteDance also reinforced the benefit that a massive population can provide to an offering that relies on a technological

feedback loop (remember China has more millennials now than the entire U.S. population and 753 million Internet users relative to just 245 million in the U.S.).

Unlike prior trips, both multinational and local business executives now agree that we are in for a long slog related to U.S.-China relations. As we have indicated for quite some time, 5G remains the centerpiece of the current technological and trade disputes, and one of the leading experts in the field told us China would do whatever it takes to be the global leader in 5G - with or without the U.S.'s support. We do not see a 'killer app' for 5G smartphones, but we do note that two-thirds of Chinese smartphone customers are willing to pay up for 5G if it means quicker uploads to social media or the ability to play mobile games with little wait time. The two-thirds figure referenced earlier is double the response rate that U.S. customers indicated, according to a 2019 survey by Deutsche Bank's Innovation Research group. On the enterprise side, we are much more bullish about the ability to transform the corporate sector. In particular, we think that 5G could have tremendous impact across China in areas such as predictive maintenance for one's car, virtual reality, autonomous cars, and industrial Smart Factory applications.

Regardless of where one thinks we are headed on 5G, locals think that China currently appears to have the lead. Consistent with this view, there is clearly a nationalistic bent evolving around its leadership position in 5G - something almost akin to the race to put someone in space, which began in earnest during the 1950s. Moreover, it has also become - de facto - ground zero for symbolizing the view amongst many locals in China that U.S. President Trump is really just using trade tactics to try to hold the country back from its preordained ascension as a global power. As such, recent decisions by the Trump administration to both sell weaponry to Taiwan and to curtail important shipments to Huawei appear something akin to crossing several of China's key red lines.

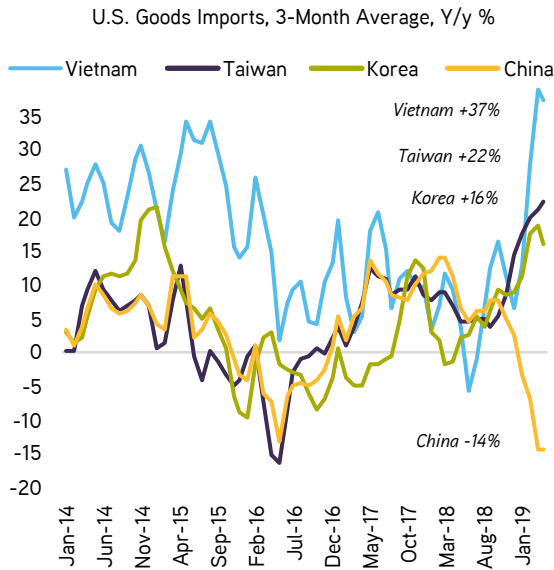
Not surprisingly, we think that the Chinese government is also concerned that the fog of uncertainty over pure trade-related issues (i.e., outside of just 5G) is also increasing the pace of corporate departures towards other countries (we heard a wide range of posited outcomes including a 100% shift in sourcing to others who will run with multi-source production in Southeast Asia, Mexico, and even the United States). At one lunch we hosted with several prominent multinational companies, all of the representatives present without exception correctly anticipated that President Donald Trump would enact the next round of \$300 billion plus in tariffs. By comparison, in Shanghai about 18 months ago, not one executive at a similar forum believed that the U.S. would enact tariffs.

³ *Ibid.*1.

⁴ Company data; *Ibid.*1.

EXHIBIT 8

U.S. Demand for Foreign Goods Is Shifting Significantly

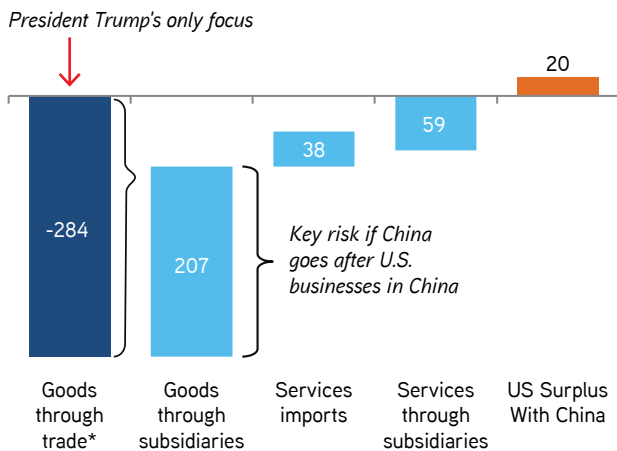


Data as at June 3, 2019. Source: EvercoreISI.

EXHIBIT 9

Goods and Services Sold Into China Through Subsidiaries Is the Key to China's Position Around Global Trade. It Is Also Where Rule of Law Issues Are Most Prevalent

2017: U.S. Surplus (Deficit) with China, US\$ Billions
(China Sold to U.S. Less U.S. Sold to China)



*China goods sold to U.S. from China net of goods sold from non-Chinese affiliates operating in China. Likewise, U.S. goods sold to China is net of goods sold to China by other countries' affiliates operating in the U.S. Data as at June 11, 2018. Source: Deutsche Bank, *China Macro: U.S. Economic Balances With Partners*.

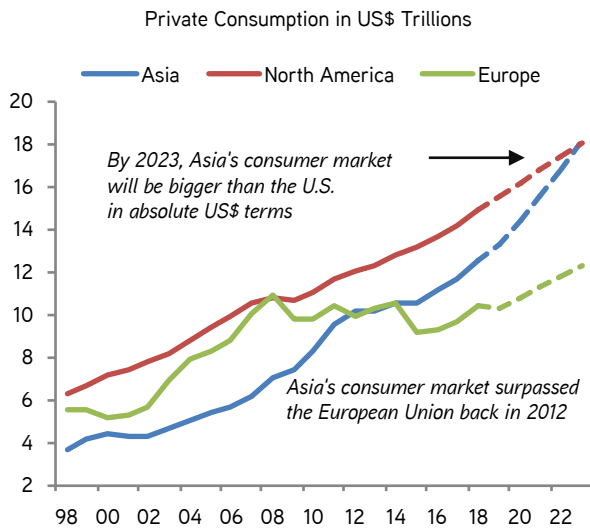
Probably more important, though, is that very few of these executives are waiting for a U.S.-China government negotiated trade 'fix,' as they believe the U.S.-China relationship has fundamentally changed. So, even if something related to traditional trade agreements is cemented and celebrated publicly by both sides, longer-term rivalry and concerns around rule of law and national security considerations will likely dwarf any headline benefit from an announcement of China opening up its market to sell more U.S. goods. Importantly, even amongst the U.S. companies that have already gained access to China, it often remains quite difficult to stay ahead of changes in local rules. As we show in *Exhibit 9*, there is a lot of money at play, and we can envision a world where China seeks to limit, not expand, some of the \$200 plus billion in goods that U.S. companies sell into China. In the semiconductor space, for example, the stakes are extremely high, as the proportion of sales into China are significant: Skyworks Solutions (80% of total sales), Qualcomm (63% of total sales), Qorvo (60% of total sales), Broadcom (52% of total sales), Micron (50% of total sales), and Intel (23% of total sales).

So, where might companies go with their supply chains if they move out of China? One large technology company confirmed it had moved more production to Thailand, despite a 10-15% cost increase. On the supplier front, it sounds like more multinationals are sourcing parts from Europe than in the past. This trend is particularly evident in the telecommunications arena. Mexico, despite the headline noise, also continues to be a beneficiary.

Overall, we think we are headed towards a Berlin Wall-type structure as it relates to global technology sourcing. Specifically, there will be offerings from both the East and the West (similar to what has already happened with Internet search but with higher stakes), and those in the middle will be forced to decide based on political leanings, need for the technology, and additional benefits and perks that may come from the technology. For other sectors and verticals, we see multinationals expanding their supply chains beyond China to South East Asia, Eastern Europe, and Latin America. Meanwhile, for U.S. firms that sell into China, we potentially expect a more difficult path ahead. Indeed, according to one Chinese news source, 80% of incremental consumer sales made in the last twelve months have gone to local players, with only 20% going towards more global or multinational companies.

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China's Consumer Market Is Growing Rapidly



Asia includes China, Hong Kong, Taiwan, India, Japan, Korea, and ASEAN (Indonesia, Malaysia, Philippines, Thailand, Singapore, Vietnam). Data as at April 9, 2019. Source: IMF, World Bank, National Statistical Agencies, Haver Analytics.

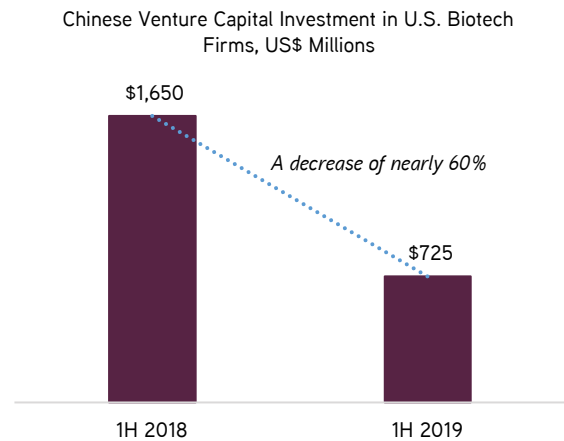
But not all news is bad news on the Chinese trade front. In the near-term China's economy will suffer from the trade dispute, but longer-term, the insourcing phenomenon could provide a steadier cushion for growth than the bears are likely to admit. One CEO of a roll-up strategy in the Industrial sector told us that he would no longer acquire any company that depended 100% on the U.S. for part inputs. Rather, he wants all the parts to be made in China on a go-forward basis. If others are thinking the same, it will require that the private sector and public sector in China invest heavily in key areas such as industrial automation, semiconductors, etc.

For global investors, this shift in CEO sentiment in one of the world's largest and fastest growing economies is significant. It likely means that most investors need to spend time finding out what industries are being insourced more rapidly. Moreover, as greater numbers of those Chinese companies that do seek partnership with foreign manufacturers shift away from the United States towards regions such as Europe, investors will need to increase dialogue with local management teams in select industries that are poised to benefit. We believe it also means investors should better understand the real estate, logistics, and infrastructure implications linked to the structural changes in business practices that we are foreshadowing from our meetings in Beijing.

Given that these geopolitical tensions are happening during a time when China's current account is moving from a surplus to a deficit as consumption increases, we were not surprised to hear of multiple industries reducing their commitment to overseas acquisitions in favor of internal development. The macro data certainly supports these statements, as money committed to areas such as U.S. biotechnology and real estate have plummeted of late (*Exhibits 11 and 12*). Said differently, the drop-off in U.S. investment is a reflection not only of

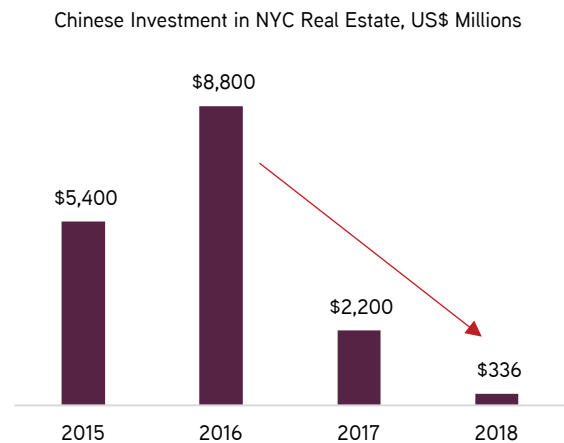
tighter CFIUS⁵ oversight but also the reality that China needs more of its own capital to fund its consumer growth initiative.

Both Rule of Law Issues and the Need for More Domestic Capital Are Forcing Chinese Investors to Withdraw From the U.S...



Data as at June 30, 2019. Source: Pitchbook.

...Across a Variety of Sectors



Data as at 2018. Source: Cushman Wakefield, *The Financial Times*.

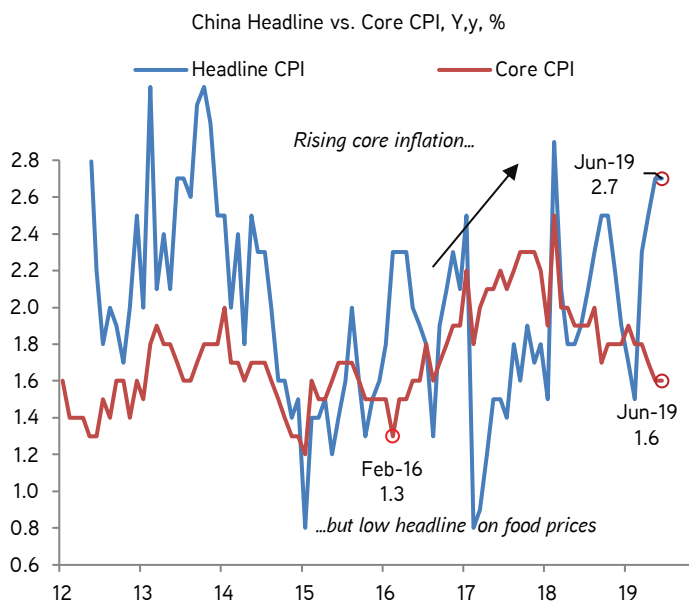
In terms of inflation, there is an overall feeling of excess capacity and intensifying pricing pressure that is likely to keep core inflation in China – and globally for that matter – under control for the near future. We may not get outright deflation, but the disinflationary forces evident during our travels appear sustainable, in our view. In addition to lower inflation being driven by technological transparency, shifting government policies around environmental upgrades in key markets like automobiles, including tougher emission standards, are dampening consumers' appetites to make purchases at current prices. Said differently, there are increased incentives to wait, which is leading to inventory build-ups in several key areas of the global

5 The Committee on Foreign Investment in the United States.

manufacturing economy. On the other hand, headline inflation in China is likely to increase materially, as pork prices, which represent roughly three percent of China's CPI basket, may rise almost 50-60% this year. One can see this in *Exhibit 13*. Overall, however, we think core disinflation remains a key trend to focus on in China these days. This may help explain the authorities' recent decision to weaken the currency in response to the latest round of U.S. tariffs.

EXHIBIT 13

Intensifying Pricing Pressure Amidst Excess Capacity Is Keeping Core Inflation Subdued, Even as a Pork Shortage Has Spiked Headline Inflation



Data as at June 30, 2019. Source: China National Bureau of Statistics, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Looking at the bigger picture, our visit reinforced our growing belief that the China story is quite complicated. The Chinese Authorities, like many around the world, are less driven by ideology than practical considerations around economic growth and stability. For example, the Chinese government has consistently espoused the need to de-lever its SOEs, but then it often accelerates lending output to these very companies when GDP growth occasionally slows. Meanwhile, it publicly states that it wants to open its markets to outsiders, but a recent U.S.-China Business Council survey indicated that there is growing feeling amongst its members that doing business in China is getting more difficult. Anti-corruption programs are also mentioned as key priorities, but some contend these initiatives are potential efforts to consolidate power.

Not surprisingly, these types of crosscurrents are difficult to interpret. Our base case remains that China will continue to move slowly to liberalize its markets. There is too much at stake at a time when growth is slowing, and the private sector is gaining independence through technological advancements. It is also committed to playing the long game in terms of trade negotiations, we believe, and as such, there is little incentive to make a deal that does not dovetail with its long-term strategic plan. We also believe that China understands the importance of its SOEs to economic growth and employ-

ment. Finally, the risk of losing control of the media or the SOEs would likely create vulnerabilities at a time when China wants to accelerate, not decelerate, its One China policy.

What to do with China: Stay the course, but get more local. There are many reasons to worry about deploying capital in China these days. Geopolitical noise is high, with the recent intentional China currency weakening, the U.S. selling military equipment to Taiwan and Hong Kong poised to celebrate China National Day on October 1, 2019, more bumps in the road likely lie ahead. Moreover, the economy is now also clearly feeling the adverse impact of a decade-long debt stimulus program, and we believe that disinflationary forces are likely to keep a lid on pricing power. Finally, the ability to realize capital gains is becoming tougher as pulling capital out of China is now more difficult and/or seeking liquidity through the U.S. IPO market is likely to become more constrained.

However, China remains a core market where investors need to be active locally for several reasons. For starters, the shift we are seeing in technology – and the delivery of goods and services related to technology – is unlike anything else we see in any other market in the world. As such, we all need to learn more about and invest meaningfully behind these changes. In addition, given the rise of the Chinese millennial, we think that there is considerable money to be made as these 330 million individuals come of age.

Investors also need to work harder to better understand the rules of engagement to ensure that they are backing initiatives that do not conflict with the government's agenda. Doing so will create significant opportunity because China still needs an increase in GDP-per-capita to meet its stated 2020 goal of doubling total GDP since 2010. In our opinion, healthcare, food safety, travel, leisure, and wellness are all areas of significant investment potential, as they represent areas where the government wants and needs private sector support to continue to improve the quality of life for its population of approximately 1.4 billion.

Finally, given the uncertainty, we think that the opportunity to buy complexity at a discount is significant. Beyond just acquiring positions through the public markets (which is becoming a more relevant opportunity set for PE firms), our conversations in Beijing with senior executives lead us to believe that there is a forthcoming wave of de-conglomeratization in China that could soon rival what we are seeing in Japan these days. Simply stated, multinationals are increasingly of the mindset that doing business in China as a foreigner is getting tougher, not easier. If we are even partially right, this opportunity could be quite meaningful to KKR's Private Equity, Real Estate, Credit, and Infrastructure franchises over the next five to seven years, we believe.

Section III: The View From Europe, Including Brexit

Breaking down Brexit: It's a new world order when it comes to immigration, cross-border connectivity, and democracy. With my colleague Aidan Corcoran coming from Brussels and me from Beijing, when we met in London our minds were already spinning with the notion that President Trump is essentially helping to usher in what appears to be a re-armament of global trade, after the collective disarmament brought on by the World Trade Organization. In hindsight,

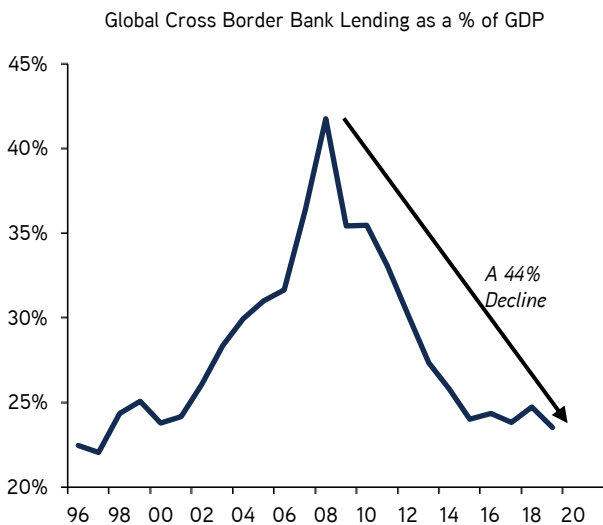
China's inclusion in the WTO in 2001 has ultimately proved destabilizing to many governmental constituents, as Beijing pursued a more aggressive form of state-directed capitalism than was expected.

Fast forward to today, and offshoring, lack of wage growth, and declining benefits have all helped to inspire more of a nationalistic bent amongst developed market politicians that has been, as guitarist Nigel Tufnel in *Spinal Tap* so eloquently proclaimed, "taken to eleven" by Donald J. Trump during his first term as President of the United States. As we show below (*Exhibits 14 and 15*), both cross border flows and global trade have been shrinking for nearly a decade, and political leadership across many parts of North America, Europe, and Asia appears ready to further accelerate the turn away from what for decades many thought were the key drivers of secular growth.

China is often cited as the poster-child in the blame game associated with the aforementioned dissatisfaction with globalization, but there is more at work here, including a fourth industrial revolution centering on technological change, rapidly shifting demographics, and heavy-handed austerity measures that exacerbated the North-South divide in Europe. Against this backdrop, the original push for Brexit potentially becomes easier to understand, in our opinion. Specifically, it is a reflection of a deeper dissatisfaction amongst Britain's population, many of whom feel 1) disenfranchised by the three million EU citizens who currently live inside the United Kingdom; 2) frustrated with decision-making processes emanating out of Brussels; and 3) alienated by rapid cultural, technological, and societal change they see as threatening to their "way of life" – particularly in smaller towns and less urban areas.

EXHIBIT 14

Cross-Border Capital Flow Trends, a Traditional Proxy for Globalization, Are Reversing as Protectionism Ramps Upwards



Data as at May 31, 2019. Source: BofA Merrill Lynch, Bloomberg.

EXHIBIT 15

Trade as a Percentage of Global GDP Peaked More Than 10 Years Ago



Data as at July 9, 2019. Source: IMFWEO, Haver Analytics.

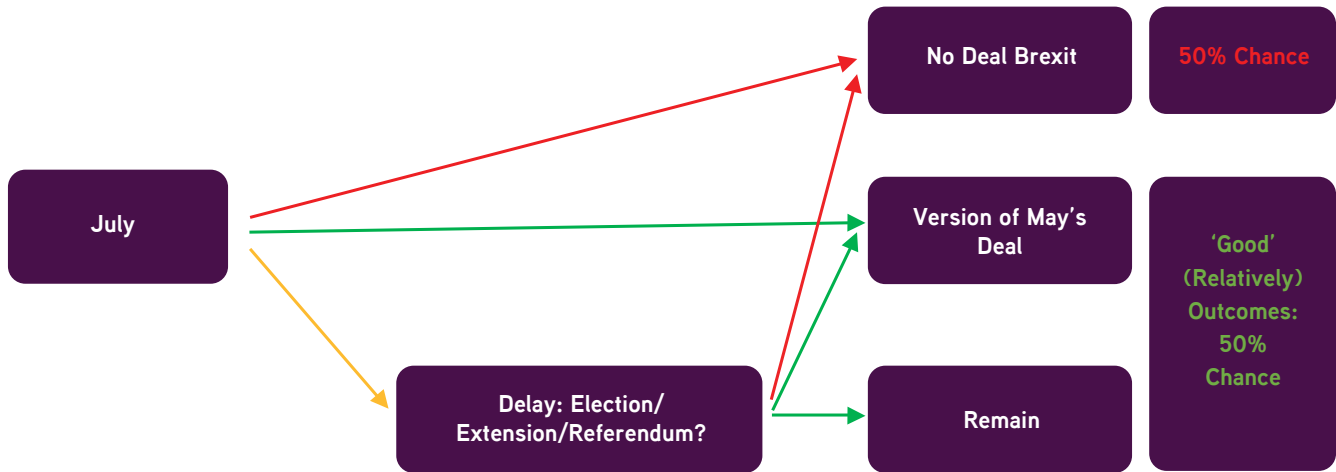
Where do we go from here? Unfortunately, a Hard Brexit is now a very real risk, particularly as there are a number of ways of reaching this outcome. Based on our internal KKR analysis, we currently assign a 50% probability to a Hard Brexit outcome, a 35% probability of some version of former Prime Minister Theresa May's deal, and a 15% probability of no exit (a no-exit outcome is hard to accomplish as it would require a pause in negotiations and a referendum, with a vote to remain – all of which bring their own challenges).

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Chairman Powell is now overtly including statements that U.S. monetary policy will be based on global events, not just U.S. economic trends. This expansion of mandate gives the Federal Reserve a lot more wiggle room, and it helps to shift the conversation with the public towards growth and away from what we view as a larger – and potentially more alarming problem – disinflationary trends.

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No Deal-Brexit Is the Single Most Likely Outcome at This Point, We Believe



Data as at July 8, 2019. Source: KKR Global Macro & Asset Allocation analysis.

As Exhibit 16 shows, three years after the Brexit referendum, the outcome is as uncertain as ever. The U.K. is currently on course to exit the EU with no deal on October 31st. A no-deal exit, whether on October 31st or after a delay, is the most likely outcome, we believe. To be sure, it is still possible that we will see a Soft Brexit or a time-out (an election or extension of negotiations), which could allow a second referendum. However, each of these possibilities has issues – May’s deal has already been rejected three times by Parliament and an extension has been ruled out by the new Prime Minister Boris Johnson, who has openly promised to ‘deliver’ Brexit by October 31st. Given the many permutations and the elevated risk, it is not hard to see why many investors have been shying away from the U.K. of late.

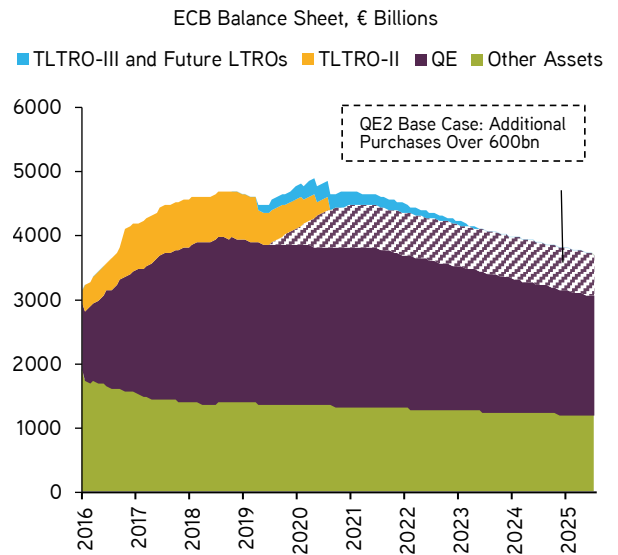
Now that PM Johnson has taken office, what comes next? The key date to note is that of the European Council meeting on October 17th and 18th, which comes shortly before the scheduled Brexit deadline of October 31st. Prime Minister Johnson has a very short window of just under three months to negotiate any amendments to the proposed deal, particularly when one considers that Britain’s House of Commons is currently in summer recess and will have only two weeks in session prior to the European Council meeting. So, the window for negotiation and parliamentary approval is clearly very tight, which raises the prospect of some form of delay. While a time-out would seem appealing, it goes against PM Johnson’s repeated commitment to see through Brexit on October 31st. As such, our view is that we are in for a roller coaster few months on Brexit.

We think that central banks, led by the ECB and the Federal Reserve, are headed towards a much more dovish stance. In London, we had the opportunity to catch up with Gavyn Davies, who we view as the Obi Wan of global macroeconomics, and his assessment, with which we agree, is that both the Fed and the ECB are making some major changes to build the case for more accommodative monetary policies. Specifically, Chairman Powell is now overtly including statements that U.S. monetary policy will be based on global events, not just U.S. economic trends. This expansion of mandate gives the

Federal Reserve a lot more wiggle room, and it helps to shift the conversation with the public towards growth and away from what we view as a larger – and potentially more alarming problem – disinflationary trends.

EXHIBIT 17

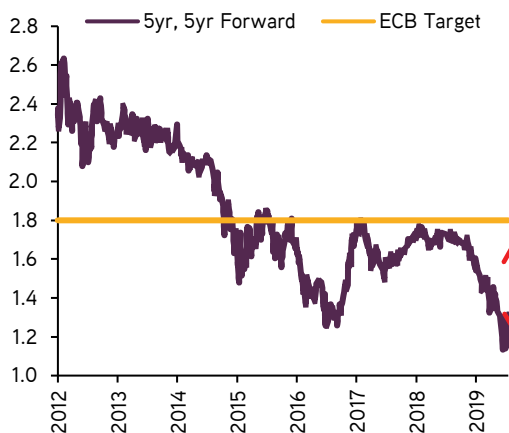
With Potentially €600 Billion in Additional QE Coming, the ECB’s Balance Sheet Will Remain Outsized for Many Years



Data as at May 31, 2019. Source: Bloomberg, Eurostat, European Central Bank, European Commission and KKR Global Macro & Asset Allocation analysis.

EZ Inflation Expectations Fell as Low as 1.13% Before Draghi's Recent Sintra Speech, the One Where He Hinted at Further QE

EUR Implied Forward Inflation, Based on Swaps Market, %



Data as at May 31, 2019. Source: Bloomberg, Eurostat, European Central Bank, European Commission and KKR Global Macro & Asset Allocation analysis.

Meanwhile at the ECB, investors should brace for a much more dovish approach, we believe, including action on both rates and QE before the end of the year. While the ECB is still evaluating its options, our current base case is an announcement in September of a restart of QE at a rate of 45 billion euros per month for implementation in December. From our perch and as we discuss in more detail below (see *Is Europe Becoming the Next Japan?*), the disinflation threat is quite real, as both inflation expectations at the short- and the long-end have collapsed of late. One can see the magnitude of the decline on the long-end in *Exhibit 18*. We also believe that economic growth will likely again disappoint on the downside in the second half of 2019.

Our bigger picture thought is that the ECB knows that the 2011-2016 model of exporting one's way out of weak growth will not be as effective in a world of looming trade wars. Rather, Germany, France, Spain, and others will need to inspire higher levels of fiscal spending as well as more domestic consumption. We think that this new playbook, which we detailed in our mid-year outlook note (see *Stick to the Plan* dated June 2018), is eminently achievable, given that Germany – the workhorse of the European economy – posted a current account surplus of 7.4% of GDP in 2018 and unemployment is at a multi-generational low (hovering around three percent⁶).

What does all this mean for investors? We believe it suggests that our *Yearn for Yield* thesis has legs, and it reinforces our view that reinvestment risk is one of most significant risks that global CIOs now face. From a business and flow perspective, it favors our efforts in Direct Lending, Asset Based Finance, Infrastructure, Opportunistic

6 Data as at June 2019. Source: Eurostat.

Credit, and Real Estate Credit (B-piece CMBS in particular). On the equity side of the house, our base case on growth multiples is that a more dovish ECB will help to protect their current lofty levels, particularly relative to history (*Exhibit 21*). Moreover, if both the Fed and the ECB move towards a formal average inflation targeting regime, then we will have underestimated the potential for a blow-off top in the public equity markets via even further multiple expansion.

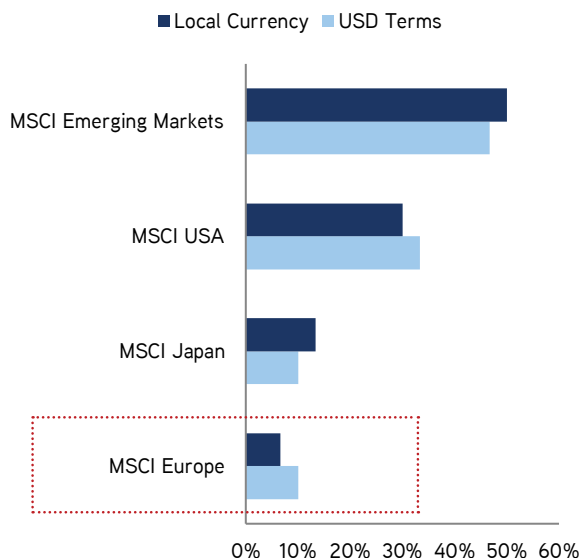
Sizing up the opportunity in European Public and Private Equities.

To be bullish on European equities relative to the U.S., Japan, and the Emerging Markets, one truly has to believe that something is different this time. Indeed, over the last 30 years, European public equities have only been the top performer twice, compared to three times for Japan, 10 times for the United States, and 15 times for the Emerging Markets, according to work done by Morgan Stanley's Graham Secker (*Exhibit 19*). Given our aforementioned views on rates and the nearly 20% weighting in financial stocks across the local indexes, we are not inclined to predict that European global equities will be the best performing stocks in 2019.

That said, European stocks are pretty beat up from a valuation perspective, as flows have been negative for 70 consecutive months. Moreover, of all the regional stock markets we cover, Europe has the biggest bifurcation between the haves and have-nots (*Exhibit 21*). Not surprisingly, given where interest rates are, the haves, which include largely growth and defensive stocks, are almost perfectly correlated with the European fixed income markets.

Performance Wise, European Public Equities Have Been the Best Performing Region Only Two Times in 25 Years

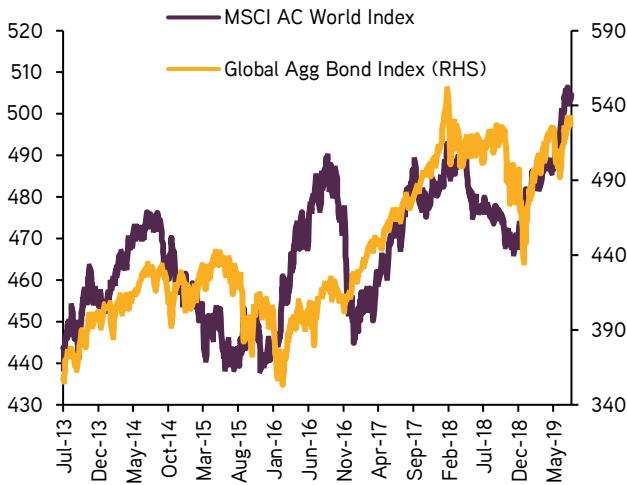
% Times as Best Performing Equity Region, 1989 - 2018



Data as at December 31, 2018. Source: Morgan Stanley, MSCI.

Like Its Global Peers, Public Equities in Europe Remain at the Mercy of the Fixed Income Markets

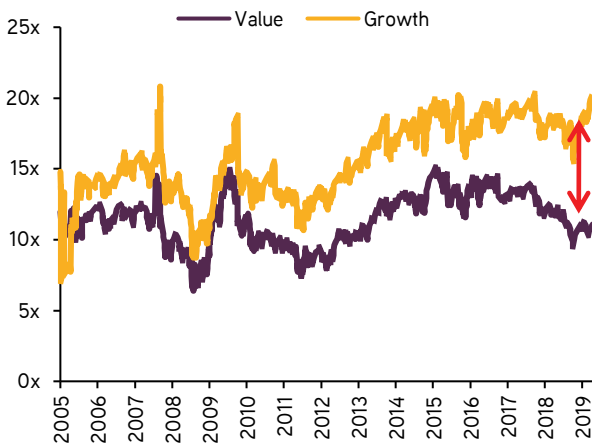
MSCI AC World Index vs. Global Agg Bond Total Return



Data as at July 18, 2019. Source: MSCI, Factset.

Europe Remains a Market of Haves and Have-Nots

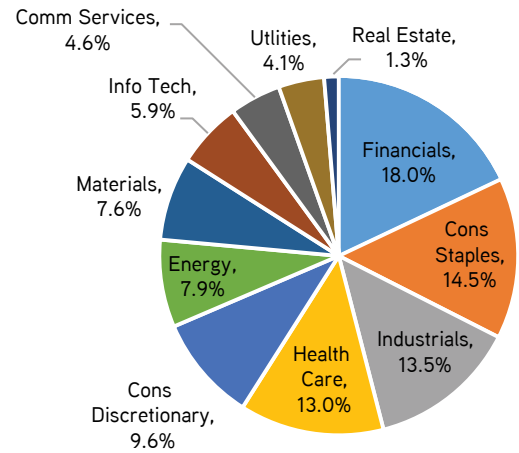
Multiple of Forward P/E



Data as at July 9, 2019. Source: MSCI, IBES, Morgan Stanley.

European Public Stock Indices Are Overweight Financials But Underweight Technology. These Weightings Are Creating a Significant Sector Arbitrage Opportunity for Private Equity

MSCI Europe Sector Weightings, %



Data as at June 30, 2019. Source: MSCI.

Interestingly, while we are not convinced that European public equity markets can outperform on a regional basis, we are highly confident that European private equity can outperform at the highest level relative to its public benchmark when compared to Asia and the U.S. Key to our thinking are the following. First, Europe's public markets are compositionally flawed. They are overweight Financials and underweight Technology. This mismatch creates an incredibly attractive arbitrage for private equity managers (*Exhibit 22*).

Second, we continue to believe that multinationals in Europe are going to shed their underperforming subsidiaries. Already, we have seen Airbus, Nestle, and Unilever sell major subsidiaries to Private Equity. And, we believe there are more of these opportunities to come as Private Equity is much better positioned to navigate complex situations and deliver upon operational improvement stories that the public markets can't match in terms of value creation. Finally, while the public markets do not reflect it, we continue to believe that one of the most efficient ways for PE to best the aggregate public indexes is to get long innovation. Logistics, consumer experiences, and payments all represent key areas where we think that Private Equity can gain attractive exposure to growth segments of the region relative to what is offered in the public markets.

Is Europe Becoming Japan? Europe's inflation dynamics do seem to be going the way of Japan. The two regions share similar headwinds in terms of demographics, weak banking systems, and a debt-fueled boom/bust cycle. To be sure, both the ECB and the BoJ have a mountain to climb to get inflation back to target. However, there are several reasons that we believe the path is not as steep for the ECB as for the BoJ. For starters, Eurozone government debt as a share of GDP is 85%, while this figure is around 200% in Japan's case. As such, we believe Europe has more room for fiscal stimulus to support monetary stimulus. Moreover, despite all the ECB has done to date, it actually has been much more conservative than the BoJ (*Exhibit 23*).

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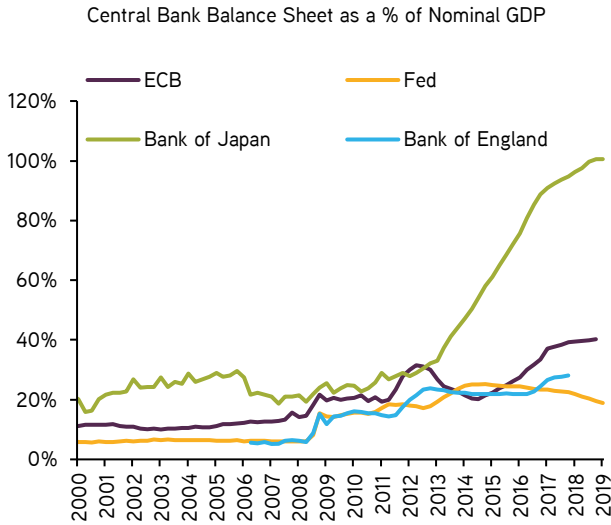
Our current base case is an announcement in September of a restart of QE.

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Therefore, we believe there is room for a significant amount of further monetary stimulus in the region. In Japan, by contrast, it is less clear where we go from here on the monetary policy front to further surprise the investment community.

EXHIBIT 23

ECB Policies May Seem Extreme, but They Remain a Far Cry from Japanese Monetary Policy



Data as at July 9, 2019. Source: European Central Bank, Fed Reserve Board, Bank of Japan, Bank of England.

EXHIBIT 24

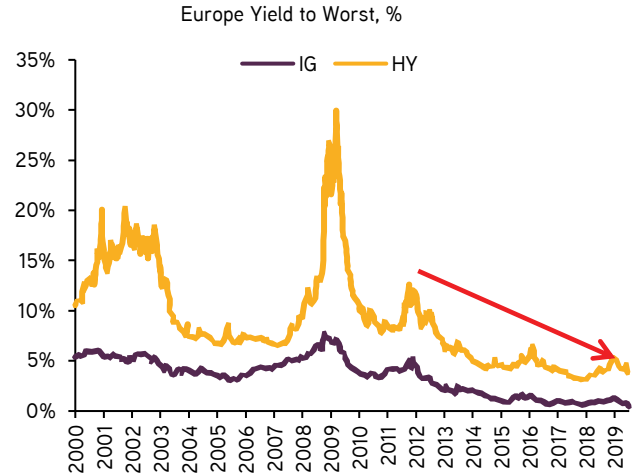
Labor Productivity in Italy Is Going Nowhere



Data as at July 17, 2019. Source Eurostat.

EXHIBIT 25

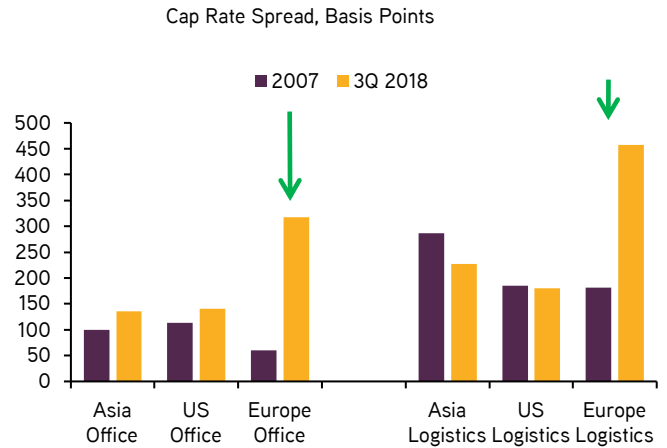
Credit Rates Have Been Compressed by the Wall of Liquidity



Data as at July 10, 2019. Source: Bloomberg.

EXHIBIT 26

We Believe European Real Estate Cap Rates Have Further to Compress in Several Areas



Data as at July 10, 2019. Source: Morgan Stanley.

However, parts of the Eurozone are very much like Japan – and quite possibly even more challenged. Europe’s fourth largest economy, Italy, for example, has lagged Japan badly across many macroeconomic benchmarks during the past decade. A key issue is that Italian productivity per worker is actually still below where it was twenty-five years ago – a truly shocking feat in this era of global technological innovation.

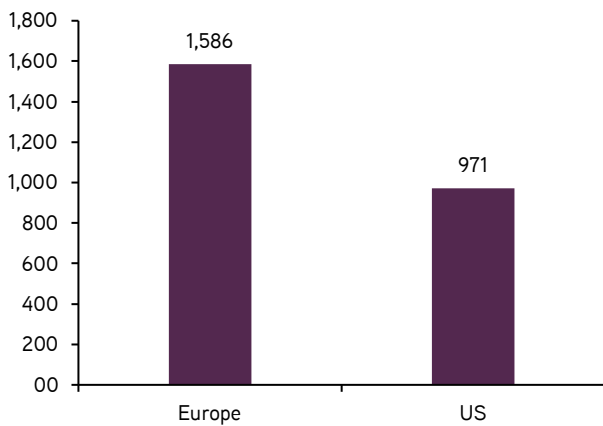
What does this all mean and what can we learn from Japan, particularly as we think about putting incremental capital in the ground in Europe? First, we think that cap rates in Europe are likely headed lower and we expect Real Estate to continue to be an attractive area for investments. In particular, we are bullish on two emerging segments of the market: multifamily and student housing. Both are relatively ‘new’ markets in Europe. For multifamily in particular, the

sector is not developed like in the United States. So, this backdrop presents both challenges and opportunities along the way. However, we think the macro tailwinds are significant, as we show in *Exhibits 27 and 28*. Second, we think that growth companies are likely to enjoy a sustained high price-to-earnings ratio in Europe's low rate environment, and as such, we believe that demographic plays such as healthcare and wealth management could garner premium valuations. Finally, as secular growth continues to slow in Europe, we think that strategic acquisitions in higher growth markets and/or carve-outs should all be considered by management teams in the region.

EXHIBIT 27

European Countries Are Global Leaders in Hosting and Housing Foreign Students, Which We Think Creates an Interesting Investment Opportunity

Enrollment of Foreign Students, 000's



Data as at September 12, 2018. Source: Organization for Economic Co-operation and Development

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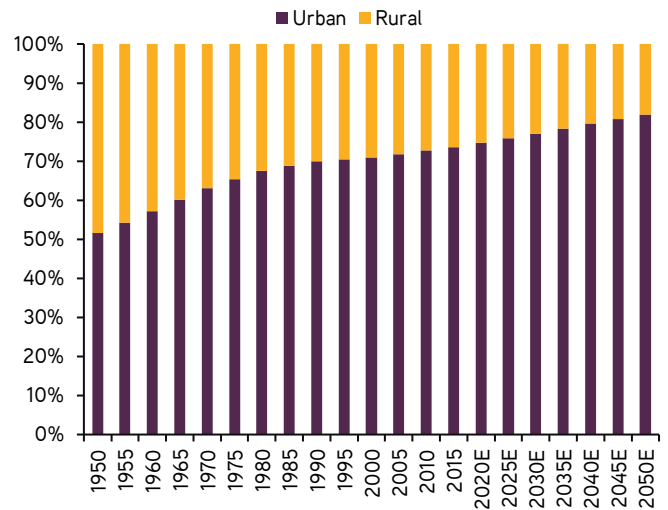
Our bigger picture thought is that the ECB knows that the 2011-2016 model of exporting one's way out of weak growth will not be as effective in a world of looming trade wars. Rather, Germany, France, Spain, and others will need to inspire higher levels of fiscal spending as well as more domestic consumption.

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EXHIBIT 28

Europe's Urbanization Trend Has Legs, and Will Support Multifamily Housing, We Believe

Europe Urban vs. Rural Population as % of Total



Data as at July 16, 2019. Source: Eurostat

Where are we headed in the developed world? It's all about earnings, the service sector, and ultimately the consumer. As we mentioned earlier, we left our meetings with the impression that more monetary stimulus from the Continent is coming, which is often viewed as bullish for risk assets. One can see this in *Exhibit 29*, which shows that stocks appreciated 13%, on average, during the next 12 months following instances when the two-year yield fell more than 50 basis points below the fed funds rate, signaling the starts of easing campaigns. The offset, however, is that we are more cautious on earnings growth and multiple expansion from current levels than the consensus. Our thinking is that markets could be more range-bound than what happened in the 1998-1999 period (when corporate profits in both Europe and the U.S. grew by 16% and 25%, respectively). On the other hand, it is hard to get really bearish when the earnings yield on stocks is still so high relative to bonds, and because we are envisioning a slowdown, not a 2008-type event.

Implied in what we are saying about this current cycle is that the services sector, which has driven the lion's share of employment gains in recent years, does not contract the way the manufacturing sector has in recent quarters (*Exhibit 33*). To date, our thesis has played out, as healthcare, education, travel, and business services – all key contributors to the service economy – have all remained solid growers through both the good times and the bad times of late. Meanwhile, manufacturing is suffering on both a cyclical and secular basis (*Exhibit 32*). Already, global auto sales are tracking below 53 million per annum, which is what we use at KKR in our bear case scenario for the sector. Consistent with this view, global inventories in the industrial sector have ballooned of late (*Exhibit 31*), according to our long-time friend Scott Davis at Melius Research.

EXHIBIT 29

The Federal Reserve Has Always Cut When the Yield on the 2-Year Note Trades Below the Fed Funds Target Rate

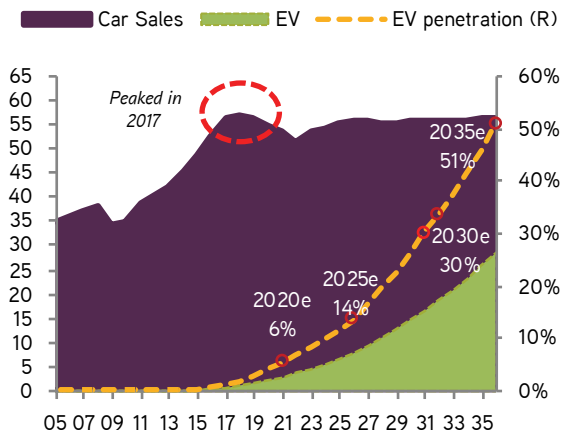
	2-YEAR YIELD - FED FUNDS TARGET (BASIS POINTS)	12-MONTH FORWARD CHANGE IN FED FUNDS TARGET (BASIS POINTS)	12-MONTH FORWARD CHANGE IN U.S. 10-YEAR YIELD (BASIS POINTS)	12-MONTH FORWARD S&P 500 TOTAL RETURN	MONTHS UNTIL OFFICIAL ONSET OF NEXT RECESSION
Apr-89	-53	-150	2	11%	16
Aug-98	-59	-25	93	40%	32
Sep-00	-52	-350	-120	-27%	7
Sep-06	-54	-50	-5	16%	16
Jun-19	-53	???	???	???	???
Median	-54	-100	-2	13%	16

Dates represent the first month in a cycle in which two-year yields were more than 50 basis points below the fed funds rate. Data as at June 7, 2019. Source: BEA, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 30

Our Work Shows That Cyclical Areas of the Economy Such as Autos Are Past Their Peak This Cycle

US+Europe+China Passenger Car Sales (millions)

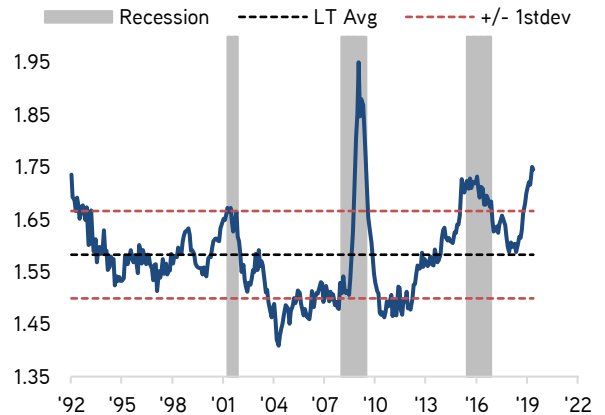


Data as at May 31, 2019. Source: Bloomberg, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 31

Industrial Channel Inventories Are Currently Two Standard Deviations Above Their Long-Term Average

Merchant Wholesalers' Durable Goods Inventory/Sales Ratio



Note: 2015-2016 shaded area represents industrial recession. Data as at July 15, 2019. Source: Bloomberg, Census Bureau, Melius Research.

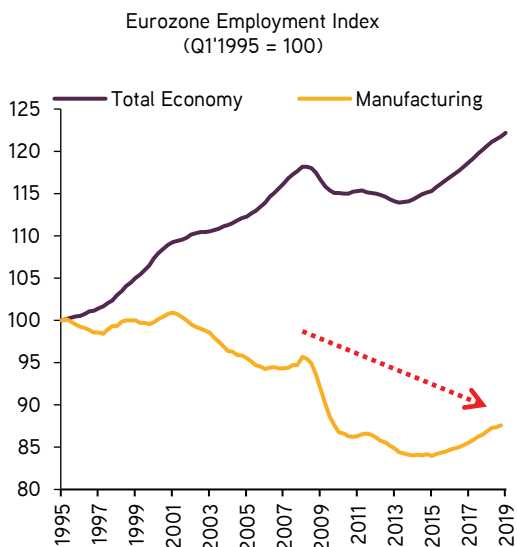
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Of all the regional stock markets we cover, Europe has the biggest bifurcation between the haves and have-nots.

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EXHIBIT 32

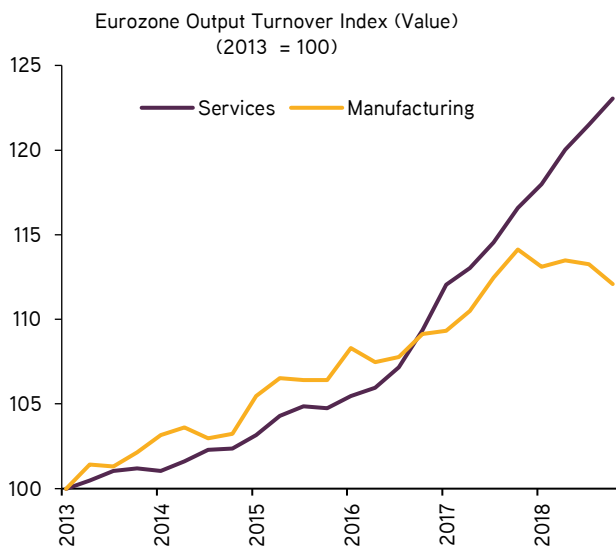
Services Over Goods Is Also the Story in Europe



Data as at July 16, 2019. Source: Eurostat

EXHIBIT 33

To Have a Sustained Recession in Europe, Services Has to Collapse



Data as at July 12, 2019. Source: Eurostat.

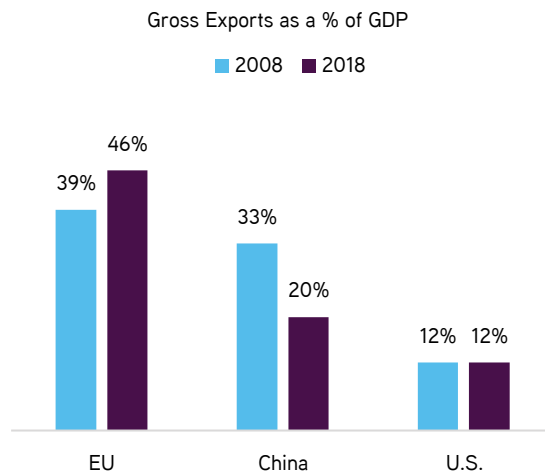
Our bottom line: There is opportunity amidst the uncertainty in Europe. We have been going to Europe for investment reasons since 1995, and rarely has the story been as difficult to understand as today. Economic growth is also slower than the consensus thinks, in our opinion. That's the bad news. The good news is that, as evidenced by the torrid pace of opportunities being evaluated by our European investment professionals, complexity and uncertainty create value for those who have a view and are willing to lean in during periods of dislocation. We believe now is one of those times.

As we peer around the corner today and think about the macro-economics of tomorrow in Europe, more economic bumpiness lies ahead, we believe. In particular, we think that the consensus for both GDP and earnings estimates are too high for the second half of 2019. We are certainly not forecasting a 2007-type bust anytime soon in Europe; rather, we continue to believe that we have moved away from the boom-to-bust-to-boom cycle framework towards more of a periodic dislocation/mini-recession environment (e.g. 2011, 2016, 2018). In this type of atmosphere, we think that the winners will be investors who have flexible capital, longer-duration liabilities, and the ability to move up and down the capital structure. From a sector and security selection perspective, it means we should continue to lean into healthcare, wealth management, technology transformation, leisure, and wellness.

If our thesis is wrong on Europe and the region experiences major negative operational leverage, it will be because we underestimated the impact of global trade. As we show in *Exhibit 34*, Europe is actually more dependent on exports than either the U.S. or China. Moreover, Europe is second only to Japan in needing global growth to boost profits. However, we also take comfort in the fact that Europe is transitioning towards more of a consumption and fiscal spending story rather than simply an export-driven one. Budgets are largely balanced, and unemployment and personal debt loads have shrunk to levels where we think that consumer spending can surprise on the upside. Moreover, wage growth in Europe is actually outpacing that of the U.S., and it is happening at a time when inflation is quite low.

EXHIBIT 34

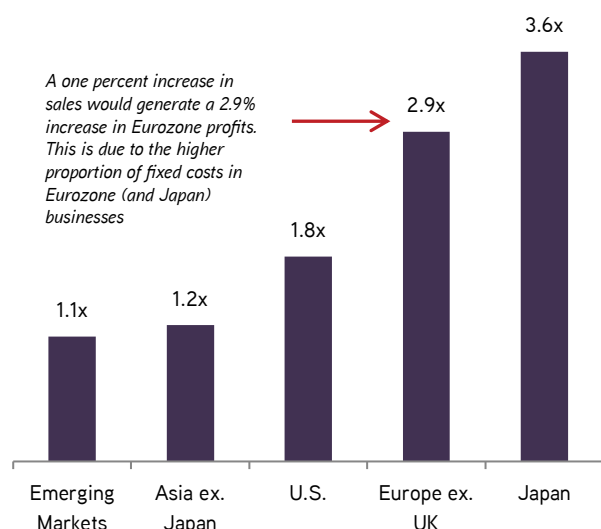
Europe Is Likely the Most Exposed to Global Trade Tensions, Given Its High Percentage of Exports



Data as at April 26, 2019. Source: Eurostat; Bureau of Economic Analysis; State Administration of Foreign Exchange (China) and China National Bureau of Statistics.

Companies in the Eurozone and Japan Are More Sensitive to Global Growth Compared to Other Firms

Historic Sensitivity of Net Profits to Sales Growth



Data as at December 2017. Source: Goldman Sachs Research.

So, our bottom line is that we suggest investors continue to find non-traditional ways to lean into Europe that draw on our expertise as well as our ability to judge relative value across regions via deep sector analysis. To this end, we favor corporate carve-outs in PE and Infrastructure, emerging real estate markets such as student housing and multifamily, and cash-flowing Asset-Based Lending ideas where there is collateral and linkage to nominal GDP.

Section IV: Conclusion

One of the strengths of the KKR platform is that it allows the KKR Global Macro, Balance Sheet, and Risk Analytics team to assess relative value by region and across capital structure, and these capabilities were clearly on display across the three continents we touched during our most recent trip from New York to Beijing and then London. As we indicated earlier, our base case is now that the downside of Brexit is likely being underestimated by market participants, while investor perception towards the U.S.-China relationship is much better understood than it was when we penned *China: A Visit to the Epicenter* nearly a year ago.

Amidst the heightened uncertainty we witnessed, we still see opportunity. Many areas of the capital markets are actually trading at discounts, and as such, we expect the percentage of private equity deals that are public to private transactions to accelerate into 2020. Corporate carve-outs too will remain in a bull market, and we now think that China could see the pace of its share of these deals quicken against an unsettled trade environment.

Meanwhile, meetings with leading executives in both London and Beijing gave us confidence that our vision of a low inflation, yearn-for-yield macro landscape is the right one. Hence, we stay positive on Asset-Based lending, B-piece Real Estate, and Infrastructure. We also want to underscore the importance of the technological changes

we are seeing across multiple industries. Even if one is not going to invest into China, understanding the competitive offerings of companies like Huawei and ByteDance is critical, in our view.

In closing, we just want to remind our readers that every cycle is different. In our humble opinion, this one will be remembered for the long-term ramifications of global “hot spots” and quantitative easing (QE) than it will for a large bank failing (e.g., 2008), or a widely overvalued sector of the equity market (e.g., Technology in 2000). In fact, our quantitative screens as well as our fundamental due diligence continues to uncover good companies trading at bad prices because of poor capital structures, earnings misses, or lack of investor understanding. Hence, the opportunity to buy complexity at a discount, fix it up, and return it to the market in a more simplistic format has – frankly – not been this good in two decades.

So, as legendary investor Warren Buffett once said, “Someone’s sitting in the shade today because that someone planted a tree a long time ago.” Our message is to spend the extra time to learn about the “hot spots” around the world, and with this knowledge, discern where to lean in and lean out in the coming quarters, as periodic dislocations inevitably bubble up. Complexity and uncertainty breed opportunity for those who are prepared.

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In this type of atmosphere, we think that the winners will be investors who have flexible capital, longer-duration liabilities, and the ability to move up and down the capital structure. From a sector and security selection perspective, it means we should continue to lean into healthcare, wealth management, technology transformation, leisure, and wellness.

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Important Information

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