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Outlook for 2019: The Game Has Changed

KKR
GLOBAL INSTITUTE

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Outlook for 2019: The Game Has Changed

As we begin 2019, we definitely tilt more positive in our global asset allocation and macro positioning, despite our call for a weaker economic environment. Many asset classes, Public Equities and Liquid Credit in particular, now appear attractive to us, and as such, we are selectively boosting exposures. However, it is not business as usual in the global capital markets these days. In our humble opinion, the game has changed. Specifically, we see four major influences that require a different approach to asset allocation in 2019: 1) a notable shift from monetary policy to fiscal is under way; 2) Technology, while still an incredibly powerful agent of change in the global economy, now faces more valuation and regulatory headwinds than in the past; 3) tightening liquidity conditions amidst higher real rates are macro headwinds that must now be considered; and 4) the rise of geopolitical uncertainty warrants a higher risk premium than in the past. Our message, however, is not to head to the sidelines and wait for these four considerations to dissipate. Rather, we want to stay invested, and maybe more importantly, we want to use periodic dislocations like we saw in the fourth quarter of 2018 to lean into areas of the global capital markets that seem to be pricing in recessionary conditions. Our bottom-line for 2019: Thoughtful asset allocation preferences, coupled with several key top-down investment themes, can drive above-average returns from current levels. No doubt, return per unit of risk is headed lower, but for investors with a long-term game plan and the ability to buy complexity amidst uncertainty, we see significant opportunities in 2019. And for those who understand how to adeptly navigate the reality that the game has changed, the upside could be even more significant.

"I am in blood. Stepped in so far that, should I wade no more, Returning were as tedious as go o'er."

MACBETH
THE TRAGEDY OF MACBETH BY WILLIAM SHAKESPEARE

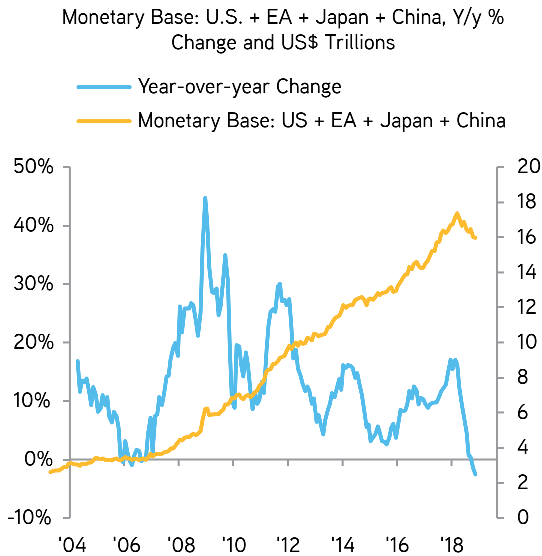
Section I: Introduction

When we huddled KKR's Global Macro & Asset Allocation, Balance Sheet, and Risk Analytics team together in late December to discuss our outlook for 2019, the tenor of the conversations reminded me of when I first read William Shakespeare's *Macbeth*. Specifically, the image that comes to mind is the scene where Macbeth is debating whether to proceed with his fiendish plot, or just call it quits. He states that, "Returning were as tedious as go o'er," or that going back will be as tough as going forward at this point in the narrative.

It is a different time and quite definitely a different setting, but we feel a similar tension when we look at the global capital markets these days. On the one hand, we are 115 months into an economic expansion in the U.S., profit margins are robust relative to trend, and most importantly to us at KKR, global central banks, the Federal Reserve in particular, are reducing their liquidity profile (*Exhibit 1*). We have also seen financial conditions become more restrictive amidst slowing global growth, which has historically been without question bad for valuations (*Exhibit 2*), at the same time that political banter has reached extraordinarily high levels. In fact, the fourth quarter of 2018 was the worst performance for U.S. Equities since the third quarter of 2011. So, as one might guess, this type of backdrop would have almost any macro portfolio manager and/or global asset allocator wanting to run for the exits across most asset classes.

EXHIBIT 1

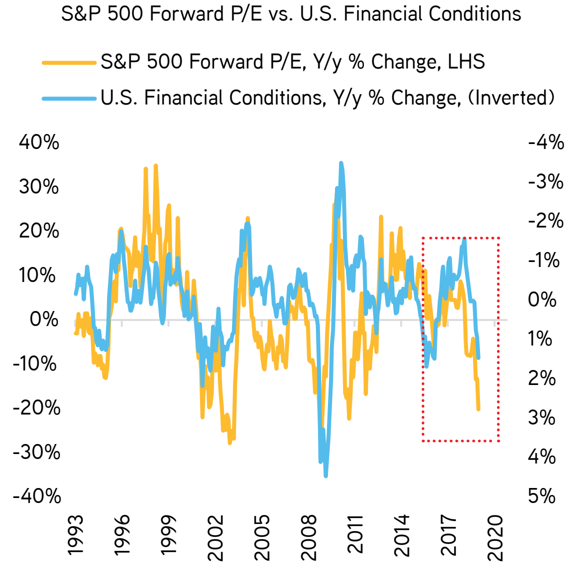
While the Global Monetary Base Is Still Outsized, It Is Now Headed Lower



Data as at December 20, 2018. Source: Federal Reserve Board, European Central Bank, Bank of Japan, People's Bank of China, Haver Analytics.

EXHIBIT 2

S&P 500 Multiple Contraction Goes Hand-in-Hand with Tightening of Financial Conditions



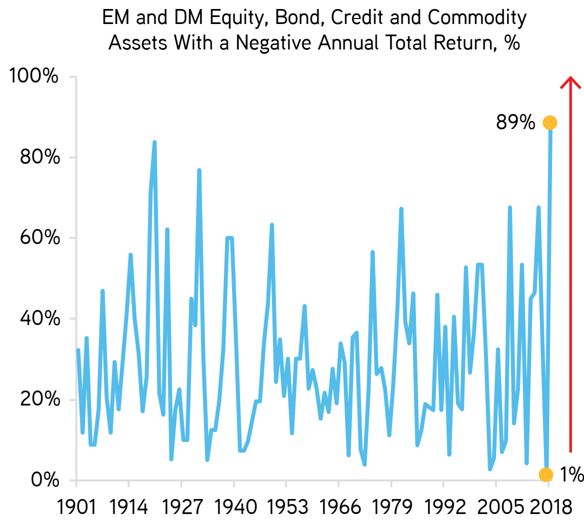
Data as at December 31, 2018. Source: Bloomberg, S&P.

On the other hand, U.S. consumers, particularly their current rate of savings, appear fine, and given demographic and immigration challenges, the unemployment rate is not likely to spike anytime soon (remember we only need roughly 100,000 jobs per month to get to steady state unemployment versus our current run rate of more than 180,000 jobs per month). The U.S. financial services system, which is usually the transfer mechanism for any real crisis, is also in decent shape. Moreover, most international markets were badly beaten up in 2018, as growth has stumbled in places like China, Italy, Japan, and Germany. Meanwhile, sentiment around global trade dynamics between the United States and China is already quite negative, and while liquidity is leaving the system, there is still a lot of it around in absolute terms (*Exhibit 1*).

> **"It is not business as usual in the global capital markets these days. In our humble opinion, the game has changed."**

EXHIBIT 3

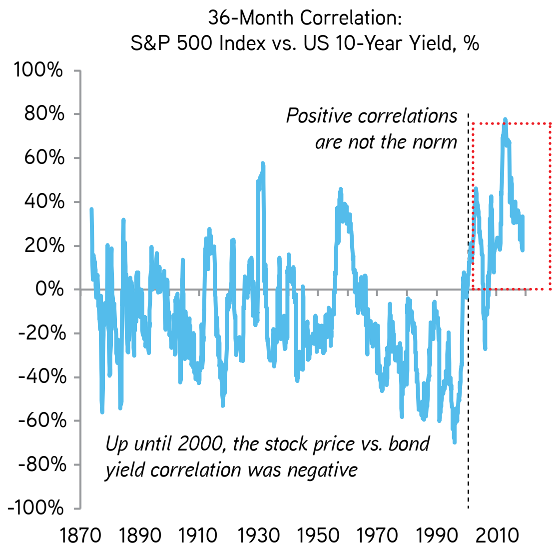
We Link the Significant Breadth of Underperformance in 2018 to the Reality that Long-Term Bonds Can No Longer Serve as Portfolio Shock-Absorbers



Note: Deutsche methodology includes total return performance on 60 equity, 40 DM and 20 EM bond markets, four credit indices, one cash proxy index and five commodity markets. Data as at December 7, 2018. Source: Deutsche Bank.

EXHIBIT 4

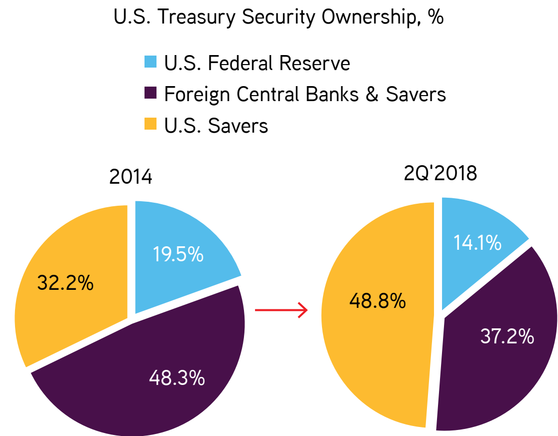
We Think that We Are Seeing a Secular Shift in the Relationship Between Stocks and Bonds Back Towards Pre-2000 Behavior. This Viewpoint Is Significant for What It Means for Macro and Asset Allocation Investors



Data as at December 31, 2018. Source: Shiller data, Standard & Poor's, Federal Reserve Board, U.S. Treasury, Haver Analytics.

EXHIBIT 5

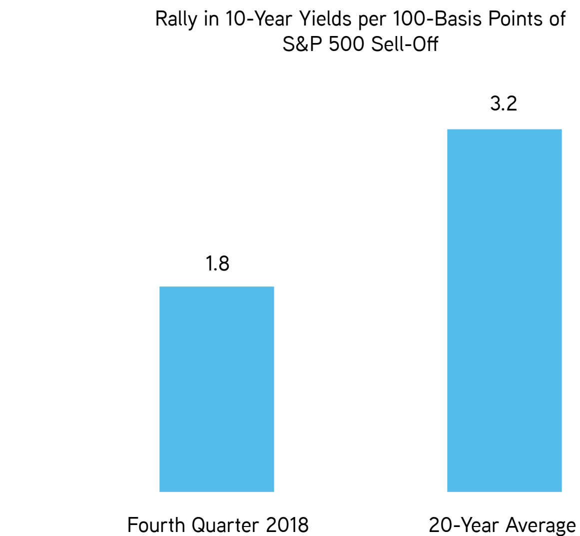
U.S. Savers Now Account for a Larger Percentage of U.S. Treasury Ownership



Data as at June 30, 2018. Russell Napier, CBO, Treasury, TIC Data, Federal Reserve.

EXHIBIT 6

Bonds Are No Longer as Effective as a Shock Absorber



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

EXHIBIT 7

Many Macro Key Performance Indicators Have Already Fallen to What We've Been Forecasting as Recessionary Levels

	RECENT CYCLE PEAK	RECENT TROUGH READING	GMAA 'MILD RECESSION' BASE CASE: RECESSION YEAR TROUGH
S&P 500	+16.8% Y/y	-19.8% vs. Sept Peak	-20% Y/y
US/EU/China Passenger Car Sales	58.5mm	52.7mm	52.4mm
WTI Crude / Bbl	$76.41	$42.53	$45.00
US Housing Starts	1.32mm	1.24mm	1.10mm
US UNEMPLOYMENT RATE	3.7%	N/A	5.0%

Notes: S&P 500 peak = September 20, 2018; Recent trough = December 24, 2018; Autos peak = 2Q18 SAAR; Recent trough = trailing three-month average SAAR as at November 2018; WTI Crude peak = October 3, 2018; Recent trough = December 24, 2018; U.S. Housing Starts peak = 1Q18 SAAR; Recent trough = trailing three-month average SAAR as at November 2018. Source: Bloomberg, Haver Analytics.

Maybe most favorably on the positive side of the ledger on a go-forward basis, however, is that the recessionary 'downturn' that we have been using in our base case economic outlook with our KKR deal teams – to ensure that we are not overpaying for future earnings power across both Equity and Credit investment opportunities – is already playing out in the markets and the economy. One can see this in *Exhibit 7*. To review, we have been looking for a 20% drawdown in equity markets, oil at $45 per barrel, weak global auto sales, and slowing housing starts – all of which essentially occurred in the second half of 2018 or are anticipated to occur in 2019 versus our original model-based expectations of an early 2020 soft recession. So, barring our being really wrong on the consumer outlook (i.e., the consumer tanks badly), we can assume many key macro indicators are already near the low end of the range (e.g., the global auto industry reported two *consecutive* quarters of negative growth in the second half of 2018, which is the first time since 2009, or the U.S. ISM fell the most sequentially in December since October 2008), except for unemployment (which is a lagging indicator – and one we do not expect to tank this cycle). As such, these indicators are likely to improve as the cycle reaccelerates – something we are still envisioning as a late-2020 event.

More importantly for investors, though, is that our work shows that the U.S. market now appears to have priced in many of these types of recessionary headwinds *(Exhibit 92)*. Indeed, with the S&P 500's trailing multiple now down 25.3% percent (versus a median of 33.4%), investors have already assumed that we are entering a period on par with either past recessions or a notable geopolitical shock. So, against this backdrop, we now think the Federal Reserve turns more dovish in 2019, including just one hike versus our prior call of two hikes. We also think that wording around its balance sheet withdrawal being on "autopilot" could be amended even further in 2019 to provide the central bank with more near-term flexibility than we previously thought. So, if we are right that many international economies are bottoming and that any economic slowdown in the United States is more akin to 2001 than to 2007 or 1929 (*Exhibit 8*), then starting to methodically add risk exposure now – not waiting until a recession has technically occurred – makes more sense.

"

Maybe most favorably on the positive side of the ledger on a go-forward basis, however, is that the recessionary 'downturn' that we have been using in our base case economic outlook with our KKR deal teams – to ensure that we are not overpaying for future earnings power across both Equity and Credit investment opportunities – is already playing out in the markets and the economy.

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EXHIBIT 8

Unless We Are Having a Crash More Akin to 2007 or 1929, Then Most of the S&P 500 Downside Tends to Occur Before the Start of a Recession

DATES				PRICE PERFORMANCE, %		DURATION (NUMBER OF MONTHS)		
S&P 500 Peak Peak	Start of Recession	End of Recession	S&P 500 Trough	SPX Peak to Start of Recession	SPX During Recession	SPX Peak to Start of Recession	Recession	Recession Start to SPX Trough
10/9/2007	1/30/2008	7/30/2009	3/9/2009	(13.4%)	(27.2%)	3.8	18.2	13.5
3/24/2000	4/27/2001	12/28/2001	10/9/2002	(18.0%)	(7.3%)	13.3	8.2	17.7
7/16/1990	8/30/1990	4/29/1991	10/11/1990	(13.6%)	17.2%	1.5	8.1	1.4
11/28/1980	8/28/1981	12/30/1982	8/12/1982	(11.7%)	13.1%	9.1	16.3	11.6
2/13/1980	2/28/1980	8/29/1980	3/27/1980	(5.1%)	8.9%	0.5	6.1	0.9
1/11/1973	12/28/1973	4/29/1975	10/3/1974	(18.9%)	(12.2%)	11.7	16.2	9.3
11/29/1968	1/30/1970	12/30/1970	5/26/1970	(21.5%)	8.5%	14.2	11.1	3.9
8/3/1959	5/27/1960	3/30/1961	10/25/1960	(8.2%)	16.7%	9.9	10.2	5.0
8/2/1956	9/27/1957	5/29/1958	10/22/1957	(14.5%)	3.6%	14.0	8.1	0.8
1/5/1953	8/28/1953	6/29/1954	9/14/1953	(11.0%)	24.0%	7.8	10.2	0.6
5/29/1946	12/30/1948	11/29/1949	6/13/1949	(20.6%)	4.8%	31.5	11.1	5.5
3/7/1945	3/29/1945	11/29/1945	3/26/1945	(5.4%)	25.1%	0.7	8.2	-0.1
3/10/1937	6/29/1937	7/29/1938	3/31/1938	(18.9%)	(18.6%)	3.7	13.2	9.2
9/16/1929	9/27/1929	4/28/1933	6/1/1932	(5.0%)	(74.1%)	0.4	43.6	32.6
9/20/2018	12/31/2018	Today		(14.5%)				
		Median		(13.5%)	6.7%	8.5	10.7	5.3
		Average		(13.3%)	(1.2%)	8.7	13.5	8.0
		Best		(5.0%)	25.1%	31.5	6.1	(0.1)
		Worst		(21.5%)	(74.1%)	0.4	43.6	32.6

Data as at December 31, 2018. Source: Bloomberg, S&P.

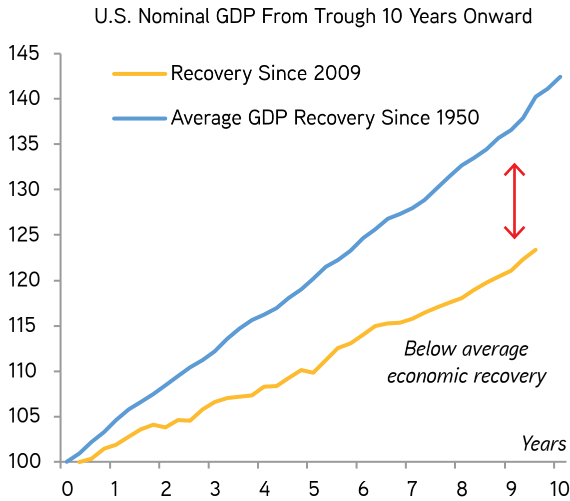
So, our advice for 2019 is to stay invested, and as we detail below, there are areas of dislocation that we think folks should immediately lean into with increased positions. *In particular, we are moving to a tactical overweight position in Global Equities for the first time in three years*. We also believe that, as we describe below, parts of Liquid Credit, Infrastructure, and Special Situations/Distressed now appear quite attractive too.

However, while we are tilting more positive in our asset allocation in 2019, we must also acknowledge that *the game has changed*. Specifically, we now believe we are entering a sustained period when the performance of capital markets will – at best – be on par with the performance of the global economy in nominal terms (*Exhibits 9* and *10*). So, we also expect lower returns with wider dispersions and higher volatility over the next few years. What's changed in our minds?

First, we believe that the shift from monetary stimulus towards fiscal stimulus is – unquestionably – better for nominal GDP growth than it is for global capital markets performance. Simply stated, our thesis is that governments will now use fiscal tools rather than monetary tools to not only attempt to drive growth higher but also to repair some of the socioeconomic divide that has unfolded after the Global Financial Crisis (GFC). In our view, this shift in focus by the 'Authorities' towards more fiscal policy help and less monetary policy stimulus is a secular, not a cyclical one. It also represents a major reversal from what occurred during the last decade. Key to our thinking is that U.S. savers have now been asked to absorb at least *an additional $360 billion in Federal Reserve balance sheet liquidity and around a $400 billion increase in the U.S. deficit at a time when other global central banks and other foreign investors are reducing their ownership of U.S. government bonds (Exhibit 5)*. If we are right, then it also means that bonds likely can't be the shock absorbers that they have been in the past two decades; we view this as a big deal for all macro and asset allocation professionals, levered accounts in particular. The shift towards increased fiscal stimulus also dovetails well with two other mega themes that my colleague Ken Mehlman and I have been highlighting: the rise of nationalistic agendas over global ones as well as the long-term impact of demographics on mature economies such as Japan, Germany, and the United States.

EXHIBIT 9

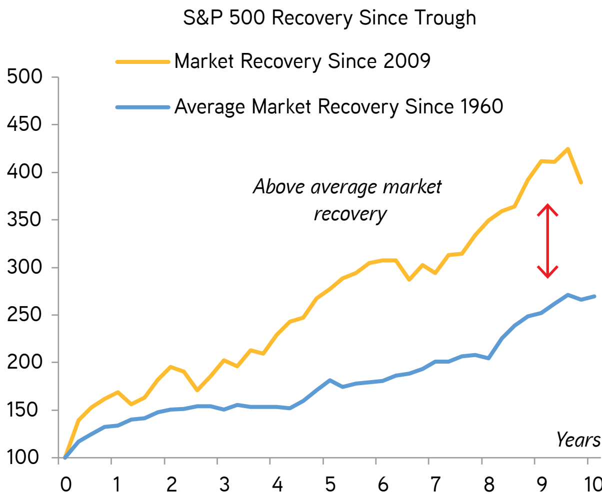
The Past Decade Has Been Extremely Weak in Terms of Economic Performance, But...



Data as at November 26, 2018. Source: Haver Analytics, Datastream, and Goldman Sachs Global Investment Research.

EXHIBIT 10

...It Has Been an Unusually Strong Financial Recovery. Looking Ahead, We Think Some Mean Reversion Is Likely

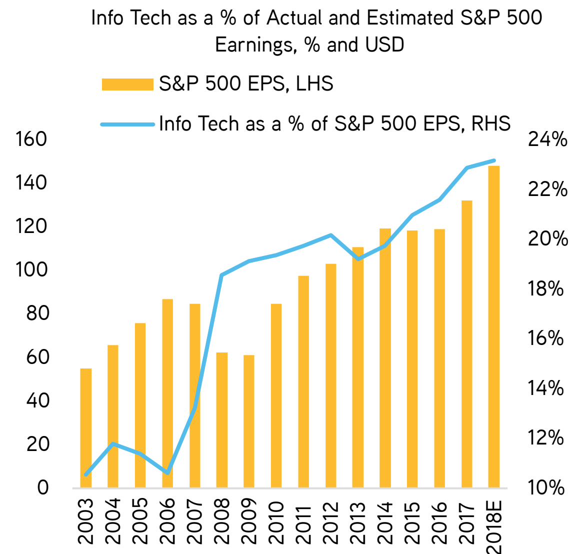


Data as at November 26, 2018. Source: Haver Analytics, Datastream, and Goldman Sachs Global Investment Research.

Second, we believe that aggregate Technology investments – which have been the key driver of returns this cycle so far – will no longer be the key leadership sector from a total return perspective in the near term. So, despite the recent carnage, we retain our underweight to Private Growth investing until valuations better adjust to the new reality of a more disciplined approach to this asset class. Meanwhile, on the public side of the sector, we expect regulatory oversight, tougher earnings comparisons, and excess dry powder to lower returns on a go-forward basis for the next few quarters. Also, as we have seen with ZTE, Huawei, and – to some degree – Apple, we also expect high-end technology to be at the epicenter of any ongoing trade friction. We see similar trends playing out in several key areas of the Venture Capital market as well.

EXHIBIT 11

We Are Structurally Bullish on Technology, But We Believe That Its Share of the S&P 500 Will Now Moderate



Data as at November 30 2018. Source: Bloomberg, S&P.

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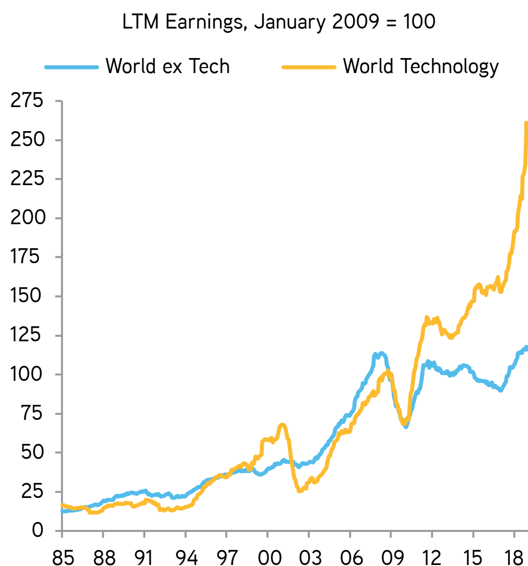
EXHIBIT 12

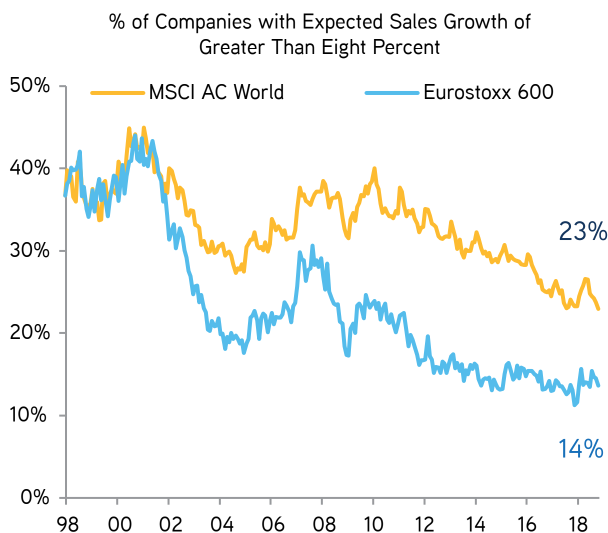
Technology Has Been the Key to EPS Growth This Cycle



Data as at November 26, 2018. Source: Worldscope, Datastream, and Goldman Sachs Global Investment Research.

EXHIBIT 13

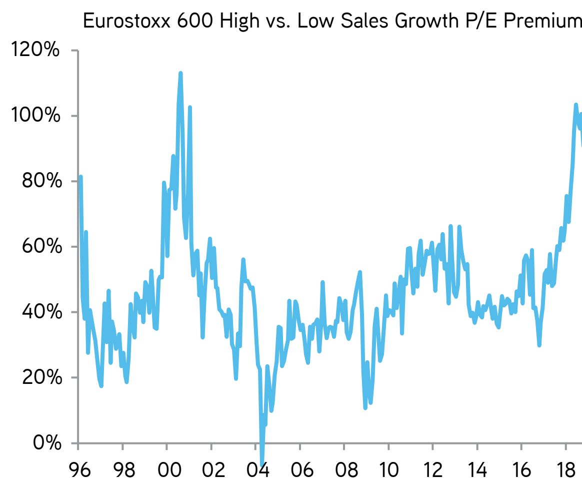
Few Companies Generate High Top-Line Growth These Days, But...



Data as at November 26, 2018. Source: IBES, Datastream, Goldman Sachs Global Investment Research.

EXHIBIT 14

...A Lot of the Good News About Growth Is Now in the Price, We Believe



Data as at November 26, 2018. Source: IBES, Datastream, Goldman Sachs Global Investment Research.

Third, we believe that the liquidity cycle has turned. It may not get highly restrictive relative to past cycles, but real rates are higher amidst central bank balance sheet retrenchment. As a result, we generally expect financial conditions to continue to tighten. If they don't, then it is because growth is slower than expected – which is not great either. Said differently, it feels like the capital markets might be "stuck" in the medium term. If growth is too strong, financial conditions will continue to tighten. If growth is too weak, it means that margins and trade negotiations are under pressure. Regardless of what happens in the near term (i.e., even if the Fed pulls back from balance sheet normalization in 2019, which we think is increasingly likely), the shift from quantitative easing to quantitative tightening will continue for years as central banks normalize their balance sheets. In the G4, for example, estimates are that sovereign issuance adds nearly one trillion dollars of new bonds to the system in 2019 (net of QE), compared to a net withdrawal of liquidity in 2016 and 2017 of more than one trillion dollars (*Exhibit 96*). If we are right, then this issue is likely to keep real rates higher than in recent years, which affects prices paid for Equities and Credit *(Exhibits 15* and *16).* It is also bearish for the momentum-driven strategies that outperformed so significantly during the 2015-1H18 period (*Exhibits 19* and *20*). Aggressive buyback programs will come under pressure too, we believe. However, as we discuss below in more detail, it is quite bullish for flexible mandates, particularly in Credit, that can harness volatility to their advantage to establish attractive entry prices.

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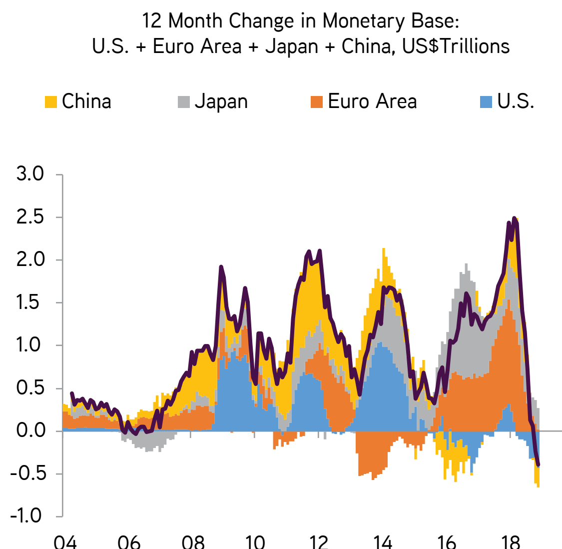
We are quite bullish on flexible mandates, particularly in Credit, that can harness volatility to their advantage.

"

EXHIBIT 15

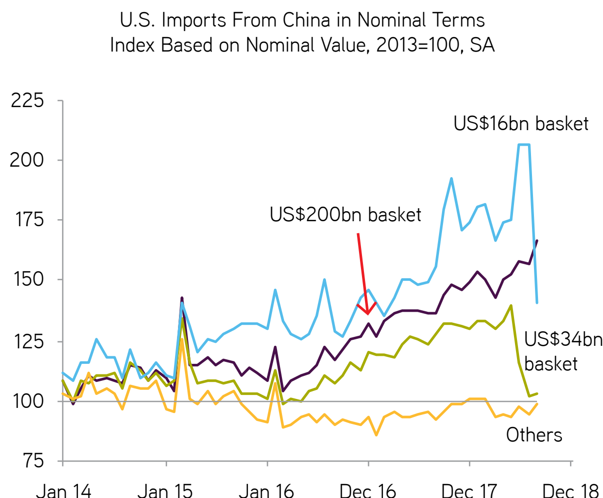
Money Supply Has Slowed Sharply as Quantitative Tightening Has Unfolded



Data as at November 30, 2018. Source: Federal Reserve Board, European Central Bank, Bank of Japan, People's Bank of China, Haver Analytics, MSCI, Bloomberg.

EXHIBIT 16

Trade Tensions Are Clearly Playing a Part in the Current Global Slowdown



Data as at September 30, 2018. Source: JP Morgan.

Fourth, we expect more geopolitical shocks in 2019. As we describe in more detail in Section V, our Investment Considerations/Risks section, we believe that current geopolitical events require a greater risk premium for risk assets in 2019. In terms of specific threats, my colleague Dave McNellis now has included some form of auto tariff in his base case U.S. GDP forecast for 2019. We also do expect President Trump to raise tariffs to 25% from 10% on the existing $200 billion of tariffed goods, and we view the technological fracases that have already occurred between China and the U.S. to accelerate further in 2019. Already, Tim's Cook's recent letter to Apple investors underscores the distinct headwinds many U.S. businesses now face in China. Meanwhile, in Europe we expect ongoing political volatility across the United Kingdom, Italy, France, and Germany in 2019. Finally, there are several important elections (e.g., India, Indonesia, Philippines, Canada, and Greece), and shifts in government policies (e.g., the consumption tax increase in Japan) that are likely to create significant handwringing in the investment community in 2019.

EXHIBIT 17

Geopolitical, Societal, and Technological Changes Are Now Having Substantial Impacts on Both Economies and Markets

GEOPOLITICAL	SOCIETAL	TECHNOLOGICAL
Distrust of government and institutions	Immigration	Global connectivity / social media
Populist and illiberal leaders	Inequality and wage stagnation	Data privacy
Nationalist challenges to international systems	Workers left behind by technology and trade	Cyber security
Identify politics and polarization	Increasing insular communities (virtual and geographic)	Aging and inadequate infrastructure
Inter-state rivalry and conflict	Demographics (aging)	Automation of industry, ag, and services
Unconventional conflict and actors (e.g., terrorism, cyber)	Environmental degradation and natural resource access	Lack of access for STEM education and skills training

Data as at December 31, 2018. Source: KKR Global Institute.

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We generally expect financial conditions to continue to tighten. If they don't, then it is because growth is slower than expected – which is not great either.

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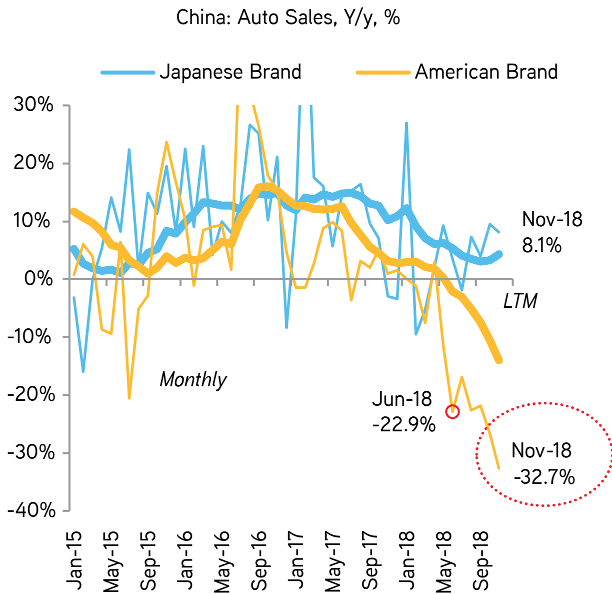
EXHIBIT 18

Recent Auto Sales in China Underscore Not Only a Cyclical Slowdown but Also a Shift in Manufacturer Preferences



Data as at November 30, 2018. Source: China Association of Automobile Manufacturers, Haver Analytics.

Without question, we now see several sizeable pockets of opportunity, but we are maintaining our more targeted mantra of *'Buying Complexity and Selling Simplicity'* as well as our penchant for leaning into periodic dislocations such as those that occurred in the fourth quarter of 2018 and in the first quarter of 2016. Importantly, though, as we describe below in more detail, we believe that our *Complexity* thesis is on the cusp of shifting from *Corporate Complexity* to *Capital Structure Complexity* over the next few years *(Exhibit 21)*. If we are right, then *understanding relative value in the corporate capital structure could become one of the most important prerequisites for success* in 2019 and beyond.

"

So, our advice for 2019 is to stay invested, and as we detail in this note, we have some high conviction areas where we think that folks should actually lean into the current dislocation with increased positions. In particular, we are moving to a tactical overweight position in Global Equities for the first time in three years.

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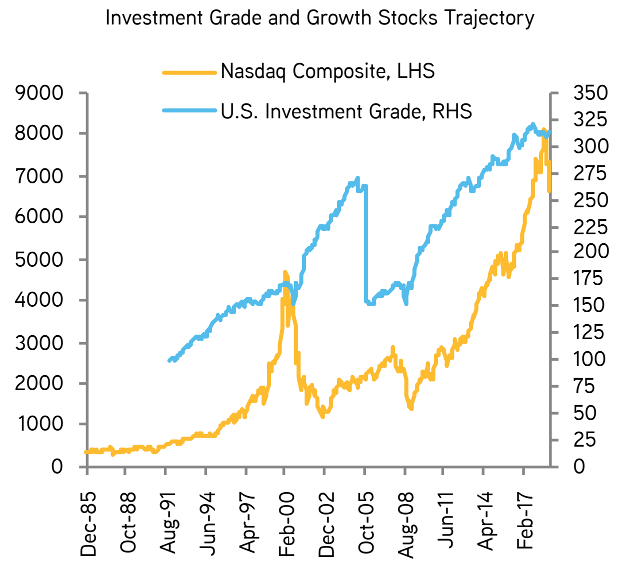
EXHIBIT 19

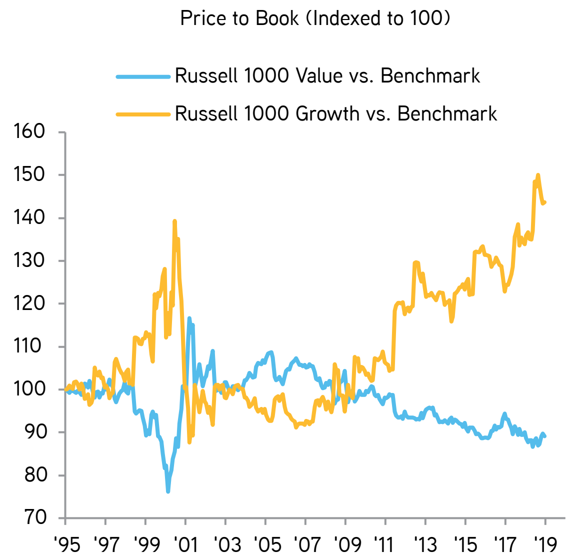
To Rid the Market of All Excesses, the NASDAQ and Investment Grade Debt – Both Major Beneficiaries of QE – Need to Crack Further



December 31, 2018. Source: Bloomberg.

EXHIBIT 20

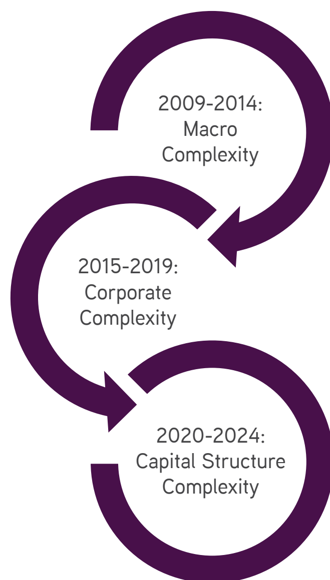
The Valuation Premium of U.S. Growth Stocks vs. U.S. Value Stocks Has Started to Mean-Revert After Reaching the Most Extreme Since 2000



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

EXHIBIT 21

We're on the Cusp of Transitioning to the Capital Structure Complexity Era



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

Against this backdrop, we believe that thematic investing has become of paramount importance if one is to exceed the median forecasts for capital markets assumptions that we have suggested in *Exhibit 93*. To this end, we believe that CIOs should consider infusing their investment portfolios with the following macro-oriented themes in 2019 and beyond:

1. **Shift from monetary to fiscal (most important theme to get right).** As part of our Paradigm Shift thesis, which Ken Mehlman and I 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 97*) during recent years. However, as we have seen of late, the shift from monetary to fiscal policy can challenge the notion of keeping nominal GDP above nominal interest rates. In particular, rising interest rates lifts the bar for nominal GDP growth in areas that require levered financing; meanwhile, fiscal stimulus is a sharper tool than monetary policy, as the benefits sometimes accrue to fewer, more targeted sectors. As such, we want to continue to increase our allocation to assets with sizeable upfront yield backed by nominal GDP growth in those more targeted areas, including transportation assets, energy delivery assets, and certain residential construction assets.

2. **Mean reversion: Margins and momentum (new theme)**. In our view, we have entered a period where two excesses are now poised to revert to the mean: *peak margins* and *momentum investing*. Indeed, given rising wages, interest rates, and increasing trade frictions, 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. Already, our channel checks suggest that higher input costs, coupled with rising compensation, are creating headwinds. Our base case is that President Trump does increase the existing tariffs to 25% from 10% on the existing $200 billion of tariffs, though we do not expect him to proceed with the additional $267 billion initiative that was floated in September 2018. Meanwhile, we believe that momentum strategies, which dominated Public Equities' performance during the past few years, will continue to come under serious pressure in 2019 (*Exhibits 19* and *20*). As we describe below in detail, this viewpoint is consistent with tighter financial conditions, and overall, it supports the strategy we still champion of *Buying Complexity and Selling Simplicity*.

3. **Capital structure complexity (new theme).** If there is one thing that became increasingly apparent during the fourth quarter of 2018, it was the inconsistencies in value that now are appearing across capital structures and asset classes (*Exhibit 21*). For example, Liquid Credit has sold off much more than some of the opportunities we are seeing in Private Credit, and as such, there is a capital structure arbitrage/opportunity that now exists for flexible capital to step in and buy into potentially "hung" new issue paper as well as unloved trading positions in Liquid Credit and Structured Products. We are also seeing some "good company, bad capital structure" opportunities emerge, particularly outside of the U.S. As a result, we now hold a large overweight to Actively Managed Opportunistic Credit, and we have again increased our position in Special Situations/Distressed this year. Meanwhile, in Asia it appears to us that growth in the Public Equity Markets is trading substantially cheaper than Private Growth opportunities. In our view, private investment opportunities in Growth will need to 'catch-down' to the rest of the public markets in 2019.

4. **Deconglomeratization (theme revisited).** As corporations around the globe look to optimize their global footprints in a world that is increasingly turning domestically focused, we believe that this transition will create a significant opportunity for investors to buy, repair, and improve non-core assets from regional and global multinationals. 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 activist dollars (which are aggressively advocating for change). Importantly, as we describe

below, we see this trend towards entities hiving off non-core assets currently extending beyond traditional corporations to include Infrastructure and Energy assets. Although this theme is not new, it is a powerful one accelerating the pace of corporate restructurings across the global capital markets.

5. **Experiences over Things, with a particular focus on millennials' purchasing power (theme revisited).** 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 the globe, particularly in Asia (where there are more than 800 million millennials; *Exhibit 113*), we see that technology has made the movement 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., too, consumers are earmarking an ever-growing amount of their paychecks for what we are increasingly coming to view as 'fixed charges' such as healthcare, rental expenses, and iPhone maintenance. However, we are growing more cautious about this theme in the high-end space, given some of the incoming data we are seeing in spending patterns of the wealthy as well as excess capacity that has been added to serve this market segment in key areas such as condominiums and resorts.

What does this all mean for asset allocation? Our key action-items for 2019 and beyond are as follows:

1. **Despite the notable slowdown in global growth we are forecasting in 2019, we are upgrading Public Equities to overweight from equal weight.** As we show below in Section III, we think that a lot of bad news is now in the price of Equities at current levels. Consistent with this view, **we are shifting our 300 basis point underweight in United States Equities to a 100 basis point overweight position.** We are certainly not day traders, but our recent decision to further underweight U.S. Equities has played out faster than we had envisioned in the second half of 2018. Key to the change in our thinking is that investors are now essentially discounting a recession into the forecast of the S&P 500's trading multiple (*Exhibit 92*). Despite our optimism, we do acknowledge that – for this rolling bear market to be complete on the equity side – the NASDAQ's highest flyers still need to underperform more broadly for some further period of time. Said differently, valuation matters again in 2019, and with our overweight position, we advocate leaning into strong cash flow generators, particularly those with pricing power and dividend increases on the near-term horizon. Meanwhile, on the international side, the poor performance that investors suffered through relative to the U.S. during the first three quarters of 2018 now appears to be reversing. Consistent with this view, our EM/DM model (*Exhibit 70*) suggests we are seeing a double bottom (similar to 1999-2001), not a structural turn in attractiveness. *Importantly, though, the international story, EM in particular, remains much more nuanced than in the past*. So, we retain our short position in Turkish Equities (despite being down more than 40% in 2018), our overweight positon in non-Japan Asia, and our underweight position in Latin America. Meanwhile, we trim Europe to 15% from 16% on the back of slowing growth and political uneasiness, and we drop our Japan exposure by two percent ahead of the October 2019 consumption tax.

2. **We are increasing our allocation for short-term U.S. government bonds to seven percent from three percent; we remain 2000 basis points underweight the long-end of the curve**. We find U.S. short duration bonds (i.e., one-to-three year bonds) as one of the most attractive risk-adjusted vehicles currently available. The asset class provides both competitive yield and potential capital appreciation (i.e., it is one of the few positive carry hedges we can find). Indeed, despite yields that are now just 19 basis points below 10-year yields in the U.S. (and well above yields available in Europe and Japan), an investor is also paying for some capital gains if the Fed does pause because of trade concerns, growth jitters, and/or geopolitical tensions. By comparison, we remain significantly underweight in long-term global bonds of all types. Our view is that interest rates do not explode to the upside. Rather, from an asset allocation perspective, we believe the long-end of the curve can no longer fulfill its traditional role in asset allocation as both a shock absorber and yield enhancer. Also, we do not want to own a long duration position where the fiscal situation is deteriorating and there is *zero* embedded term premium in the security. As such, we hold a zero percent position in this global asset class relative to a benchmark of 20%.

3. **We are consolidating all our Liquid Credit positions into our Opportunistic Credit bucket.** After over two years of leaning-in to Leveraged Loans as a pure play idea, we are reducing this overweight to zero from three percent and a benchmark weighting of zero. Leveraged Loans have had a great run in recent years, as their floating rate feature and strong technical flows have served this asset class well, particularly relative to High Yield. Where to go in corporate credit? We now hold a seven percent position in Actively Managed Opportunistic Credit, which provides us with greater ability to *toggle* between High Yield, Structured Credit, and Loans. Said differently, given the dislocation of late, we want a little more flexibility to arbitrage capital structures and asset classes than in the past. We also like this vehicle because it is a direct play on our *Buy Capital Structure Complexity* thesis. Importantly, we think that Liquid Credit has priced in the growth slowdown we are forecasting in 2019 much

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We now see several sizeable pockets of opportunity, and are maintaining our more targeted mantra of 'Buying Complexity and Selling Simplicity' as well as our penchant for leaning into periodic dislocations like those that occurred in the fourth quarter of 2018 and in the first quarter of 2016.

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more appropriately than many parts of Private Credit have, and as such, we skew the portfolio heavily in this direction.

4. **Continuing a migratory pattern we started during last year, we are adding another one percent to Distressed/Special Situations (four percent compared to three percent previously and a benchmark weighting of zero)**. To be sure, this call is a walk, not run idea, but if we are right about increasing volatility and late cycle behavior, we think our logic directionally makes sense. Without question, we are transitioning from QE to Quantitative Tightening (QT), and as such, we want to be leaning in – not out – at this point in the cycle towards taking advantage of the Capital Structure Complexity we now see emerging as a major theme (*Exhibit 21*). In terms of the specific opportunity set we see emerging in this asset class, we are growing increasingly bullish that Distressed/Special Situations managers may have success buying positions from lower quartile Direct Lending managers and the banks that provided leverage to fund these investments during the recent periods of excess. We also expect more fallen angels from the traditional Investment Grade market. Finally, we are already seeing quality positions in liquid credit that might be a touch too 'spicy' for our Actively Managed Opportunistic Credit account (i.e., either too illiquid or may require some active management) but would be well suited for the Distressed/Special Situations arena.

5. **We add two percent to a new asset class for us – Stabilized Credit – that further boosts our exposure to nominal GDP-linked assets**. See below for details, but we view this asset class, which is directly levered to short-term commercial real estate loans, as a non-correlated allocation in our credit book relative to traditional High Yield (*Exhibit 26*). All told, through our new position in Stabilized Credit, our existing two percent position in CMBS B-piece assets, and six percent in Asset-Based Finance, we now have a full 10% of our Credit portfolio allocated towards assets linked to nominal GDP (and this does not include our seven percent position in Energy/Infrastructure; details below), which remains one of our key investment themes for 2019.

6. **However, we are lowering our Opportunistic Real Estate Equity allocation to two percent versus three percent and a benchmark of two percent.** As noted above, Real Estate Credit appears to be a more efficient vehicle for playing our nominal GDP-linked theme at current levels. Also, we note that there is a lot of money sloshing around in Core Real Estate. So, within Real Estate Equity we prefer more complex situations where there is less cap rate risk. In particular, we like value-added stories where product supply is constrained and demographics are more favorable, including in the southeastern U.S.

7. **We maintain our 300 basis point overweight to Traditional Private Equity as well as our 500 basis point underweight to Growth/VC/Other.** On the one hand, we note that the Private Equity industry has substantially repositioned its skill set to focus more on operational expertise (relative to leverage), which tends to be more of a sustainable differentiator, particularly later in the economic cycle when multiple expansion is less likely. Private Equity can also provide a more thoughtful approach to sector exposure to key markets that either may be under- or over-indexed. We find this insight to be particularly relevant in Europe, as its public markets are overweight cyclicals like Financials. By comparison, the valuation correction that we have been forecasting in the Growth/VC/Other markets is now unfolding. Deals priced in the second half of 2018 will now see lower valuation marks in 2019 in areas where deal teams stretched on valuation metrics amidst ebullient market conditions. This reality will be particularly hard felt in funds that were relying primarily on *unrealized* gains on an IRR basis. Given the carnage of late, however, we do want to highlight that this is an investment area that we intend to revisit for an upgrade in the first half of 2019.

8. **We also continue into 2019 with our 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. As we mentioned earlier, we also want to grab as much upfront yield as we can in early 2019. In terms of areas of focus, we prefer last mile financing in Telecom, Energy Infrastructure build-ups, and Water.

9. **We are maintaining a Cash position of one percent**. Coupled with our seven percent shorter duration Treasury call, we now have eight percent of our portfolio in assets that 1) have competitive yields; 2) have zero to positive correlation with market volatility; and 3) can be moved quickly into other asset classes as periodic dislocations occur.

10. **In terms of currency, we think that the U.S. dollar peaks in 2019.** However, we do not think it is USD down and all other currencies up (*Exhibits 133 and 134*). Rather, we think performance will become more divergent against the U.S. dollar depending on local central bank policy, susceptibility to foreign funding, and exposure to U.S. China trade and technology tensions. Our favorite pairs are long Japanese yen and euro against the U.S. dollar, and short Australian dollar against the yen. We also think our viewpoint is supportive of better performance in some of the non-Japan Asia markets where we hold a 300 basis point overweight in 2019. A change in the direction of the dollar could also help flows into U.S. Liquid Credit re-accelerate in the second half of the year.

Looking at the big picture, we feel strongly that the road ahead during the next few years will remain bumpy. Unlike the past 8-10 years, central bank liquidity has peaked, and as such, we are inclined to tilt more defensive in three areas we believe still need to mean revert: Momentum Stocks, Investment Grade Credit, and parts of Core Real Estate. That said, we also take a lot of comfort in the reality that 1) many asset classes have already been hit hard (*Exhibit 3); and* 2) our macro models suggest a slowdown, not economic Armageddon. Hence, we are comfortable with our decision to enter 2019 with a modest overweight to Public Equities and our sizeable overweight position to Actively Managed Opportunistic Credit.

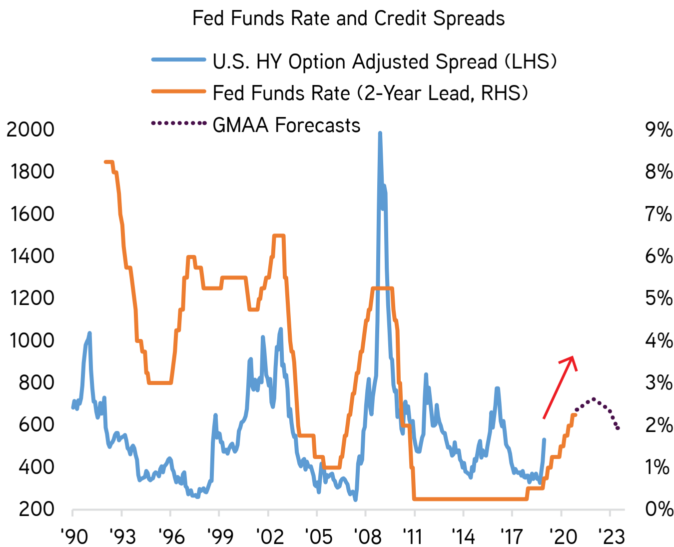
Regardless of whether one is bullish or bearish on a cyclical basis, our longer-term message is that CIOs need to reassess their portfo-

lios for the macro environment we envision during the next five- to seven-years (see *Rethinking Asset Allocation*; November 2018). Central to our thinking is that the relationship between stocks and bonds that has persisted for the last 20 years may also be changing, we believe. To review, since the Tech bubble peak in 2000, stocks and bond prices have been negatively correlated. As a result, weakness in the stock market has actually largely been offset with strong bond market performance amidst falling interest rates. One can see this in *Exhibit 4*. However, this relationship is actually somewhat anomalous – an input that we think many investors may be underappreciating. In fact, if you take a longer-term perspective, the relationship between stocks and bonds since 2000 is actually an outlier, as stock and bond performance is traditionally positively, not negatively, correlated.

The catalyst for some form of mean reversion in this relationship, we believe, will be the notable shift that we are now seeing amongst the global 'Authorities' away from monetary policy towards fiscal policy (which likely means bigger deficits). If we are right, then *many levered multi-asset class portfolios could endure much greater downside capture than in the past*. Already, this shift in relationship is partly to blame for what happened to these types of accounts in the fourth quarter of 2018, as 10-year yields rallied only 1.8 basis points per percentage point of SPX sell-off, compared to 3.2 basis points, on average, during the prior 20 years, a substantial 44% decline.

EXHIBIT 22

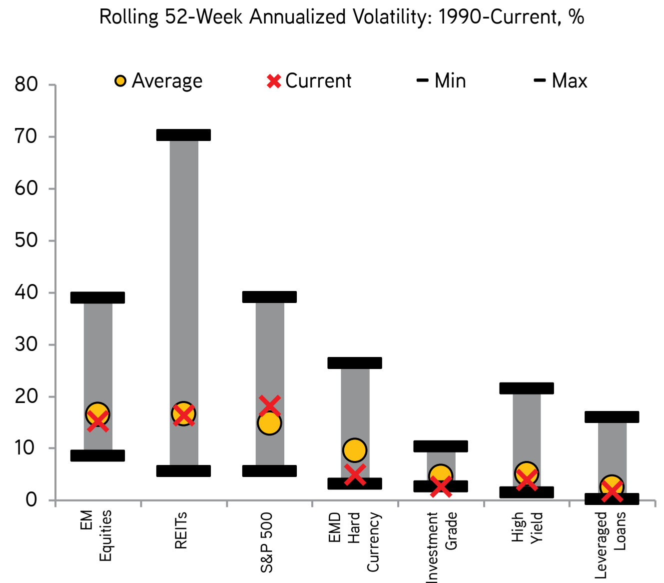
The Fed Funds Rate Tends to Lead Volatility by Two Years



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

EXHIBIT 23

For Both Cyclical and Secular Reasons, We See Higher Volatility Ahead Across Almost All Asset Classes



Data as at December 28, 2018. Source: Bloomberg.

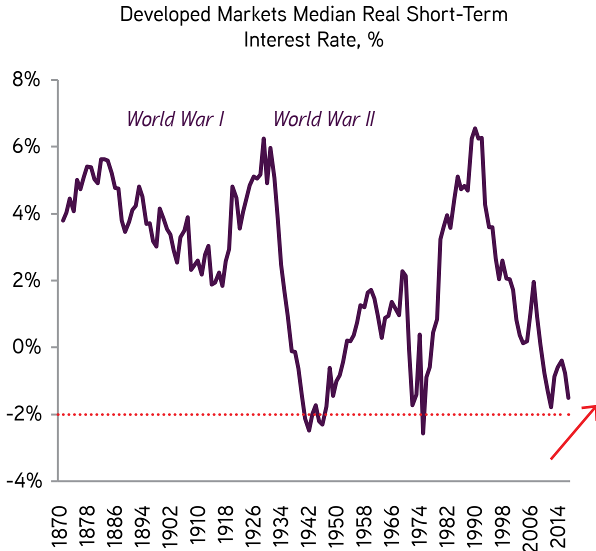
For both cyclical (e.g., Federal Reserve rate increases) and secular reasons (e.g., the end of Quantitative Easing), there is also the risk of much higher volatility ahead across the global capital markets. Our work undeniably shows that the Sharpe ratio, or return per unit of risk, could be poised to fall meaningfully during the next three- to five-years. This insight should not come as a major surprise, as Sharpe ratios across almost all asset allocation accounts we see from our seats are currently well above trend line. However, the dampening effect that excess money supply provided to the capital

"Regardless of whether one is bullish or bearish on a cyclical basis, our longer-term message is that CIOs need to reassess their portfolios for the macro environment we envision during the next five- to seven-years. Central to our thinking is that the relationship between stocks and bonds that has persisted for the last 20 years may be changing."

markets is now ending. Maybe more important, though, is that the quest by politicians to mitigate rising socioeconomic tensions in many large economies will likely lead to more policies that are not as market-friendly as in the past.

EXHIBIT 24

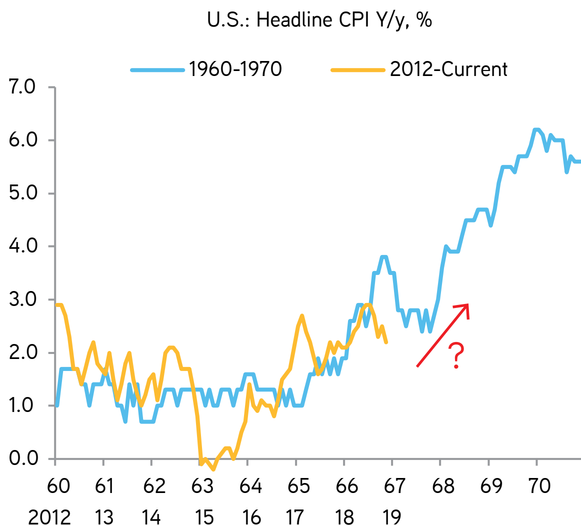
Median Developed Markets Real Rates Are Near Historic Lows; We Expect Some Mean Reversion



*Includes: Australia, Belgium, Canada, Switzerland, Germany, Denmark, Spain, Finland, France, Italy, Japan, Netherlands, Norway, Portugal, Sweden, UK, and U.S. Data as at October 31, 2018. Source: Goldman Sachs Investment Research.

EXHIBIT 25

We Are Not in the Inflation Camp, but History Suggests Investors Should Command Some Term Premium as Insurance



Data as at November 30, 2018. Source: Bureau of Labor Statistics, Haver Analytics.

EXHIBIT 26

KKR GMAA 2019 Target Asset Allocation Update

ASSET CLASS	KKR GMAA JANUARY 2019 TARGET, %	STRATEGY BENCHMARK, %	KKR GMAA JUNE 2018 TARGET, %
Public Equities	54	53	53
U.S.	21	20	17
Europe	15	15	16
Turkey	-1	0	-1
All Asia ex-Japan*	10	7	10
Japan	5	5	7
Latin America	4	6	4
Total Fixed Income	24	30	24
Long Duration Global Government	0	20	0
Short-Duration U.S. Bonds	7	0	3
Asset-Based Finance	6	0	8
High Yield	0	5	0
Levered Loans	0	0	3
High Grade	0	5	0
Emerging Market Debt	0	0	0
Actively Managed Opportunistic Credit	7	0	6
Global Direct Lending	0	0	2
Real Estate Credit (B-piece)	2	0	2
Stabilized Credit	2	0	0
Real Assets	9	5	11
Opportunistic Real Estate	2	2	3
Energy / Infrastructure	7	2	7
Gold	0	1	0
Grains (Corn)	0	0	1
Other Alternatives	12	10	11
Traditional PE	8	5	8
Distressed / Special Situations	4	0	3
Growth Capital / VC / Other	0	5	0
Cash	1	2	1

*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 December 31, 2018. Source: KKR Global Macro & Asset Allocation (GMAA).

So, as we enter 2019, our message is not to head for the sidelines. Rather, it is to stay invested in areas where there is some valuation 'cushion.' It also means to stay opportunistic in terms of leaning into our longer-term macro themes. On the other hand, we want to avoid the fat tails that have built up during this cycle. For our nickel, momentum stocks, many parts of Core Real Estate, and Investment Grade debt markets all represent areas where allocations should be minimal; hence, we have zero weightings in our portfolios.

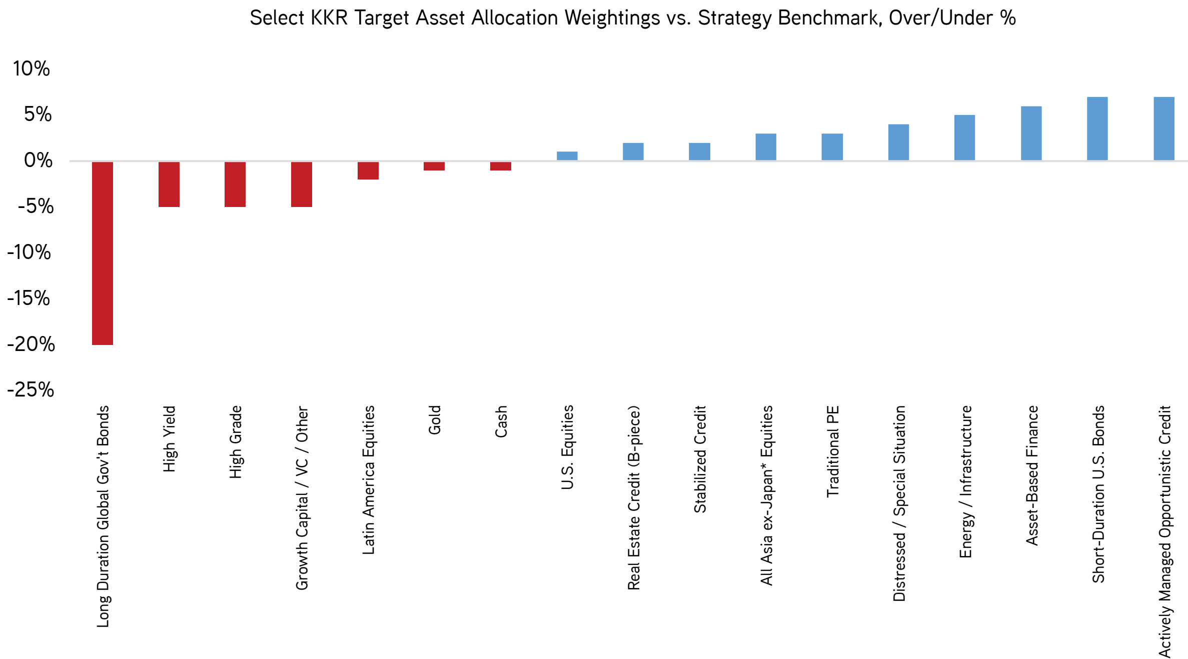
We believe that upfront yield also matters more in the environment we are envisioning, and as such, we have found new and diverse ways to support this premise in our asset allocation, including Stabilized Credit (i.e. short-term commercial real estate loans), CMBS (B-piece), Actively Managed Opportunistic Credit, and parts of Infrastructure/Energy. Yield not only becomes a bigger part of the total return equation in a lower return environment but it also dampens volatility. Meanwhile, with our now larger position in shorter duration U.S. government bonds, we also like that we have some significant positive convexity in the portfolio if volatility persists and growth slows the way we envision in 2019.

Meanwhile, within both our Public and Private Equity portfolios, we want to avoid companies that do not make money at this point in the cycle, particularly in the Growth markets. Simply stated, we still think that there is a valuation discrepancy that needs rebasing (*Exhibits 13 and 19*). We also want to reduce substantially our equity exposure to companies with weak capital structures. With money supply growth slowing, this shortcoming will likely become exposed, we believe. On the other hand, our advice is to buy corporate carve-outs, favor companies with pricing power, and lean into capital structure complexity.

If we are wrong in our outlook, it likely will be because central banks do in fact stay on "autopilot," as Federal Reserve Chairman Powell said to investors in his press conference in late December 2018. Given how fast money supply crashed in 2018, we think the "autopilot" approach would be a mistake, as it would lead to a continuation of fourth quarter 2018-like conditions. Or central bankers could swing to the other extreme (i.e., become super dovish) in an attempt to sooth the recent spike in financial conditions. This scenario is not an outlandish one, particularly given our view on growth. However, we would view it as merely a delay of the inevitable balance sheet unwind that still needs to occur – not a change in course. As we indicated earlier, we have moved from monetary stimulus as the key long-term driver of growth to fiscal stimulus, and politicians are rarely as adept at managing the capital markets as are central bankers. We believe this new reality for investing underscores our view that *the game has changed*.

EXHIBIT 27

We Have Shortened Duration, Leaned Into Dislocated Liquid Credit, and Now Favor an Overweight to U.S. Equities. We Also Prefer Assets with Yield Linked to Nominal GDP



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

Section II: Macro Basics

In the following section we describe in detail several key macroeconomic considerations where we think CIOs should have a view.

Global Economic Outlook

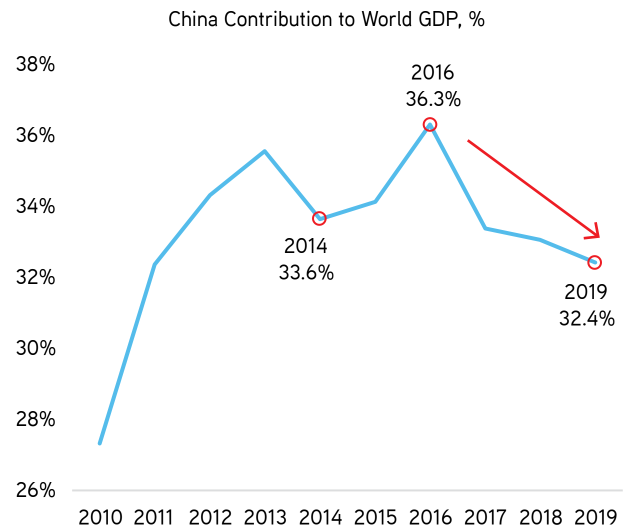
Forecasting GDP is never easy, but completing this task in today's unsettled world requires even more attention to the details. To this end, we wanted to mention upfront some of the key inputs that we include in our GDP and inflation forecasts. We note the following:

- For starters, we do include an auto tariff in our U.S. forecast for approximately four months of the year. This headwind acts as a 20 basis points drag on GDP this year in the U.S.
- Meanwhile, our global forecasts assume that President Trump does increase the existing tariff rate to 25% from 10% but does not proceed with further tariffs on the proposed $267 billion of goods imported from China to the United States. However, we fully expect trade sparring around the Technology sector to remain at elevated levels in 2019.
- Another important input in our global GDP forecast is that we assume Chinese currency remains relatively stable at around 7.0 in 2019 as long as U.S. China trade tensions do not escalate further than we envision in our base case.
- In Europe, the swing factor in 2019 and beyond is undoubtedly politics. Our view is that the political uncertainty we are seeing in the U.K., Italy, and France, among others, does exact a toll on Eurozone GDP growth but that ultimately sense prevails. That said, the ECB matters too. It has ended its purchasing of new securities and is actively discussing rate hikes, although we believe timing here could slip into 2020.
- As we describe below in greater detail, we also assume that the benefit of the Trump administration's stimulus starts to wane by the back half of the year.
- Finally – and potentially most importantly – as we mentioned at the outset of this *Insights* note, we think that many of the key variables we had been forecasting for our 2020 U.S. recession are in the process of unfolding. Specifically, the stock market has dropped 20%, oil has hit $45 per barrel, auto sales have tanked, and U.S. housing has slowed. Meanwhile, Italy, Germany, and Japan have all had at least one negative quarter of growth of late. Given our view that any recession would be modest (the U.S. consumer is in decent shape; thus any downturn would likely be more akin to 2001 than 2008), we think many key macro variables are already near the low end of the ranges that we've been envisioning in our 'mild recession' base case. As such, we think these variables stand a reasonable chance of stabilizing around current levels before eventually picking up when the global economy reaccelerates – something we are currently envisioning as a late-2020 event.

Our bottom line: Overall, we have slower than consensus expectations for growth in most parts of the world, and we expect less inflationary pressures. That said, we do still expect upward pressure on wages, which is why we are more conservative than the consensus on margin expectations in 2019. Importantly, though, as we describe in our regional forecasts, there are more pushes and pulls to consider than in the past. In particular, increased fiscal stimulus amidst tighter monetary policy represents a new chapter for investing – one that will be quite different than the 2011-2017 period. The positive is that, despite slowing growth and tighter financial conditions, we believe we have a sound investment playbook for navigating the current market environment. In addition, we think our local presence across our 24 offices can help deliver not only more regionally focused insights but also a globally coordinated view that we believe will help folks better understand the complexities that they will face in the 'new' investment environment that we are envisioning.

EXHIBIT 28

China Accounted for Over 36% of Global GDP Growth in 2016, but Its Contribution Has Fallen Nearly Four Percentage Points of Late



Data as at October 9, 2018. Source: IMFWEO, Haver Analytics.

> **"Our bottom line: Overall, we have slower than consensus expectations for growth in most parts of the world, and we expect less inflationary pressures. That said, we do still expect upward pressure on wages, which is why we are more conservative than the consensus on margin expectations in 2019."**

EXHIBIT 29

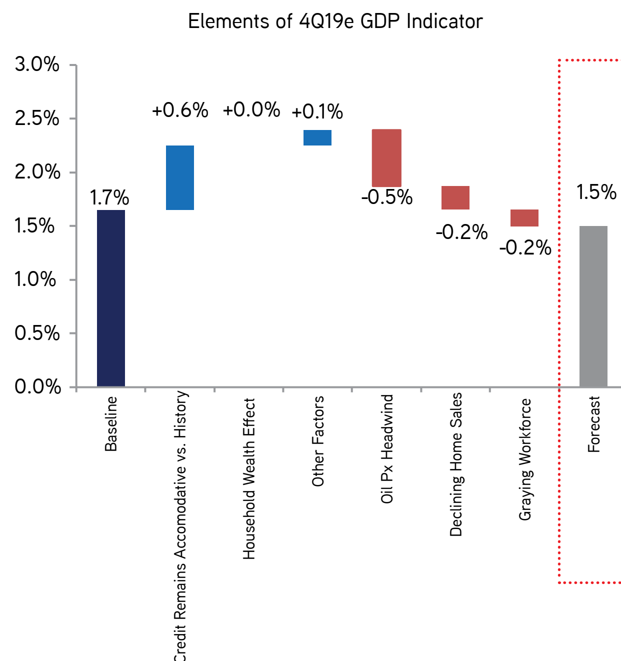
We Are Generally More Cautious on Global Growth and Inflation in 2019

2019 GROWTH & INFLATION BASE CASE ESTIMATES				
	GMAA Target Real GDP Growth	Bloomberg Consensus Real GDP Growth	KKR GMAA Target Inflation	Bloomberg Consensus Inflation
U.S.	2.25%	2.6%	2.0%	2.3%
Euro Area	1.5%	1.6%	1.5%	1.7%
China	6.2%	6.2%	2.3%	2.4%
Mexico	1.9%	2.0%	4.0%	4.1%

GDP = Gross Domestic Product. Bloomberg consensus estimates as at December 31, 2018. Source: KKR Global Macro & Asset Allocation analysis.

EXHIBIT 30

We Expect Full-Year 2019 U.S. GDP of 2.25%, Characterized by a Fading of Momentum Throughout the Year



Our GDP leading indicator is a combination of eight macro inputs that in combination we think have significant explanatory power regarding the U.S. growth outlook. Data as at December 31, 2018. Source: Federal Reserve, Bureau of Labor Statistics, National Association of Realtors, ISM, Conference Board, Bloomberg, KKR Global Macro & Asset Allocation analysis.

U.S. Economic Outlook

My colleague Dave McNellis expects full-year 2019 U.S. GDP of 2.25%, which we think is likely to be characterized by a fading of momentum throughout the year (e.g., approximately 3.2% Y/y in 4Q18 drifting down to 1.5% Y/y by 4Q19). Interestingly, the recent collapse in the U.S. ISM during December to 54.1 from 59.3 in the prior month is actually quite analogous to what happened in the United States during the initial commodity bear market in late 2015/ early 2016. During that period, ISM New Orders fell swiftly from the low-60s to near 50, and subsequently U.S. real GDP slowed from the mid-3% range on a year-over-year basis to the mid-one percent range a year later.

Importantly, though, developments in financial conditions, which are often the most difficult to accurately model, will govern whether overall growth troughs around that mid-one percent range, or continues falling towards even slower growth in 2020. To fall more sharply in 2020, we would have to see a worse than expected deterioration in the U.S. consumer. Our base slowdown has been for something more akin to 2001, a technical recession in which consumer spending stayed positive.

On the other hand, to call an "all clear" on growth risks from current levels, we want to see some combination of 1) a ratcheting down of trade tensions (versus the current trajectory of escalation); 2) a move by the Fed to pause or even ease policy; and/or 3) a sharp reversal in manufacturing momentum. We think these steps are necessary because right now almost all the key indicators that guide our GDP views are becoming more concerning (*Exhibit 31*). That said, our models *do* suggest lower oil prices will eventually become a net tailwind, but not until early-2020.

"

Interestingly, the recent collapse in the U.S. ISM during December to 54.1 from 59.3 in the prior month is actually quite analogous to what happened in the United States during the initial commodity bear market in late 2015/early 2016. During that period, ISM New Orders fell swiftly from the low-60s to near 50, and subsequently U.S. real GDP slowed from the mid-three percent range on a year-over-year basis to the low-one percent range a year later.

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EXHIBIT 31

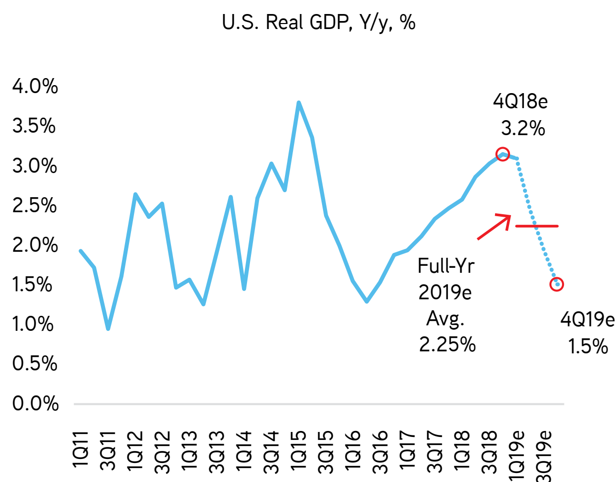
Every Element of Our U.S. GDP Indicator Has Softened or Stayed the Same for 2019 Relative to 2018

COMPONENTS OF KKR GMAA U.S. GDP LEADING INDICATOR			
	2018	DEC-2019E	CHANGE DEC-2019 VS. 2018
Intercept	1.7%	1.7%	0.0%
Misc. Factors	-0.1%	-0.1%	0.0%
Int'l Short Rates	0.1%	0.0%	-0.05%
Credit Conditions	1.2%	0.6%	-0.6%
Household Wealth	0.3%	0.0%	-0.3%
Oil Px Dynamics	-0.3%	-0.5%	-0.3%
Existing Home Sales	0.0%	-0.2%	-0.2%
Total	**2.9%**	**1.5%**	**-1.4%**

Our GDP leading indicator is a combination of eight macro inputs that in combination we think have significant explanatory power regarding the U.S. growth outlook. Data as at December 31, 2018. Source: Federal Reserve, Bureau of Labor Statistics, National Association of Realtors, ISM, Conference Board, Bloomberg, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 32

2019 Is a Story of Fading U.S. GDP Momentum in the United States



Data as at December 31, 2018. Source: Bureau of Economic Analysis.

EXHIBIT 33

Our U.S. Forecasts Assume a Continued Cyclical Slowdown in Housing and Autos

KKR GMAA BASE CASE		
	U.S. HOUSING STARTS, '000S	U.S. AUTO SALES, MILLIONS
2015	1,107	17.4
2016	1,177	17.5
2017	1,208	17.2
2018e	1,250	17.2
2019e	1,200	17.0
2020e	1,100	14.0
2021e	1,250	15.5

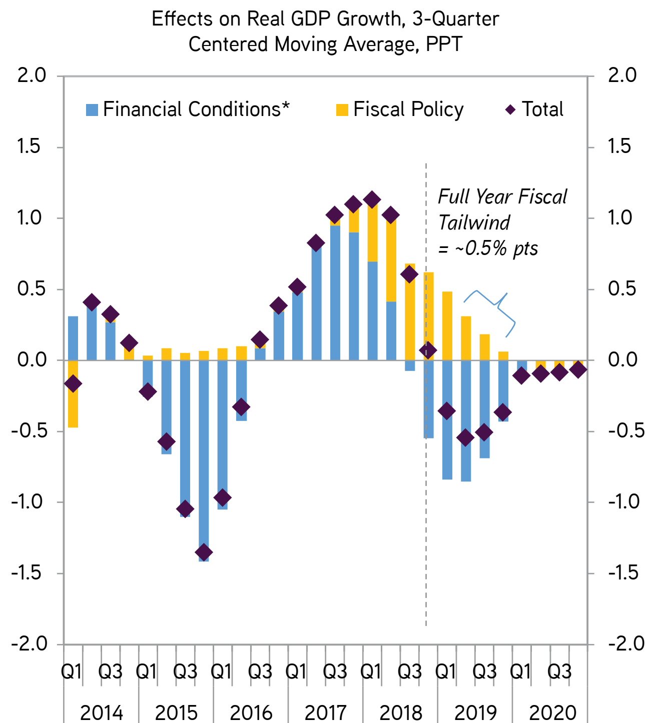
Data as at December 31, 2018. Source: KKR Global Macro & Asset Allocation analysis.

So, what will we be watching during the year? We view the tailwind from fiscal easing and the headwind from tariffs as essentially offsetting each other in 2019. By 2020, fiscal tailwinds disappear so tariffs will then become a net drag if they remain in place as we head into the end of this year. One can see this in *Exhibit 32*. Meanwhile, broad-based auto tariffs are a point of particular sensitivity that we are watching closely. One can see this in *Exhibit 35*.

"However, while we are tilting more positive in our asset allocation in 2019, we must also acknowledge that the game has changed. Specifically, we now believe we are entering a sustained period when the performance of capital markets will – at best – be on par with the performance of the global economy in nominal terms."

EXHIBIT 34

We See Fiscal Easing as a 50 Basis Point Tailwind to U.S. GDP in 2019...



Data as at December 5, 2018. Source: Goldman Sachs Investment Research.

EXHIBIT 35

...But It Is Substantially Offset by Potential Tariff-Related Headwinds of 40 Basis Points

	DIRECT POTENTIAL GDP EFFECT	% OF TOTAL IMPACTING 2019E	2019E POTENTIAL IMPACT	COMMENT
$200 billion China tariffs @25%	-0.4%	50%	-0.2%	Assumes partial impact already felt in 2018
25% Auto and Auto Part tariffs	-0.5%	33%	-0.2%	Tariffs in effect only part of year and potentially offset by advance buying
TOTAL			-0.4%	

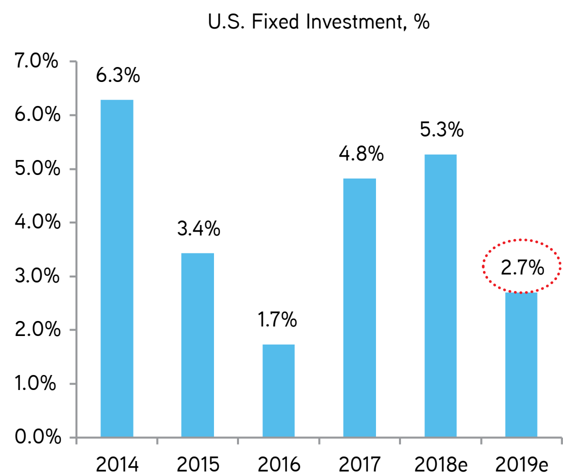
Data as at November 15, 2018. Source: KKR Global Macro & Asset Allocation analysis.

On a bottom-up basis, the growth slowdown we envision is the product of cooling fixed investment growth (*Exhibit 36*), normalizing inventories (following pre-tariff stock-builds), and increasing drag from net exports. Digging into the details, the key factors we see weighing on fixed investment in 2019 include slowing housing starts and auto sales, declining upstream energy investment, and potentially some deferrals of business capex due to tariff-related uncertainty.

However, there are some offsets to consider. For example, we expect consumption growth to remain strong, and government spending growth to ramp up to 2.5% this year from 1.9% in 2018. Falling gasoline prices provide the most clear-cut support to U.S. consumers. Without question, we believe that personal consumption expenditures (PCE) will be one of the key positive economic highlights of 2019 – almost similar to what transpired in the 2015-2016 crude oil downturn (*Exhibit 37*). Other factors supporting the consumer outlook include the low unemployment rate (which we expect to hover around just 3.7% this year) and the personal saving rate of six percent, which permits scope for further spending growth without running savings down to concerning levels.

EXHIBIT 36

On a Bottom-Up Basis, the Most Notable Slowing We Expect to See in 2019 Is in Fixed Investment Activity...

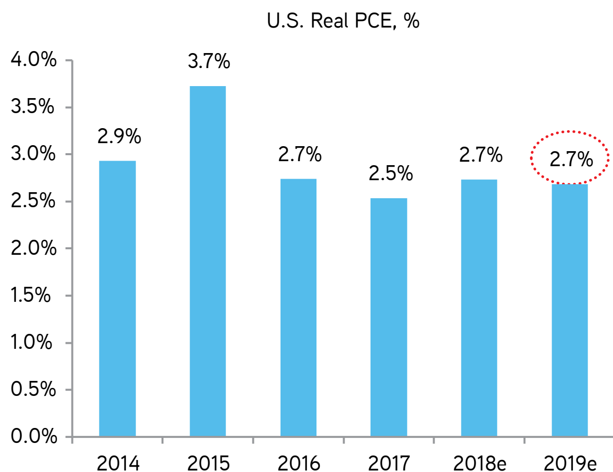


Data as at December 21, 2018. Source: Bureau of Economic Analysis, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

> **"Without question, we believe that personal consumption expenditures will be one of the key positive economic highlights of 2019."**

EXHIBIT 37

...We Think Consumption Growth, However, Will Likely Remain Strong



Data as at December 21, 2018. Source: Bureau of Economic Analysis, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

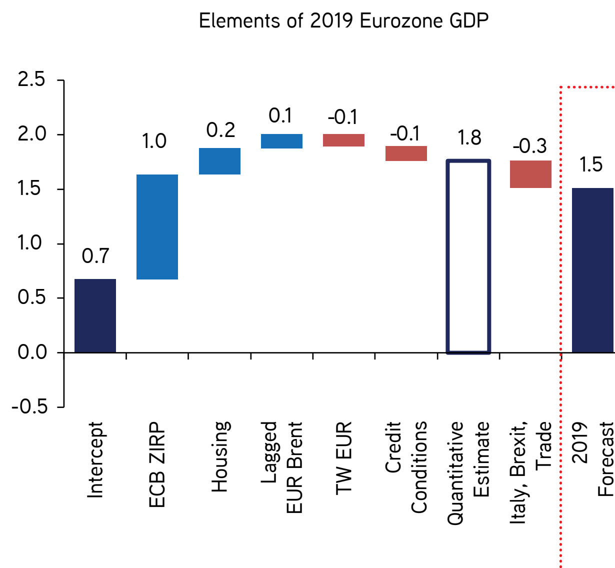
Our bottom line is that the United States outlook for 2019 is "soggy." Specifically, we expect slowing, but not negative, growth caused by factors that include the lagged effects of higher oil prices, the housing market slowdown, the move to higher credit spreads, the peaking in business and consumer confidence, and the further imposition of tariffs. We certainly appreciate that our call is currently for something of an "unstable equilibrium" in which economic conditions become more challenging but do not break sharply lower. Maybe even more importantly, we appreciate that our views will likely evolve quite dynamically throughout the year—a backdrop that is ripe for market volatility.

European Economic Outlook

Turning to the Eurozone, my colleague Aidan Corcoran believes economic activity is set to slow substantially from about 1.9% in 2018 to closer to 1.5% in 2019. The key drivers for the deceleration are 1) geopolitical uncertainty from many pockets within Europe including Italy, Spain, Germany, the U.K., and France; 2) auto tariffs; and 3) more restrictive policies around global technology supply chains. While these drivers are prominent topics in the news today, we actually view them as secular headwinds with deep political and social causes that will play out over many years. Fortunately, despite ending its formal purchase program in December 2018, the ECB policy is not only still highly accommodative but also will likely remain so. In fact, as we show below in *Exhibit 38*, we think Eurozone growth would be almost 100 basis points lower in 2019 if it were not for support from ECB policy.

EXHIBIT 38

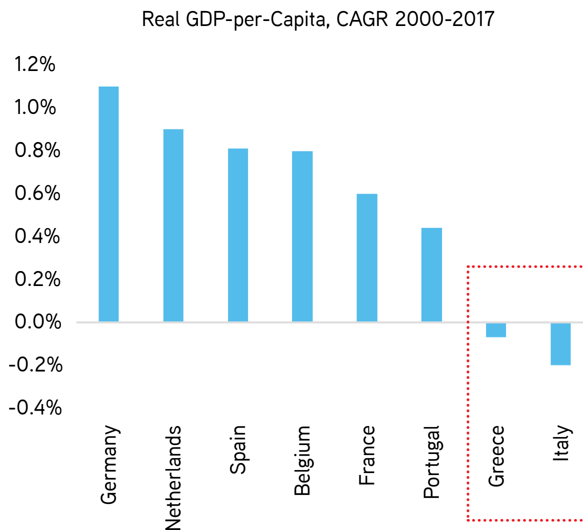
Despite Slowing Asset Purchases, Our Eurozone GDP Model Points to a Continued Large Impact of ECB Policy



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

EXHIBIT 39

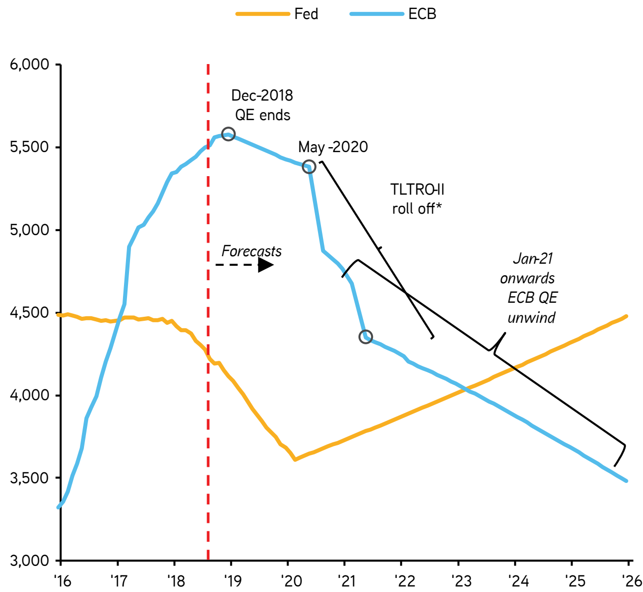
Italy's Real GDP-per-Capita Growth Has Been Lower Than That of Greece During the 2000-2017 Period



Data as at December 31, 2018. Source: Eurostat, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 40

The ECB's Earlier Decision to "Do Whatever It Takes" With Its Balance Sheet Is Now Approaching Maturity



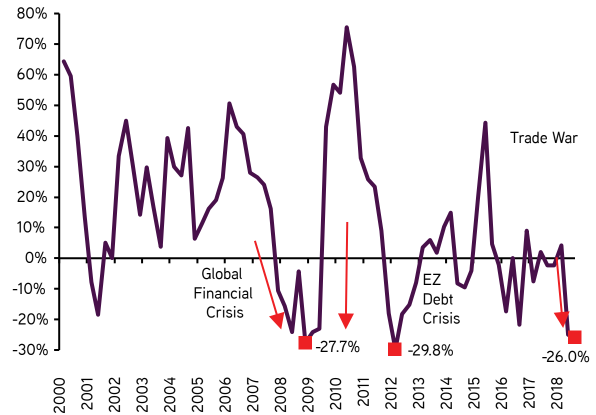
The ECB is likely to offer a further LTRO program to ease the funding cliff caused by scheduled run off of TLTRO-II we show in the chart. Data as at December 31, 2018. Source: Bloomberg, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

No doubt, one hundred basis points of annualized central bank stimulus certainly sounds like a big number, so we wanted to drill down on why we are comfortable with this estimate. For starters, one of the most striking implications of ECB policy action and its divergence from the Fed is the spread between the U.S. and German 10-year Treasury rates, which is now around 250 basis points. As a result, this wide gap helps keep Eurozone financial conditions supportive. It also means European corporates face low borrowing costs, particularly relative to their U.S. peers.

> **"Finally, when we think about the macro in Europe, investors need to appreciate that regardless of what happens next in the trade war, the threat of further tariffs already constitutes a meaningful drag on the economy."**

EXHIBIT 41

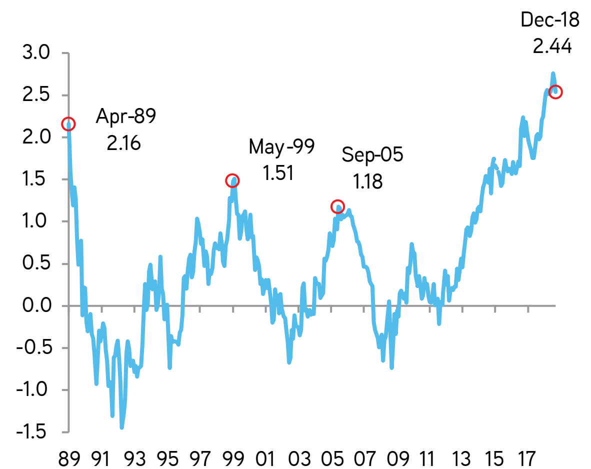
German Management Teams Are Highly Focused on Trade Risks



*% Bal is percentile balance of those who assessed positive vs those who assessed negative. E.g., For Q32018, where value stands at -26, 26% more of all surveyed parties expected a decrement in trade volume over the next six months than those who expected an increase. Data as at November 30, 2018. Source: Ifo-Institut für Wirtschaftsforschung, Haver Analytics.

EXHIBIT 42

The Divergence Between U.S. and German Yields Is Currently Providing Europe With a Significant Funding Advantage

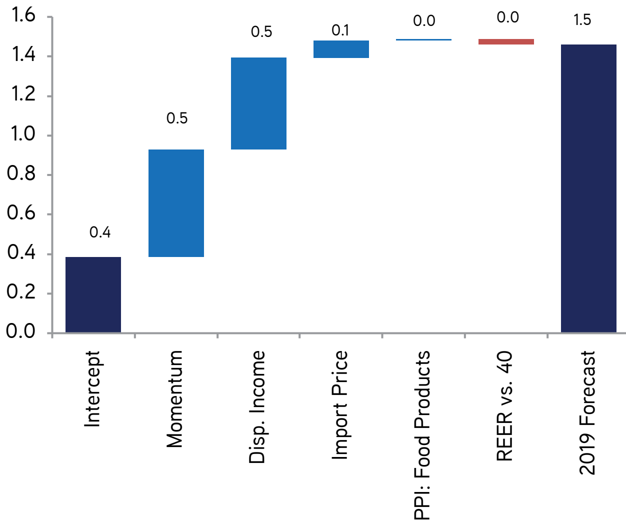


Data as at December 31, 2018. Source: Bloomberg.

Meanwhile, weak inflation in Europe continues to give the ECB space to provide the monetary support the economy has needed in recent years. However, the inflation story is not a simple one, as wage inflation in the Eurozone is actually running at above four percent per year – a healthy rate, all else being equal. However, *all else is not equal, as core inflation remains stuck closer to one percent*. This notable divergence certainly complicates ECB policy normalization, but it ultimately gives the central bank in Europe some leeway to be more dovish in policy than it would otherwise.

EXHIBIT 43

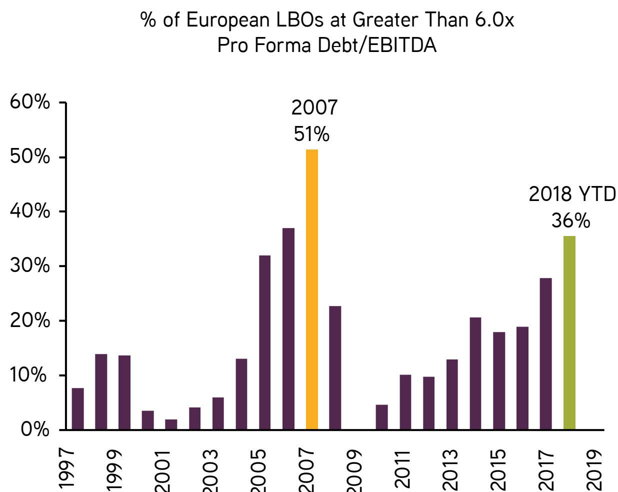
Our Forecast for Headline Inflation in Europe Remains Muted for 2019



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

EXHIBIT 44

LBOs With More than 6.0x Leverage Reached 36% of Deals in 2018, the Highest Since 2007

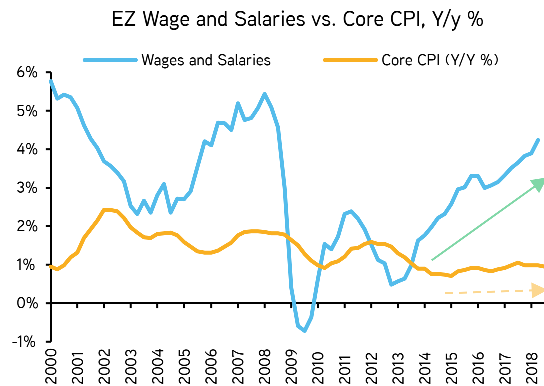


Source: LCD Stats, Bloomberg, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Importantly, Europe's demographics problem is making the tension between inflation and wage growth more noticeable of late. Indeed, despite very little pricing power, corporate management teams are citing tight labor markets as a major limiting factor on business growth and profits. Given these trends, it is crucial that Europe continues to reform its labor market to achieve greater flexibility. Unfortunately, history shows that a transition of this sort is difficult, particularly amidst challenging local and regional politics. In Italy, for example, the current populist government is actually actively seeking to undo labor market reforms enacted by the previous government. Meanwhile, in the United Kingdom, Brexit is contributing to labor market tightness through reduced labor inflows, with the number of EU workers in the UK falling at a rate of about five percent year-over-year as of third quarter 2018 versus a three-fold increase in the EU immigrant population since 2000.

EXHIBIT 45

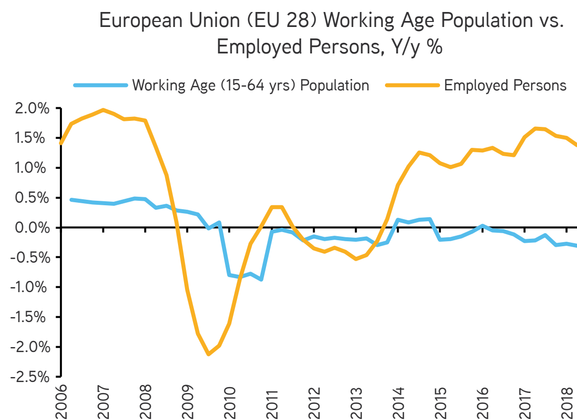
Eurozone Wage Inflation Has Finally Recovered, but Core Inflation Still Lags. This Combination Means Corporate Margins Are Likely at Risk



Data as at November 30, 2018. Source: ECB, Eurostat, Haver Analytics.

EXHIBIT 46

Negative Demographics Are Contributing to EU Labor Market Tightness



Data as at November 30, 2018. Source: ECB, European Commission, Haver Analytics.

We also believe that the above cited labor market tightness is something an investor might miss if he or she just watched the unemployment rate. True, the Eurozone unemployment rate has fallen a long way from a peak of 11% in 2013 to under eight percent today. However, this eight percent figure is not indicative of the true tightness of the labor market, as it is actually now in-line with where most folks put the long run stable rate or NAWRU (the Non-Accelerating Wage Rate of Unemployment). Without question, our view after our recent trip across Europe is to focus on what companies are saying rather than the headline macro statistics, as the Eurozone labor market is tighter than it appears. Slowing immigration and lack of skilled labor – among other factors – were reasons given during our meetings with CEOs and CFOs.

Finally, when we think about the macro in Europe, investors need to appreciate that regardless of what happens next in the trade war, the threat of further tariffs already constitutes a meaningful drag on the economy. One way to quantify this is to look at what German corporates are saying. Last year, sentiment on foreign trade among German management teams fell to levels seen only twice before: during the GFC and during the Eurozone debt crisis. One can see this in *Exhibit 41*. No doubt, this is a key theme to watch as we move through 2019, and it will certainly affect how the ECB thinks about its policies.

So, our bottom line for Europe is one of decelerating growth amidst heightened political uncertainty. If there is good news for the economy, it is that the ECB is further behind the Federal Reserve in its tightening campaign. As such, our models continue to point towards favorable monetary policy as a notable tailwind. On the other hand, poor demographics and the shift towards more fiscal spending are leading to wage increases that we think could dent corporate profitability in 2019 more than the consensus may now be expecting.

China Economic Outlook

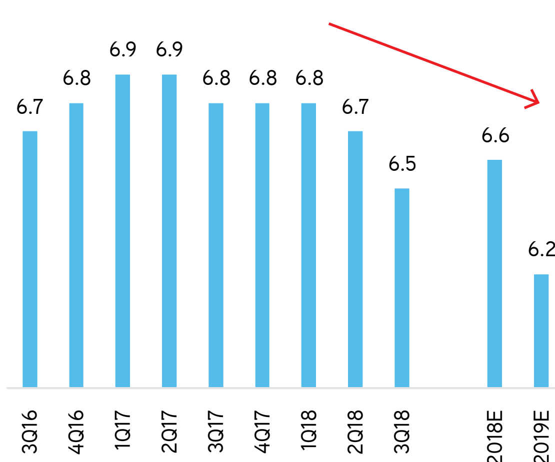
For 2019, my colleague Frances Lim forecasts real GDP growth of 6.2% and a CPI of 2.3%, respectively. These estimates compare to an estimated GDP growth rate of 6.6% and an inflation rate of 2.2% in 2018. Overall, as the Apple pre-announcement accurately foreshadowed, the growth slowdown that we are predicting should feel material, as we see growth decelerating to six percent by second quarter of 2019 versus 6.8% growth in the first quarter of 2018.

Similar to her peers in the KKR Global Macro & Asset Allocation group, Frances is assuming that President Trump increases tariffs on the $200 billion to 25% from 10% in March 2019. Thus, the cumulative direct trade related impact for calendar year 2019, including tariffs that went into effect in 2018, is an estimated 30 basis points off growth.

However, there will be important offsets, including both monetary and fiscal stimulus as the balance of priorities tilts back towards stability from deleveraging and reform. Key to our thinking is that President Xi Jinping will strive to keep growth at an average of 6.1-6.2% over the next two years in order to achieve the Communist party's stated goal of doubling GDP by 2020. How is the government going to do this? We think by doing a bit of everything. Recall that in 2018 a value-added tax cut, a personal income tax cut, and a special personal income deduction were all announced. According to Frances, these initiatives will likely add an additional 50 basis points to GDP growth in 2019, which should soften the impact from tariffs as well as the government's deleveraging program. Further, there has been some marginal loosening of credit restrictions. So, we expect stronger public spending on infrastructure, increased local government bond issuance, increased local government financing vehicles (LGFV) funding, and marginally less scrutiny of Public-Private Partnerships to all help. We also expect the government to boost infrastructure capex back towards a low double digit growth rate from below zero at present and 20% in early 2017. Importantly, we believe that the Chinese government's goal is to ensure stability – not soaring house prices, spikes in investment, or surging capital markets. We think that stimulus will be measured and paced, unlike the 2009/2010 experience.

EXHIBIT 47

China's Real GDP Growth Will Continue to Moderate



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

"

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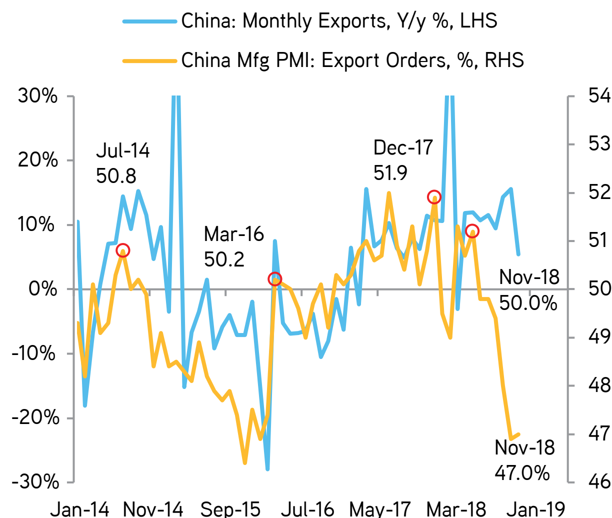
EXHIBIT 48

Tariffs and the Rethinking of Supply Chains Are Dampening China Export Growth



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

Meanwhile, reserve requirement ratio cuts (RRR), VAT and corporate tax cuts (particularly for SMEs) and lower social security contributions will aid the corporate sector and business sentiment. While we expect the benchmark lending rate to remain stable, we expect additional RRR cuts in 2019 as well as overall lower absolute market interest rates. Finally, lower personal income taxes and higher VAT rebates should help soften the blow from job losses in the export sector.

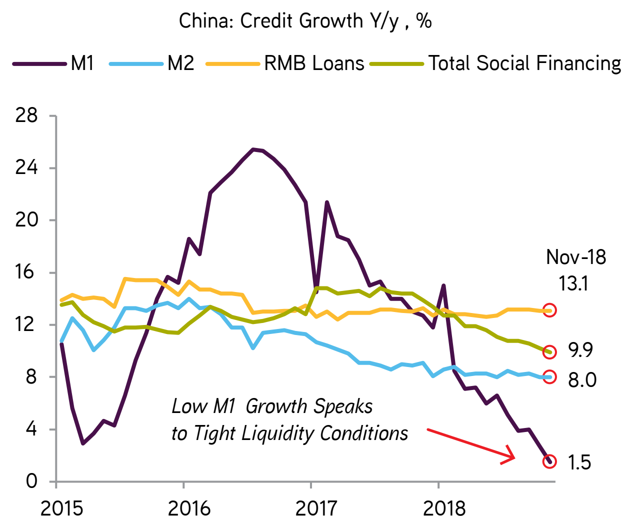
On the inflation front, Frances expects slower growth to weigh on core inflation. However, the weaker renminbi, coupled with elevated commodity prices, hog prices in particular due to the swine flu, and supply side shortages, are likely to keep headline inflation above core inflation. As a result, we expect an average China headline CPI of 2.3% in 2019, slightly above this year's average of 2.2%.

Where could we be wrong? Our main concern centers around the trade war escalating further than our base case suggests, resulting in a second order impact on sentiment that is worse than expected. This scenario could lead to a domino effect whereby property investment and construction spending weaken sharply. Meanwhile, job losses in export related sectors would likely dent both consumer sentiment and wages, causing consumer spending to slow sharply. Further, the sharp weakness in exports could lead to the resumption of large capital outflows. The end-result could be uncontrolled deleveraging, that would have global repercussions.

On the flip side, if trade tensions deescalate and Trump takes further tariffs off the table to limit the impact on the U.S. consumer, the fiscal and monetary easing enacted in 2018 likely would limit headwinds from deleveraging and weaker sentiment. Credit growth (i.e., total social financing growth) could reaccelerate towards the low teens range, home prices could rise across the board, commodity prices could rebound, the currency could strengthen, and debt-to GDP could begin rising again. Thus, while there may be stronger growth, tail risks may also increase again.

EXHIBIT 49

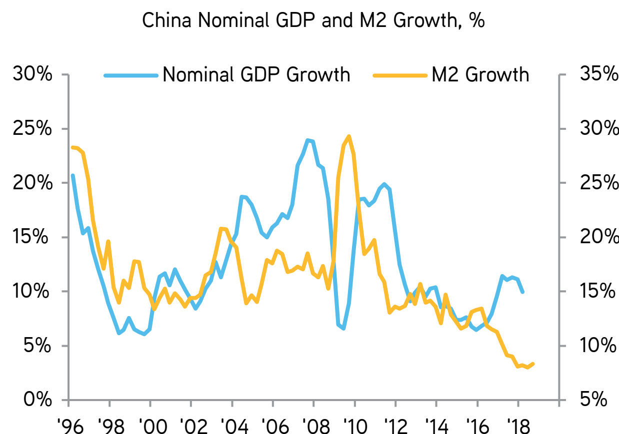
The Recent Reserve Ratio Cut in China Is Intended to Ease the Tightening of Financial Conditions



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

EXHIBIT 50

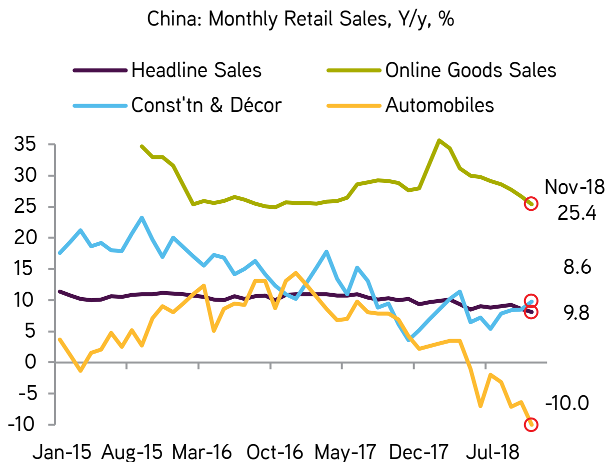
Tightening Liquidity Is Placing Downward Pressure on Nominal GDP



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

EXHIBIT 51

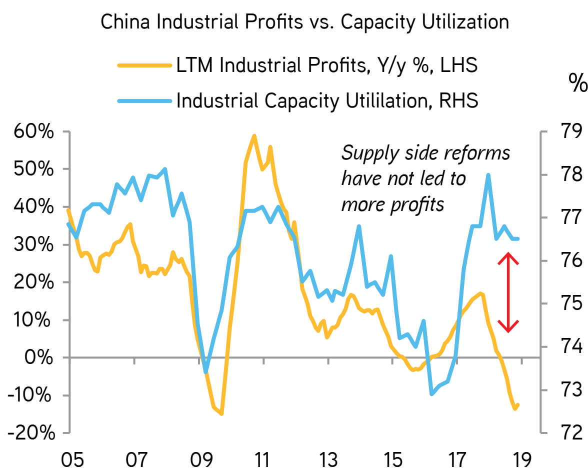
Weakening Retail Sales Reflect a More Cautious Chinese Consumer



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

EXHIBIT 52

In China We Now See Falling Profits, Despite High Capacity Utilization



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

In sum, we think China faces another challenging year. There are both structural (e.g., over-levered state-owned enterprises) and cyclical forces (e.g., questioning of supply chains) at work that are creating a sustained downshift in Chinese economic growth. However, as we indicated above, we do expect ongoing government stimulus measures on both the fiscal and monetary side to try to prevent a destabilizing growth slowdown from occurring. Also, *nominal* GDP is already running well below prior levels, so corporate profitability does not face the same type of major headwind it did during the 2011-2015 "crash" in nominal GDP (when it fell nearly 70%). In the end, though, we see both slower growth and weaker inflation as the key outcomes for 2019, particularly relative to the first half of 2018. Given that China is still more than one third of global growth, we believe that this perspective is quite relevant, as investors think about macro trades and asset allocation in 2019. Hence, we are using conservative growth estimates not only in China but also in the United States, Mexico, and Europe in 2019.

Mexico Economic Outlook

My colleague Brian Leung expects real GDP growth of 1.9% in 2019 (just below consensus expectations of 2.0%). We expect headline inflation to average four percent in 2019 (also just below consensus expectations of 4.1%). We expect MXN-spot to depreciate by approximately three percent per annum in 2019 to 2023 (less than the negative six percent implied by forwards but more bearish than consensus expectations of one percent appreciation).

The risks to growth are skewed to the downside, in our view. President Andrés Manuel López Obrador's (AMLO) policy uncertainty is here to stay, with the recent cancellation of the Texcoco airport coinciding with fresh declines in business confidence and a softening of manufacturing PMIs.

"

In sum, we think China faces another challenging year. There are both structural (e.g., over-levered state-owned enterprises) and cyclical forces (e.g., questioning of supply chains) at work that are creating a sustained downshift in Chinese economic growth. However, as we indicated above, we do expect ongoing government stimulus measures on both the fiscal and monetary side to try to prevent a significant growth slowdown from occurring.

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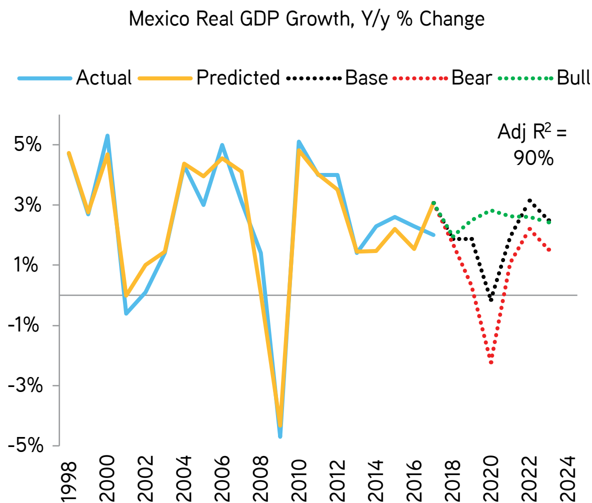
EXHIBIT 53

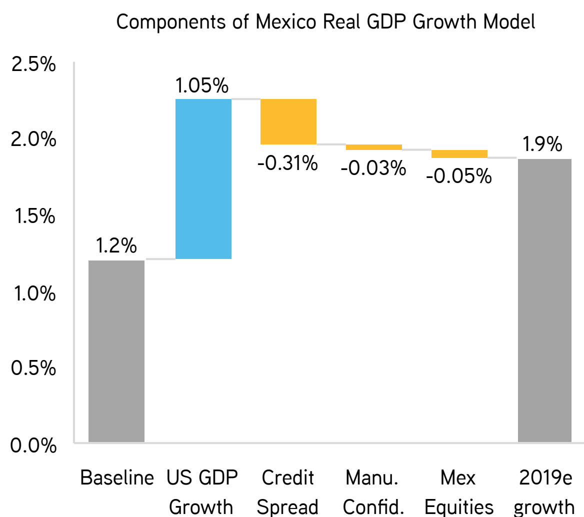
We Expect Mexico Real GDP to Grow 1.9% in 2019, Compared to a Consensus of Two Percent



Data as at December 31, 2018. Source: Bloomberg, Haver Analytics, Banxico, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 54

In Mexico, the Positive Impact of Solid, Albeit Decelerating U.S. GDP Growth, Is Adversely Affected by Widening Credit Spreads



Data as at December 31, 2018. Source: Bloomberg, Haver Analytics, Banxico, KKR Global Macro & Asset Allocation analysis.

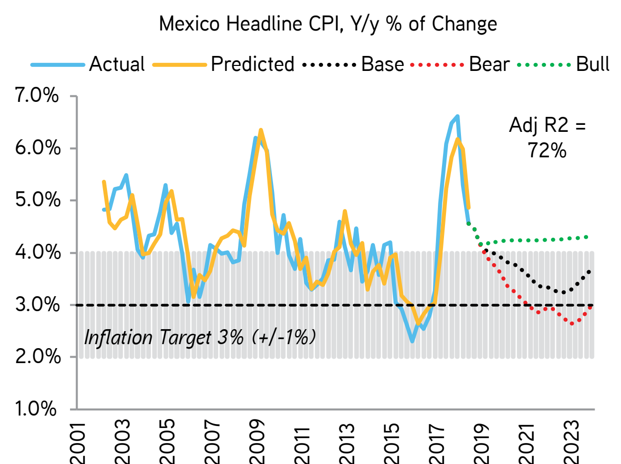
Meanwhile, stubborn inflation and a volatile peso could keep monetary policy a little more restrictive than our base case, putting a cap on growth. AMLO's 2019 budget, which targets a one percent primary surplus, is also overly ambitious, and as such, it is likely to result in some fiscal slippage, we believe. While a ratings downgrade is not in our base case, we expect investors to demand a higher risk premium going forward to compensate for the risk of deteriorating public finances over the medium term.

On the flipside, we expect solid, albeit decelerating U.S. GDP growth to support the Mexican economy via remittances, tourism and exports in 2019. It is also our expectation that the United States–Mexico–Canada Agreement ('USMCA') will ultimately be ratified, even if it takes longer than expected in the U.S., which is critical in removing a tail risk to Mexico in 2019 vs 2018. Domestic demand should also get a boost from higher-than expected public expenditure, as AMLO's 2019 budget introduces new programs such as a universal pension for senior citizens and large, but commercially questionable, infrastructure projects. Finally, the recent decline in oil prices is effectively a tax cut that should translate into higher real disposable income. Said differently, we believe consumption growth could surprise to the upside in 2019 because people with a higher propensity to consume have stronger balance sheets and better access to resources.

Our bottom line is that Mexico will continue to face structural productivity growth issues relative to other EM countries. As a result, we believe Mexico's GDP growth will remain moderate in the 1.75%-2.25% range in 2019e, as opposed to its potential growth rate of 2.6% (or the plus three percent 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 problems – all issues that have plagued it for some time. And given that AMLO policy uncertainty is likely on the rise, investors need to demand a higher risk premium to remain in Mexico. As such, we should stick to our playbook in Mexico and pursue investment themes that have both strong economic and political logic, e.g., delivering renewable power, utilizing low-cost U.S. natural gas, and supporting tourism.

EXHIBIT 55

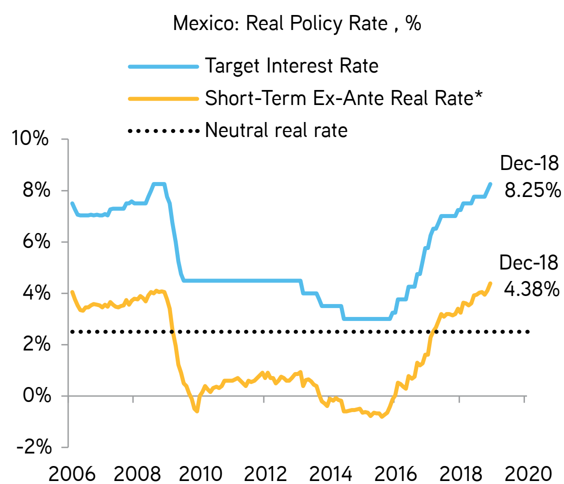
We Expect Inflation to Average Approximately Four Percent in 2019, With Upside Risk From AMLO's Fiscal Policies and Pass-Through from Recent Peso Depreciation



Data as at December 31, 2018. Source: Bloomberg, Haver Analytics, Banco de Mexico, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 56

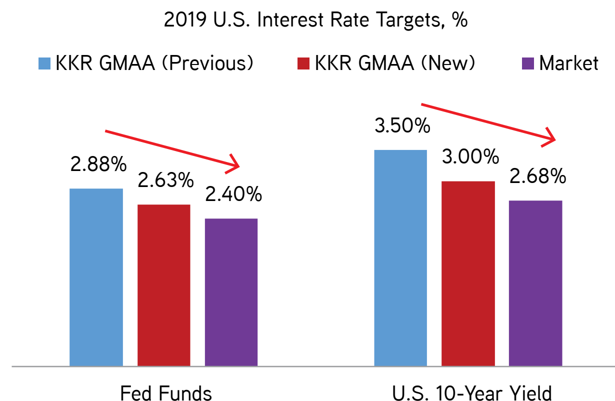
Policy Rate in Mexico Is Now at 8.25%. As Such, the Real Ex-Ante Interest Rate Remains Very Restrictive at Around 4.40%



Note: * policy rate less inflation expectations. Data as at December 31, 2018. Source: Bloomberg, Haver Analytics, Banco de Mexico, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 57

We Are Lowering Our 2019 10-Year Yield Target to 3.0% from 3.5%. Our Fed Outlook, Which Has Been More Dovish than the FOMC's 'Dots Plot,' Comes Down a More Modest 25 Basis Points



Data as at December 19, 2018. Bloomberg, KKR Global Macro & Asset Allocation analysis.

Section III: Key Inputs

In the following section, we detail key inputs from the team related to interest rates, inflation, oil, stocks versus bonds, and cycle duration.

Interest Rates/Inflation

As we laid out several times in our *Insights* notes during 2018 (e.g., *see 2018 Outlook* and *Mid-Year 2018*), we have been maniacally focused on extending our liabilities across all our corporate investments because we thought the consensus for interest rates was too benign. Today, however, we no longer feel this way because the market has essentially caught up to our Fed Funds expectations on the short end of the curve. One can see this in *Exhibit 57*, which looks quite different from the picture we laid out in January 2018.

Interestingly, though, on the long end of the curve (and the risk of being too theoretical), we do look for greater normalization of the term premium embedded in 10-year yields than the consensus viewpoint of zero (*Exhibit 58*). Specifically, despite growing concern about an economic slowdown, we continue to think investors should demand some term premium 'cushion' for two reasons: 1) the notable increase in the U.S. deficit (nearly $400 billion); and 2) the $360 billion of annual run-off from the Federal Reserve. We fully acknowledge that the balance sheet might not actually be *"on autopilot"* but we do think that the Federal Reserve Bank wants to normalize its balance sheet over the next few years. As such, we estimate that fair value for the 10-year yields in 2019 should be closer to 3.00%, down from our prior forecast of 3.25%, but above the market's current view of 2.68%.

"

Bigger picture, given our view on margins, trade, and tightening financial conditions, we believe pricing power is likely to become the theme du jour across the global capital markets in 2019. As such, we prefer companies with a demonstrated track record of high and stable gross margins, low labor costs and strong balance sheets; they should also be better equipped to withstand higher financing costs as well as increased input cost pressure towards their end-users.

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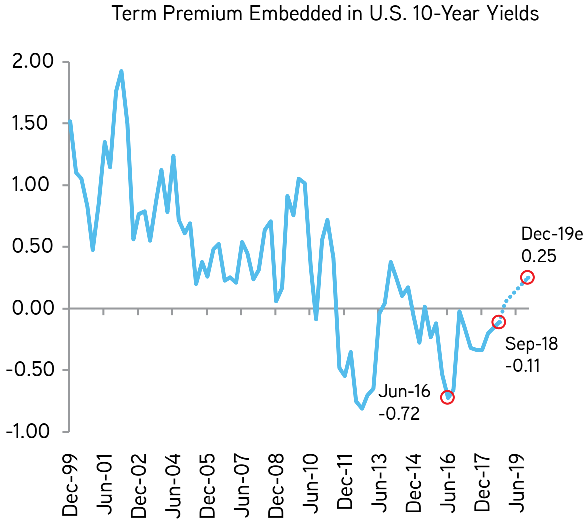
EXHIBIT 58

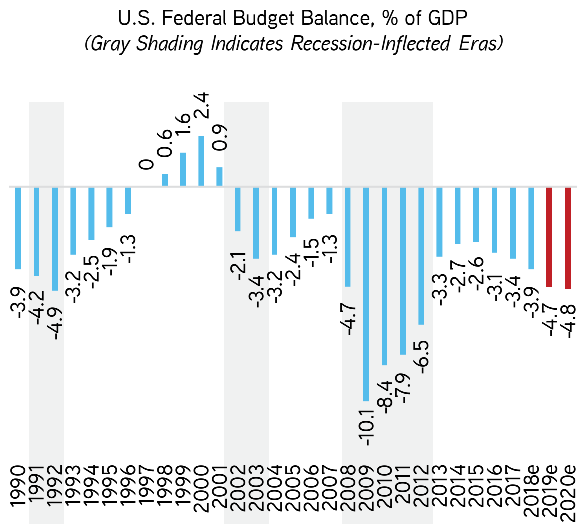
Over Time, We Think 10-Year Yields Will Embed Further Normalization of the Term Premium



e = KKR GMAA estimates. Historical data based on Kim and Wright model published by U.S. Federal Reserve. Data as at November 15, 2018.

EXHIBIT 59

Because the U.S. Budget Deficit Is Headed to an Historically Extreme Level for a Non-Recessionary Period, We Think Some Term Premium Is Required

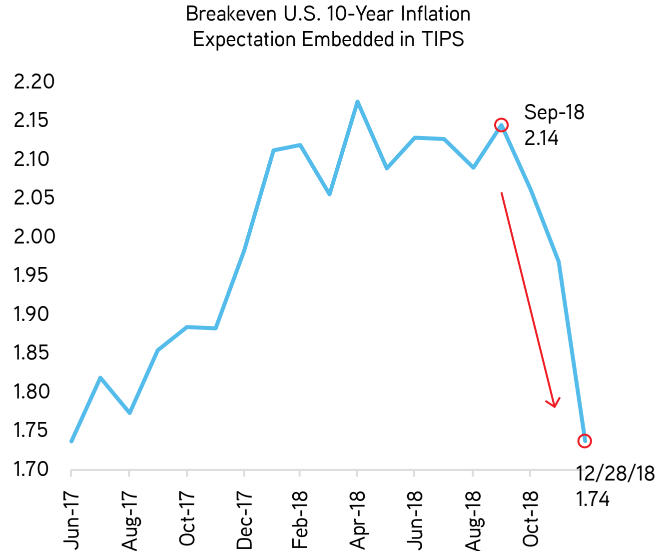


e = Bloomberg consensus estimates. Data as at December 21, 2018. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

In terms of inflation, we expect two percent CPI inflation in 2019, down from 2.4% in 2018. Importantly, we do not view this mild CPI forecast as being inconsistent with our outlook for a rising pace of wage growth. Instead, we view CPI as being held back by cyclical factors (i.e., falling gasoline prices) as well as structural factors (i.e., moderating rental and health care inflation.)

EXHIBIT 60

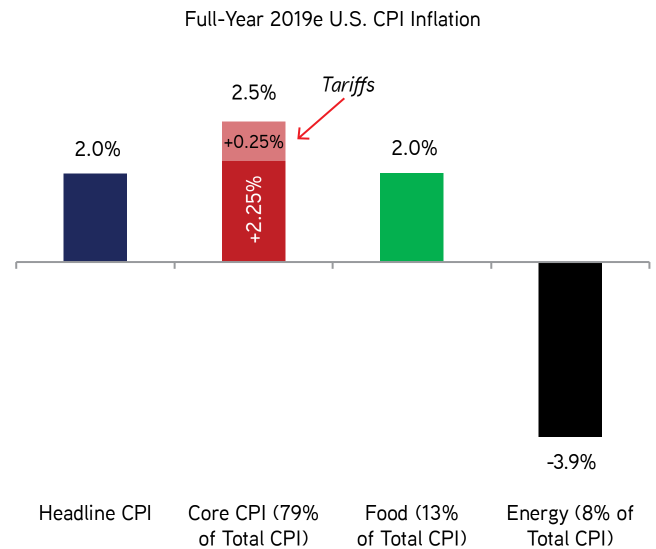
Softening Inflation Expectations Give the Fed Cover to Moderate Its Rate Hikes



Data as at December 28, 2018. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 61

In Terms of U.S. Inflation, We Believe That Oil Prices Will Keep Headline Low, but We Think Tariff Pass-Throughs Will Exert Upward Pressure on Core



e = KKR GMAA estimates. Data as at December 12, 2018. Source: Bureau of Labor Statistics, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Our view is that core inflation in the U.S. continues to chop around in the 2.0-2.5% range (i.e., slightly above the FOMC's two percent target, but not taking off out of control). Importantly, many of the key inflation items that started strengthening this year have started softening again – rents and health care in particular, which together make up approximately 50% of the overall core inflation basket.

What does all this mean for the Federal Reserve? We now think the FOMC does only one hike in 2019, which helps to bridge the gap between a decent consumer outlook and a notable slowdown in some of the cyclical factors that are now weighing on the economy. As such, we are now below the Federal Reserve's current projection for two hikes in 2019. Meanwhile, on the balance sheet front, we now assign greater than 50% probability that the Federal Reserve does slowdown its balance sheet runoff at some point in 2019. Key to our thinking, as we have shown in earlier exhibits, is that money supply growth is now running negative, which we view as too harsh at this point in the traditional tightening cycle.

Outlook for Stocks and Credit: Drilling Into the Details

As we describe below in detail, we favor Equities over Credit at this point, particularly given the significant contraction in equity trading multiples of late. However, to believe in Equities amidst a period of slowing global growth, we fully acknowledge that an investor will certainly have to have conviction in a variety of our macro and micro assumptions. To this end, we note the following key inputs to our forecasts:

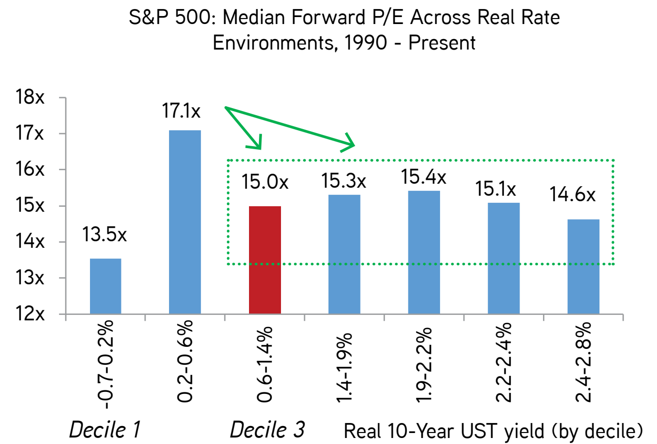
We have more modest EPS growth expectations than the consensus: based on both our top down and bottom's up work, we expect approximately 2.5% EPS growth in 2019. This forecast is well below consensus expectations of 6.5%, and it represents a notable slowdown from the approximately 23% the S&P 500 enjoyed in 2018. What drives our below consensus thinking is that, as we show in *Exhibit 66*, our earnings growth leading indicator (EGLI) is predicting a significant deceleration. Key headwinds, many not present as recently as 2016, include central bank stimulus withdrawal, wider credit spreads, a relatively stronger U.S. dollar against twin deficit economies (note: lagging variable), higher oil prices (note: we model out a lag), and peaking business and consumer confidence.

We have more conservative operating margins assumptions than the consensus: In terms of operating margins, we forecast modest compression to 11.2% in 2019e from 11.4% in 2018e, which is less optimistic than consensus expectations of 11.6%. The combination of peaking demand, rising input costs, tighter financial conditions, wage pressure and tariffs should all prevent margins from expanding for a third straight year.

That said, there are several important mitigants that should limit significant margin degradation in 2019. First, the impact from higher short-term interest rates should be manageable, given that nearly 70% of S&P 500 debt is long-term fixed rate, not floating-rate. Second, our work suggests that wage growth only becomes problematic once it equals or exceeds top-line growth. However, with average hourly earnings growth currently at 3.1% year-over-year, it is not at the four percent that traditionally has created major issues for margins. Finally (and maybe most importantly) continued productivity gains could offset some of the wage inflation, keeping unit labor costs relatively stable *(Exhibit 130)*.

EXHIBIT 62

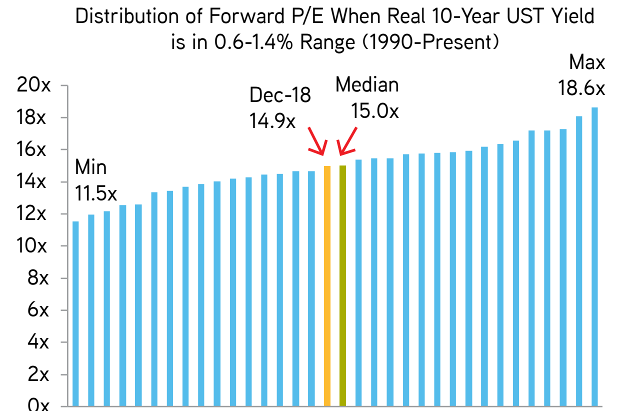
Real 10-Year Yields Have Moved Up to the 0.6%-1.4% Range (Decile 3), Which Is Associated With Lower P/E Ratios



Data as at December 28, 2018. Source: Bloomberg, Haver Analytics, S&P, IBES.

EXHIBIT 63

After the Recent Sell-Off, Today's Forward P/E of 14.9x Is Already 0.1 Turn Below the Median of 15.0x



Data as at December 31, 2018. Source: Bloomberg, Haver Analytics, S&P, IBES.

"

Our Price-to-Earnings ratio already reflects tightening financial conditions, we believe.

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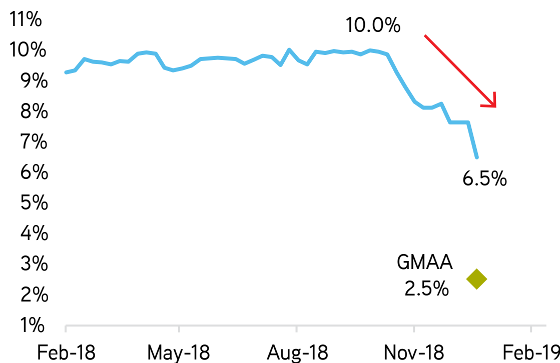
EXHIBIT 64

2019 Estimates Have Been Revised Lower to 6.5% from Approximately 10.0%; We Think They're Headed Lower Still Towards 2.5%



Data as at December 31, 2018. Source: Bloomberg, Haver Analytics, S&P, IBES.

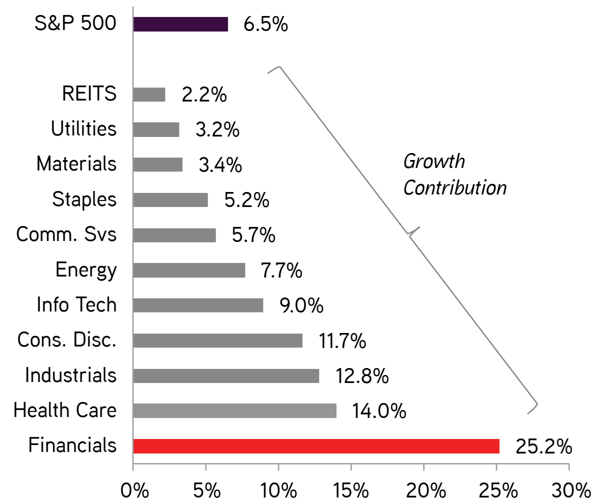
Our Price-to-Earnings ratio already reflects tightening financial conditions, we believe: In terms of a target price-to-earnings ratio, in 2019 we expect the S&P 500 to trade in the 15.5x-16.5x range. The silver lining is that the fourth quarter 2018 sell-off in risk assets has already de-rated forward multiples to 14.9x today from a high of 17.3x back in September 2018. Said differently, much of the pessimism may already be priced-in, we believe, though we do not believe that 2019 will be a straight path upward. We also believe that a more dovish Federal Reserve will help steady the multiple in 2019.

As one might guess after a 12-month period of 23% year-over-year earnings growth that produced a -4.4% total return, we have spent some extra time thinking through the right P/E ratio for stocks on a go-forward basis. Importantly, our research leads back to a similar conclusion: Tightening financial conditions, including higher real rates and slower growth, mean lower multiples than in recent years. One can see a visual summary of our thesis in *Exhibits 67* and *68*, respectively.

There are other reasons that a top-down approach to P/E ratios leads us to be more conservative on valuation metrics. First, as we show in *Exhibit 65*, more than 40% of total EPS growth in 2019 is expected to come from cyclical sectors such as Financials, Energy, and Industrials. Our work shows that this increased contribution from cyclical earnings growth relative to overall earnings growth supports a more conservative valuation in 2019. Second, our quantitative EPS model suggests not only slower growth but also more dependence on financial conditions than in past years – a reality to which the market generally ascribes a lower multiple.

EXHIBIT 65

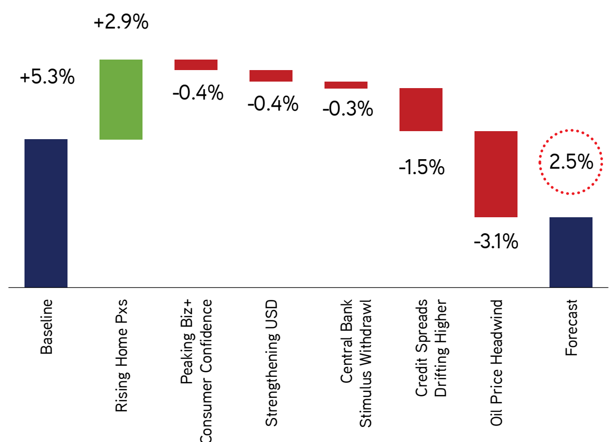
The Consensus Now Expects 6.5% EPS Growth in 2019, Down From 10.0% Previously. We Think That This Growth Rate Is Still Too Optimistic Across Many Sectors



Data as at December 31, 2018. Source: Bloomberg, Haver Analytics, S&P, IBES.

EXHIBIT 66

Our EGLI Suggests U.S. EPS Growth Is Likely to Decelerate Significantly in 2019 Towards 2.5%, Dragged Down by a Variety of Factors



Data as at December 31, 2018. Source: Bloomberg, Haver Analytics, S&P, IBES.

Our Total Return forecast of six to 14% percent suggests there is upside from current levels: So, when we pull it all together, our base case, including dividends, calls for around a nine percent return assuming the S&P 500 trades at approximately 16.0x our 2019 EPS estimate of $167/share versus $163/share in 2018. One can see this in *Exhibits*

67 and *68*, respectively.

Bigger picture, given our view on margins, trade, and tightening financial conditions, we believe pricing power is likely to become the theme du jour across the global capital markets in 2019. As such, we prefer companies with a demonstrated track record of high and stable gross margins, low labor costs and strong balance sheets; they should also be better equipped to withstand higher financing costs as well as increased input cost pressure towards their end-users. Not surprisingly, Healthcare, Biotechnology, Energy Mid-Stream assets, and parts of Technology and non-Retail Consumer appear the most interesting to us in 2019.

EXHIBIT 67

Our Work Suggests That U.S. Equities Are Now at Attractive Levels

S&P PRICE INDEX AT VARIOUS P/E AND EPS LEVELS

EPS \ P/E	14.5X	15.0X	15.5X	16.0X	16.5X	17.0X	17.5X
$159	2,312	2,391	2,471	2,551	2,631	2,710	2,790
$161	2,341	2,421	2,502	2,583	2,664	2,744	2,825
$163	2,370	2,451	2,533	2,615	2,697	2,778	2,860
$165	2,399	2,481	2,564	2,647	2,730	2,812	2,895
$167	2,428	2,511	2,595	2,679	2,763	2,846	2,930
$169	2,457	2,541	2,626	2,711	2,796	2,880	2,965
$171	2,486	2,571	2,657	2,743	2,829	2,914	3,000
$173	2,515	2,601	2,688	2,775	2,862	2,948	3,035
$175	2,544	2,631	2,719	2,807	2,895	2,982	3,070

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

EXHIBIT 68

In Percentage Terms, We Now See 6-14% Upside in U.S. Equities (Inclusive of Dividends)

S&P TOTAL RETURN AT VARIOUS P/E AND EPS Y/Y LEVELS

EPS \ P/E	14.5X	15.0X	15.5X	16.0X	16.5X	17.0X	17.5X
(2.4%)	(5.7%)	(2.4%)	0.8%	4.1%	7.3%	10.6%	13.8%
(1.2%)	(4.5%)	(1.2%)	2.1%	5.4%	8.7%	12.0%	15.3%
0.1%	(3.3%)	0.0%	3.3%	6.7%	10.0%	13.3%	16.7%
1.3%	(2.1%)	1.2%	4.6%	8.0%	11.4%	14.7%	18.1%
2.5%	(1.0%)	2.5%	5.9%	9.3%	12.7%	16.1%	19.5%
3.7%	0.2%	3.7%	7.1%	10.6%	14.1%	17.5%	21.0%
4.9%	1.4%	4.9%	8.4%	11.9%	15.4%	18.9%	22.4%
6.2%	2.6%	6.1%	9.7%	13.2%	16.7%	20.3%	23.8%
7.4%	3.8%	7.4%	10.9%	14.5%	18.1%	21.7%	25.2%

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

> **"Tightening financial conditions, including higher real rates and slower growth, mean lower multiples than in recent years."**

EXHIBIT 69

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

CHANGES IN P/ES DURING A FED TIGHTENING CYCLE

US RATE HIKE CYCLES: AVERAGE P/E DECLINE IS 2.5X									
Start	Feb-72	Feb-74	Nov-76	Apr-83	Nov-86	Jan-94	May-99	May-04	**Dec-15**
Stop	Aug-73	Jul-74	Apr-80	Aug-84	May-89	Feb-95	May-00	Jul-06	**Present**
P/E RATIOS									
Start	19.4x	12.2x	11.0x	12.5x	12.5x	14.9x	23.5x	16.5x	**17.0x**
Stop	15.1x	9.9x	7.0x	10.7x	11.0x	12.6x	22.2x	14.0x	**14.9x**
CHANGE	-4.3X	-2.3X	-4.0X	-1.8X	-1.5X	-2.3X	-1.3X	-2.5X	-2.1X

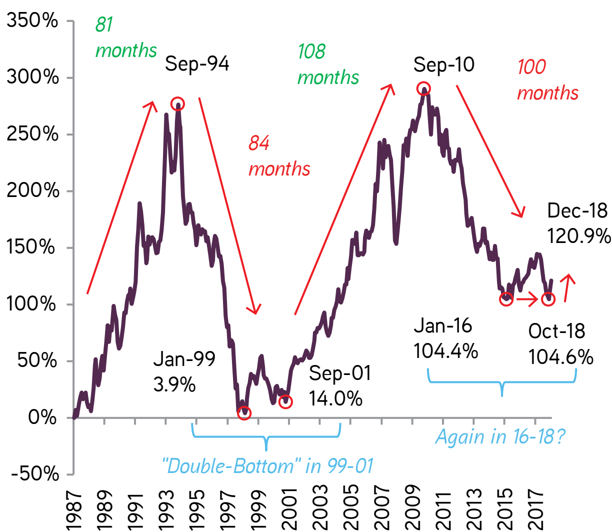
Data as at December 31, 2018. Source: Cornerstone Macro, Bloomberg.

On the international side of the global Equity ledger, much of the bear market has already played out, we believe. Indeed, the Chinese equity market finished 2018 down 27%, while Europe slipped around 15% in U.S. dollar terms. As a result, we would immediately lean into non-Japan Asia, which we underscore with our 300 basis point overweight to this region in our target asset allocation in *Exhibit 26*. This viewpoint is also consistent with what our EM/DM model is suggesting (*Exhibit 71*). Specifically, in line with our prior call for a potential double bottom in EM similar to what we saw in the 1999-2001 timeframe, we think that EM has again been re-tested this cycle. We are undeterred, and we would buy into attractive long-term markets, particularly those that could benefit from the rethinking of global supply chains, including Vietnam, Indonesia, and the Philippines. On the other hand, we remain short Turkey, given its excesses, and we remain underweight Latin America.

Within Europe, we are now equal weight versus the benchmark. We prefer Spain, France, and Germany at the expense of slower growth and heavy bank-weighted economies like Italy. By sector, we would lean into investments linked to household formation, logistics, and technology-enablers across both the consumer and corporate sides of the economy.

EXHIBIT 70

EM May Have Put in a 'Double Bottom' Relative to DM, Similar to What Happened in 1999-2001



Data as at December 20, 2018. Source: MSCI, Bloomberg, Factset, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 71

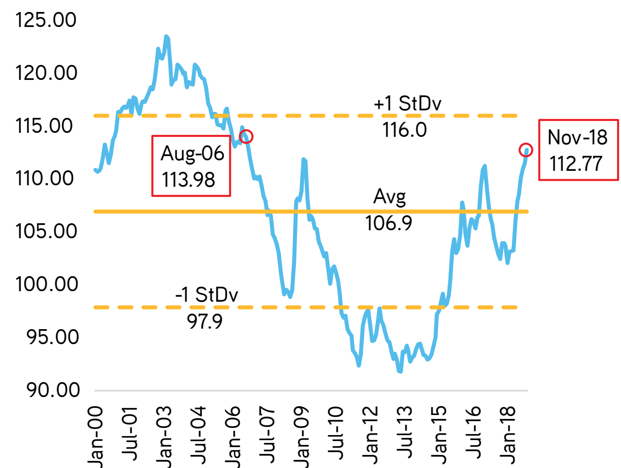
Our EM Model's Indicators Still Tilt Slightly More Positive

	'Rule of the Road'	May '15	Jan '16	Aug '16	May '17	Sep '17	Jun '18	DEC '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	We recommend selective engagement with EM investing in 2019. Momentum is tenuous but many equity indexes and FXs look fairly washed out. Falling commodity prices are a concern, but earnings fundamentals have been impressively resilient across most countries and sectors.							

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

EXHIBIT 72

USD Real Effective Exchange Rate vs. Emerging Markets Is at Strongest Level Since Mid-2000s. Any Reversal Would Be Bullish for EM Equities



* Exchange rate vs. U.S. "Other Important Trading Partners."
Data as at December 20, 2018. Source: Federal Reserve, Bloomberg.

EXHIBIT 73

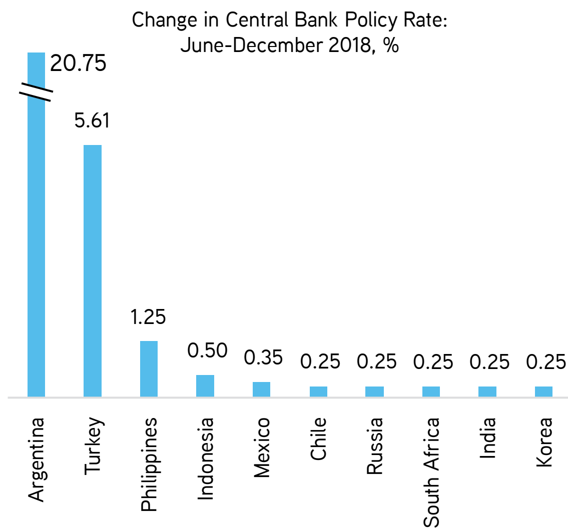
Our Cycle Dashboard Suggests That Equities Are Starting to Look Somewhat Attractively Valued at the Aggregate Level, With U.S. Equities Looking Much Less Overvalued and International Equities Slightly Undervalued

	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 Grwth (Rate-Adj. Equity Valuation)	Shiller P/E	Avg. Across Credit & Cycle Metrics	Unemp. Rate *(inverse)*	Credit Spreads *(inverse)*	Trailing 5yr Equity Mkt Return
U.S.	0.3	0.2	0.7	-0.2	1.0	-1.0	0.6	0.4	1.4	0.1	-0.2
Europe	-0.1	-0.5	-0.3	-0.5	0.4	-1.6	-0.4	0.5	1.7	0.3	-0.6
EM	-0.2	-0.4	0.3	-0.6	-0.3	-0.6	-0.9	0.1	0.5	0.3	-0.6
Japan	-0.4	-0.8	-1.4	-1.1	0.9	-1.4	-1.1	0.3	1.2	-0.7	0.4

Note: Readings show number of standard deviations Rich/(Cheap) vs. History. Data as at December 31, 2018. Source: Bloomberg, Factset.

EXHIBIT 74

EM Central Bankers Have Already Begun to Adjust Policy to Address Their FX Weakness



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

"Specifically, in line with our prior call for a potential double bottom in the Emerging Markets similar to what we saw in the 1999-2001 timeframe, we think that EM has again been re-tested this cycle. We are undeterred, and we would buy into attractive long-term markets, particularly those that could benefit from the rethinking of global supply chains."

Meanwhile, on the Credit side, my colleague Brian Leung forecasts a total return of 3.8% for U.S. High Yield in our base case (*Exhibit 75*), -0.6% in our bear case and 6.3% in our bull case. In terms of specifics, our base case assumes that credit spreads widen by 55 basis points in 2019, which is less aggressive than the sharp 170 basis points of widening in 2018. Consistent with our rates outlook, we also assume that U.S. 5-year Treasury yields increase by a modest 15 basis points in 2019. As a result, the current effective yield of 7.9%, once adjusted for approximately 500 basis points of expected credit and capital losses from widening spreads and rising rates, will get us to a return of 3.8%.

While this return might appear quite conservative on the surface, we believe that there are several macro forces to consider. First, the G3 central bank balance sheet is contracting for the first time this cycle (*Exhibit 76*) just as the fiscal impulse from tax reform fades. Second, earnings and GDP growth deceleration amidst escalating trade tensions should weigh on confidence and business investment. Third, as we describe in greater detail below, we have revised down our oil price expectations for 2019-2020.

Given the specter of yield curve inversion and slowing growth, investors have already also begun to demand a higher recession risk premium, even if there is no actual recession in 2019. As such, credit spreads are more vulnerable to widening as past and continued Fed hikes usher in an era of structurally higher volatility, in our view. If there is a silver lining, it is that spreads are now at more reasonable levels and that we do think the default rate will stay relatively low in 2019, given record high interest coverage ratios (*Exhibit 80*).

Overall within Corporate Credit, including both liquid and illiquid investments, *our strong message is to avoid the 'tails.'* Specifically, on one end of the credit spectrum, we are more cautious on 'tails' we see emerging in smaller-sized Direct Lending mandates; on the other end of the spectrum, parts of the traditional safe-haven Investment Grade debt markets also look stretched to us (i.e. we expect an increase in fallen angels). However, within these two categories of Corporate Credit, we are now seeing attractive emerging opportunities within High Yield, Structured Products, and parts of the Levered Loan market. Importantly, though, we think that the opportunity set in Credit during 2019 will remain fluid. If we are right, then our sizeable overweight to Actively Managed Opportunistic Credit should give us adequate flexibility to toggle between asset classes. Finally, on the international debt side, we do see some interesting opportunities emerging (no pun intended) in Emerging Market debt. As such, this area could be one that we seek exposure to at some point during the first half of 2019 if market conditions continue to turn more hostile.

> **"We are more cautious on 'tails' we see emerging in smaller-sized Direct Lending mandates; parts of the traditional safe-haven Investment Grade debt markets also look stretched to us."**

EXHIBIT 75

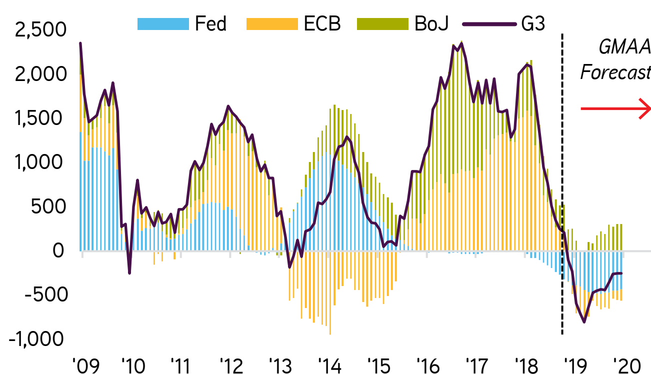
We Forecast a Total Return of 3.8% for U.S. High Yield Credit in 2019, Below Its 30-year Median of 5.9%

2019 U.S. HY Total Return Forecast Assumptions		
Base Case	U.S. HY	5-Year UST
Current Spread (yield) (bp)	533	251
2019 Expected Target Spread (Yield) (bp)	588	266
Predicted Change (bp)	55	15
Effective Duration	4.2	
(1) Capital Gain/Loss (via spreads) (bp)	-230	
(2) Capital Gain/Loss (via rates) (bp)	-62	
(3) Credit Loss (bp)	-120	
(4) Effective Yield (bp)	789	
Total Return (1) + (2) + (3) + (4)	**3.8%**	
Memo: 30y Median Total Return	**5.9%**	

Data as at December 31, 2018. Source: ICE-BofAML Bond Indices, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 76

G3 Central Bank Balance Sheets Are Set to Meaningfully Contract for the First Time This Cycle



Note: assumes ECB winds down QE by end-2018; assumes Fed BS run-off continues until early 2020; assumes BoJ purchases continues at the current reduced pace vs stated level. Data as at December 31, 2018. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 77

We Forecast a Total Return of 2.1% for U.S. Investment Grade Credit in 2019 in Our Base Case...

2019 U.S. IG Total Return Forecast Assumptions		
Base Case	**U.S. IG**	**7-Year UST**
Current Spread (yield) (bp)	159	259
2019 Expected Target Spread (Yield) (bp)	175	273
Predicted Change (bp)	16	15
Effective Duration	6.9	
(1) Capital Gain/Loss (via spreads) (bp)	-112	
(2) Capital Gain/Loss (via rates) (bp)	-102	
(3) Credit Loss (bp)	0	
(4) Effective Yield (bp)	425	
Total Return (1) + (2) + (3) + (4)	**2.1%**	
Memo: 30y Median Total Return	***7.5%***	

Data as at December 31, 2018. Source: ICE-BofAML Bond Indices, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 78

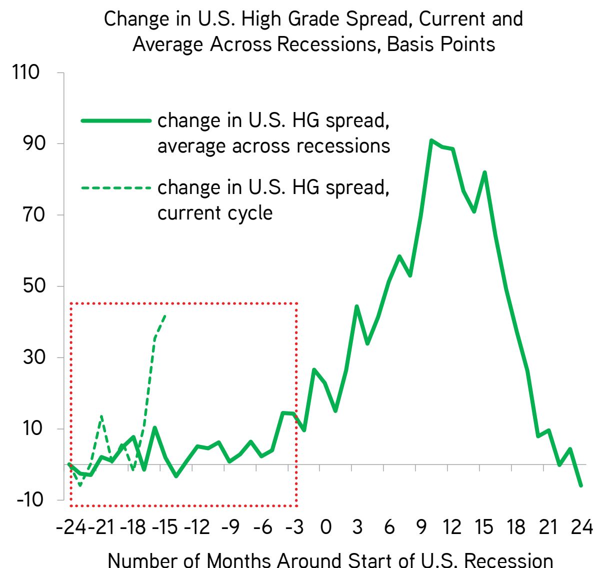
...But in Our Bear Case Where U.S. Treasury Yields Decline by Approximately 40 Basis Points, Our Total Return Would Actually Be Closer to 2.8%

2019 Total Return Forecast Assumptions		
Bear Case	**U.S. IG**	**7-Year UST**
Current Spread (yield) (bp)	159	259
2019 Expected Target Spread (Yield) (bp)	217	221
Predicted Change (bp)	58	-38
Effective Duration	6.9	
(1) Capital Gain/Loss (via spreads) (bp)	-400	
(2) Capital Gain/Loss (via rates) (bp)	259	
(3) Credit Loss (bp)	-8	
(4) Effective Yield (bp)	425	
Total Return (1) + (2) + (3) + (4)	**2.8%**	
Memo: 30-year Median Total Return	***7.5%***	

Data as at December 31, 2018. Source: ICE-BofAML Bond Indices, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 79

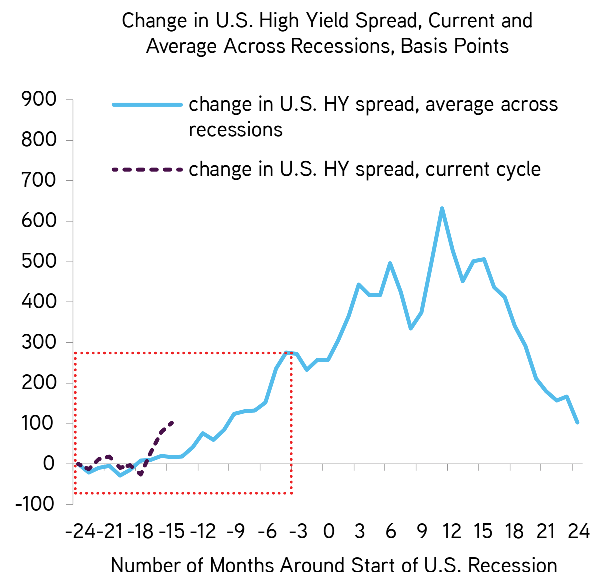
Spreads in Investment Grade Debt Now Reflect Some of the Conservatism We Have Held Towards this Asset Class



Data as at December 31, 2018. Source: JP Morgan.

EXHIBIT 80

Meanwhile, Spreads in High Yield Are Actually Not Far from Trend Relative to Past Recessionary Cycles



Data as at December 31, 2018. Source: JP Morgan.

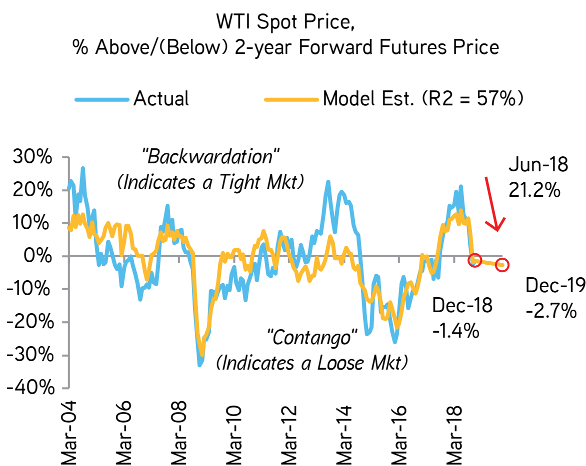
Oil Outlook

At the risk of overextending our drama metaphors, we think oil today is beginning the second act of what we think will be a three-act drama of decline, stagnation, and eventually recovery. We think this second act will encompass a bumpy bottoming process in which oil trades in the $40-55 per barrel range in 2019-20 but fails to gain meaningful traction to the upside. We expect medium-term fundamentals will be marked by a glut of U.S. supply and a shortfall of global demand, particularly in 2020, when we continue to incorporate a mild recession into our thinking. **Looking farther ahead, our envisioned "third act" begins around 2021, when we think multiple supportive factors could begin to take hold, including better demand growth and a fall-off in supply due to low levels of new project sanctioning.**

Looking at the details, we think the key driver of the first leg down in WTI crude oil from $75 to $60 (our "Act 1") was a flattening of the oil futures curve, which had been trading at extreme levels of backwardation as recently as October (*Exhibit 81*). The backwardation (i.e., spot prices were far above long-term expected prices) signaled that traders believed oil inventories would continue to draw and were at risk of becoming dangerously low. This story started changing in October as the consensus began to appreciate that inventories were actually likely to build in 2019 (*Exhibit 82*). The Iran sanctions waivers announced by the White House in early November further cemented the case for a well-supplied market in 2019, and we believe the recent OPEC cuts will only be enough roughly to balance the market, not to create material tightness.

EXHIBIT 81

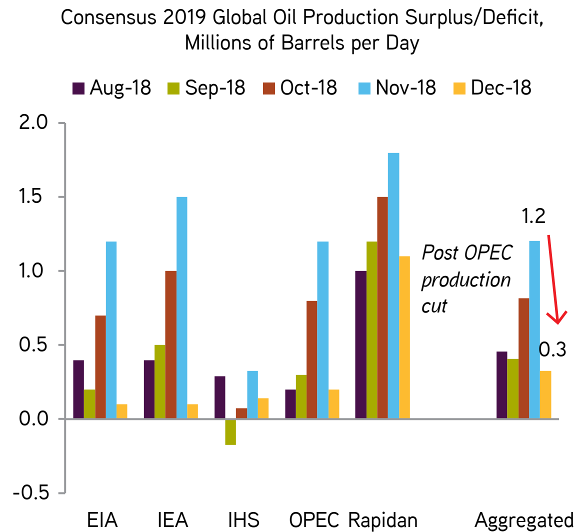
Oil Pricing Has Now Corrected from What We Had Viewed as Over-Stretched Levels of Curve Backwardation...



Data as at December 11, 2018. Source: Bloomberg, Energy Intelligence, ISM, Haver Analytics, KKR Global Macro & Asset allocation analysis.

EXHIBIT 82

...As the Consensus Has Come to Appreciate that the Market Will Be More than Adequately Supplied with Crude in 2019



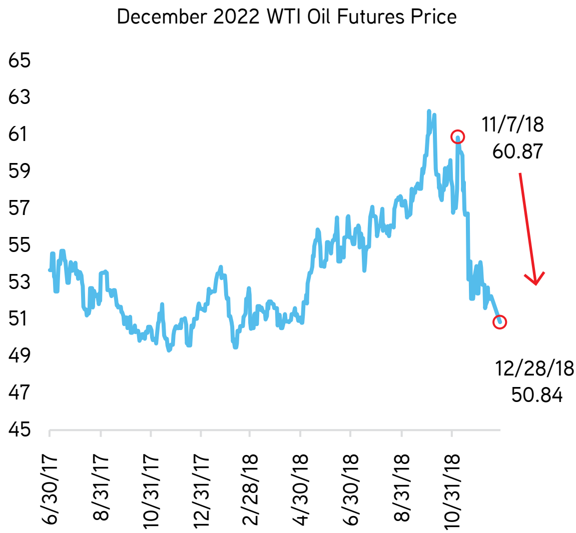
Data as at December 31, 2018. Source: KKR Global Macro & Asset Allocation analysis, Bloomberg, Haver Analytics, IEA, EIA, Energy Intelligence, Rapidan.

Since mid-November, the oil narrative has shifted from one of curve flattening to one of falling expectations for long-term prices (Our "Act 2"; *Exhibit 83*). We believe what is creating the current bearishness in dated futures is a surge in shale oil supply (*Exhibit 84*). U.S. supply has grown at an annualized rate of almost two million barrels per day over the past six months, which is approximately twice our estimate of through-the-cycle global oil demand growth. The record U.S. supply growth is even more impressive, or scary, depending on one's perspective, when investors consider that it has taken place amidst a horizontal land rig count of only about 900, which is still down by one-third from 2014-era peak levels.

> "To call a bottom in oil, we need to see both evidence of a U.S. production response to the recent price weakness and a visible path back towards a market with stable or drawing inventories."

EXHIBIT 83

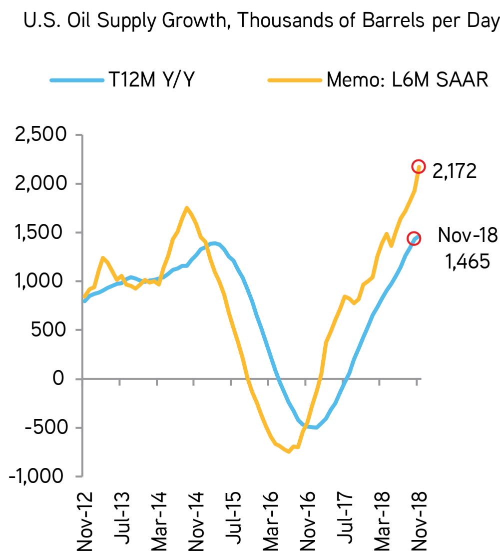
For Oil to Stabilize from Here, However, We Need to See Some Improvement in Long-Term Oil Price Expectations...



Data as at December 28, 2018. Source: Bloomberg.

EXHIBIT 84

...We Suspect this Might Not Happen Until There Is Better Evidence of a Shale Production Response to Recent Price Declines

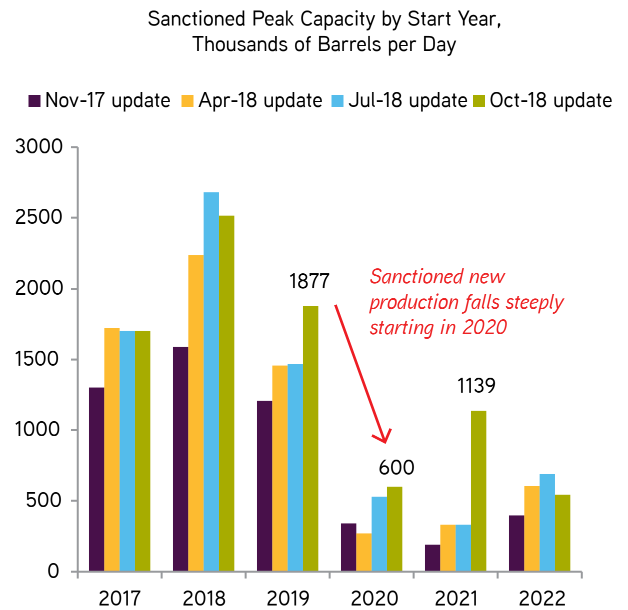


Data as at December 28, 2018. Source: Energy Intelligence, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

To call a bottom in oil, we need to see both evidence of a U.S. production response to the recent price weakness and a visible path back towards a market with stable or drawing inventories. Importantly, though, we currently do not envision both those conditions being met until 2021. Financial conditions have tightened for producers, but that has not yet translated into a meaningful fall-off in rig counts. Even once rig counts decline, production growth is likely to remain strong for a few quarters more as producers make their way through a substantial inventory of drilled but uncompleted wells ('DUCs'). Then, when U.S. production finally does fall off, markets could remain well supplied for some time due to the stagnant global demand growth we are envisioning in 2019-2020.

EXHIBIT 85

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



Data as at October 31, 2018. Source: IHS Markit.

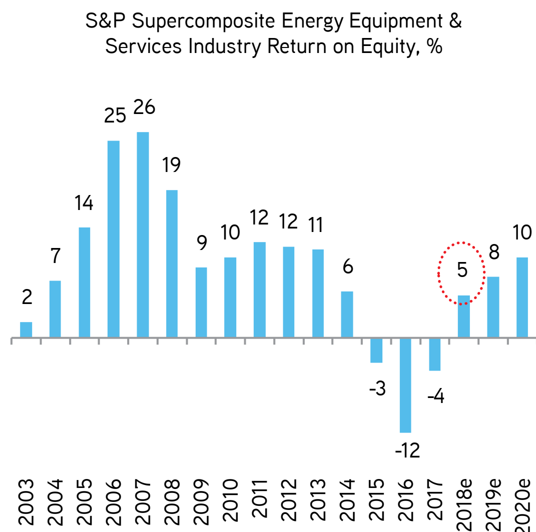
"

Looking farther ahead, our envisioned 'third act' begins around 2021, when we think multiple supportive factors could begin to take hold, including better demand growth and a fall-off in supply due to low levels of new project sanctioning.

"

EXHIBIT 86

Energy Services Pricing Seems Unsustainably Low at Current Levels



Data as at September 30, 2018. Source: Bloomberg.

Looking out beyond 2020, we remain optimistic on the longer-term prospects for crude oil. We envision a recovery coming in the 2020s (our "Act 3"), as the most productive shale acreage in the U.S. becomes tapped-out and increasingly challenging to replace. Furthermore, we expect conventional oil (i.e., non-shale) supply to become constrained by the recent lack of new project sanctioning (*Exhibit 85*). Meanwhile, oil demand will also receive a boost starting in 2020 from implementation of the International Maritime Organization (IMO) 2020 regulations on high sulfur fuel oil, which S&P Platts estimates will increase apparent demand by about 400,000 barrels per day.

Putting all the pieces together, we think that in the early 2020s, oil prices will need to start rising from levels that support shale oil production (e.g., in the $40-50 range) to levels that support new conventional oil exploration, including adequate returns on investment for the services complex (*Exhibit 86*). In our minds, this means WTI oil prices rising back towards the $60 range, which is well above current market expectations (*Exhibit 87*). If we are correct, there will be important opportunities in coming years to invest in the long-term upside opportunity for global oil markets.

EXHIBIT 87

Our WTI Oil Price Expectations for 2019-20 Have Come Down in Recent Months, but Much Less Than Broad Market Expectations Have. We Remain Constructive on the Long-Term Oil Opportunity.

	KKR GMAA - Dec'2018	***WTI Futures Dec'18***	**Dec'18 Forecasts GMAA vs. Futures**	KKR GMAA - Sep'2018	WTI Futures Sep'18	Sep'18 Forecasts GMAA vs. Futures	*Change in GMAA Forecasts: Dec vs. Sep*	*Change in Futures: Dec vs. Sep*
2019e	**50.00**	***47.76***	**2.24**	65.00	70.35	-5.35	*-15.00*	*-22.59*
2020e	**45.00**	***49.66***	**-4.66**	47.50	66.94	-19.44	*-2.50*	*-17.28*
2021e	**55.00**	***50.18***	**4.83**	55.00	63.34	-8.34	*0.00*	*-13.17*
2022e	**60.00**	***50.39***	**9.61**	60.00	60.53	-0.52	*0.00*	*-10.14*
2023e	**62.50**	***50.54***	**11.97**	62.50	58.63	3.88	*0.00*	*-8.09*

Forecasts represent full-year average price expectations. Data as at December 28, 2018. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

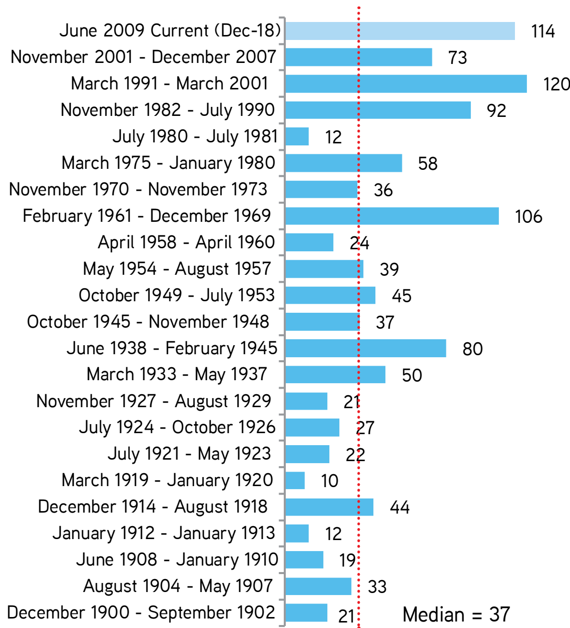
Where We Are in the Cycle/Recession Risks

No doubt, making forecasts on where we are in the cycle or when a recession will hit is a tough gig. However, we have found over time that using a steady approach with consistent data and a repeatable framework definitely can add value to an investor's approach to capital allocation. Maybe more importantly, we also have been able to build some effective models to help us assess what the market is pricing in (i.e., are investors extrapolating too much optimism or pessimism about current economic trends), which can often be more important than calling the cycle. Finally (and almost irrespective of cycle timing), we believe our process helps us focus on the key variables where excesses or surpluses have built up (e.g., Technology in the late 1990s, Housing in 2007, Momentum stocks in 2018).

At the moment – after nine years of consecutive S&P 500 positive performance – investors now seem concerned about both a recession and a bear market. This viewpoint is actually not a crazy one if we use history as a guide. Indeed, if we just look at the historical data in *Exhibit 89*, we see that performance usually turns choppy after multiple years of strong performance. Specifically, after eight or nine years of consecutive positive S&P 500 returns, the market chopped around or went down soon thereafter each time (i.e., 1929, 1990, 2000). Often these downturns in the market were preceded by or coincided with an economic slowdown.

EXHIBIT 88

We Are Quite Long in the Tooth in Terms of Pure Cycle Duration at 114 Months



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

EXHIBIT 89

Market Performances Following Long Stretches of Consecutive Up Years Are Usually Choppy

# of Consecutive Years of Positive Returns	Start	End	Cumulative Return	CAGR
3	1954	1956	113%	28.7%
3	1963	1965	61%	17.1%
3	1970	1972	41%	12.2%
3	1978	1980	67%	18.7%
4	1942	1945	146%	25.2%
4	1958	1961	104%	19.5%
5	2003	2007	83%	12.8%
6	1947	1952	154%	16.8%
8	1982	1989	299%	18.9%
9	1991	1999	450%	20.9%
9	2009	2017	259%	15.3%
				18.7%

Data as at December 31, 2018. Source://www.econ.yale.edu/~shiller/, Bloomberg.

Consistent with this historical perspective, our longer-duration recession model, which one can see in *Exhibit 90*, is starting to flash some significant warning signs. Key variables on which to focus include a rising Fed Funds rate, peaking leading indicators, and increased leverage in the corporate sector. Given this, our base case remains that we will have a shallow recession in 2020, though this could come sooner if central bankers are not sensitive to the tightening financial conditions that we are seeing in the U.S., China, and Europe.

As we mentioned at the outset of this report, we also want to underscore how low consumer delinquencies remain a formidable tailwind for growth. As we show in *Exhibit 91,* our model suggests that we would be in recessionary territory without such a strong consumer outlook. Importantly, though, if auto and credit card delinquencies do increase from current levels, the probability of a broader economic downturn will rise materially. Why? Because these current tailwinds are acting as major offsets to the warning signs our model is showing in more traditional metrics that we track.

Our Bottom Line: For 2019, we still expect significantly decelerating growth throughout the year that essentially feels recessionary in nature. Consistent with this view, our quantitative U.S. EPS and recession models both suggest that rising interest rates, coupled with relatively high leverage levels on corporate balance sheets, may lead to a serious slowdown in earnings growth that could ultimately cause increased levels of risk for the U.S. economy over the next several quarters. The key to how slow things get economically, we believe, is whether confidence begins to wane in 2019, which could dent both consumer spending (most important) and capital expenditures.

"

Our bottom line for 2019: we still expect significantly decelerating growth throughout the year that essentially feels recessionary in nature. The key to how slow things get economically, we believe, is whether confidence begins to wane in 2019, which would ultimately dent both consumer spending (most important) and capital expenditures.

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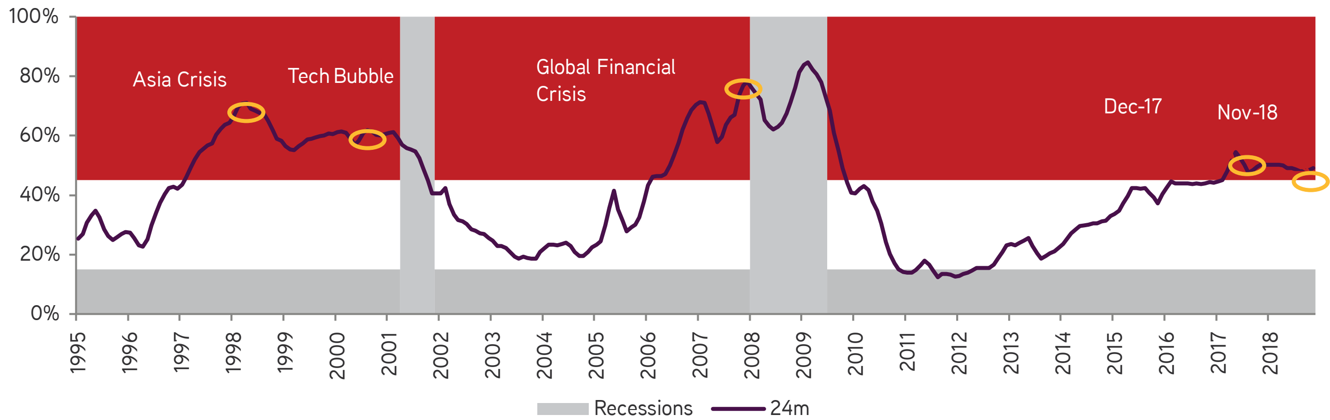
EXHIBIT 90

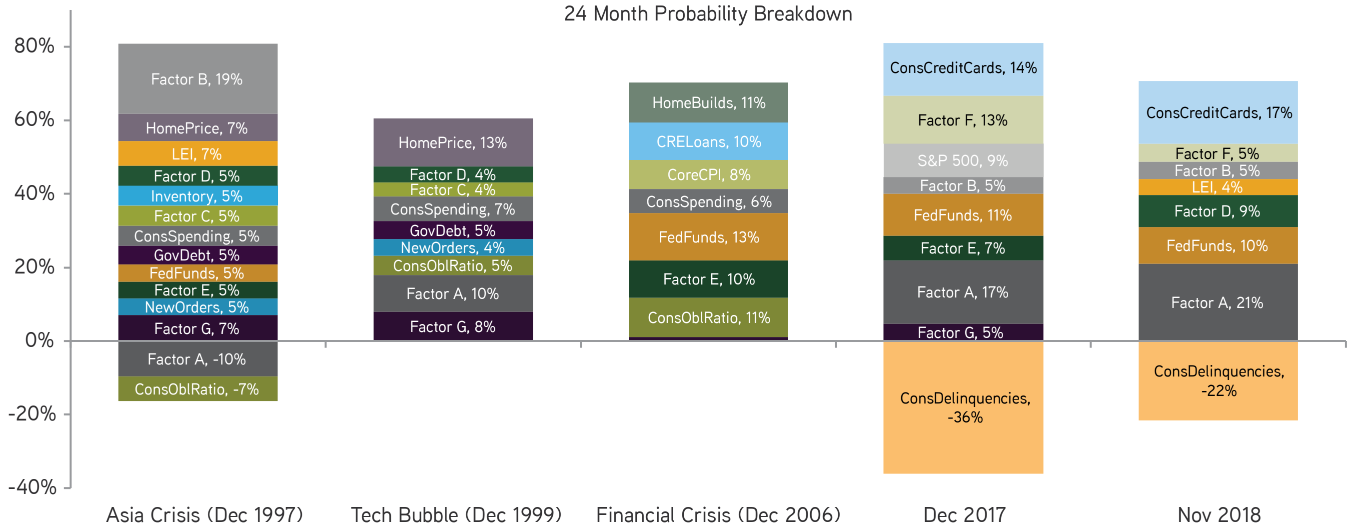
Our Model Continues to Suggest an Elevated Risk of an Economic Downturn Within 24 Months e.g., by Mid-2020



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

EXHIBIT 91

The Key to Any Potential Recession in 2019/2020 Is How the Consumer Performs



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

If there is good news (and we think that there is), *it is that markets already seem to be pricing in much of a recession, or at least something close to it*. To review, in the base recession that we have been laying out for folks in recent years we have suggested a 20% equity market correction, $45 oil prices per barrel, slowing home sales, and weakness in the global auto sector. All of these outcomes have now largely occurred, and as such, we take comfort that investors are now being compensated with a sizeable margin of safety from current levels. One can see this in *Exhibit 92*, which shows that Equities have de-rated 25.3%, or to a level just below a full-blown recession and on par with some prior crisis-like events. On the other hand, our U.S. High Yield Credit implied default rate still has some catching up to do. Indeed, we note that the median change in implied default rate is 4.3 percentage points, compared to just 3.4 percentage points today (*Note: we're not measuring the trough to peak increase in default rates here; we're measuring the change based on the peak-to-trough forward PE dates to keep the analysis consistent*).

> "If there is good news, it is that markets already seem to have priced in much of a recession."

EXHIBIT 92

Equities Are Now Pricing in a Recession; Credit Is Not Far Behind

S&P 500 TRAILING P/E AND U.S. HY IMPLIED DEFAULT RATES AT EQUITY MARKET TROUGHS, 1990 TO DATE					
EVENT	DATE OF TROUGH TRAILING P/E	TROUGH TRAILING P/E (X)	PEAK-TO-TROUGH P/E DE-RATING (%)	IMPLIED U.S. HY CREDIT DEFAULT RATE (%)	CHANGE IN IMPLIED DEFAULT RATE (%)
2014-16 Energy Bust	2/29/2016	17.8x	-6.6%	9.1%	+3.4%
2011 US Debt Ceiling	9/30/2011	12.6x	-21.9%	10.1%	+5.2%
2010 EU Sovereign Debt Crisis	6/30/2010	14.2x	-41.1%	8.7%	-0.6%
2007-08 GFC	2/27/2009	12.1x	-32.9%	20.3%	+9.5%
2002 US Recession	9/30/2002	18.1x	-33.8%	13.9%	+6.5%
1994 Bond Massacre	12/30/1994	15.3x	-38.1%	2.9%	-0.4%
Median		**14.8x**	**-33.4%**	**9.6%**	**+4.3%**
Best		*18.1x*	*-6.6%*	*2.9%*	*-0.6%*
Worst		*12.1x*	*-41.1%*	*20.3%*	*+9.5%*
Current Sell-Off	12/31/2018	**17.1x**	**-25.3%**	**5.6%**	**+3.4%**

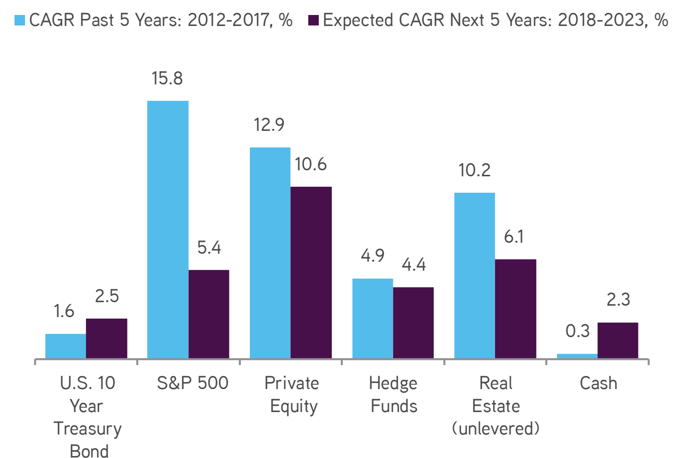
Data as at December 31. 2018. Source: Bloomberg, Haver Analytics, S&P.

Looking at the big picture, we also want to underscore a point we made earlier, particularly for longer-term strategic investors. *Specifically, as government 'Authorities' shift away from monetary policy towards fiscal policy, it could likely result in more range-bound trading across the global capital markets versus what occurred during the past 5-10 years*. On the one hand, if fiscal policy leads to better GDP growth outcomes, we think that central bank normalization could tighten financial conditions faster than the current economy can handle. Indeed, as we already have seen in 2018, the QT normalization process that started in October has been quite unsettling for the global capital markets.

> **"Looking at the big picture, we also want to underscore a point we made earlier, particularly for longer-term strategic investors. Specifically, as government 'Authorities' shift away from monetary policy towards fiscal policy, it could likely result in more range-bound trading across the global capital markets versus what occurred during the past 5-10 years."**

EXHIBIT 93

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

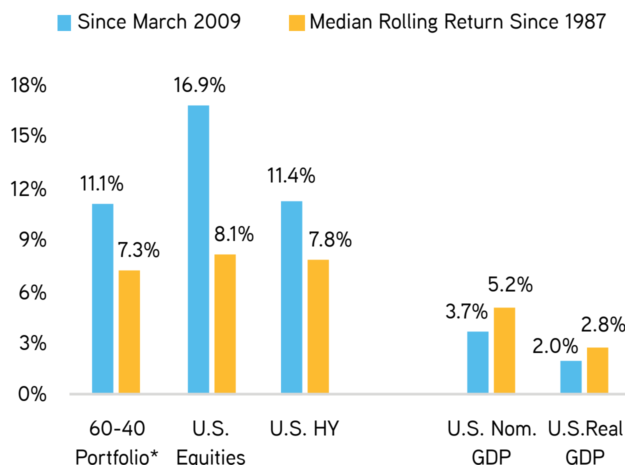


Data as at December 31 2018. Source: Bloomberg, Cambridge Associates, NCREIF, HFRI Fund Weighted Composite Index (HFRIFWI Index), KKR Global Macro & Asset Allocation.

On the other hand, if growth disappoints, central bankers will have less flexibility to provide downside cushion to the markets than in the past, as both government debt loads and budget deficits will likely be bigger than normal. Also, there appears to be less appetite amongst voters for central bank intervention. Hence, our view is that *the game has changed*.

EXHIBIT 94

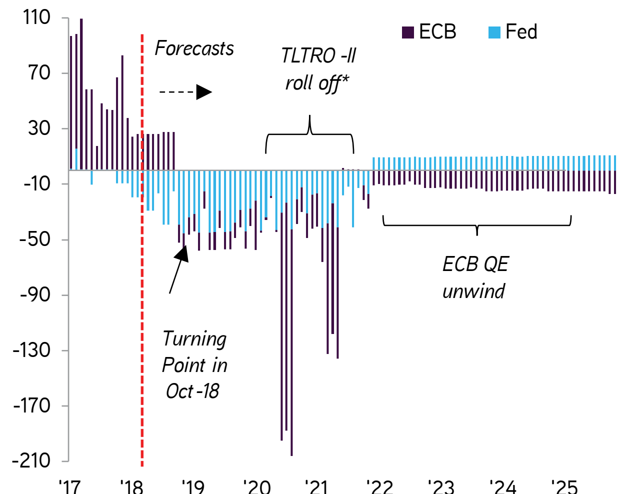
Financial Assets Have Handily Outperformed the Real Economy. We Now See Some Mean Reversion



Note: * 60% US Equities and 40% US Treasury Bonds. Data as at December 28, 2018. Source: Bloomberg, MSCI, ICE-BofAML Bond Indices.

EXHIBIT 95

Beginning in October 2018, Central Bank Flows Turned into a Modest Headwind (Net Selling)



* 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: Federal Reserve, European Central Bank, KKR Global Macro & Asset Allocation analysis.

Section IV: Key Themes

Shift from Monetary to Fiscal If there is one theme that we believe investors have to get right at this point in the cycle, it is the shift away from monetary stimulus towards fiscal stimulus. This narrative is certainly playing out in spades in the U.S., but a recent trip through Europe, including Italy and Spain, leads us to a similar conclusion. Central banks in developed markets are full up after buying $16 trillion in assets, and politicians now believe that they must inspire growth that is more evenly balanced across the vast socio-economic constituencies they serve.

"Politicians now believe that they must inspire growth that is more evenly balanced across the vast socio-economic constituencies they serve."

EXHIBIT 96

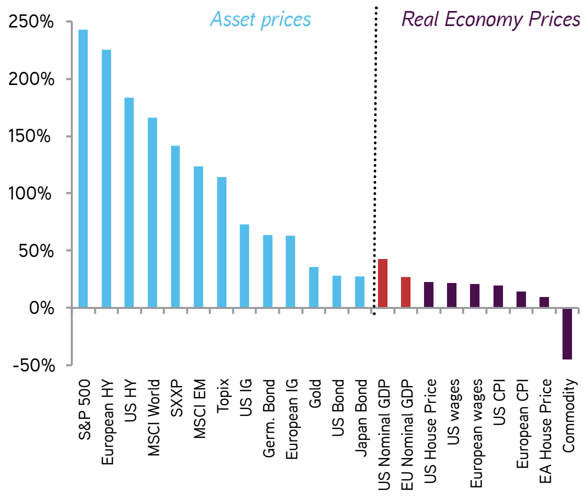
G4 Sovereign Issuance Less Central Bank Purchases Shows that Net Issuance Has Swung by $1.5 Trillion Between 2016 and 2019

	NET ISSU-ANCE	Y/Y % CHANGE	CENTRAL BANK PURCHAS-ES	Y/Y % CHANGE	NET IS-SUANCE 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%	1,078	119%	812	-48%
2014	1,482	-22%	820	-24%	663	-18%
2015	1,044	-30%	1,093	33%	-50	-108%
2016	964	-8%	1,465	34%	-501	-908%
2017	955	-1%	1,067	-27%	-112	-78%
2018e	1,421	49%	589	-45%	832	841%
2019e	1,424	--	447	-24%	977	17%
Total	12,110		7,791		4,320	

G4 = BoJ, BoE, Fed, Eurozone. QE = Quantitative easing. Data as at November 30, 2018. Source: National Treasuries, Morgan Stanley Research.

EXHIBIT 97

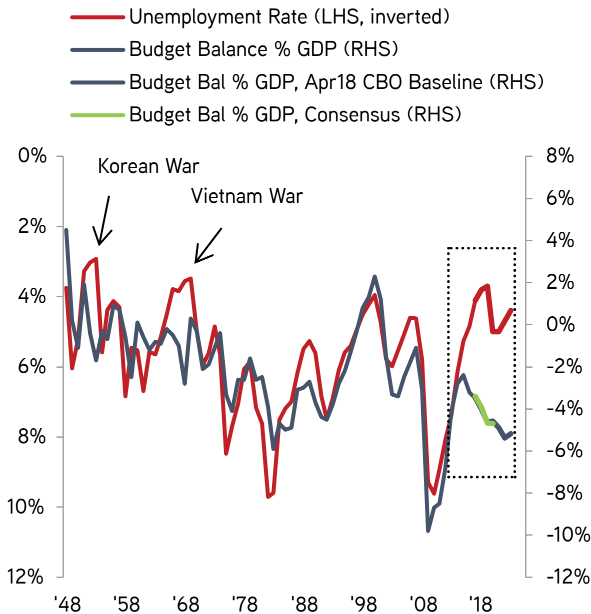
We Think That Governments Are Now Focused on Driving Better Performance in the Real Economy Relative to the Financial Economy



Data as at December 31, 2018. Source: Goldman Sachs.

EXHIBIT 98

The Combination of Tax Cuts and Budget Deal Could Drive a Record Divergence Between the U.S. Budget Balance and the U.S. Unemployment Rate

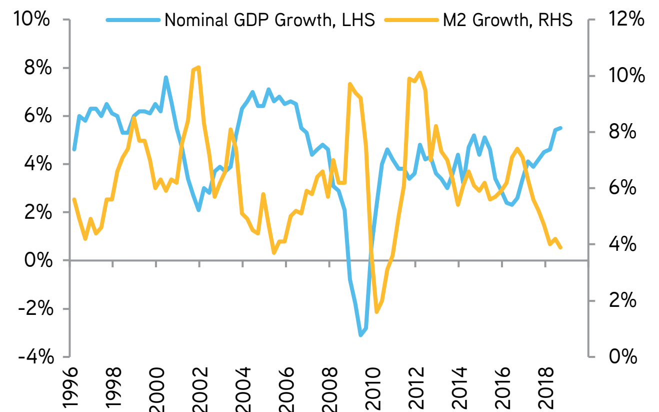


Data as at December 31, 2018. Source: Department of Labor. Department of Commerce. CBO. Goldman Sachs.

In our humble opinion, this transition will continue to be bumpy because we both have to unwind the monetary stimulus and pay for the fiscal stimulus at a time when most economies already have too much government debt. This overhang is certainly an issue in the United States, Italy, and Spain. Moreover, growth through fiscal stimulus likely creates much more angst for global central bankers under a variety of scenarios. On the one hand, in situations where fiscal stimulus does inspire faster GDP growth, it puts central bankers on notice that they may need to do more to control mandates, including inflation targeting and financial stability in certain circumstances. On the other hand, if growth does not materialize, it means that central bankers might have to adjust the pace of their balance sheet unwinds – something that most central bankers prefer not to do in fits and starts.

EXHIBIT 99

Money Supply Growth Is Cratering. As a Result, Politicians, Not Central Bankers, Are Now Driving GDP Trends



Data as at September 30, 2018. Source: Bloomberg.

> **"In our humble opinion, this transition will continue to be bumpy because we both have to unwind the monetary stimulus and pay for the fiscal stimulus at a time when most economies already have too much government debt."**

So, what does this all mean for investing? Without question, *we advocate a diversified portfolio of financial assets that now benefit directly from any attempts to improve nominal GDP*. As evidenced by our six percent overweight position in the Asset-Based Finance arena of Private Credit, we believe that the opportunity is significant. For example, across Asia, Europe, and the United States, we see a growing number of publicly traded financial intermediaries that 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 the Asset-Based Finance arena. We also believe that some of the recent dislocation in fourth quarter of 2018 has created situations where financial intermediaries and promoters now want partners to help increase their liquidity profiles. In many instances, investors are being compensated with attractive yields (e.g., first liens in the high single digits and second liens in the low double digits) and sturdy collateral (e.g., planes, ships, housing, etc.)

We are also seeing an increased opportunity set in the B-piece segment of the commercial mortgage market, driven by 'new' retention rules that notably favor investors with long duration liabilities. Stabilized Credit, which provides shorter-term direct loans in the commercial sector, also dovetails nicely into our macro thesis. Similar to B-piece Real Estate Credit, it too has a regulatory moat around its business, and its assets are less correlated to more popular credit corporate investments like High Yield (*Exhibit 100*).

"

So, what does this all mean for investing? Without question, we advocate a diversified portfolio of financial assets that now benefit directly from any attempts to improve nominal GDP. As evidenced by our six percent overweight position in the Asset-Based Finance arena of Private Credit, we believe that the opportunity is significant.

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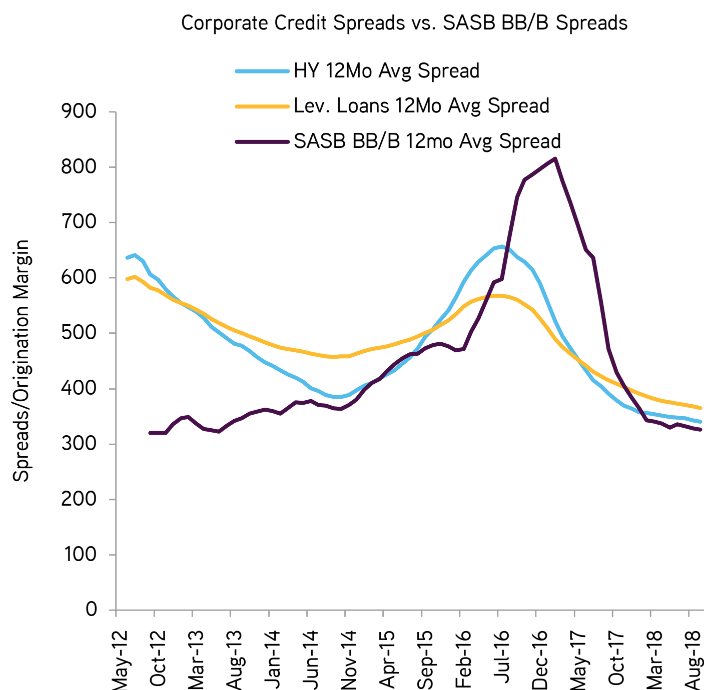
EXHIBIT 100

Historically Low Correlations Between SASB BB / B Tranches and the High Yield / Bank Loan Market Have Made Stabilized Credit an Interesting Asset Class for Allocators with Long Duration



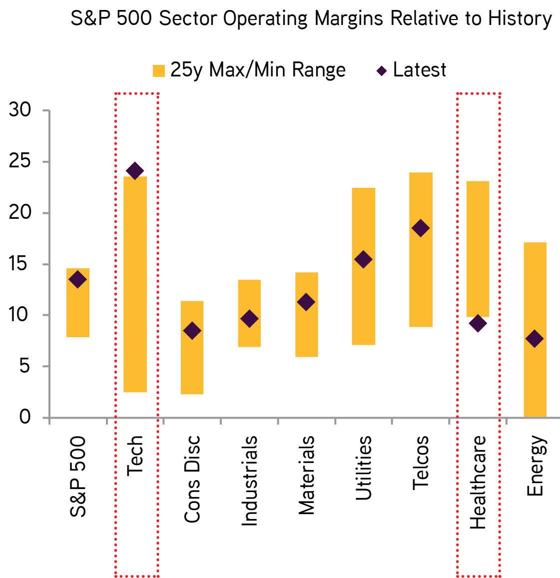
SASB is Sustainability Accounting Standards Board. Average origination spread across new issue SASB BB / B tranches; option adjusted spread for Merrill Lynch High Yield Index ("MLHY"); spread to maturity for LSTA Loan Index. Data as at September 30, 2018. Source: Merrill Lynch, LSTA, JPM Research.

Meanwhile, within the Infrastructure sector, we have seen a notable number of divestitures of hard assets, particularly those with contractual revenue step-ups, in recent quarters. From our perch, it appears that Europe has emerged as the most active region for Infrastructure carve-outs, but trend lines in both the United States and Asia are firming too. Asia is particularly interesting these days, given an investor can get around a 300 basis point premium (unlevered) to developed market opportunities. In our view, this return profile provides a little more cushion than what we are seeing in some of the more levered transactions in more developed markets these days. Overall, though, we do want to highlight that the carve-out opportunities we are seeing are 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.

Mean Reversion: Margins and Momentum Legendary investor John Bogle has been credited with the statement, "Mean reversion is the iron rule of the financial markets." We wholeheartedly agree and would focus investors on two areas of the market where we think some significant mean reversion is still warranted in 2019: corporate margins and momentum-style investing. On the margin front, *Exhibit 101* shows both aggregate and sector margin levels relative to trend for the S&P 500 for the last 25 years. As the exhibit indicates, margins are hovering near peak levels at a time when rising input costs related to tariffs as well as labor shortages in key growth industries are likely to emerge as notable headwinds.

EXHIBIT 101

S&P 500 Margins Are Hovering Near Record Levels at a Time When Wages and Input Costs Are Rising. By Sector, Technology Is at the High End, While Healthcare Is at the Low End



Data as at September 30, 2018. Source: Bloomberg.

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On the margin front, both aggregate and sector margin levels relative to trend for the S&P 500 are the highest on record for the last 25 years. We also want to underscore that there is now an unusually strong relationship between margins and the performance of the S&P 500.

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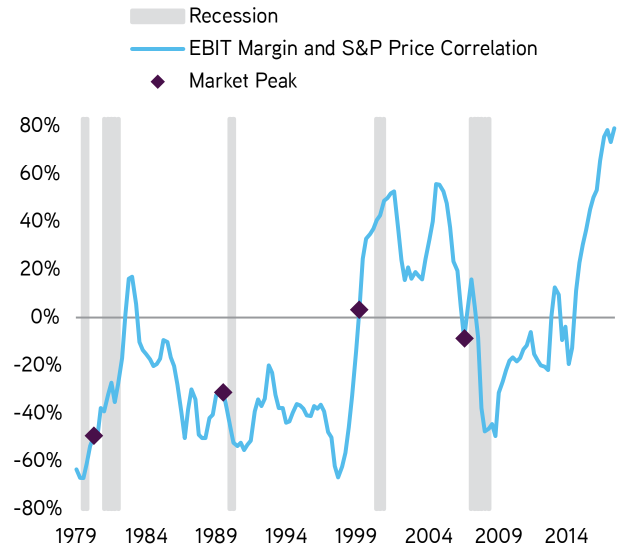
EXHIBIT 102

The Correlation Between Equity Market Performance and Margins Is Historically Elevated

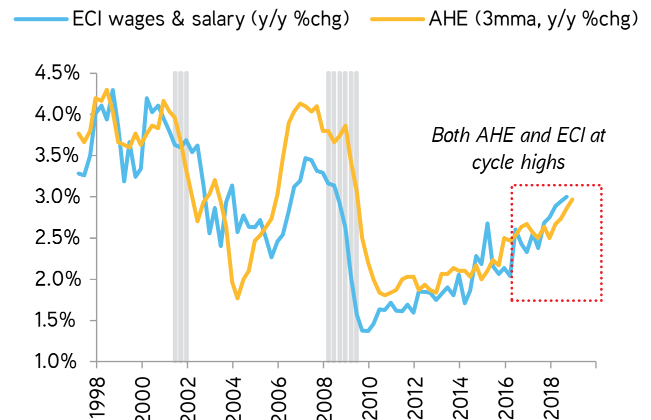
Rolling Five-Year Correlation of EBIT Margin Y/y vs. S&P 500 Price Y/y, %



Top 500 stocks by market cap. Ex-Financials and Real Estate. Data as at 2Q18. Source: Morgan Stanley Research.

EXHIBIT 103

Both Average Hourly Earnings and the Employment Cost Index Are Now at Cycle Highs

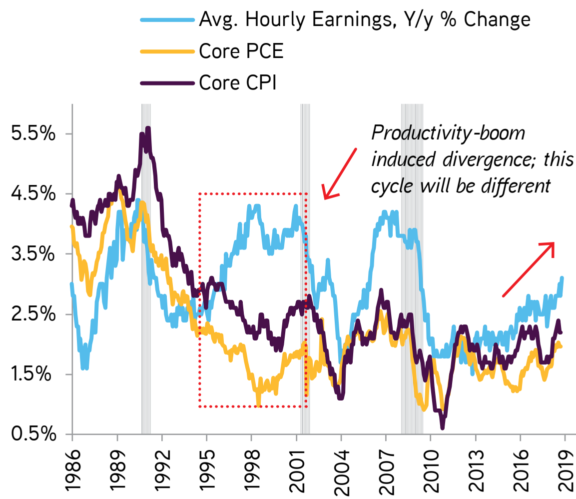


Data as at December 7, 2018. Source: Bureau of Labor Statistics, Haver Analytics.

We also want to underscore that there is now an unusually strong relationship between margins and the performance of the S&P 500. One can see this in *Exhibit 102*, which highlights some excellent work done by Morgan Stanley's Mike Wilson.

EXHIBIT 104

Wage Growth Is Currently Running Ahead of CPI, a Late-Cycle Phenomenon that Will Likely Exert Pressure on Margins Going Forward



Data as at December 7, 2018. Source: Bureau of Labor Statistics, Haver Analytics.

Importantly, higher wages, rising interest rates, and tariff costs are all contributing to what we believe is an inevitable peak in corporate margins amidst slower growth. Given this backdrop, we continue to advocate an overweight position in Healthcare, and we would begin to lean into parts of Energy (i.e., more processing functions), both sectors where margins are below average relative to history. We also think some deals are emerging in certain parts of the Industrial sector, given the recent sell-off. On the other hand, we would be more cautious in sectors where margins are now running notably above historical trends (e.g. Technology Software). Within Technology, we are growing increasingly concerned about areas where the business is maybe more cyclical than the market currently thinks, but the capital structure does not have the requisite amount of flexibility to weather any major revenue slowdown (*Exhibit 127*).

EXHIBIT 105

Momentum Strategies, Which Have Defined This Bull Market, Are Now Reversing

U.S. FACTOR RANKING BY 6-MONTH RATE OF CHANGE, TOTAL RETURN TERMS								
DEC-16	MAR-17	JUN-17	SEP-17	DEC-17	MAR-18	JUN-18	SEP-18	DEC-18
Value	US B/mark	Momentum & Growth	Momentum & Growth	Momentum & Growth	Momentum & Growth	Momentum & Growth	Momentum & Growth	Min Vol
US B/mark	Value	Quality	Quality	Quality	Quality	Quality	Quality	Dividend
Quality	Quality	US B/mark	US B/mark	US B/mark	US B/mark	US B/mark	US B/mark	Value
Dividend	Momentum & Growth	Min Vol	Min Vol	Dividend	Min Vol	Min Vol	Min Vol	Quality
Momentum & Growth	Dividend	Dividend	Dividend	Value	Dividend	Dividend	Dividend	US B/mark
Min Vol	Min Vol	Value	Value	Min Vol	Value	Value	Value	Momentum & Growth

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

Meanwhile, on the momentum front, we believe that this strategy will be a casualty of slowing money supply growth. One can see this in *Exhibit 105*, which shows the recent fall-out from momentum as a strategy. In our view, this is not an aberration, but the reversal of a trend that has been in place since June 2017. Also, higher real rates should make it more difficult for momentum stocks with higher P/E ratios to continue their bull run. Though some of these names have been hit hard of late, our recommendation is not to bottom fish. Rather, we continue to tilt towards buying complex situations, many of which provide some attractive valuation cushion. We would also use current market weakness to buy cash flowing companies with rising dividend yields and prefer pricing power stories, particularly across Telecom, Industrials, Energy, and Consumer Discretionary. On the Credit side, we seek out a similar profile. So, we are not advocating bottom fishing in recently beaten-down momentum stories or companies with aggressive capital structures.

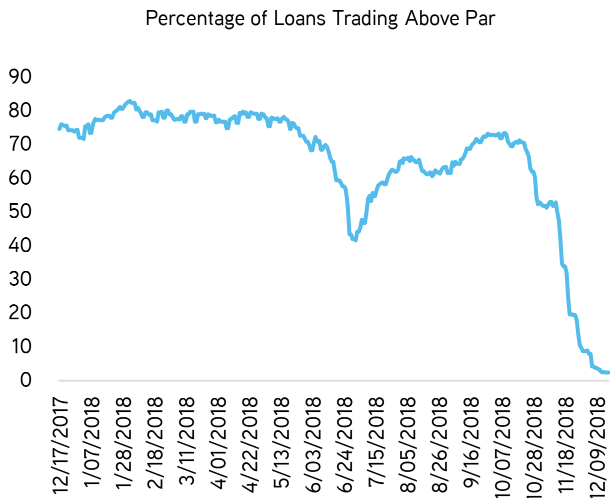
Capital Structure Complexity: Lean In During the past seven years at KKR, we have been intently focused on buying into Complexity. It started in 2011 when an investor could harness macro fears to buy high quality companies at discounted prices where there was upside leverage to the trading multiple. From 2014-2018, as overall multiples

expanded, we focused investors more narrowly on corporate complexity, with a particular emphasis on corporate carve-outs. While still a powerful theme (see below), *we are increasingly of the mindset that we are headed towards a period of notable opportunity in capital structure complexity, particularly for investors who can judge relative value amidst market dislocations.*

This relative approach, we believe, is fast becoming a key differentiator amidst increased market volatility. For example, in today's Credit markets we are seeing High Yield sell-off sharply at a time when Private Credit yields are holding. *As such, the yields are largely comparable, and in some instances, there is now the possibility to earn Equity-like returns through publicly traded Credit, a phrase we have not used in several years*. Hence, our rationale for making a huge bet on Actively Managed Opportunistic Credit in 2019. We have also again increased our weighting to Distressed/Special Situations because tightening financial conditions are creating interesting opportunities for debt restructuring higher up in the capital stack (e.g., operating company debt and/or preferred) with what appear to be PE-like returns in many instances.

EXHIBIT 106

Less Than Three Percent of Loans Are Currently Trading Above Par Versus More than 70% at the Beginning of 2018



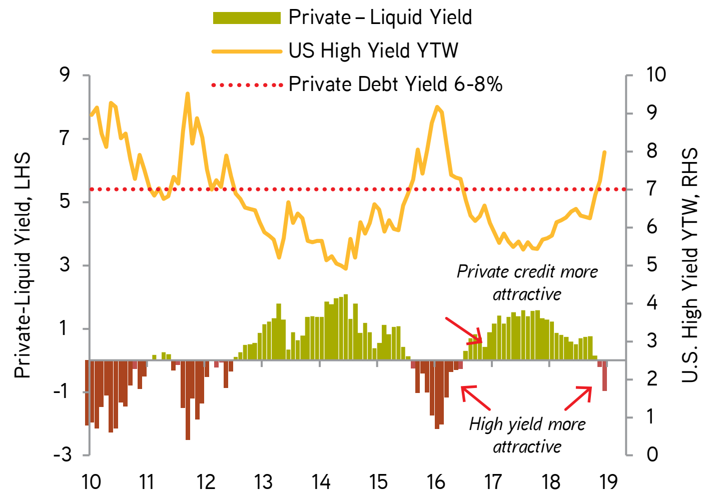
Data as at December 17, 2018. Source: LSTA.

On the Private Equity side, our strong suggestion is that allocators should focus more on public-to-private deals than sponsor-to-sponsor transactions. Without question, public markets are trading at discounts to the private markets as we enter 2019, and *given the carnage*, we are more open to Private Equity taking non-control stakes in Public Equities in 2019. This viewpoint represents a change in our thinking, but as we show below in *Exhibit 109*, a lot of damage has been done. We feel similarly about certain positions in Credit as well.

In terms of sectors and themes we favor, we encourage investors to lean into Healthcare, Energy Infrastructure, Asian Technology (public markets), and parts of Industrials (some of which are over-discounting a recession). On the other hand, we remain cautious on Private Growth in many areas of the world (valuation concerns) and certain cyclicals, including autos.

EXHIBIT 107

Liquid High Yield Looks Increasingly Cheap Relative to Private Credit



Data as at December 20, 2018. Source: Credit Suisse, EPFR.

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Also, higher real rates should make it more difficult for momentum stocks with higher P/E ratios to continue their bull run. Though some of these names have been hit hard of late, our recommendation is not to bottom fish. Rather, we continue to tilt towards buying complex situations, many of which provide some attractive valuation cushion.
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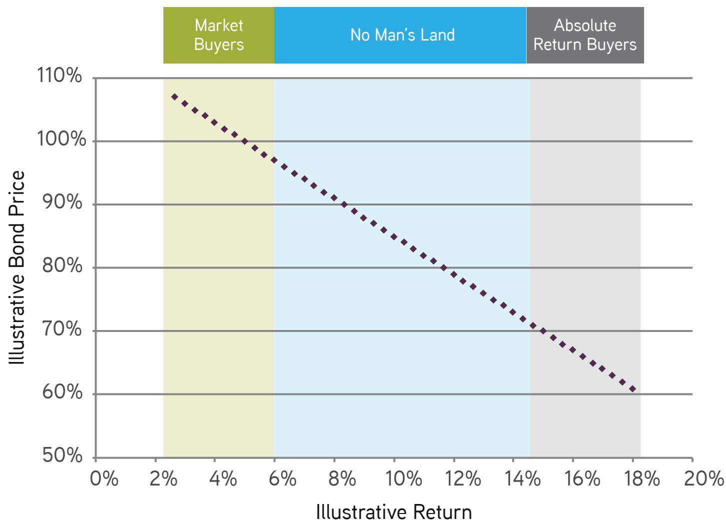
EXHIBIT 108

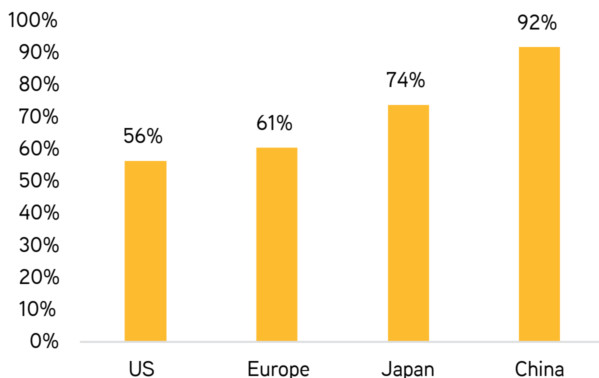
We Think That Actively Managed Opportunistic Credit and Distressed/Special Situations Are Attractive Vehicles for Buying Credits in What We Call 'No Man's Land'



Data as at December 2018. Source: KKR Credit.

EXHIBIT 109

The Recent Sell-off in Global Equities Has Been Significant. We Now See Value Emerging in Equities

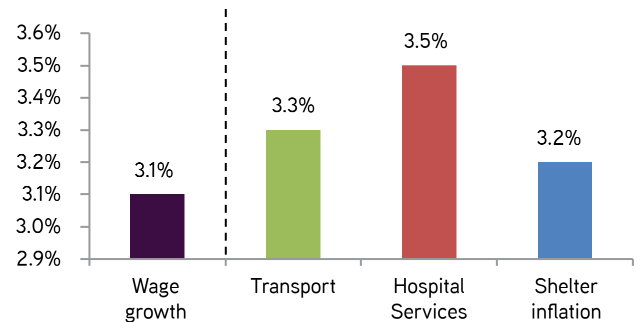


Data as at December 31, 2018. Source: Factset.

Experiences Over Things While this theme is not a new one for us, the pace of implementation appears to have accelerated in recent months. Importantly, we do not think the trend towards experiences is just the "Amazon" effect. Rather, we believe that key influences such as increased healthcare spending, heightened rental costs, transportation, and rising telecommunications budgets (e.g., iPhones) are leaving less and less discretionary income for traditional items, particularly mainstream retail goods (*Exhibit 110*). Recent trips to Asia and also continental Europe lend support to our view that this trend towards experiences is global in nature and cuts across a variety of demographics. For example, in Japan and Germany, aging demographics are boosting the use of later-stage healthcare offerings, while younger individuals in the U.S. are embracing more health, wellness and beautification. Our view is that mobile shopping and online payments are only accelerating this trend and our recent travels lead us to believe that this shift is occurring in both developed and developing countries. One can see this in *Exhibit 111*.

EXHIBIT 110

Even in a Low Unemployment Rate Environment, U.S. Consumers Are Being Forced to Be More Selective With Their Purchases

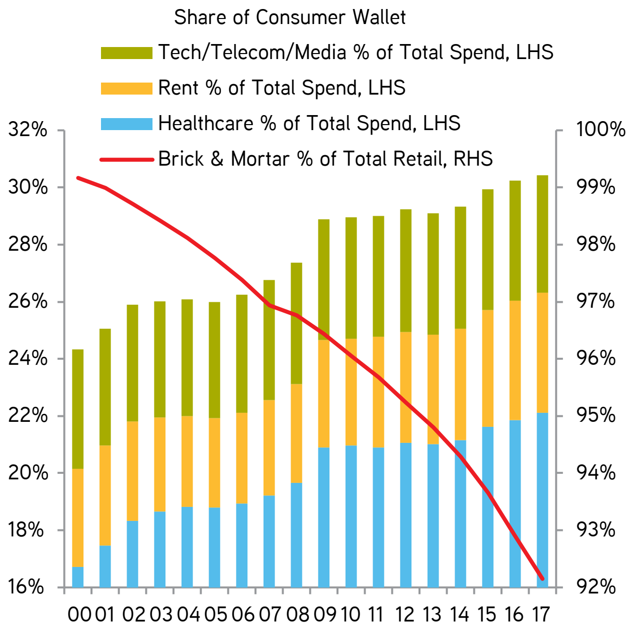


Data as at November 30, 2018. Source: Bureau of Labor Statistics, Haver Analytics.

Nowhere is this shift towards e-commerce more prevalent these days than in China (*Exhibit 112*), with its outsized millennial population (see *China: A Trip to the Epicenter,* August 2018). By way of background, of the total 828 million millennials in Asia, my colleague Frances Lim estimates that fully 40%, or 330 million, are today in China. To put the 330 million in perspective, we would note that there are 'just' 66 million millennials in the U.S. Importantly, though, as we saw with Apple's recent pre-announcement in early January 2019, this segment of consumers – even given its mighty heft – is also not immune to some of the trade and geopolitical anxieties that we have been highlighting to investors for quite some time.

EXHIBIT 111

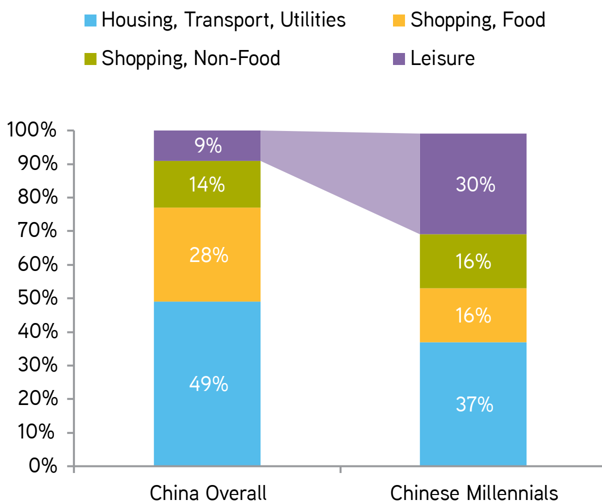
Disposable Income Available for Traditional 'Things' Is Waning at a Time of Significant Change in Consumer Spending



Data as at December 31, 2017. Source: Bureau of Economic Analysis, IDC, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 112

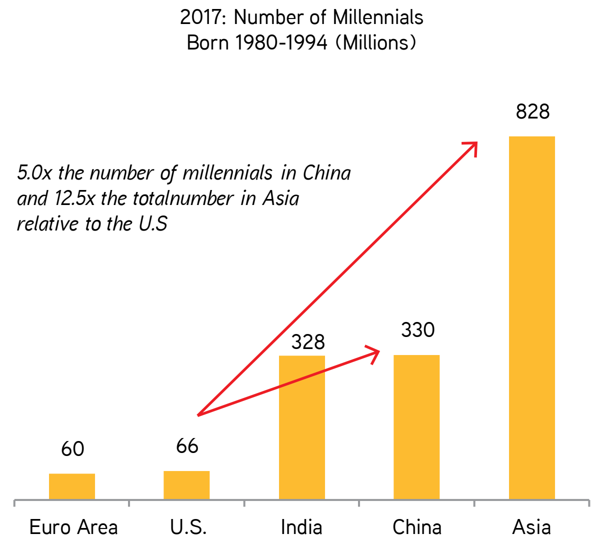
Chinese Millennials Save Less, and Allocate Three Times More of Their Incomes to Leisure



Data as at May 31, 2017. Source: Bureau of Labor Statistics, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 113

With More than 6x as Many Millennials in Asia as in the U.S. and Europe Combined, the Asian Millennial Will Reshape the Global Consumer Market



Asia includes China, India, Japan, Hong Kong, Korea, and ASEAN (Indonesia, Malaysia, Philippines, Thailand, Singapore, Vietnam). Data as at June 24, 2017. Source: United Nations World Population Prospects, Haver Analytics.

"

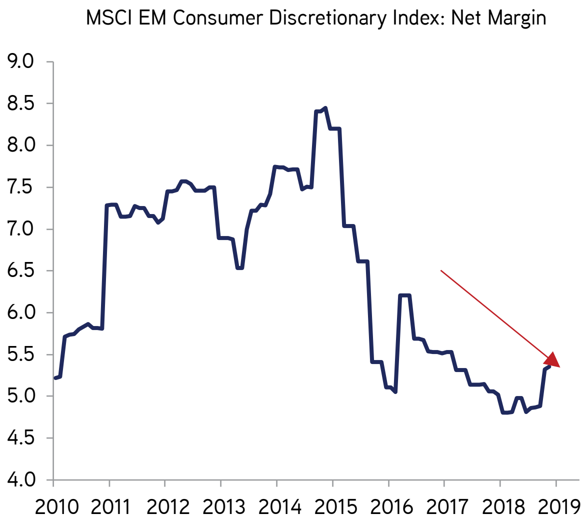
Recent trips to Asia and also continental Europe lend support to our view that this trend towards experiences is global in nature and cuts across a variety of demographics. For example, in Japan and Germany, aging demographics are boosting the use of later-stage healthcare offerings, while younger individuals in the U.S. are embracing more health, wellness, and beautification.

"

Personal financial services, healthcare services, wellness/beauty, healthier foods, and food safety should also be major long-term beneficiaries of the environment we are envisioning. We also anticipate continued demand for China to tackle air, water and soil pollution, likely creating opportunities for companies that address these issues. Importantly, though, the Chinese consumer is becoming increasingly sophisticated, which is leading to a more demanding customer who uses technology more often to drive value, selects aspirational brands over standardized ones, and comparison shops more often than in the past.

EXHIBIT 114

Fiscal and Current Account Headwinds Have Implications for Profitability, Particularly in the Consumer Sector



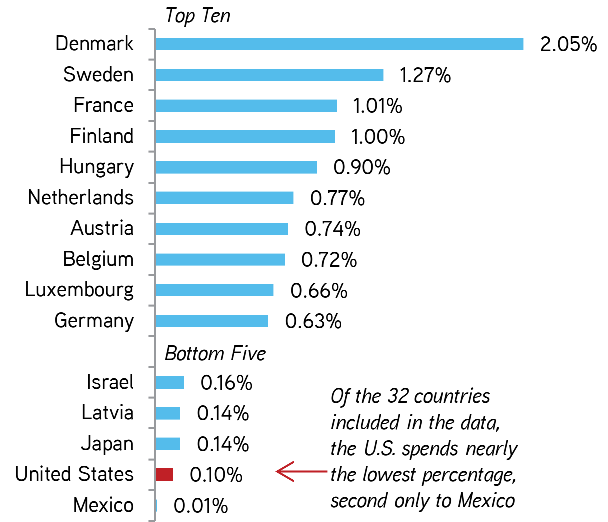
Data as at December 31, 2018. Source: MSCI, Factset.

The other major influence on consumer behaviour is technological change and how it is affecting the consumer experience/well-being, particularly around employment trends. To this end, we note the following:

- 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 know over a dozen separate jobs during his or her lifetime while education will become a lifelong affair, not something completed prior entering the workforce, with retraining becoming the new normal.
- The United States spends roughly one-fifth of what the average European country devotes to active labor market programs, which are designed to provide individuals who lose their jobs with the training, skills, and counseling necessary to return to the job market.

EXHIBIT 115

Public Expenditures on Assistance and Retraining for Unemployed Workers in the U.S. Remain Quite Low



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

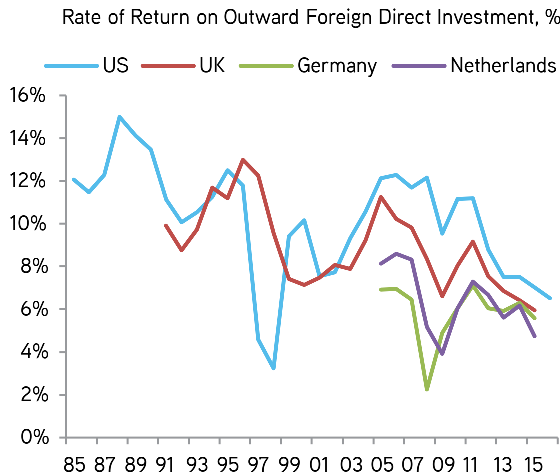
So, our bottom line is that it is not business as usual in the large and growing global consumer arena. To be sure *Experiences over Things* continues to gain momentum, and we want to play this trend in size. However, as we detailed above, we think fully understanding the influences of education and 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.

Structurally Bullish on Deconglomeratization Although not new, this theme is a powerful one that is accelerating the pace of corporate restructurings across the global capital markets. In our humble opinion, many corporations used low-cost funding to over-expand in recent years, and with global trade now slowing at the same time domestic agendas are taking precedence, we expect more firms to hive off unprofitable subsidiaries and non-core businesses (*Exhibit 118*). This trend has fully gained momentum in Japan, Europe, and India, and we expect other business communities to move this way over the coming months and quarters.

> **"Personal financial services, healthcare services, wellness/beauty, healthier foods, and food safety should also be major long-term beneficiaries of the environment we are envisioning."**

EXHIBIT 116

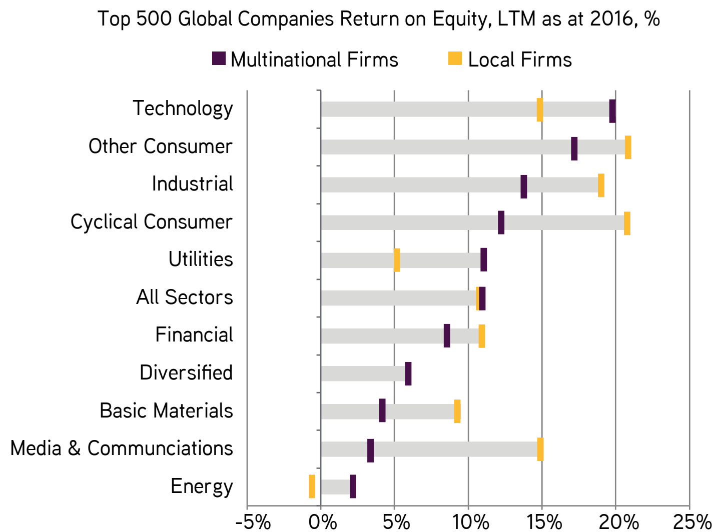
Rate of Returns for FDI Declining in Many Areas of the Global Economy



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

EXHIBIT 117

Local and Regional Competitors Are Increasingly Challenging the Returns of the Multinational Firms



Data as at January 31, 2017. Source: National Statistics, OECD, The Economist.

EXHIBIT 118

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	3,907	2,319	1,122	248	167	51

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, many U.S. energy companies are right-sizing their footprints, as Wall Street encourages them 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. Finally, we are seeing our deconglomerization thesis play out in spades in the infrastructure sector. In particular, there has been a lot of activity involving deals in the tower and fiber arena and we also have seen an increasing number of potential transactions in areas such as energy midstream and pipeline assets.

"We also note that we are seeing a lot of corporate 'streamlining' occurring outside of the traditional multinational sector."

Section V: Investment Considerations/Risks

In the following section, we detail several key investment considerations that we believe portfolio managers should have on their horizon as they consider exposures and hedging strategies in 2019. They are as follows:

Risk #1: Credit Is in Worse Shape Than We Think Without question, the number one concern for our team is tightening financial conditions amidst shifting stimulus towards fiscal channels and away from monetary ones. In our base, we assume this baton-hand-off creates some notable bumps, but we are not forecasting any major breakage (aka a 2008-type event). However, given how fast central bank liquidity is currently exiting the system, we may be too optimistic in our thinking if central banks don't slow down a bit in the first half of 2019. Indeed, as we have detailed many times in this report, money supply growth is slowing amidst tightening financial conditions, and we do worry that the Fed is now approaching a policy mistake with its "autopilot" approach to QT. In addition, our base case assumes that the U.S. consumer does not stop spending, so that any economic slowdown we see over the next few quarters is more akin to 2001, not 2008.

Meanwhile, unlike in prior cycles, supply in key markets such as High Yield remains tight. We view this discipline as a notable positive (*Exhibit 120*). In addition, we think that corporate interest coverage ratios are generally in good shape relative to prior cycles (*Exhibit 122*), which leads us to forecast a rising – but not insurmountable – default rate.

EXHIBIT 119

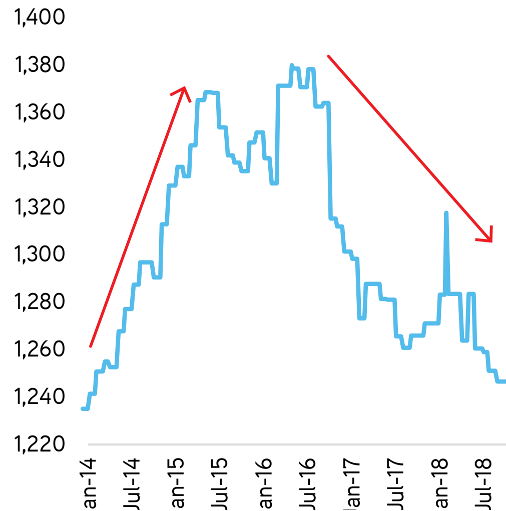
Most of the Credit Market Growth Has Been in IG and Loans

SIZE OF THE CREDIT MARKETS US$ BILLIONS	2008	2018	% CHANGE
U.S. High Yield	$727.6	$1,231.8	69.3%
U.S. Investment Grade	$2,496.9	$6,405.7	156.5%
EM USD	$183.2	$535.4	192.2%
U.S. Loans	$594.2	$1,129.7	90.1%
Total	$4,001.9	$9,302.6	132.5%

Data as at December 12, 2018. Source: BofA Merrill Lynch Global Research, TRACE FINRA.

EXHIBIT 120

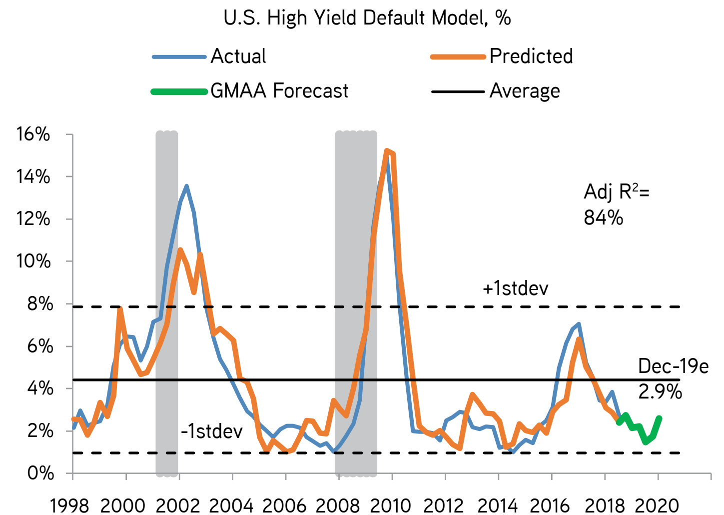
High Yield Supply Is Actually Shrinking



Data as at October 31, 2018. Source: BofA Merrill Lynch Global Research, TRACE FINRA.

EXHIBIT 121

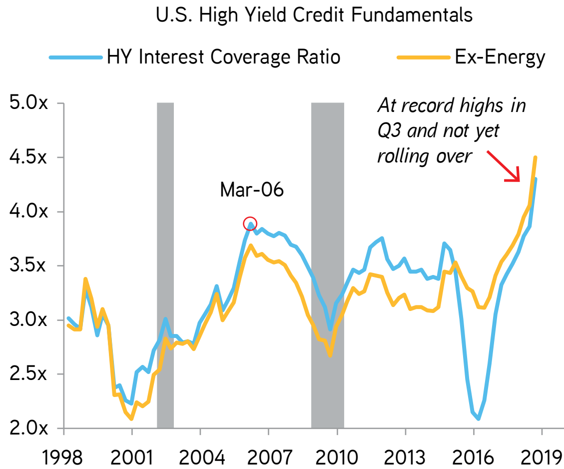
While Defaults Should Pick Up in 2019, We Expect Them to Stay Relatively Benign Versus History...



Note: HY default model based on senior loan survey lending conditions, distress ratio and ratings migration rate. Data as at December 31, 2018. Source: Bloomberg, Haver Analytics, Federal Reserve, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 122

...In Part Due to Robust Fundamentals With Interest Coverage Ratios Making New Highs in Third Quarter of 2018

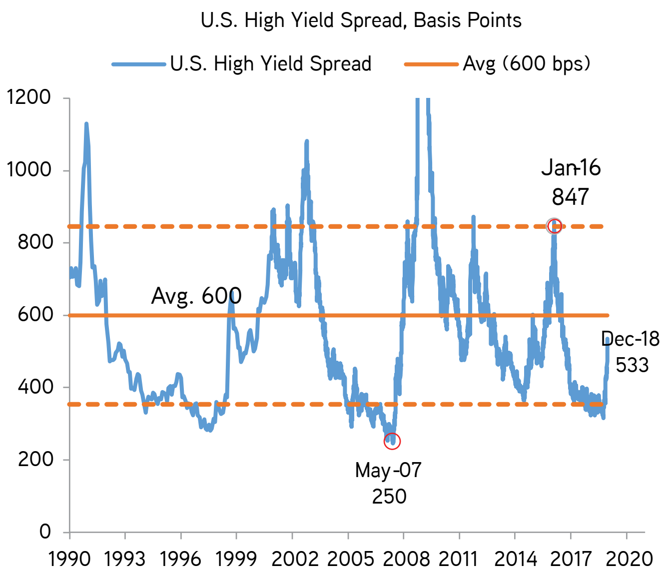


Data as at September 30, 2018. Source: Bloomberg, Haver Analytics, BofAML, KKR Global Macro & Asset Allocation analysis.

However, there is certainly the risk that we are viewing the world through rose-colored glasses. For starters, we must acknowledge that the overall Credit market has exploded in size during recent years (*Exhibit 119*). Without question, it has enjoyed massive growth and deteriorating underwriting standards. In addition, even with the acute spread widening in recent months to 533 basis points, on the basis of spread-per-turn of leverage, we still do not believe investors are being compensated adequately should all of the headlines headwinds we outlined earlier come to pass (*Exhibits 123* and *124*).

EXHIBIT 123

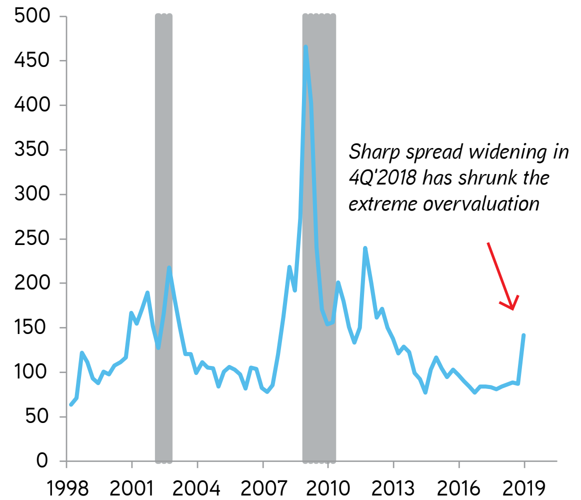
After Tightening to Near Record Levels, High Yield Spreads Are Now Widening Again



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

EXHIBIT 124

Spread-Per-Unit of Leverage Is Now Just Beginning to Return Towards More Normal Levels



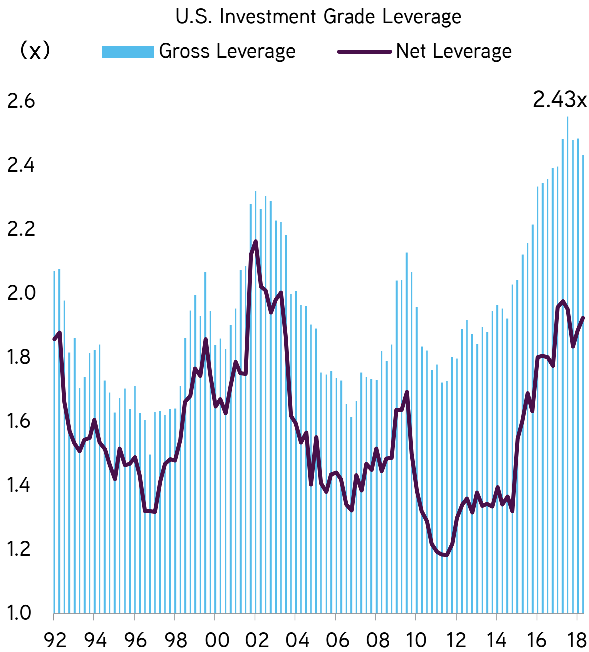
Spread data as at December 31, 2018; leverage data as at December 31, 2017. Source: BofAML, Bloomberg.

Meanwhile, truth be told, *we are actually more nervous about Investment Grade debt than we are High Yield at this point in the current cycle*. Key to our thinking is that, as we show in *Exhibit 125*, gross leverage and net leverage are both re-approaching levels not seen since the late 1990s, a period that led to a sudden surge in 'Fallen Angels.' All told, the BBB segment of the Investment Grade market is now 49% of the entire IG market, compared to 38% in 2007; moreover, the size of the entire Investment Grade market has doubled during this same period.

> **"However, given how fast central bank liquidity is currently exiting the system, we may be too optimistic in our thinking if central banks don't slow down a bit in the first half of 2019."**

EXHIBIT 125

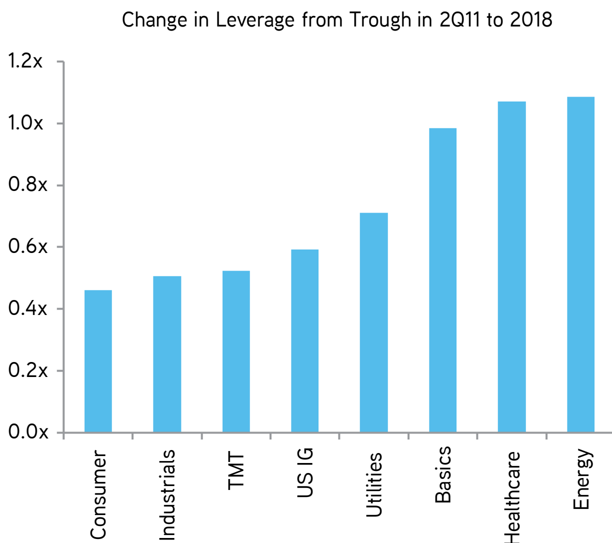
Investment Grade Leverage Risk Is Quietly Testing Record Levels Again...



Data as at October 31, 2018. Source: Morgan Stanley.

EXHIBIT 126

...Particularly in the Energy, Healthcare, and Materials Sectors

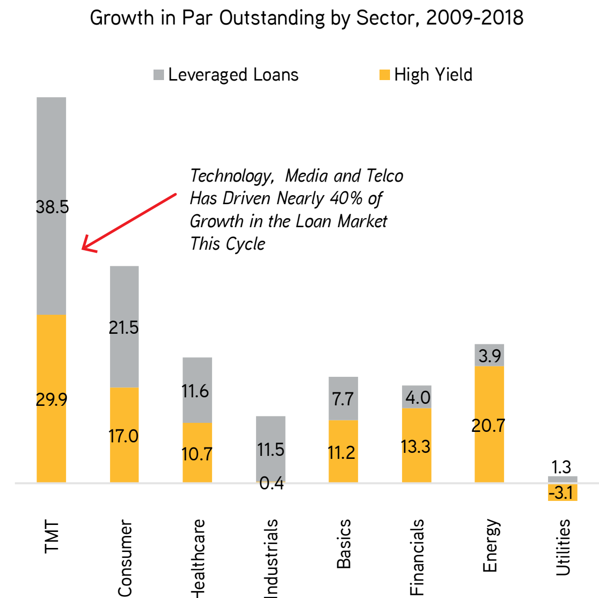


Data as at June 30, 2018. Source: Morgan Stanley.

Technology credits, including Levered Loans, are also an area worth focusing on in 2019. Software has become defined as a truly recurring revenue business. We agree that it may be in many instances, but given the amount of deal activity we show in *Exhibit 127*, it certainly had better be in all instances. Otherwise, investors could face a similar situation to what we experienced during past areas of large issuance. One can see this in *Exhibit 128*.

EXHIBIT 127

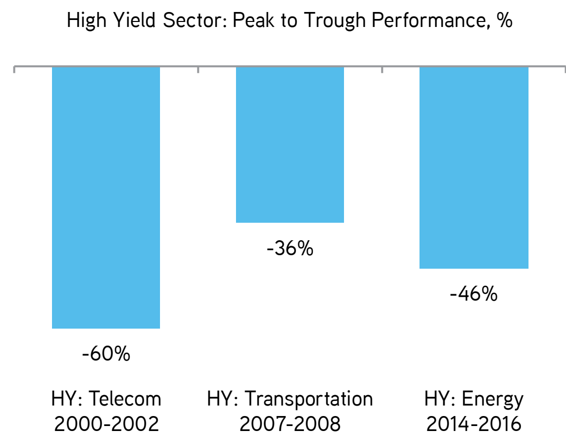
In the Past, Sectors That Saw a Surge in Credit Growth...



Data as at December 31, 2018. Source: FTSE Fixed Income, Morgan Stanley.

EXHIBIT 128

...Experienced a Significant Correction



Data as at December 31, 2016. Source: FTSE Fixed Income, Morgan Stanley.

"

Meanwhile, unlike in prior cycles, supply in key markets such as High Yield remains tight.

"

To hedge against any issues in Credit, we suggest Investment Grade CDX payer swaptions for full tail risk insurance. Despite skew being wider in Investment Grade bonds, the overall level of volatility is still very low, resulting in less premium spend per unit of expected payout. Also, Investment Grade spreads tend to move more in multiples of original spread than High Yield in risk-off scenarios (i.e., it's easier for a credit that trades at 20 basis points to widen to 80 basis points in a risk-off event rather than a credit that trades at 300 basis points to widen to 1,200 basis points). A six-month 25 delta IG payer swaption struck at 80 basis points (versus 57 basis points forward) costs 15.5 basis points upfront. This compares to the equivalent 25 delta HY payer swaption struck at 92 (versus 100 on the forward) costs of 103 basis points upfront.

Risk #2: We Underestimate Negative Operating Leverage, and Margins and EPS Fall More Quickly Than Expected As we indicated earlier, we think margin pressure will be a key theme in 2019, and as such, we want to be tactically nuanced in this area of the market. However, our practical approach could be too optimistic if growth slows much more quickly and/or severely than expected. To review, S&P 500 revenue growth has generally been highly correlated with the path of U.S. nominal GDP growth, which we estimate will decelerate to 4.3% in 2019e from 5.4%. Our base case at present also calls for revenue growth to decelerate towards four percent in 2019 from 8.2%.

However, given all the uncertainty in the world, it is worth considering the bear case. Specifically, if U.S. average hourly earnings continue to grow at the current rate of approximately 3.1%, while revenue growth slows to approximately 1.5% (*Exhibit 131*), our simplistic framework tracking the revenue-wage growth differential would actually turn negative by 4Q2019 (*Exhibit 129*), a threshold which has coincided with the prior two recessions in 2008 and 2001. Under this bear case scenario, our 2019 S&P 500 target would be in the 2300-2450 range, driven by $163 of earnings (i.e., no growth) and a forward multiple of 14.0-15.0x.

A potential mitigating factor is if productivity continues to improve, which would offset some of the wage inflation and keep unit labor costs relatively stable (*Exhibit 130*). However, if CEOs get more concerned about trade tensions, they may pull back on capital expenditures (which are key to productivity) at exactly the time spending needs to increase to boost productivity.

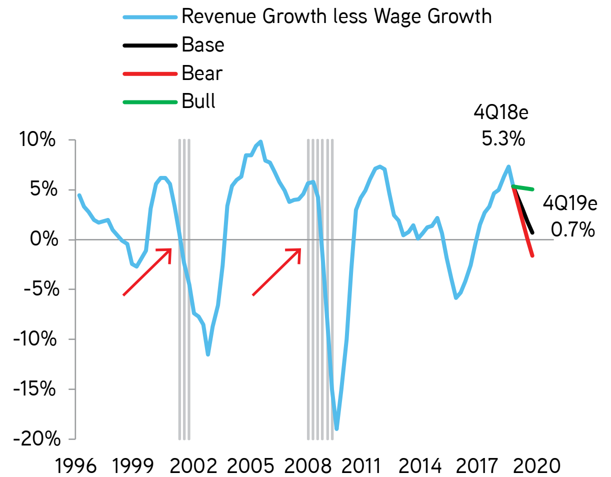
"

Technology credits, including Levered Loans, are also an area worth focusing on in 2019.

"

EXHIBIT 129

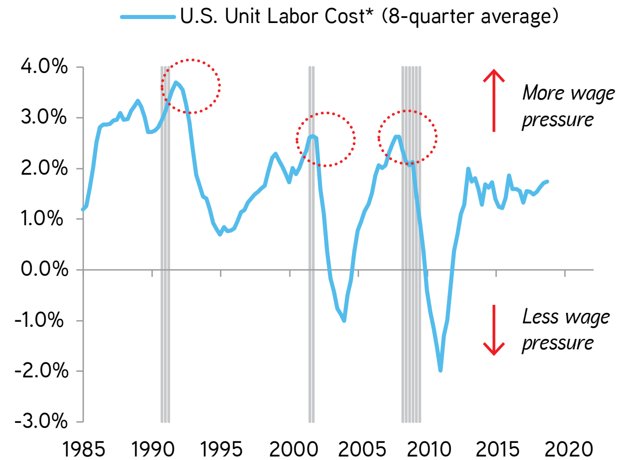
We Believe That Slowing Growth Amidst Higher Wages Will Become a Headwind to Margins in 2019...



Data as at November 30, 2018. Source: Bloomberg, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 130

...Unless Better Productivity Growth Offsets Rising Wages, Keeping Unit Labor Costs Relatively Stable

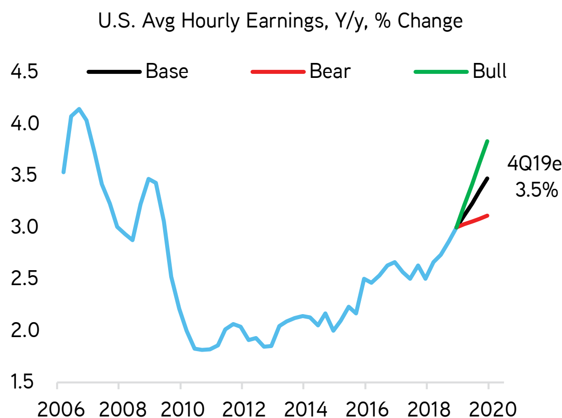


* Unit Labor Cost Growth = Wage Growth - Productivity Growth

Data as at November 30, 2018. Source: Bloomberg, Haver Analytics, Bureau of Economic Analysis.

EXHIBIT 131

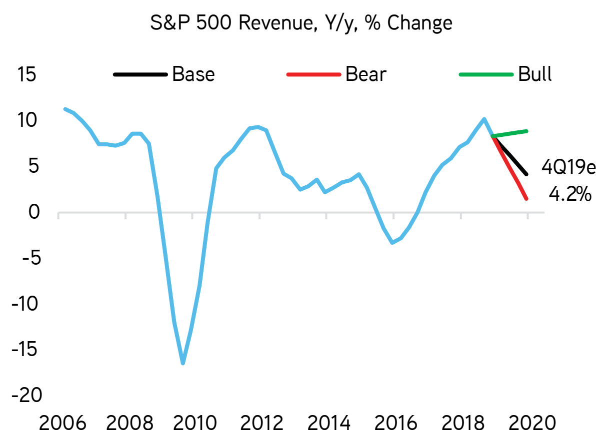
Our Base Case Assumes AHE Growth Reaches Approximately 3.5% by Fourth Quarter of 2019



Data as at December 2, 2018. Source: Bloomberg, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 132

While S&P 500 Revenue Growth Could Trail Off to Approximately 4.2% by Fourth Quarter of 2019



Data as at December 2, 2018. Source: Bloomberg, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

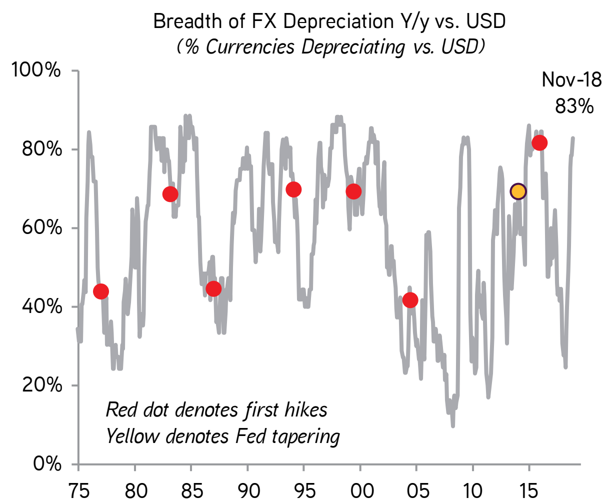
> **"We think margin pressure will be a key theme in 2019, and as such, we want to be tactically nuanced in this area of the market."**

To hedge against this aforementioned risk, we recommend simple collar or spread based approaches with duration and strikes to match an investor's strategic needs to cheapen the structure in today's high volatility environment. Maybe more important, though, than any specific hedge is for macro traders and allocators to avoid companies and portfolios where negative operating leverage appears to be a sizeable risk.

Risk #3: Fat Tails in Leading Currencies While we are not currency traders, we do hedge currencies across all our funds through the KKR Global Macro & Asset Allocation, Balance Sheet, and Risk team. At the moment, with nine hikes under our belt in the United States, we think that the breadth of currency performance will begin to diverge. Within the G10, for example, we expect non-Fed policies to dictate the path of currencies. So, as the ECB and BoJ embark on normalization, the euro and yen are both likely to strengthen against the U.S. dollar. On the other hand, across emerging economies, we think global quantitative tightening may play an even bigger role, particularly for twin deficit countries that rely on international funding, like Turkey and South Africa. Furthermore, U.S.-China trade and technology-related headlines are likely to impact countries linked to the China supply chain, such as Korea and Taiwan, particularly as it relates to technology.

EXHIBIT 133

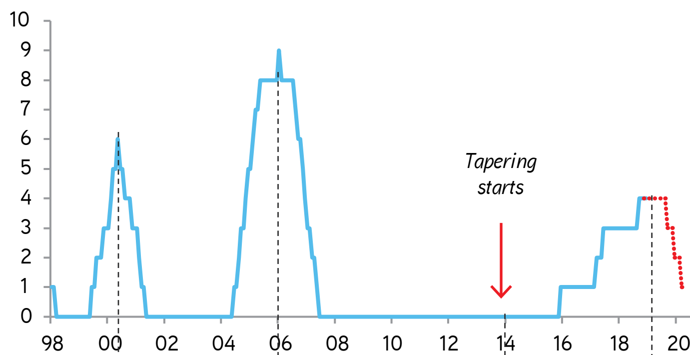
Ubiquitous Dollar Strength Against All Currencies in 2018...

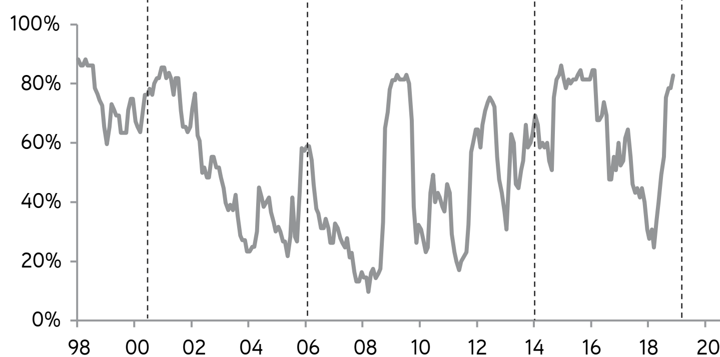


Percentage of 65 global currencies depreciating on a year-over-year basis against the U.S. dollar. Data as at November 30, 2018. Source: Federal Reserve Board, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

EXHIBIT 134

...Will Give Way To More Divergent Performance in 2019





Percentage of 65 global currencies depreciating on a year-over-year basis against the U.S. dollar. Data as at December 28, 2018. Source: Federal Reserve Board, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

However, again given all the uncertainty in today's world, one of the key areas of debate within our team is the potential for a fat tail risk to emerge as we shift from monetary stimulus to fiscal stimulus. In particular, we believe that recent behavior patterns to stimulate economies in the U.S. and China could cause either the Chinese yuan or the U.S. dollar to stumble more than many folks are currently thinking over the next 12-24 months. In the U.S., for example, we are growing increasingly concerned that investors may begin to shift their focus from the Federal Reserve raising rates to the large deficits President Trump is onboarding. Were this to occur, then we would likely enter a dollar bear market that would ultimately lead to less consumption, higher inflation, and a more hawkish Federal Reserve.

Meanwhile, China is clearly stimulating its economy to offset the downward pressure that trade tensions are causing. To date, the local currency has remained firm, but the market cannot consistently ignore that the government has turned notably more accommodative – a stance that currency markets generally find unsettling. Moreover, if imports continue to grow well in excess of exports, we think that this mismatch will signal to the government that their currency should be even lower.

To hedge against these potential fat tails in the currency markets, my colleagues Frances Lim and Phil Kim recommend an option based approach buying JPY / selling USD. With the lion's share of Fed tightening completed, BoJ embarking on policy normalization and JPY's safe haven currency status, there are a number of relevant catalysts for this hedge to work in your favor. With USDJPY volatility and skew trading at a high premium, we believe expressing this trade through a long 6 month ATMF (110) / 20 Delta (105) Put Spread for a total cost of 1.20% realizing a return of 3.9x (assuming spot expires at 105) is highly compelling.

Risk #4: Geopolitical and Socioeconomic Tensions The rising socioeconomic tensions, geopolitical rivalry, and global populism we anticipated last January have indeed caused disruptions in global trade, the largest democracies in Europe and the U.S., and across many industries, particularly technology. We also see strains of nationalist and economic populism gaining momentum globally, including in the major economies of Latin America and Asia. Like in the U.S., these forces often intersect with more assertive and less conventional leaders like Donald Trump, Xi Jinping, and AMLO (and in some cases also more authoritarian ones like Vladimir Putin and Viktor Orban) that openly challenge international norms, are more confrontational, and are less predictable in policy outcomes.

Our colleagues Ken Mehlman and Travers Garvin expect these trends to accelerate in 2019, unfortunately. For starters, the four largest democracies in Europe face unprecedented populist challenges, with the migration/immigration theme as a common political disrupter across geographies. In the U.K., a stalemate on how to implement the 2016 referendum result on Brexit threatens not just the government's survival but the country's economic prosperity. In France, the most widespread violent protests in 50 years, those of the "yellow vests," are threatening President Macron's domestic and European structural reform agenda. In Germany, Chancellor Merkel, too, is weakened, and has announced her intention to not run again. In Italy, we are witness to an unstable Euro-sceptic populist left/right alliance. Furthermore, significant electoral gains by populist parties in Spain and Sweden, and spring elections for the European parliament are likely to further erode the position of power held by the center-left and center-right political blocks for much of the post-WWII period in Europe.

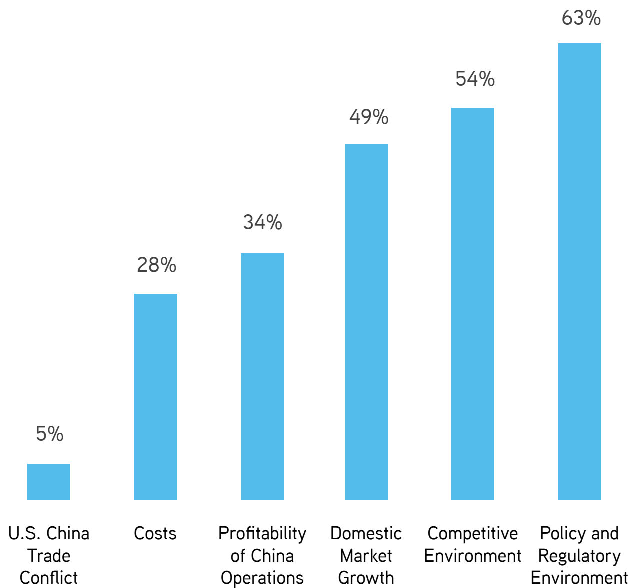
The United States faces disrupting forces as well: the Republicans have been replaced in the House by a Democratic majority hungry for oversight of the Trump Administration; there is a growing field of potential 2020 Democratic Presidential candidates, many of them U.S. Senators, all vying for attention; and investigations of President Trump by Special Counsel Robert Mueller and other authorities are maturing. All of this will pull Democratic leaders to the left – and we expect President Trump to respond to these new challenges by counterpunching even harder and doubling down on "America First."

It is most remarkable that these populist forces and trends have risen while economies have generally been strong. And assuming economic drift or slowdown in 2019, these forces and trends are likely to accelerate.

Today's environment also presents an unprecedented and unsustainable dichotomy: we see historic concentrations of economic power and political authority – at the same time, the power to shape public attitudes is increasingly diffused to digitally empowered activists and a skeptical, socially conscious public. This disconnect between the economic/political elite and rise of these "new power" activists and public could lead to a new era of redistribution, driven by efforts to break up concentrated wealth and corporate power. A "war on concentration" could have broad ideological appeal – keying off themes of fairness and competitiveness.

EXHIBIT 135

For Long-Term Players in China, Policy and Regulatory Environment Are Issues That Trump the Current Trade Conflict



Source: 2018 U.S.-China Business Council Survey.

In sum, our outlook on trade tilts more bearishly than some others – as we believe 1) President Trump is committed to the United States pursuing a more muscular trade policy, 2) the U.S. and other Western powers are locked in an increasingly structural geopolitical struggle with China that does not lend itself to easy resolutions or half measures and 3) populist trends will continue to contribute globally towards a resurgence in nationalist tendencies.

Given the above, our view is that investors should make sure to maintain some additional liquidity or shock absorbers in their portfolios. Hence, our decision in 2019 is to add a sizeable position in short duration government bonds. However, there is a bigger shift in approach that should be implemented, we believe. Specifically, as our colleagues Ken Mehlman and Travers Garvin have been advocating through their work at KKR, investors need to spend more time on the 'soft stuff', including reputational risks.

To this end, we believe that all allocators of capital should carefully assess whether companies and industries act like monopolists, can appropriately mitigate the negative externalities of their business models, and thoughtfully consider business practices that are "allowed but not proud" – and look to invest with companies who credibly maintain their social "license to operate."

"The rising socioeconomic tensions, geopolitical rivalry, and global populism we anticipated last January have indeed caused disruptions in global trade, the largest democracies in Europe and the U.S., and across many industries, particularly technology. We expect these trends to accelerate in 2019, unfortunately."

Section VI: Conclusion

As this 2019 outlook piece underscores, we do think that the "game has changed." Specifically, we see four major influences that require a different approach to asset allocation: 1) a shift from monetary policy to fiscal is under way; 2) Technology valuations reflect a lot of good news at a time when regulatory and trade-related risks are rising; 3) tightening liquidity/higher real rates are acting as a drag on capital markets assumptions; and 4) the rise of geopolitical uncertainty is creating de-stabilizing situations across the globe that often require a higher risk premium.

However, our message is not to head to the sidelines and hide. Rather, we want to stay invested but we want to do so in a way that leverages our key macro themes across our traditional asset allocation buckets. Equally as important, we want to use periodic dislocations like we saw in the fourth quarter of 2018 to overweight areas that fully seem to be pricing in a recession, or some type of sustained downturn, i.e., a 2008-type event (that we do not, however, think is likely to occur).

No doubt, a key area of debate in 2019 will clearly be whether global central bank policies could be more nuanced as it relates to predetermined pace of Quantitative Tightening. After doing extensive research for this report, we now think that is a greater possibility, given that money supply growth slowed faster than either the 'Authorities' or investors had anticipated in 4Q18.

So, the backdrop that we are envisioning in 2019 should create more of a two-way market for buyers and sellers to transact, compared to the mini-crash the markets witnessed in December 2018 (note: December 2018 was the worst performance for the S&P 500 since 1931). If we are wrong and market conditions do sour notably from here, it will be because money supply growth remains negative and corporate margins fall faster than expected. This is not our base case, but it is one we are watching closely. Alongside these headwinds, Credit too could turn downward more than we have modeled.

Overall, though, *our base case is that there is now a fair amount of valuation "cushion" built into the prices across the global capital markets, Public Equities in particular, at current levels*. Hence, our bottom-line for 2019: Thoughtful asset allocation preferences, coupled with several key top-down investment themes, can drive above average returns from current levels. No doubt, Sharpe ratios are headed lower in aggregate, but for investors with a long-term game plan and the ability to buy complexity amidst uncertainty, we see significant opportunities ahead in 2019. Moreover, for those who understand how to adeptly navigate the reality that the *game has changed*, the upside could be even more significant, we believe.

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