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Another Swing at the Plate

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Another Swing at the Plate

In response to a surge in client questions we have fielded since our 2019 Outlook piece was published in early January, we are taking "another swing at the plate" to address four key issues where there appears to be the most investor interest/consternation. First, we see China's desire to internalize its economy as a long-standing goal that accelerated after the Global Financial Crisis, not the election of Donald J. Trump. Second, despite all the headline noise in Europe, we continue to uncover multiple ways for private investors to drive both absolute and relative performance. Third, our work shows that we are at an inflection point in the U.S. fixed income markets, one that argues for shorter duration and more upfront yield against cash flowing collateral. Finally, we are advocating a more nimble approach to both public and private markets in 2019. Actively Managed Opportunistic Liquid Credit is certainly central to this call to arms, but our framework also extends clearly in the private markets as well.

"My motto was always to keep swinging."

HANK AARON
RETIRED AMERICAN MAJOR LEAGUE BASEBALL (MLB) RIGHT FIELDER

If there is good news about our most recent *Insights* piece (see *Outlook for 2019: New Playbook Required*, January 2019), it is that the note certainly has engaged our client base in ways we have not seen in some time. In fact, we have been deluged with follow-up questions and requests for data from clients and others seeking to dig deeper into the key macroeconomic and asset allocation issues that we laid out. Given the state of affairs around the world these days, however, we are not totally surprised, as investors consider various strategies to not only deploy but also to harvest capital in an environment littered with macroeconomic uncertainties.

What has been surprising, though, is how concentrated the questions have been around a few specific topics. With this in mind, we wanted to take "another swing at the plate" to provide further guidance on four areas of the global macro landscape that seem to be the most important to our current clients. They are as follows:

1. **In Terms of Ongoing Trade Tensions, Our Macro Work Underscores That China Has Been Preparing for This Type of Trade Slowdown for Some Time.** To be sure, the current trade tariffs are creating some notable headwinds in China, but they pale in comparison to what the effect could have been a decade ago. Consider that exports as a percentage of the Chinese economy have already shrunk from 36% in 2008 to just 18% today *(Exhibit 10)*, a nearly 50% decline in only a decade. Maybe more importantly, we believe that exports as a percentage of GDP could be headed into the low double digit range or below that of the U.S. over the next five to seven years – almost irrespective of which way the trade negotiations turn out. As we detail below, China made a conscious decision to internalize much of its end demand following the Global Financial Crisis (GFC) – long before the election of President Donald J. Trump. For investors, we think that this shift in priorities represents a major investment consideration – one with both opportunities and risks.

2. **A Recent Trip to Europe Reinforces Our Strong Belief That Private Equity Will Meaningfully Outperform Public Equities During the Next Few Years.** As we describe in greater detail below, our work shows that European public equity indices are structurally underrepresented in key growth markets like Technology and Business Services. At the same time, however, they are overweight cyclical industries such as Natural Resources and Financials, both areas that we believe face some significant long-term challenges in the years ahead. *As such, despite heightened concern about Europe's many challenges from our client base, we actually feel pretty good about the opportunity set for Private Equity to arbitrage these compositional shortcomings to the benefit of its investor base*. In fact, we left Europe thinking that the performance spread of Private Equity over Public Equities could actually be higher than normal in Europe on a prospective basis. Also, we were encouraged to hear from several macro thinkers that more stimulus could be on the way, including a program to again fuel the appetite of banks to lend. We think it will definitely be needed, given all the crosscurrents. Consistent with this more cautious view, my colleague Aidan Corcoran is lowering his 2019 Euro Area Real GDP growth forecast to 1.2%, compared to his prior estimate of 1.5% and a current consensus of 1.4% versus 1.6% at the start of the year.

3. **Portfolio Construction 101: Buy Shorter Duration Cash Flowing Assets Linked to Nominal GDP and Trim Positions in Longer Duration Sovereign Debt.** Given the sizeable debt loads that many governments now carry amidst rising deficits, we think that there is a growing risk of a "crowding out effect" towards other asset classes, including U.S. stocks and credit securities. Of interest to us right now is that U.S. savers are being asked to step up and replace global central banks and international investors as more meaningful owners of U.S. Treasury Bonds — thereby reducing the availability of capital for individual investors to own other financial assets (*Exhibit 47*). From what we can tell, many of our clients may not fully appreciate how fast this transition is occurring. If we are right, then our asset allocation "action item" is clear: Investors should aggressively overweight cash flowing assets linked to nominal GDP that are backed by hard collateral. Meanwhile, within the government bond market, we also tilt towards shorter duration securities in the United States. Details below.

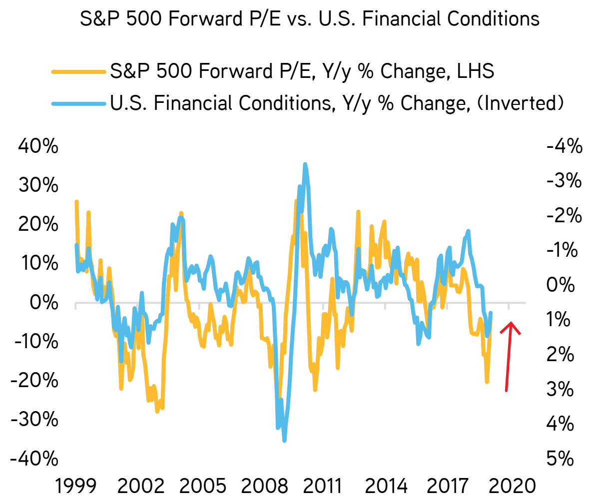
4. **Given Where We Think the World Is Headed, We Believe Now Is the Time to Increase – Not Decrease – Flexibility Across Mandates.** Importantly, we have the highest conviction about a more flexible approach in Liquid Credit. As many of our readers know, we did downgrade our tactical overweight to Levered Loans in our 2019 target asset allocation in January; however, we want to be clear: *We were not making a major negative near-term call on the creditworthiness of Levered Loans, or we certainly would not have upgraded U.S. Equities at the same time.* At the risk of stating the obvious, Public Equities actually sit below Levered Loans in a corporation's capital structure. That said, given our view on more volatility ahead, we definitely want to increase our flexibility across our Credit mandates — where applicable — to construct portfolios that have the ability to toggle more easily across Levered Loans, High Yield, and Structured Products. Hence, we entered 2019 holding a six hundred basis point overweight in Actively Managed Opportunistic Credit, compared to a benchmark weighting of zero. We also want to make the point clear that our view about more flexibility is not restricted to just Liquid Credit. Rather, one of our biggest themes for 2019 is that investors should try to take advantage of periodic dislocation that might emerge across *all* asset classes and/or regions. For example, China growth stocks retreated much more aggressively than European growth stocks during the fourth quarter of 2018, and as such, today we now see more relative value in Asian growth stocks (*Exhibits 59* and *60*). We also expect, given the contraction in equity multiples in the United States during this time period, to see more public-to-private transactions than sponsor-to-sponsor deals in 2019 as overall valuations converge. In our view, these types of "special situations" are likely to increase, not decrease, in frequency, and as such, we are viewing asset allocation this year through a much less traditional lens.

Looking at the big picture, our macro framework suggests that risk asset prices are now more appropriately valued on an absolute basis as well as relative to financial conditions. One can see this in *Exhibit 1*. As such, we are downgrading our tactical overweight to U.S. Equities back towards an equal weight position. With the proceeds, we take our Cash position to an equal weight position relative to our benchmark of two percent versus our January 2019 allocation of one percent. To review, we had upgraded U.S. Equities from 300 basis points underweight in 2018 relative to our benchmark to a 100 basis point overweight position in January 2019 based on our belief that investors were already pricing in a recession (whether or not one actually occurred). Today, after a solid 10% move up in the S&P 500 since January 1, 2019, we think that fear is no longer being discounted in global equity prices, U.S. ones in particular. We are not bearish, but we do not think that public markets will continue to appreciate in a straight line from current levels if earnings growth continues to disappoint.

Overall, we think that the environment for many risk assets seems fairly balanced. On the one hand, economic growth trends are quite weak, and our forecasting models continue to point towards a notable deceleration during 2019. On the other hand, central banks are now – without question – more dovish than most anyone in the investment community was thinking coming into this year. Importantly, inflation remains low, which we believe now provides many global central bankers with some much needed "air cover" to be patient amidst record low unemployment rates in countries like the United States, Germany, and the United Kingdom.

EXHIBIT 1

Equity Multiples Overshot Financial Conditions in 4Q18, Which Led to Our Upgrade of U.S. Equities. We Now See the Outlook Between the Two As More Balanced

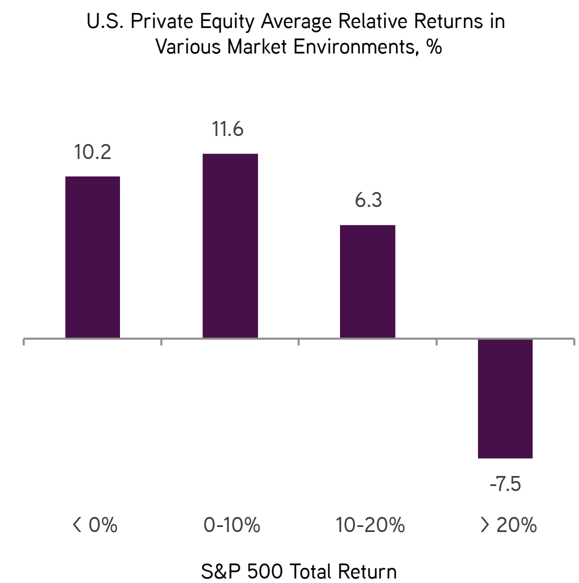


Data as at February 20, 2019. Source Bloomberg, S&P.

Against this backdrop, our asset allocation tilts towards investments that are linked to nominal GDP, have collateral against them, and generate upfront cash flow. As a result, we remain overweight Real Assets, Global Infrastructure in particular. We also remain constructive on more flexible mandates across both liquid and illiquid investments, and as such, maintain our increased allocations to both Actively Managed Opportunistic Credit and Special Situations. Finally, we continue to overweight Private Equity in size (300 basis points), as our work shows that the value of private investments grows more important later in the cycle (*Exhibit 2*).

EXHIBIT 2

Private Equity Typically Outperforms Over the Cycle Relative to Public Equities. However, the Majority of the Alpha Often Comes When Capital Markets Conditions Are Not So Ebullient



Note: Private Equity returns as per Cambridge Associates. Data based on annual returns from 1989-2016. Source: Cambridge Associates, Bloomberg, KKR Global Macro & Asset Allocation analysis.

"Consider that exports as a percentage of the Chinese economy have already shrunk from 36% in 2008 to just 18% today, a nearly 50% decline in only a decade. Maybe more important, we believe that exports as a percentage of GDP could be headed into low double digit range or below that of the U.S. over the next five to seven years – almost irrespective of which way the trade negotiations turn out."

EXHIBIT 3

Market Returns, Following Long Stretches of Consecutive Strong Positive Performance, Usually Become More 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%
		Avg. CAGR	**18.7%**	

Data as at December 31, 2017. Source://www.econ.yale.edu/~shiller/, Bloomberg.

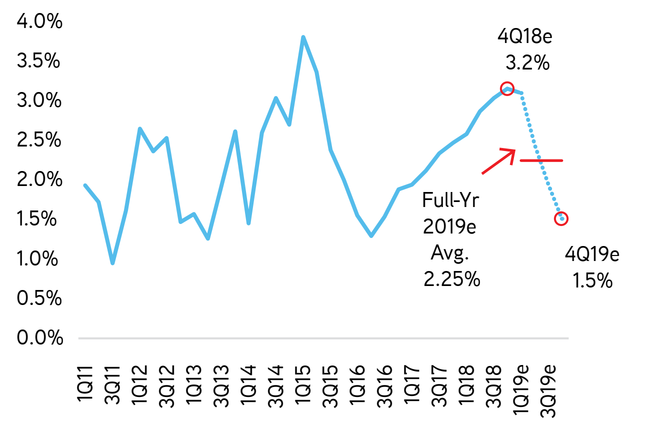
In terms of risk, we think the biggest threat is that returns are capped by the overhang of quantitative tightening for the next few years. In particular, if growth does reassert itself, central bankers will be incentivized to drain liquidity from the system faster than the market is currently projecting. On the other hand, if central bankers remain dovish, it is likely because growth is subpar, uneven, or some combination of both. Also, in a slower growth environment, we think that higher wages amidst minimal pricing power could dent margins more than the consensus currently thinks. The risk of rising input costs should not be underestimated, as our work continues to point to a notable decline in revenue growth estimates during the next few quarters (*Exhibit 4*).

> **"One of our biggest themes for 2019 is that investors should try to take advantage of periodic dislocation that might emerge across asset classes and/or regions."**

EXHIBIT 4

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

U.S. Real GDP, Y/y, %

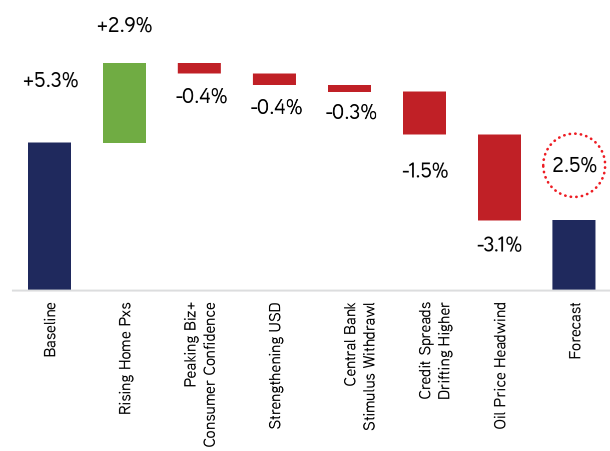


Data as at December 31, 2018. Source: Bureau of Economic Analysis, KKR Global Macro & Asset Allocation estimates.

EXHIBIT 5

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

S&P 500 Earnings Growth Leading Indicator (EGLI): Components of December 2019 Forecast



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

Details

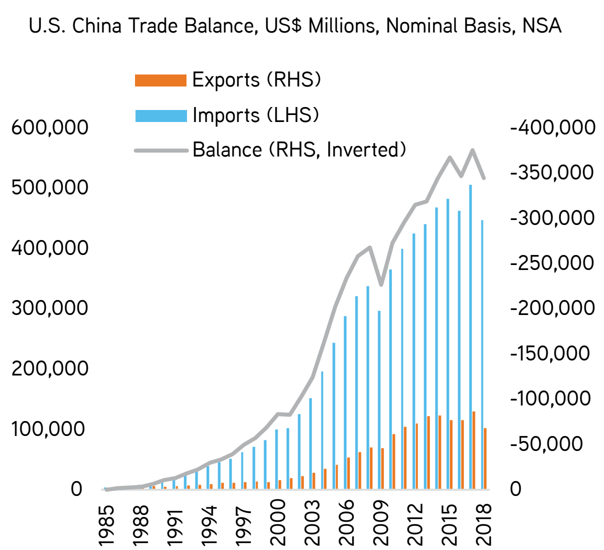
Theme #1. China Trade Tensions: Our Research Shows That China's Dependence on Global Trade Has Been Declining Consistently for Some Time

There has obviously been a lot written and said about U.S.-China trade tensions of late. In our humble opinion, much of the current discussion misses the reality that China made a decision nearly a decade ago to reduce its reliance on external demand for economic success. Hence, China may be much further along in its ambition to insource more goods and services than the consensus now appreciates. So, while U.S. tariffs are certainly problematic for China, they are not likely to have the same impact today that they would have had three to seven-years ago when China was much more dependent on an export-driven model for economic growth.

To understand our viewpoint, a little historical perspective may be warranted. To review, heading into the 2007 economic downturn, China was – without question – highly dependent on global trade, exports in particular, for its growth. At its core, there was a symbiotic relationship between the U.S. and China where U.S. consumers would buy China's goods and in return China would buy U.S. bonds. This strategy worked quite well for years, and truth be told, it actually began in earnest upon China's ascension into the WTO in 2001. One can see this in *Exhibit 6*.

EXHIBIT 6

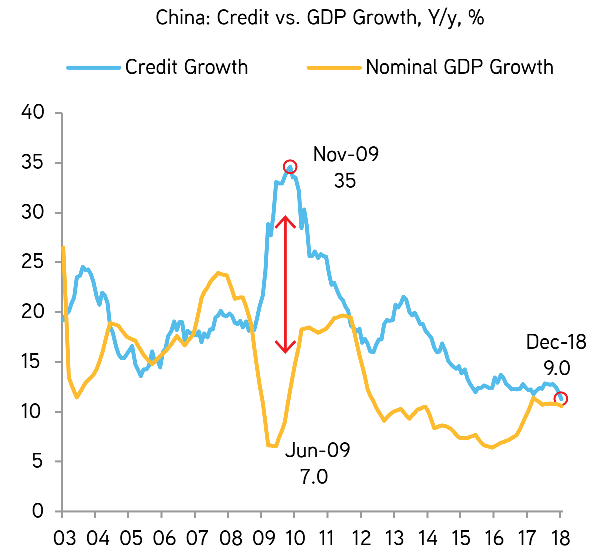
After China's Ascension into the WTO in 2001, Globalization Was Largely Defined by China Buying U.S. Bonds and the U.S. Buying Chinese Goods



Data as at 2018. Source: US Census. https://www.census.gov/foreign-trade/balance/c5700.html

EXHIBIT 7

When the American Consumer Vanished During the GFC, China Had to Use Massive Amounts of Credit to Maintain Its Targeted Growth Levels. Since Then, It Has Been Focused on Becoming Less Reliant on External Demand



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

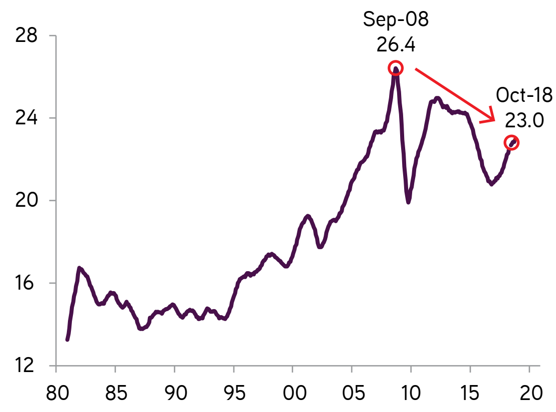
However, when the downturn linked to the Global Financial Crisis occurred, China reawakened to a stark reality: it was more dependent on foreign demand as a driver of internal growth than it wanted to be. Without question, upheavals within the U.S. banking system — and among its best customers — sent shock waves through the Chinese economy, as U.S. unemployment spiked amidst negative credit growth and de-leveraging. Hence, at the depths of the crisis in 2008/2009, in order to maintain economic and social stability, the Chinese government was forced to aggressively stimulate its economy – and the global economy for that matter – through an extremely blunt instrument: excessive credit creation. This stimulus in turn fueled a record boom in fixed asset investment. One can see this graphically in *Exhibit 7*.

While the strategy did prevent the crisis from washing up on China's shores, it saddled the country's economy with even more debt. In particular, the state-owned enterprises (SOEs) and local government funding vehicles (LGFVs) became bloated, as directives to build infrastructure and increase employment often led to poor allocation of capital and capital ratios. Ultimately, these overhangs have weighed on nominal GDP (*Exhibit 7*).

Not surprisingly, the Chinese government has been working diligently since the downturn not only to reduce its dependence on foreign demand but also to internalize more intermediate goods and to grow its domestic demand economy. As part of this transition, global trade slowed well before the recent trade disputes. In fact, one can see in *Exhibit 8* that global trade actually peaked in 2008.

EXHIBIT 8

We Believe Global Trade Momentum Actually Peaked in 2008



Data as at October 31, 2018. Source: IMFWEO, Haver Analytics.

EXHIBIT 9

China's New Model Is Focused on Recycling Its Surpluses Into Its Own Economy, Not U.S. Assets. This Shift Has Important Implications for All Assets, Real Estate in Particular

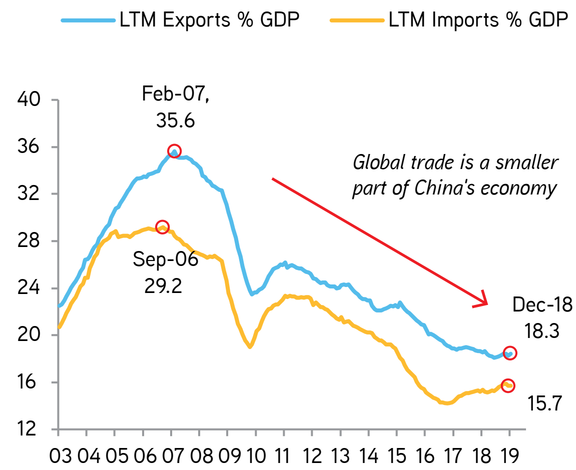
TOP FOREIGN BUYERS OF U.S. COMMERCIAL REAL ESTATE, US$ BILLIONS				
	2016		2018	
1	China	$19.8	Canada	$44.0
2	Canada	$14.6	France	$8.9
3	Germany	$6.4	Singapore	$7.0
4	South Korea	$4.2	China	$6.4
5	Singapore	$3.4	Germany	$6.2

Note: Based on transactions of properties or portfolios $2.5 million or greater. Data as at December 31, 2018. Source: Real Capital Analytics.

Moreover, China's exports as well as its imports have begun to shrink aggressively in recent years. One can see the magnitude of this shift in *Exhibit 10*, which shows that exports and imports as a percentage of the country's GDP have fallen by almost 50% in about a decade. Consistent with this strategy, China has leveraged its technology to move aggressively into higher value-added exports (*Exhibit 11*).

EXHIBIT 10

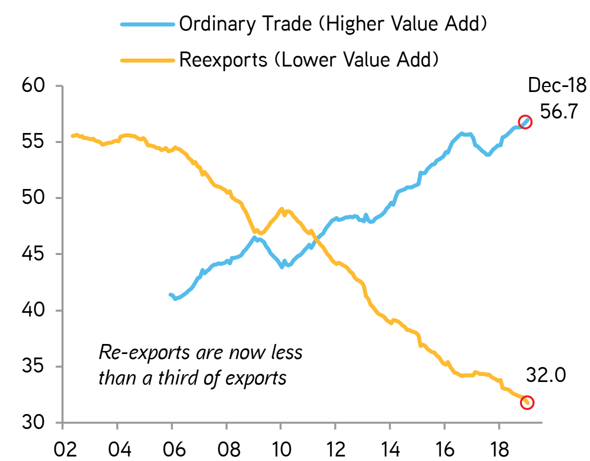
Importantly, Trade Is Becoming a Smaller Part of China's Economy…



Data as at December 31, 2018. Source: China Customs, Haver Analytics.

EXHIBIT 11

…And Within Trade, the Focus Is Clearly Towards the Higher Value-Added Parts of the Global Food Chain



Data as at December 31, 2018. Source: China Customs, Haver Analytics.

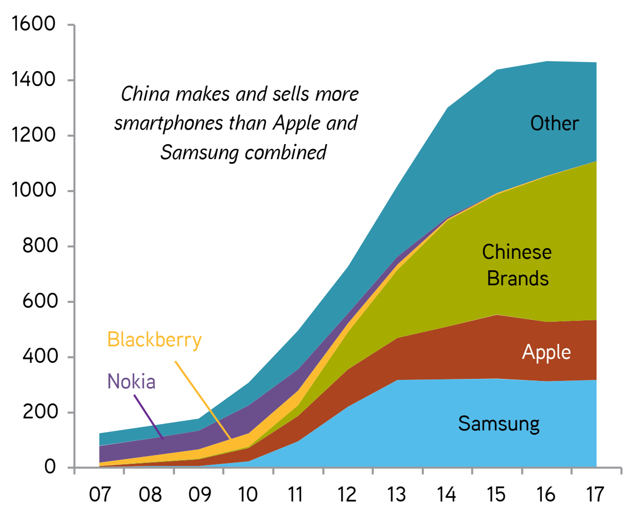
Not surprisingly, the United States views this notable increase in higher value added products and services as a potential threat to its own economic interests. For example, in the smartphone industry, China has been able to meet its growing internal demand with more and more Chinese brands. In fact, as we show in *Exhibit 12*, Chinese brands now make and sell more smartphones than Apple and Samsung combined. A similar story has played out in autos. All told, China produced and bought 24 million cars last year, of which 10 million (42%) are China-branded cars. The U.S. sold only 2.4 million cars in China last year.

Meanwhile, within semiconductors (which we view as a legitimate proxy for the highest value-added segment of the production curve), China still has more work to do. However, as *Exhibit 13* shows, even here China has begun to make significant progress towards being more self-sufficient. This viewpoint was reinforced during a recent trip when we learned that the government is currently helping to fund $200 billion or more in semiconductor production plants. Said differently, if China does end up being the number one producer of semiconductor chips, it won't be from a lack of trying by the combined private and public sectors.

EXHIBIT 12

China's Share of Global Mobile Phone Manufacturing Is Rising. We Do Not Think This Increase Is by Accident

Global Smartphone Shipments
(Millions of Units)



Data as at July 24, 2018. Chinese brands include Xiaomi, Huawei, ZTE, OPPO, Vivo, Lenovo (HK-based), Coolpad, Gionee, Hisense and K-Touch. Source: Morgan Stanley Global Smartphone Model.

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China has leveraged its technology prowess to move aggressively into higher value-added exports. Not surprisingly, the U.S. views this notable increase in higher value-added products and services as a potential threat to its own economic interests.

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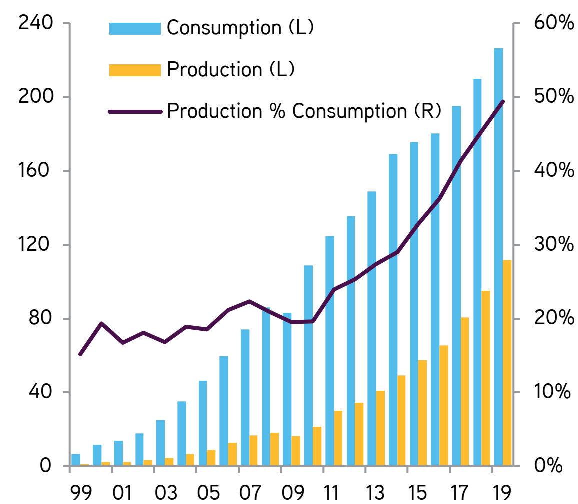
EXHIBIT 13

We Believe China Will Move Aggressively Into the Design of Memory Chips and Compound Semiconductors After the ZTE Issue

China's Integrated Circuit Consumption and Production: 1999-2019e, US$ Billions

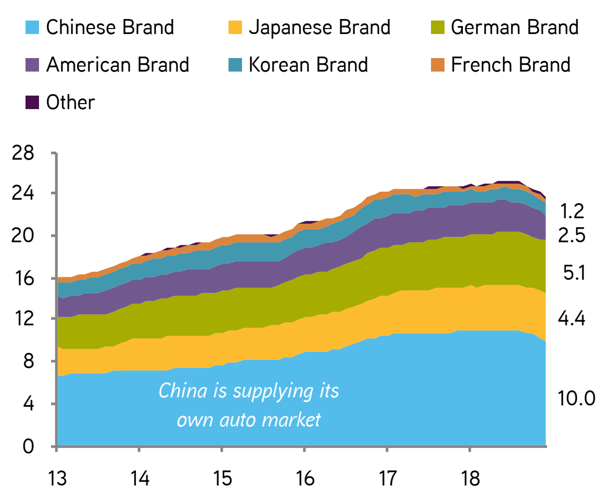


Data as at November 15, 2017. Source: PWC China's Semiconductor Industry.

EXHIBIT 14

China Is Now Supplying More of Its Own Auto Market...

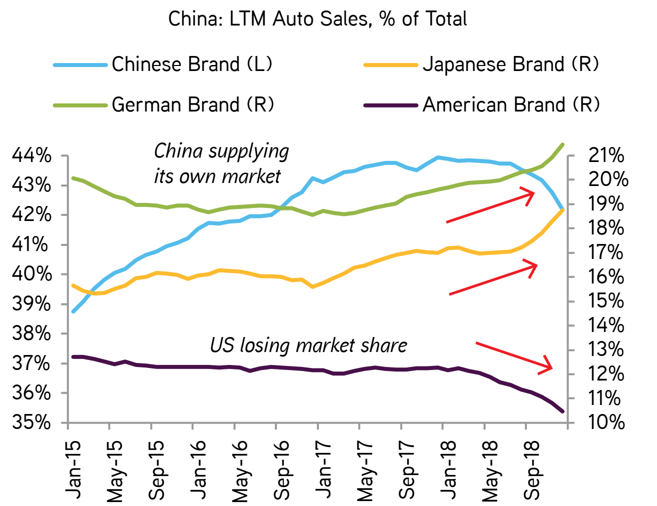
China: LTM Auto Sales, Millions of Units



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

EXHIBIT 15

…While the U.S., in Particular, Is Losing Market Share in China



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

Beyond the transition of its export economy, China has also increased its sway over U.S. firms doing business in China – a reality that we believe the current U.S. administration may be underestimating. As we show in *Exhibits 16* and *17*, there are now more than $200 billion in goods manufactured by U.S. firms in China that these same U.S. firms sell into China. Hence, when one normalizes for goods sold through subsidiaries as we do in *Exhibit 17*, the actual trade deficit is considerably smaller than many investors and politicians currently think.

"

In our humble opinion, much of the current discussion misses the reality that China made a decision nearly a decade ago to reduce its reliance on external demand for economic success. Hence, China may be much further along in its ambition to insource more goods and services than the consensus now thinks.

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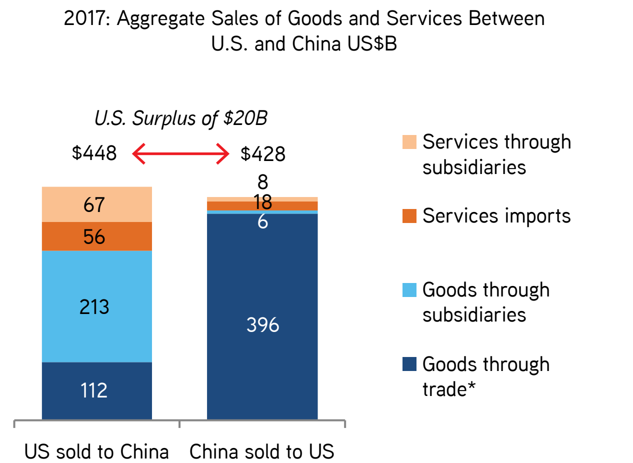
EXHIBIT 16

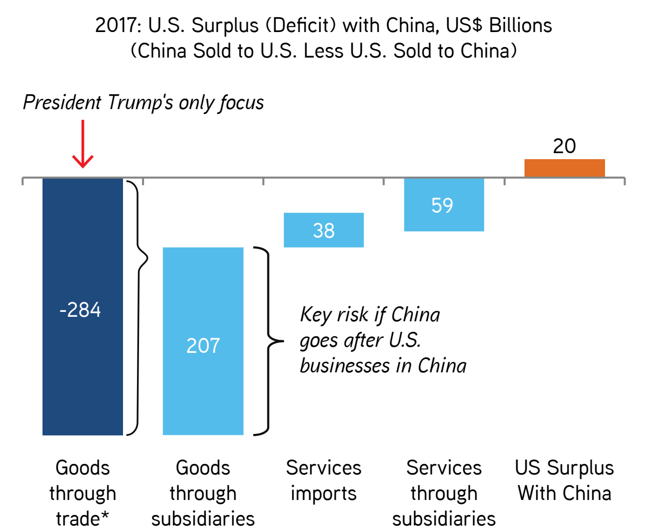
The U.S. Trade Deficit With China Appears Smaller If Adjusted for Sales of U.S. Goods Into China



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

EXHIBIT 17

When One Adjusts for U.S. Goods Sold in China, the Deficit Is Not as Robust as the Headlines Currently Suggest



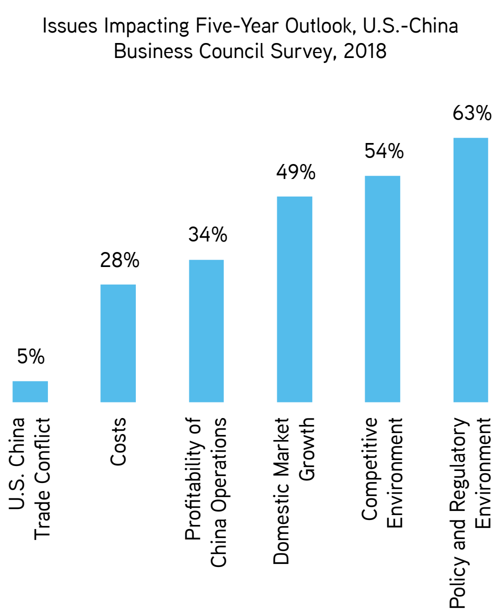
*China goods sold to U.S. from China net of goods sold from non-Chinese affiliates operating in China. Likewise, U.S. goods sold to China is net of goods sold to China by other countries' affiliates operating in the US. Data as at June 11, 2018. Source: Deutsche Bank, China Macro: U.S. Economic Balances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

In sum, we are not arguing that trade tensions are not affecting the Chinese economy. Rather, we are arguing that China shifted its long-term strategic priorities away from dependence on the United States going as far back as 2009. As a result, China is in a much better position than it would have been pre-2009 to counter President Trump's tariffs. Moreover, by insourcing more goods as well as meeting growing domestic demand with more domestically-manufactured products and services, China has begun to insulate itself from the vagaries of the geopolitics that currently dominate the global headlines.

Against this backdrop, we are not surprised that many U.S. CEOs doing business in China are growing increasingly concerned about the long-term impact of the heightened tensions between that country and the U.S. as these tensions have the ability to derail growth in one of the largest market opportunities for these American companies. Interestingly, as one can see in *Exhibits 18* and *19*, pure economic trade tensions are not what really concerns U.S. CEOs in China. They worry much more about rule of the law issues, including permitting and monitoring, that might creep up if tensions continue to escalate. Based on recent meetings in Beijing, Shanghai, and Washington, DC, we think this current state of heightened concern is appropriate.

EXHIBIT 18

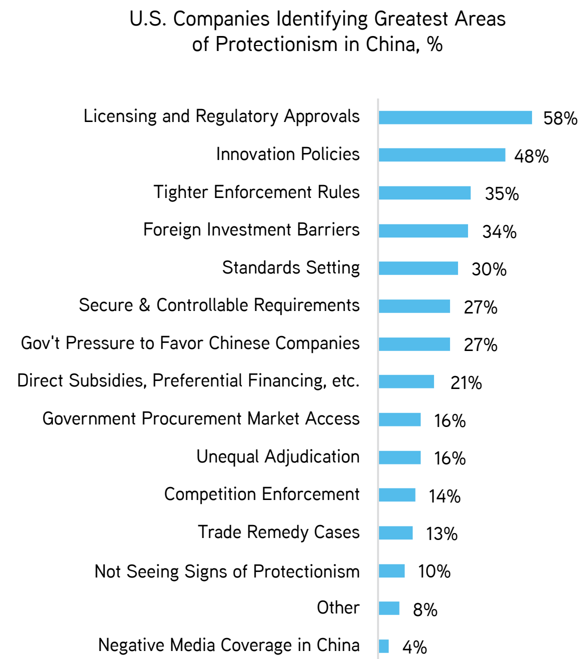
The Policy and Regulatory Environments Are Far More Important to U.S. CEOs Than Short-Term Trade Issues Are



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

EXHIBIT 19

U.S. Companies Continue to Cite Regulatory Issues Among Their Top Challenges to Doing Business in China



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

Our bottom line: While we expect some thawing of overall trade tensions in the coming weeks, we think that national security issues around technology protocols remain a "hot button" for the U.S. government. As such, we do expect some shift in tactics. Specifically, we do expect the U.S. to move away from the bluntness of broad-based tariffs towards more of a precision approach, which might include using targeted attacks on key areas such as Chinese technology IPOs in the U.S. (where audited financial statements need to be compliant). We also believe that potential occurrences of cyberespionage will become intensely scrutinized and publicized by U.S. officials.

Given this view, we do not think that China will sit by idly. Rather, we expect China to even further accelerate its reliance on internal demand, with a particular focus on services for its outsized millennial population. We also expect China to continue to move into higher value-added areas, as it laid out in its 2015 China 2025 vision. Given its poor demographics (China's working age population is shrinking by two million a year), we believe this initiative is a government imperative.

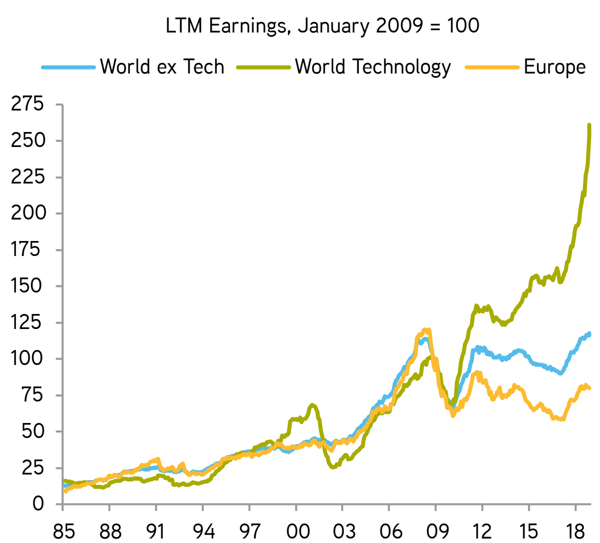
For investors, this shift in strategy is creating both opportunities and risks. For example, we do expect supply chains to evolve, which should benefit economies such as Vietnam, Indonesia, and even Mexico. Given this view, we also think that logistics will need to be rethought. As mentioned earlier, capital flows will also become increasingly important to study, and in the near term, we expect U.S. real estate in major cities such as New York to soften – all else being equal. Finally, we expect ownership of U.S. Treasuries to shift away from foreign investors, including China, towards the hands of U.S. savers. If we are right, then domestic investment offerings are going to have to have more competitive yields to remain an important destination for the capital of U.S. savers.

Theme #2. Europe: Amidst the Chaos, We Found a Few Misunderstood Opportunities

While geopolitical risk and growth concerns in Europe continue to dominate the headlines, my colleague Aidan Corcoran and I came away from a recent macro deep dive in "hot spots" like Italy and the United Kingdom with a more positive view than the consensus on certain investment opportunities. No doubt, one has to pick the right spots in Europe; yet, the arbitrages that we think exist offer significant alpha for investors who are willing to take more of a top down approach to capital deployment in the region than they might typically otherwise do. In particular, *we continue to have high conviction that Private Equity in Europe will easily outperform Public Equities over the next five to seven-years*. Indeed, from almost any vantage point, Europe's public indices are not only saddled with slower growth companies but also are overweight sectors like Banks and Upstream Energy. Meanwhile, these same indices are underweight key sectors like Technology. One can see this in *Exhibits 20* and *21*. Said differently, there is a dramatic portfolio construction arbitrage opportunity that Private Equity as an asset class can effectively employ for clients to deliver significant alpha relative to Public Equities (even if Public Equities in Europe perform poorly). As industry data shows, many top quartile performing European Private Equity portfolios have historically been overweight in sectors such as Technology and Business Services, areas of the economy that appear to be well placed to perform strongly relative to traditional Banking and Energy. In addition, many have had success investing in less cyclical industries such as Healthcare and E-commerce.

EXHIBIT 20

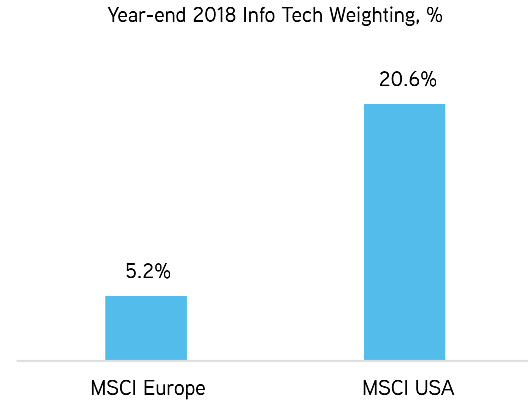
Technology Has Been the Key to EPS Growth This Cycle Not Only in Europe but Also Across the World...



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

EXHIBIT 21

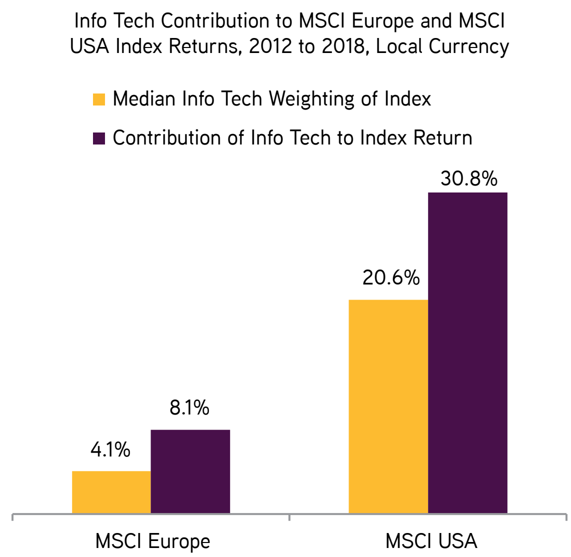
...Yet It Has Been Underrepresented in European Indices; We Think This Lack of Representation Is a Significant Arbitrage for PE



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

EXHIBIT 22

The Huge Weighting in U.S. Indices to the Tech Sector Explains Essentially All the Relative Outperformance Versus Europe On a Currency-Adjusted Basis



Note: 2012 to 2018 weighting is the median of all years. Data as at December 31, 2018. Source: MSCI, Bloomberg.

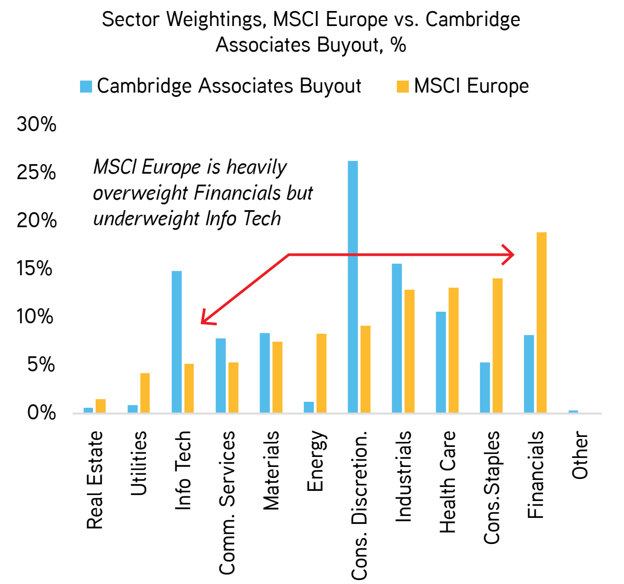
"

The third offering of TLTRO loans we now expect is an important support for the banking sector and the economy.

"

EXHIBIT 23

The Composition of Public Versus Private Indices Is One of the Explanations as to Why European Public Equities Has Lagged Performance Wise



Data as at 3Q18 for Cambridge; 4Q18 for MSCI Europe. Source: MSCI, Cambridge Associates.

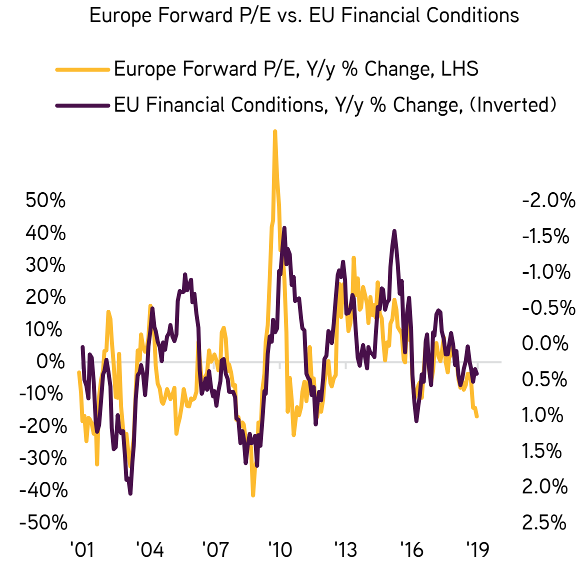
We also left our deep dive more constructive on the direction of financial conditions in Europe. Similar to the U.S., Quantitative Tightening ("QT") in Europe is likely to occur more gradually than previously anticipated. In the past three months, there has been a material change in appetite for QT, and as such, central banks across Europe and the U.S. are now skittish. This notable change in sentiment suggests that QT will happen more slowly and more delicately than we saw in the second half of 2018. This viewpoint is bullish for almost all risk assets because it means that we are likely to get some reprieve from tightening financial conditions.

Consistent with this position, Aidan recently adjusted his LTRO forecast to reflect a new offering of long term loans, to be announced at the March or April meeting, with banks ultimately choosing to roll 80% of outstanding long term loans with upcoming maturities into the new facility. Previously, Aidan had assumed the ECB would seek to roll the loans into its more standard short and medium term refinancing facilities. One can see the the magnitude of his revised forecast in *Exhibit 25*.

The third offering of TLTRO loans we now expect is an important support for the banking sector and the economy. To date, the ECB has provided 722 billion euros of TLTRO's to banks around the Eurozone, with particularly notable uptake in weaker economies. All told, Italian banks have taken a full 35% of the outstanding amount of these loans. This makes the TLTRO a particularly effective weapon as — unlike the ECB's QE program, which is shared basically in proportion to GDP — the TLTRO's tend to go where they are most needed. So, if our call is correct and TLTRO-III is delivered in the coming months, this initiative could prove to be a meaningful support mechanism for the Eurozone economy.

EXHIBIT 24

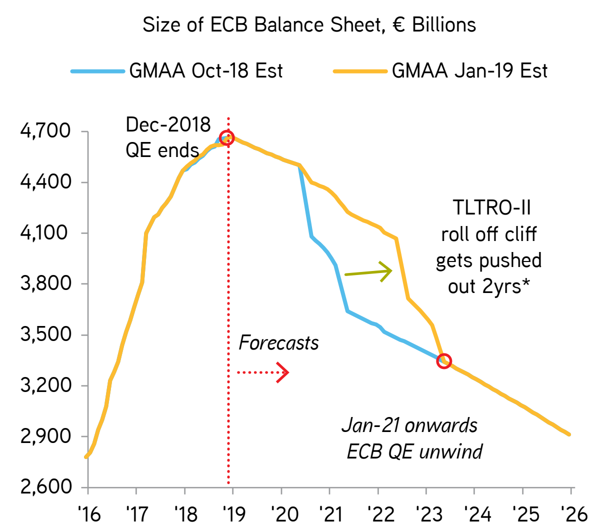
European Multiple Contraction Goes Hand in Hand with Tightening of Financial Conditions. As Such, a Slower Pace of QT Should Be an Important Tailwind



Data as at January 17, 2018. Source Bloomberg, S&P.

EXHIBIT 25

We Believe That QT Is Now Poised to Occur More Slowly Than the Consensus Thinks. We Also Believe That Banks Will Benefit from a Third Round of TLTRO Loans

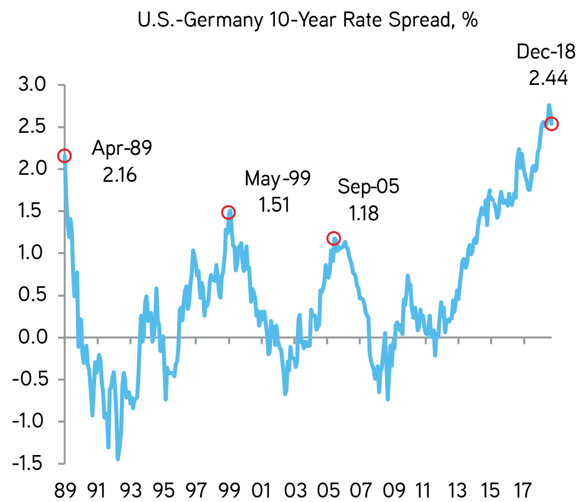


* Our Oct-18 estimate assumes TLTRO rolls off according to scheduled repayment dates (in June 2020, September 2020, December 2020 and March 2021). Our Jan-19 estimate assumes that 80% of TLTRO is extended for two years (before rolling off completely by early 2023). Source: KKR Global Macro & Asset Allocation analysis, European Central Bank.

Relative to the rest of world (the U.S. in particular), financing costs in Europe still remain attractive. We link the starting point to the spread between the U.S. Treasury and the German bund being at a multi-decade high. One can see this in *Exhibit 26.* Moreover, while financing costs have increased in places like Italy and Spain, they are not where they were in earlier years. As such, in local industries where companies have built a competitive advantage in Spain and Italy, we do not see financing costs denting their ability to win business against more fiscally conservative European peers (e.g., Germany).

EXHIBIT 26

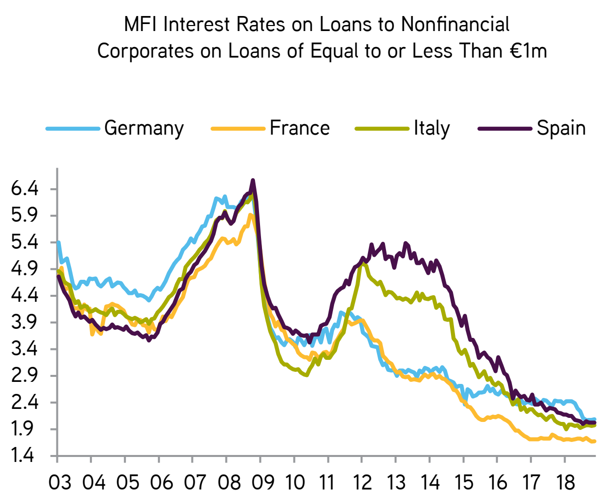
The Divergence Between U.S. and German Yields Is Currently Providing Europe With a Significant Funding Advantage



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

EXHIBIT 27

Importantly, Interest Rates for the Periphery Have Converged With Those of Core EU Countries

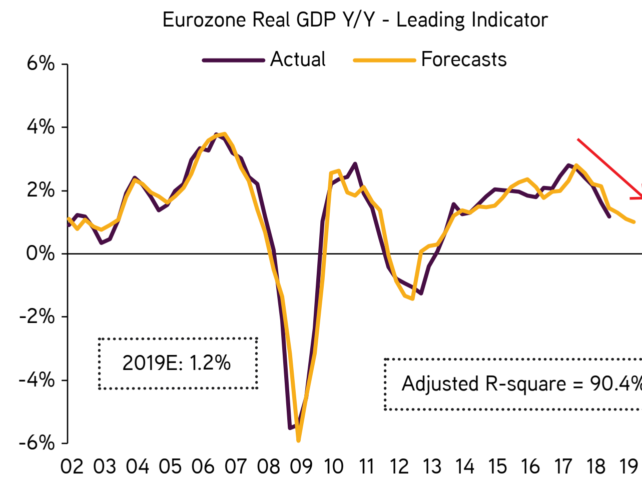


Data as at November 30, 2018. Source: European Central Bank.

Despite low rates and easier financial conditions, Aidan is still lowering his 2019 GDP forecast for the region to 1.2% from 1.5%. Indeed, the slowdown witnessed in the second half of 2018 is now bleeding into 2019 more than we expected. In particular, the dramatic fall-off in growth reflected somewhat of a perfect storm: Brexit, Italy, world trade, autos recession, tigher credit conditions, Yellow Vest protests, and extreme weather conditions (which limited the flow of goods on Germany's waterways). During this period, the German economy went from being the engine of Eurozone recovery, to barely escaping recession in the second half of 2018.

EXHIBIT 28

Our Updated Forecast Shows Eurozone GDP Growth of 1.2% in 2019, Which Is the Slowest Rate of Growth Since the Recession of 2012-2013

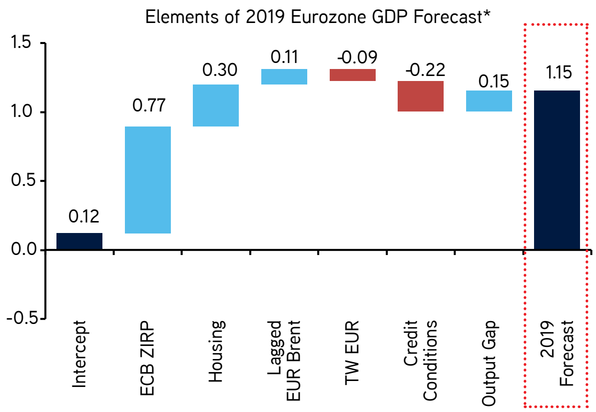


Data as at January 31, 2019. Source: Eurostat, ECB, EC, Global Macro & Asset Allocation analysis.

> **"Relative to the rest of world (the U.S. in particular), financing costs in Europe still remain attractive. We link the starting point to the spread between the U.S. Treasury and the German bund being at a multi-decade high."**

EXHIBIT 29

ECB ZIRP Remains the Key Positive Driver of Growth, but Credit Conditions Are Now a Meaningful Headwind



*Intercept is the sum of Intercept Coefficient and Momentum. Revised Forecast after incorporating the change in GDP because of Italy, Brexit, Trade. Data as at January 31, 2019. Source: Bloomberg. Eurostat, ECB, EC, Haver Analytics and KKR Global Macro & Asset Allocation analysis.

As we look ahead, we are *not* expecting the political uncertainty, which we believe is acting as a notable headwind to GDP growth in the region, to abate. Brexit, Italy and trade uncertainty are definitely important political forces to watch, but our recent trip reminded us again that the list of Europe's political woes actually runs much more broadly. For example, in Spain, Prime Minister Sanchez has recently called snap elections for the 28th of April, complicating the otherwise pretty positive Spanish outlook. Moreover, all of Europe goes to the polls in May to elect Members to the new European Parliament, raising the risk of stronger populist representation at the European level. So, our bottom line is that, given all these moving parts, we now think a more conservative posture towards GDP growth is warranted in the near-term.

"

As we look ahead, we are not expecting the political uncertainty, which we believe is acting as a notable headwind to GDP growth in the region, to abate. Brexit, Italy and trade uncertainty are definitely important political forces to watch, but our recent trip reminded us again that the list of Europe's political woes actually runs much more broadly.

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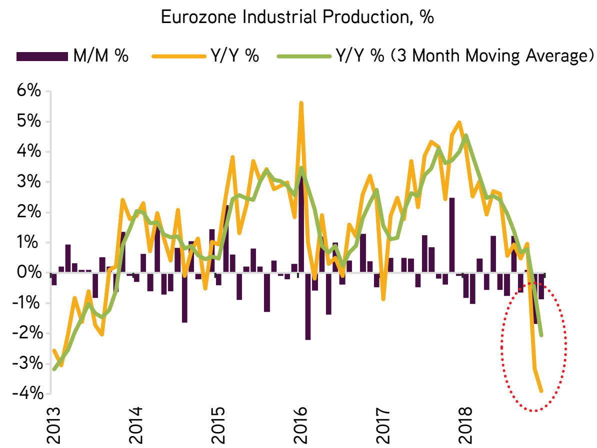
EXHIBIT 30

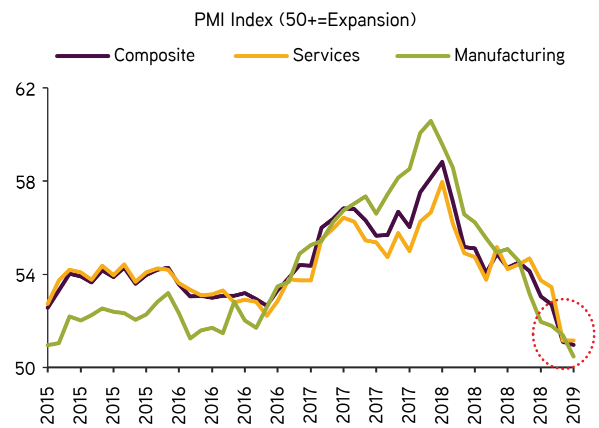
Eurozone Industrial Production Entered Recession Late in 2018. We Now Look for It to Climb Out of the Doldrums



Data as at February 15, 2019. Source: Eurostat.

EXHIBIT 31

Activity in the Services Sector Has Certainly Not Been Immune to the Recent Global Economic Headwinds

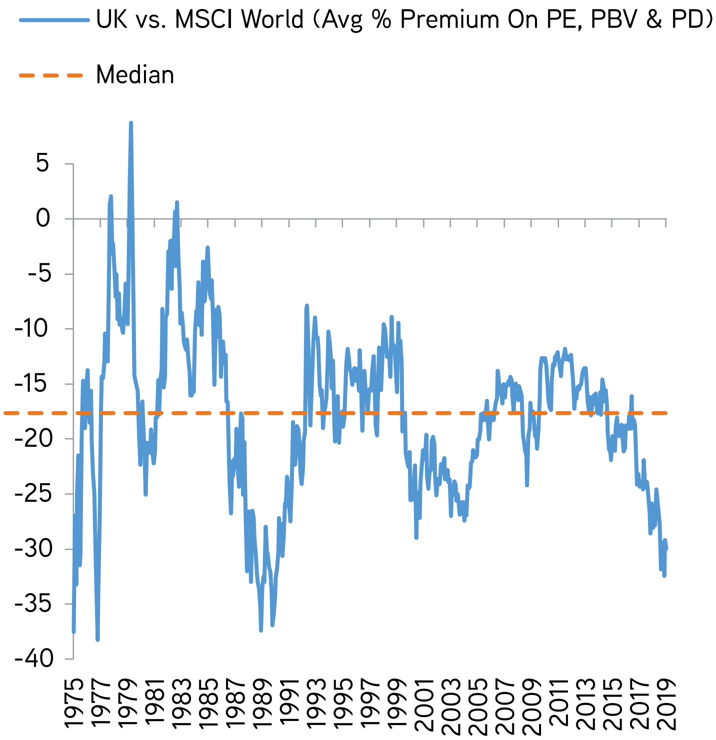


Data as at February 15, 2019. Source: IHS Markit.

Overall, despite all the noise and uncertainty, we actually left thinking that Europe still presents a variety of potentially attractive investment opportunities, particularly for private investors. Specifically, we still see significant opportunities in the corporate carve-out arena for the private equity industry in Europe to pursue. From our vantage point, these transactions will likely be large deals, and may require a lot of operational intensity, but they generally should come in at multiples that are far below the industry mean. Meanwhile, it feels to us that many parts of the European public equity markets are oversold and now warrant some investor attention. For example, as recently detailed to us by veteran Morgan Stanley European equity strategist Graham Secker, European companies with linkages to China have seen their equities significantly de-rated (*Exhibit 33*), which may present potentially attractive buying opportunities further down the line. A similar story holds true in the United Kingdom, where the stock market has now given up all its gains this century (yes, this century). Finally, we continue to see a steady stream of special situation opportunities, many of which are linked to good companies with poor capital structures.

EXHIBIT 32

The 30% Discount for MSCI UK Versus MSCI World Is Around a 30-Year Extreme. We Think It May Now Be Time to Step In

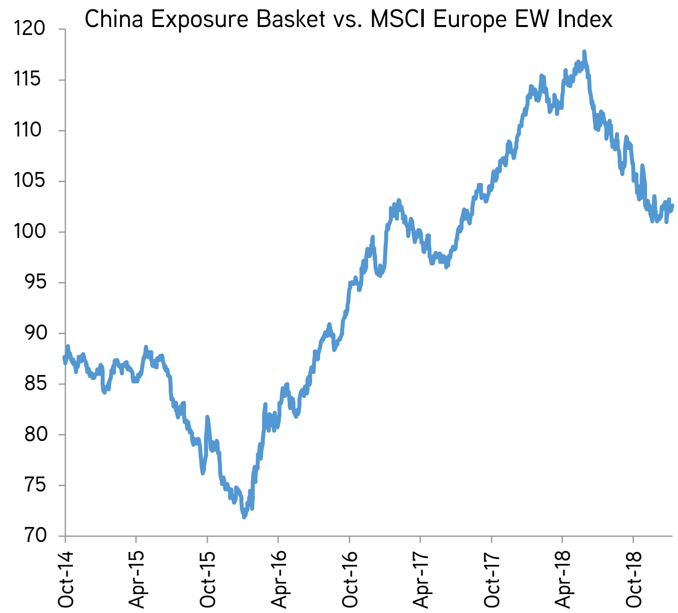


Note: Average relative valuations use 12-month forward data where available (forward P/E data starts in 1987) and trailing data where forward P/E not available. Data as at January 31, 2019. Source: MSCI, IBES, Morgan Stanley Research.

To be sure, Europe is a complicated investment region, and a sophisticated macro lens is required in conjunction with any bottom-up approach to investing. For starters, as we mentioned earlier, the outlook for growth in Europe is relatively anemic, and indeed, in Italy a technical recession may already have occurred in the second half of 2018 (defined by two quarters of sequential negative growth). Heightened trade tensions, controversial immigration policies, weak auto sales, and ongoing political acrimony are all largely to blame. If there is good news, it is that several of the headwinds that contributed to the recent GDP slowdown in the Eurozone are already starting to subside (notably weather and the auto supply chain disruption caused by new regulations).

EXHIBIT 33

The Relative Underperformance of European Shares With China Exposure Is Heading Towards a Two-Year Low. We View This as a Potential Emerging Opportunity

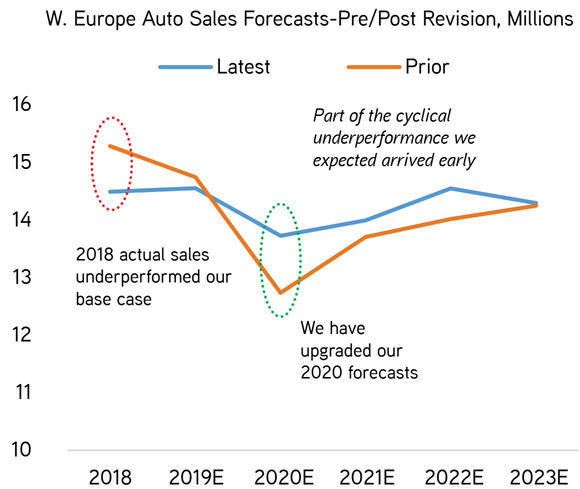


Note: Average relative valuations use 12-month forward data where available (forward P/E data starts in 1987) and trailing data where forward P/E not available. Data as at January 31, 2019. Source: MSCI, IBES, Morgan Stanley Research.

"Overall, despite all the noise and uncertainty, we actually left thinking that Europe still presents a variety of potentially attractive investment opportunities, particularly for private investors. Specifically, we still see significant opportunities in the corporate carve-out arena for the private equity industry in Europe to pursue."

EXHIBIT 34

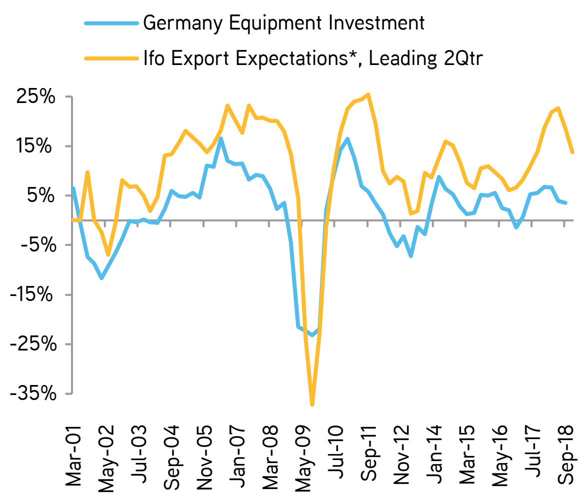
Part of the Cyclical Underperformance We Anticipated in Autos Arrived Early



Data as at January 2019. Source: KKR Global Macro & Asset Allocation analysis.

EXHIBIT 35

However, We Think That the Economic Data Is Poised to Recover Off Its Low Base

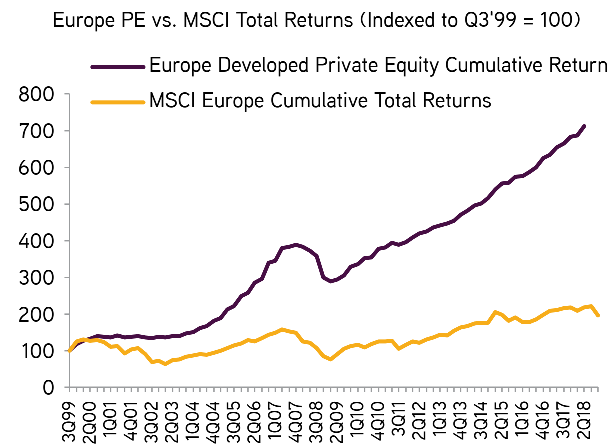


Data as at 3Q18. Source: Ifo-Institut fnr Wirtschaftsforschung, Federal Statistical Office, Haver Analytics.

Finally, beyond the obvious political risks, the biggest risks in our minds are wages going up faster than people realize may happen. Europe needs only about 1.0-1.5% GDP growth to drive unemployment lower, and most industries are now running out of quality personnel. While higher wages are currently only denting profit margins, recent work by the Bank of England suggests that inflation is not far behind. We do not see the threat of inflation from our perch at KKR in Europe, but we respect this viewpoint.

EXHIBIT 36

For a Variety of Reasons, European Private Equity Has Significantly Outperformed Public Equity Over the Long Haul



Note: All returns are in EUR; PE returns are net of fees, expenses and carried interest. Public Equities data as at 4Q18; Private Equity as at 2Q18. Source: Bloomberg and Cambridge Associates.

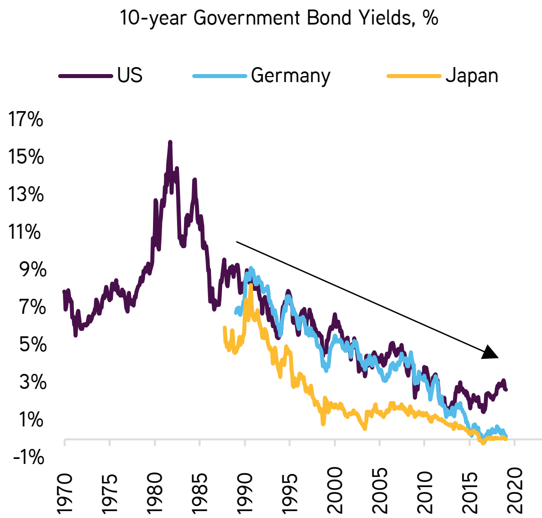
Theme #3. Buy Shorter Duration Cash Flowing Assets Linked to Nominal GDP and Trim Positions in Longer Duration Sovereign Debt

In addition to a flurry of questions about China trade tensions and European political uncertainties (and the impact on investing) of late, we have received an increasing number of inbounds from investors about how one should think about the role of sovereign debt, U.S. securities in particular, from a macro and asset allocation perspective. This question is not an easy one, but our bottom line is that *the bull market in long-term bonds that began in the early 1980s is over – and we do not make this statement lightly*. We see several forces at work. For starters, long-term interest rates are now extraordinarily low by historical measures at a time of increasing deficits and less central bank support in the marketplace. One can see this in *Exhibits 37* and *38*, respectively.

"No doubt, one has to pick the right spots in Europe; yet the arbitrages that we think exist suggest significant alpha for investors who are willing to take more of a top down approach to capital deployment in the region than they might typically otherwise do."

EXHIBIT 37

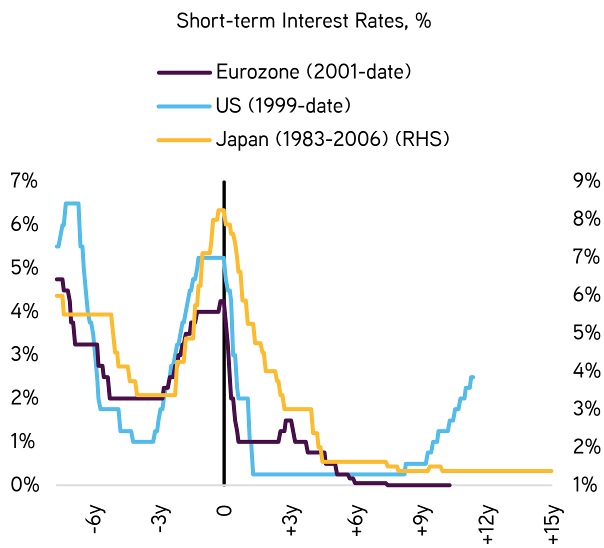
Bond Yields Are Now at a Multi-Generational Low



Data as at February 11, 2019. Source: Bloomberg.

EXHIBIT 38

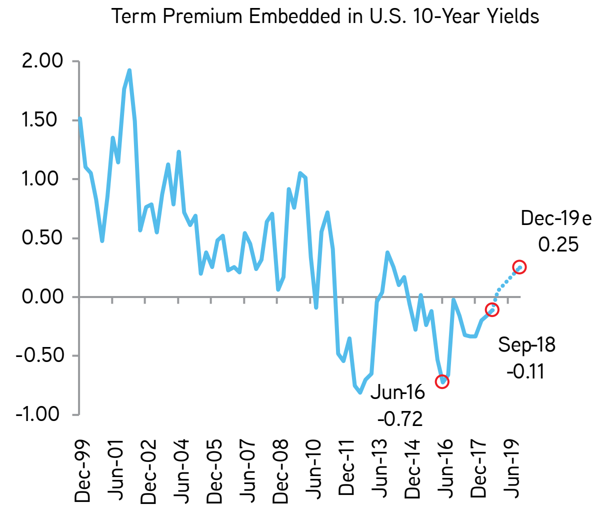
Outside of the U.S., the "Japanification" of Interest Rates Has Largely Occurred



Note: 0 on x-axis = peak in short-term rates; Short Term Prime Lending Rates used as proxy for Japan; ECB Main Refinancing Rate for Eurozone; Fed Funds Rate for U.S. Data as at February 11, 2019. Source: Bloomberg.

EXHIBIT 39

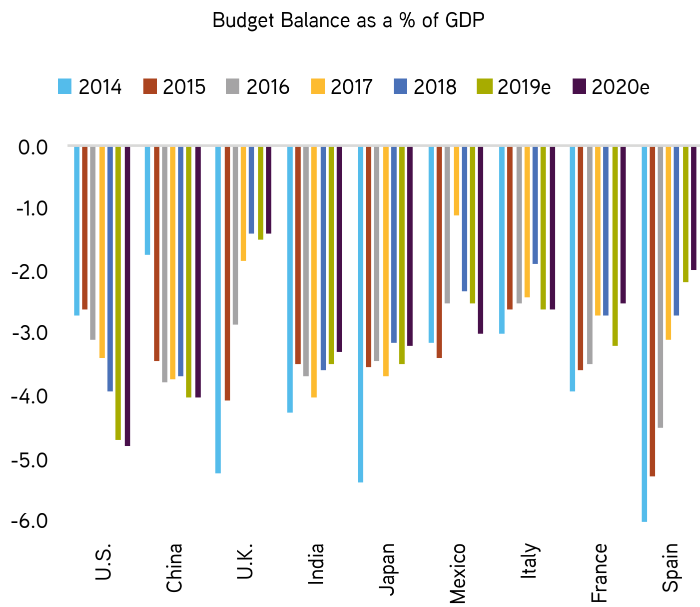
Over Time, We Think 10-Year Yields Will Embed Further Normalization of the Term Premium



e = KKR Global Macro & Asset Allocation estimates. Historical data based on Kim and Wright model published by U.S. Federal Reserve. Data as at November 15, 2018. Source: Bloomberg.

EXHIBIT 40

Despite Having Better Growth Than Its Peers, the U.S. Budget Deficit Is Expanding Rapidly



Data as at February 22, 2019. Source: Bloomberg.

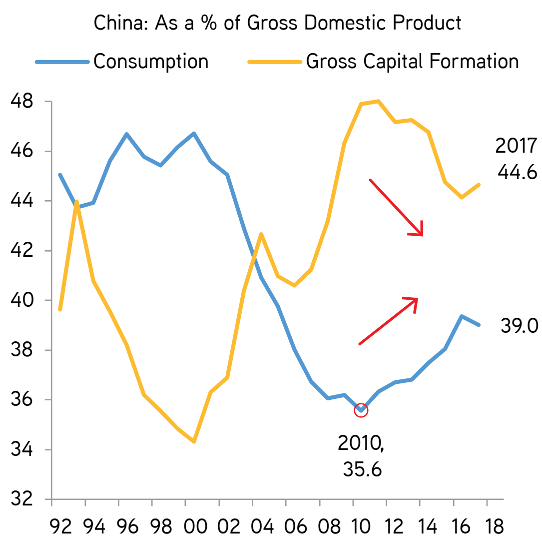
Beyond the low level of absolute rates, there are other forces at work in the global bond markets to consider. For example, we think that more and more emerging economies, China in particular, now have less interest in owning foreign issues as they turn more domestically focused. One can see this in *Exhibits 41* and *42*, respectively, which show that China now has less structural desire to own U.S. bonds as its current account surplus shrinks amidst rising consumption (*Exhibit 43*).

This shift could – over time – prove somewhat jarring, we believe. It also calls into question the original model of "globalization" implemented after China joined the WTO in 2001, which was largely predicated on U.S. consumers buying cheap Chinese goods at the same time that Chinese savers recycled their excesses into U.S. Treasuries. However, as China builds greater internal demand versus exporting to others, its current account surplus dissipates, and alongside of it, the country's appetite for U.S. sovereign debt.

There are also other issues to consider, as rising debt levels are also affecting who wants to own U.S. sovereign debt. All told, U.S. debt-to-GDP is expected to be close to 80% in 2019, compared to 52% a decade ago. Moreover, as we show in *Exhibit 47*, record deficits are impacting who is responsible for funding the U.S. government's growing deficit. Specifically, U.S. savers are now being asked to shoulder more of their country's debt burdens. If sustained, there will likely be a crowding out effect that could dent multiples for stocks and credit spreads in fixed income.

EXHIBIT 41

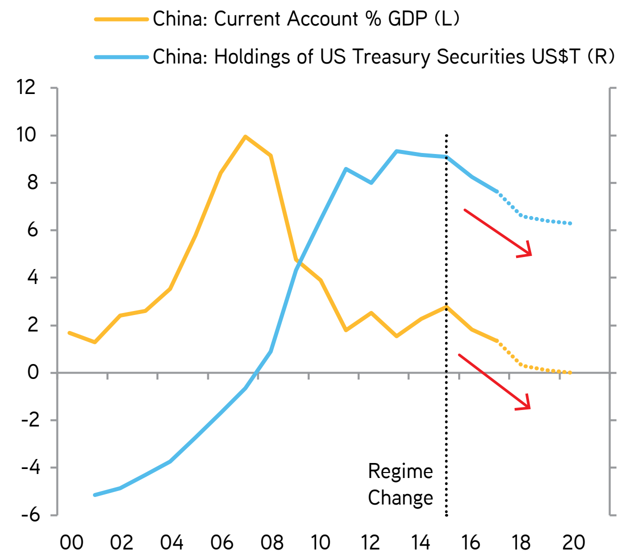
China's Consumption Economy Is Getting Bigger, While Investment Is Poised to Shrink



Data as at December 31, 2017. Source: China National Bureau of Statistics, Haver Analytics.

EXHIBIT 42

As China's Current Account Surplus Shrinks, Its Desire to Own as Many Treasuries Will Wane Too, We Believe



Data as at December 31, 2018. Source: U.S. Department of Treasury, State Administration of Foreign Exchange, Haver Analytics.

> **"It also calls into question the original model of 'globalization' implemented after China joined the WTO in 2001, which was largely predicated on U.S. consumers buying cheap Chinese goods at the same time that Chinese savers recycled their excesses into U.S. Treasuries."**

EXHIBIT 43

China Is Dominating World Consumption in Many Areas. As It Further Internalizes Demand, There May Be Less Reason to Own U.S. Treasuries

CHINA AS A % OF WORLD CONSUMPTION	1995	2000	2005	2010	2015	2018
Cement	31.5%	35.7%	45.3%	56.2%	57.7%	58.0%
Coal	29.9%	30.0%	42.7%	48.5%	50.8%	50.7%
Steel	12.7%	15.1%	31.7%	43.2%	43.2%	44.7%
Industrial Robots	–	–	3.5%	6.7%	27.0%	39.2%
Cotton	22.0%	25.0%	37.8%	39.8%	31.7%	32.1%
Rice	35.8%	34.1%	31.0%	30.5%	30.2%	29.5%
Hydroelectricity	7.7%	8.4%	13.6%	20.7%	28.6%	28.5%
University Grads	7.4%	9.0%	17.1%	20.5%	25.7%	26.6%
Mobile Phones	4.0%	11.6%	17.8%	16.2%	18.0%	19.2%
Beef & Veal	8.4%	9.6%	10.1%	11.2%	12.7%	14.0%
Oil	4.7%	6.1%	8.2%	10.7%	12.6%	13.0%
Nuclear Energy	0.6%	0.6%	1.9%	2.7%	6.6%	9.4%
Nat Gas	0.8%	1.0%	1.7%	3.4%	5.6%	6.6%
Coffee	0.0%	0.0%	0.2%	0.8%	1.7%	2.4%

Data as at 2018 or latest available. Source: USDA, USGS, World Steel Association, China National Bureau of Statistics, EIA, IEA, BP Statistical Review, World Bureau of Metal Statistics, International Federation of Robotics, Bloomberg, Haver Analytics.

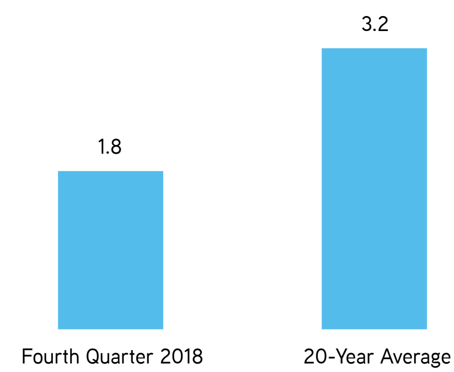
> "Of interest to us right now is that U.S. savers are being asked to step up and replace global central banks and international investors as more meaningful owners of U.S. Treasury Bonds, thereby reducing the availability of capital for individual investors to own other financial assets."

Given the aforementioned changes in buying behavior patterns, we are not surprised that bonds did not perform as admirably during the market meltdown at the end of 2018. Specifically, as we show in *Exhibit 44*, bonds rallied about 40% less than they typically have during the last 20 years, for the reasons we cited above. Meanwhile, in less liquid assets like the U.S. Real Estate market, we have seen a similar phenomenon, as Chinese flows into real estate have turned decidedly negative. One can see this in *Exhibit 45*.

EXHIBIT 44

Long-Term Bonds Are No Longer as Effective as a Shock Absorber in Asset Allocation, We Believe

Decline in 10-Year Yields per 100-Basis Point of S&P 500 Sell-Off

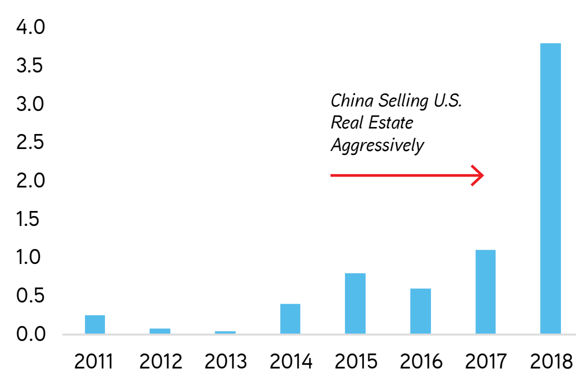


Data as at December 31, 2018. Source: Bloomberg.

EXHIBIT 45

China Materially Accelerated Its Sales of U.S. Real Estate in 2018

Sales of U.S. Commercial Real Estate by Chinese Investors, US$ Billions

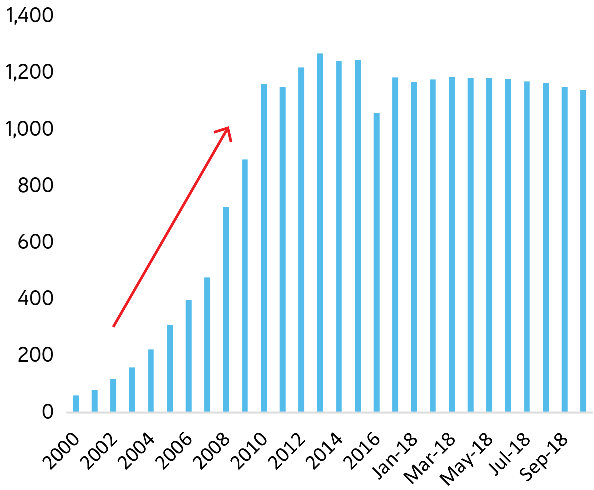


Data as at January 29, 2019. Source: *Wall Street Journal*.

EXHIBIT 46

The Significant Ramp Up in Purchases of U.S. Government Securities by China Is Likely a Thing of the Past

China Holdings of U.S. Government Long-Term Securities, US$ Billions

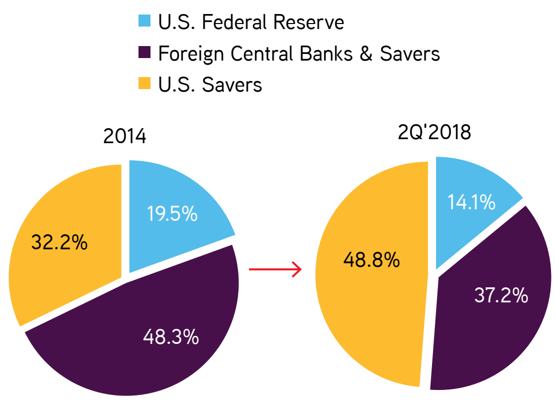


Note year-end data thru 2017 is December monthly holdings. Data as at December 17, 2018. Source: Department of the Treasury/Federal Reserve Board.

EXHIBIT 47

U.S. Savers Have Stepped in to Account for a Larger Percentage of U.S. Treasury Ownership

U.S. Treasury Security Ownership, %



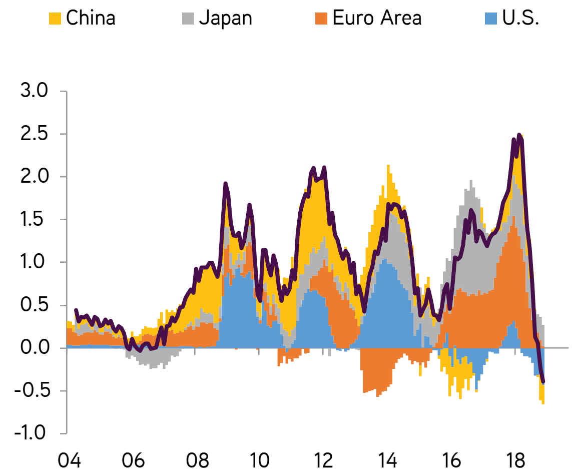
Data as at June 30, 2018. Source: Russell Napier Orlock Advisors, CBO, Treasury, TIC Data, Federal Reserve.

If there is good news in the near term, it is that central bankers are slowing down QT. Indeed, as *Exhibit 48* shows, we think that the global central banking community badly underestimated how fast money supply would fall off at the end of 2018. We also believe that there is little to no inflation in the system in the near term, which should provide central banks in both Europe and Japan the ability to keep overall rates lower than they otherwise would.

EXHIBIT 48

Money Supply Slowed Sharply in 2018, as Quantitative Tightening Became a Reality

12-Month Change in Monetary Base: U.S. + Euro Area + Japan + China, US$Trillions

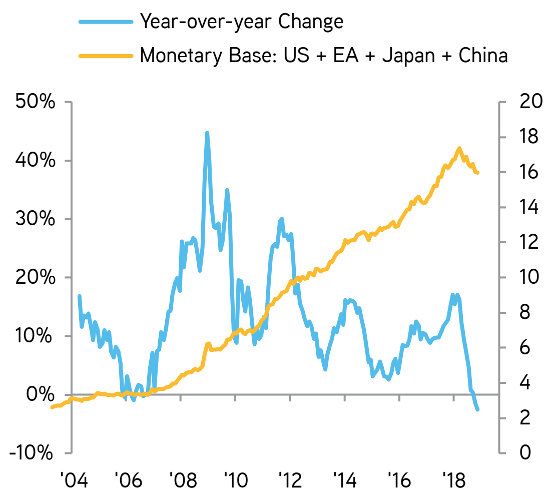


Data as at November 30, 2018. Source: Federal Reserve Board, European Central Bank, Bank of Japan, People's Bank of China, Haver Analytics, MSCI, Bloomberg.

EXHIBIT 49

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

Monetary Base: U.S. + EA + Japan + China, Y/y % Change and US$ Trillions



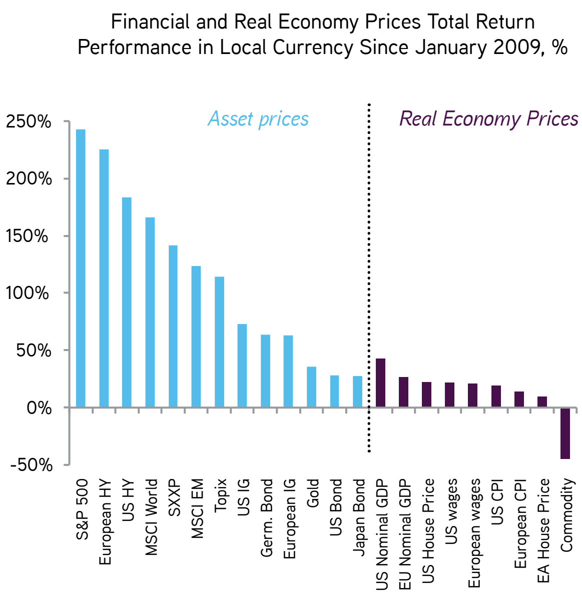
Data as at December 20, 2018. Source: Federal Reserve Board, European Central Bank, Bank of Japan, People's Bank of China, Haver Analytics.

However, the current situation of low rates, rising debt loads, and widening deficits is long-term unsustainable, in our view. Indeed, history shows that when central bankers run nominal GDP over nominal interest rates for long periods of time, investors benefit from migrating towards assets that are linked to nominal GDP, particularly those that have collateral backing them. Hence, our strong desire to overweight Asset-Based Finance, Infrastructure, and Real Estate Credit in 2019.

There is also a political angle to our asset allocation preferences at this point in the cycle. Key to our thinking is that, after a decade of quantitative easing, financial assets have performed wildly better than assets linked to nominal GDP. One can see this in *Exhibit 50*. As such, we expect more politicians to embrace agendas that boost nominal GDP, even if it comes at the expense of financial assets, including higher deficits and debt loads.

EXHIBIT 50

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



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

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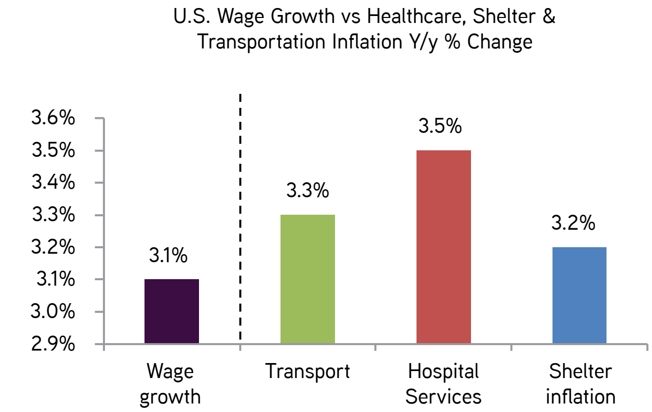
We remain constructive on more flexible mandates across both liquid and illiquid investments, and as such, have increased our allocations to both Actively Managed Opportunistic Credit and Special Situations.

"

EXHIBIT 51

As Non-Discretionary Expenses Increase, Politicians Will Increasingly Need to Look for Ways to Boost Nominal GDP and Nominal Wages to Avoid Further Divisions of Wealth Accumulation



Data as at January 31, 2019. Source: Bureau of Labor Statistics, Haver Analytics.

So, our bottom line is that we think we are at an inflection point for the role that long-term bonds can play in multi-asset class portfolio. True, the slowdown in QT will likely give the bond market more air cover in the near term, but our message is to use this period of calm before the storm to readjust one's portfolio towards shorter duration, cash flowing assets linked to nominal GDP.

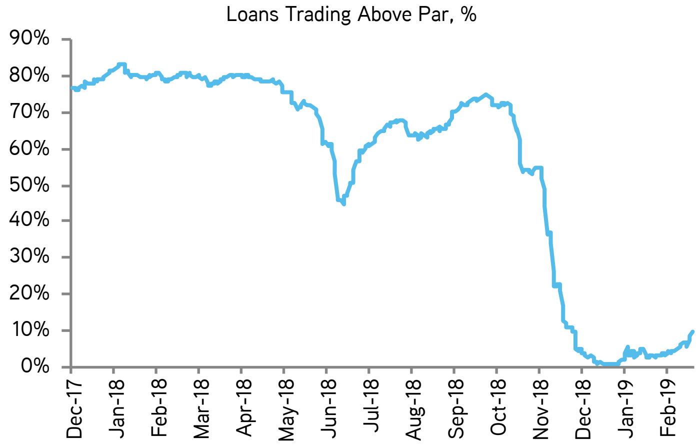
Theme #4. Given Where the World Is Likely Headed, We Think That Now Is the Time to Increase – Not Decrease – Flexibility Across Mandates

As someone who has dedicated his career to providing structure, not only for KKR's balance sheet but also to leading allocators around the world, I fully admit that I have called an "audible" to be more flexible in 2019. Not surprisingly, that decision has raised some eyebrows with a lot of folks in the investment community. So, we wanted to spend some time describing why we think now is the time to have more flexibility in the capital allocating process.

First, we think that the technical backdrop supports a more flexible mindset. As we discussed in our *Outlook for 2019*, as well as earlier in this piece, 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 likely 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.

EXHIBIT 52

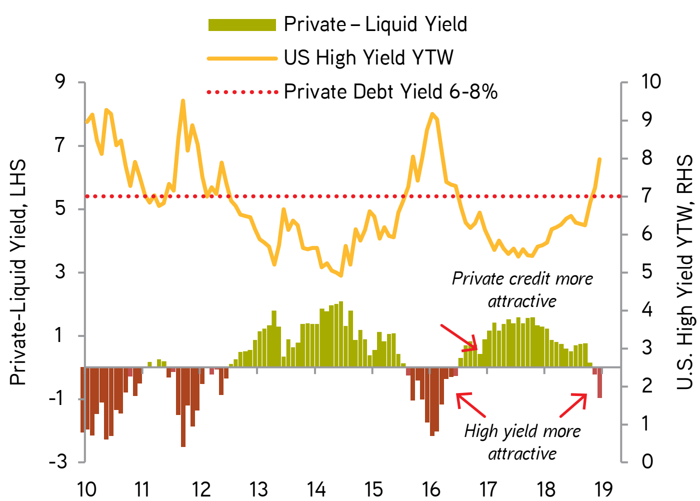
Levered Loans Have Not Snapped Back as Quickly as Some Other Asset Classes



Data as at February 22, 2019. Source: LSTA.

EXHIBIT 53

Liquid High Yield Looks Increasingly Cheap Relative to Private Credit

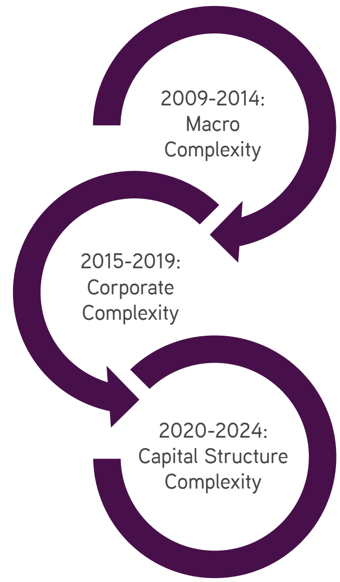


Data as at December 20, 2018. Source: Credit Suisse, EPFR.

> "Given this uneven technical backdrop amidst rising geopolitical tensions, we are increasingly bullish on our theme of capital market arbitrages."

EXHIBIT 54

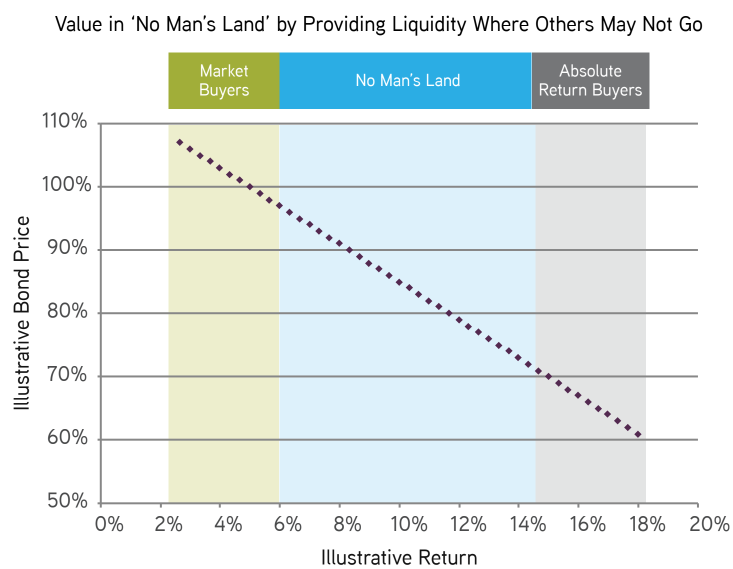
We're on the Cusp of Transitioning to the Capital Structure Complexity Era



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

EXHIBIT 55

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'

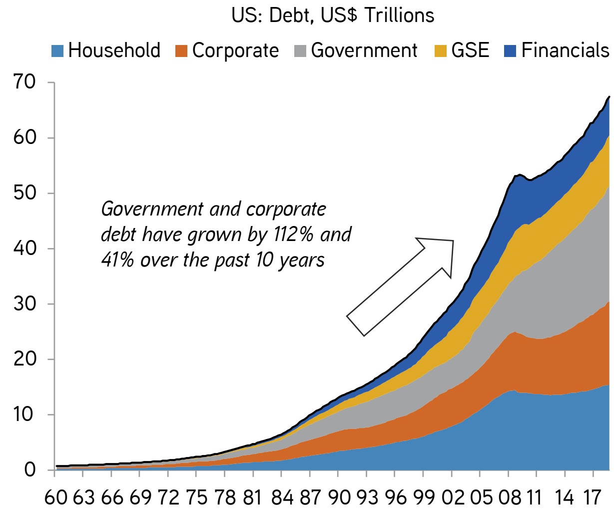


Data as at December 2018. Source: KKR Credit.

Equally as important, the structure of the capital markets has changed. As we show below, algorithmic trading now dominates the developed markets, and it is increasingly influencing flows in the emerging markets. Meanwhile, on the debt side of the house, the stock outstanding has exploded at the same time that the dealer inventory required to support this vast amount of growth has shrunk. Without question, these technical mismatches are creating periodic distortions that accrue mightily to investors with patient capital, solid underwriting skills, and – perhaps most importantly – the ability to toggle across asset classes and securities.

EXHIBIT 56

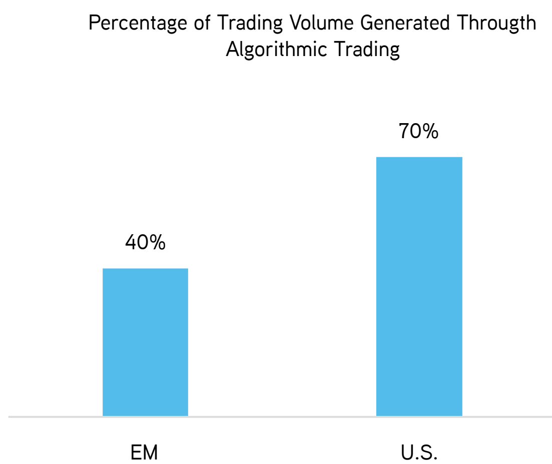
U.S. Government and Corporate Debt Has Increased by 112% and 41%, Respectively, Over the Last 10 Years



Data as at September 30, 2018. Source: Federal Reserve Board, Haver Analytics.

EXHIBIT 57

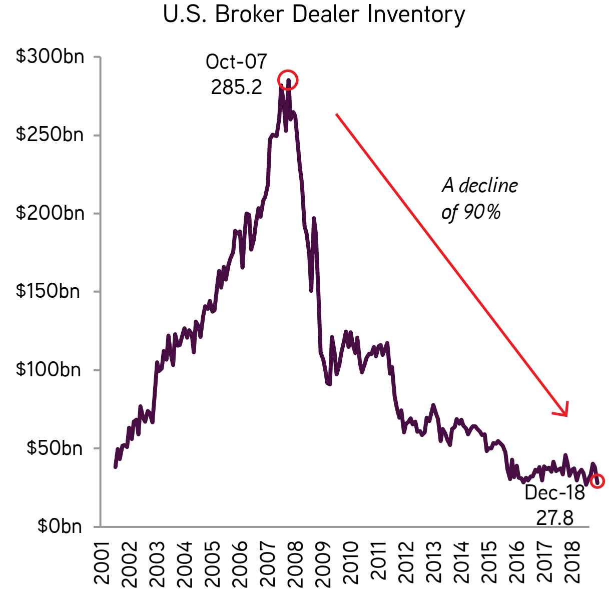
A Growing Proportion of Market Volatility Can Be Explained by Quant Based Trading



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

EXHIBIT 58

Credit Trading Strategies Are No Longer Well Supported by Wall Street. As Such, the Potential for Periodic Dislocations Is Now Structurally Higher, We Believe



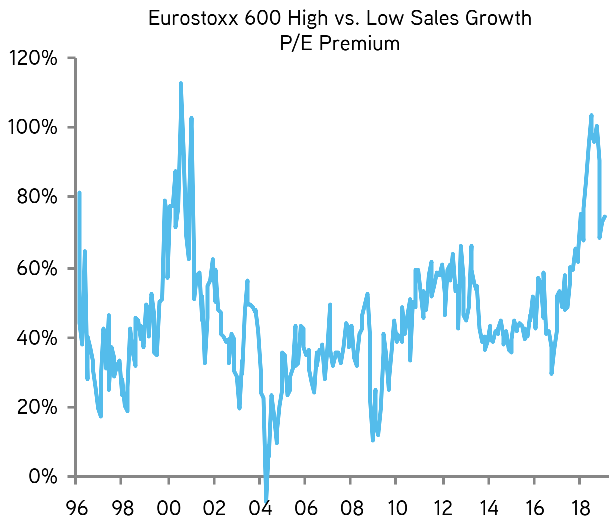
Data as at December 31, 2018. Source: Federal Reserve Bank of NY, Haver Analytics.

Given this uneven technical backdrop amidst rising global geopolitical tensions, we are increasingly bullish on our theme of capital market arbitrages. Indeed, if there is one thing that became apparent during the fourth quarter of 2018, it was the inconsistencies in value that appeared across capital structures and asset classes. For example, Liquid Credit sold off much more than some of the opportunities we saw in Private Credit during the fourth quarter of 2018, and as such, a significant capital structure arbitrage/opportunity emerged that favored flexible capital that could step in and buy into potentially "hung" new issue paper as well as unloved trading positions in Structured Products. While many of these dislocated opportunities have been corrected in 2019, we do not think that the last quarter of 2018 was a "one off" situation, particularly if we are right about slowing growth amidst peaking corporate margins. Moreover, despite the recent rally, we are still seeing some "good company, bad capital structure" opportunities emerge, especially outside of the U.S. So, consistent with this overall macro backdrop, we now hold a massive overweight to Actively Managed Opportunistic Credit, and we have again increased our position in Special Situations/Distressed this year.

Meanwhile, there are also equity arbitrages to pursue. For example, it appears to us that growth public equities in Europe are trading substantially more expensive than they are in Asia. One can see this in *Exhibits 59* and *60*, respectively. We also think that public growth opportunities in Asia are also cheaper than private growth opportunities after the fourth quarter of 2018 correction. As such, private investment opportunities in growth will need to "catch-down" to the rest of the public markets in 2019, we believe.

EXHIBIT 59

In Europe Growth Stocks Are Still Expensive...



Data as at January 31, 2019. Source: IBES, Datastream, Goldman Sachs Global Investment Research.

EXHIBIT 60

....However, China Equities, Technology Growth Stocks in Particular, Have Experienced a Massive Correction

Data as at January 31, 2019. Source: MSCI, Factset.

On the Private Equity side, our strong recommendation is that allocators focus more on public-to-private deals than sponsor-to-sponsor transactions in 2019. In many instances public markets are trading at discounts to the private markets, and given the carnage during 4Q18, we are more open to Private Equity taking non-control stakes in Public Equities at this point in the cycle.

Conclusion

We welcome debate with our clients and prospects, and we hope "Another Swing at the Plate" shows that we are eager to engage deeply on topical issues. Without question, we are living in fairly unprecedented times, and we certainly do not have all the answers. No one does.

In terms of what appears to be most topical, it seems that there are four areas where clients and others want more direction. To this end, we summarize our views in the four most debated areas as follows:

1. While trade tensions are certainly unsettling to the Chinese economy, our base view is that China is now very close to reducing its reliance on external constituents to drive growth. We see more gains ahead in terms of internal consumption throughout China. In particular, we look for the Chinese millennial population, which is now 300 million strong, to bolster the country's GDP-per-capita ratio towards levels more on par with the average developed market consumer. Already, the Asian consumer market in aggregate has surpassed that of Europe, and over the next five years, will overtake the U.S. as the biggest and fastest growing consumer market in the world. At the same time, we expect the U.S. Authorities to focus more heavily on technology as a national security issue, including a more intense focus on cyber espionage as well as intensifying scrutiny of Chinese capital raises, including heightened regulation of any Asian-backed technology IPOs debuting in the U.S. If we are right, then we think that certain Asia and U.S. supply chains are likely to become more distinct than they have been in the past.

2. Despite all the headline risk in Europe, we actually lean more positive than the consensus in certain areas of the Union's capital markets. Central bank liquidity remains outsized at a time when inflation is low. Given some of the compositional flaws we have uncovered in many public indexes in Europe, we believe that for investors who are willing to migrate towards the private markets, the opportunity for Private Equity to outperform the public markets is quite significant during the next five to seven years years. At the moment, corporate carve-outs and other special-situation investments appear the most attractive to us.

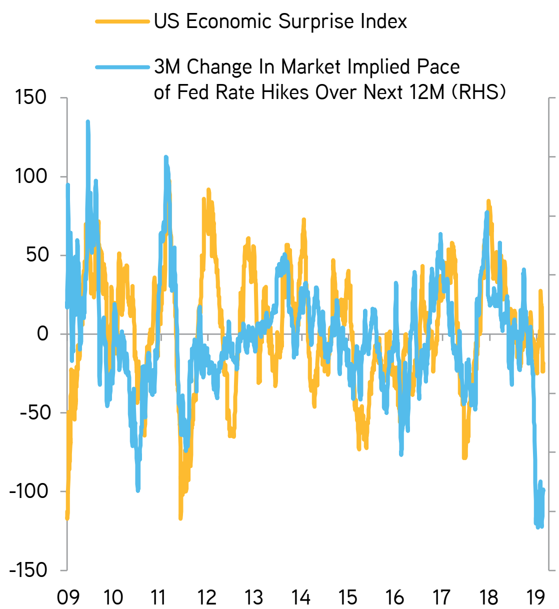
3. We see a secular shift occurring in the government bond market, particularly in the United States. Our view is that flows are changing structurally, as China insources more and more of its demand function. Also, we think that rising deficits amidst low rates and high debt stock underscores that investors should be shortening duration. Investors should also own more collateralized assets linked to nominal GDP.

4. Given increasing geopolitical tensions and late cycle behavior, we expect more volatility ahead. To this end, we have shifted more of our portfolio allocations towards vehicles that can pivot across asset classes and across geographies. Importantly, this approach applies not only to liquid markets like Actively Managed Opportunistic Credit but also across private markets such as Distressed/Special Situations.

Overall, though, our macro view is increasingly of the mindset that we may be stuck in a long, upward sloping, trading range for financial assets. On the one hand, if growth proves to be too strong, then central banks will have to lean more into QT. On the other hand, if growth is slower than expected, we believe margins and profits could likely be at risk.

EXHIBIT 61

Economic Surprises Don't Yet Match the Market's Dovish Tilt Toward Fed Expectations. Our View Is That Growth Will 'Catch Down' During 2019



Data as at February 21, 2019. Source: Bloomberg, Morgan Stanley Research.

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On the Private Equity side, our strong recommendation is that allocators focus more on public-to-private deals than sponsor-to-sponsor transactions in 2019.

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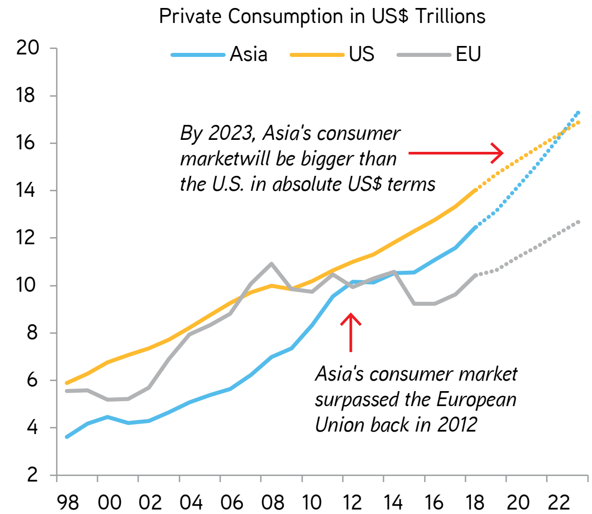
EXHIBIT 62

Asia Will Soon Overtake the U.S. as the Largest Consumer Market in US$ Terms



Asia includes China, Hong Kong, Taiwan, India, Japan, Korea, and ASEAN (Indonesia, Malaysia, Philippines, Thailand, Singapore, Vietnam). Data as at February 11, 2019. Source: IMF, World Bank, National Statistical Agencies, Haver Analytics.

However, almost irrespective of which direction the headline indexes trade during the next few years, we believe that the additional work we did for "Another Swing at the Plate" has provided us with even more conviction in the key asset allocation themes that we are now using to generate alpha. Equally as important, this exercise has left us with even greater confidence in the power of the client network we have built through our *Insights* notes during the past seven years. Without a doubt, your questions, your skepticism, and your feedback make us better by forcing us to dig deeper into the most critical variables that influence our macro and asset allocation frameworks. For this partnership that we have developed together, we say thank you, and we look forward to more of the same in 2019 and beyond.

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