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.

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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.

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.

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.

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.

Fourth, we expect more geopolitical shocks in 2019.

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.

Despite the notable slowdown in global growth we are forecasting in 2019, we are upgrading Public Equities to overweight from equal weight. We are shifting our 300 basis point underweight in United States Equities to a 100 basis point overweight position.

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 are consolidating all our Liquid Credit positions into our Opportunistic Credit bucket.

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 pen- chant for leaning into periodic dis- locations like those that occurred in the fourth quarter of 2018 and in the first quarter of 2016.

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).

We add two percent to a new asset class for us – Stabilized Credit – that further boosts our exposure to nominal GDP-linked assets.

However, we are lowering our Opportunistic Real Estate Equity allocation to two percent versus three percent and a benchmark of two percent.

We maintain our 300 basis point overweight to Traditional Private Equity as well as our 500 basis point underweight to Growth/VC/Other.

We also continue into 2019 with our 700 basis point weighting in Energy/Infrastructure, compared to a benchmark weighting of 200 basis points.

We are maintaining a Cash position of one percent.

In terms of currency, we think that the U.S. dollar peaks in 2019.

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.

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.

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.

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.

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

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.

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.

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.

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.

Our Price-to-Earnings ratio already reflects tightening financial conditions, we believe. Tightening financial conditions, including higher real rates

and slower growth, mean lower multiples than in recent years.

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.

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.

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. 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).

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).

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.

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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.

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).

As we mentioned at the outset of this report, we also want to underscore how low consumer delinquencies remain a formidable tailwind for growth.

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.

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

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.

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

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.

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.

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.

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 note that we are seeing a lot of corporate ‘streamlining’ occurring outside of the traditional multinational sector.

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.

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

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

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.

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.