Invesco

Emerging markets

Belt and Road: An emerging growth engine amid geopolitical rumblings

February 2019

This marketing document is exclusively for use by Professional Clients and Financial Advisers in Continental Europe (as defined in the important information), Qualified Investors in Switzerland and Professional Clients in Isle of Man and the UK. This document is not for consumer use, please do not redistribute. Please read the risk warnings that appear on page 7.

By Ken Hu,
Chief Investment Officer, Fixed Income, Asia Pacific

China's Belt and Road Initiative (BRI) reflects the change in the country's economic model to point to more outbound direct investments across Asia, Europe, the Middle East and Africa (EMEA) and their adjacent seas (the 'B&R region'). In response, other major economic powers are increasing their direct investments in the region, too. This competition means higher capital inflows and long-term fixed income investment themes have arisen. It is hoped that it will also improve governance, which would be structurally positive for some Belt & Road countries. A focus on environmental, social and governance (ESG) factors can help investors mitigate risks.

1. Geopolitical background
First announced in 2013 by the Chinese government, the Belt and Road (B&R) Initiative became part of the constitution of the Chinese Communist Party in October 2017. This was an outstanding move and indicates the importance of this initiative to China. The initiative promotes the land and sea connectivity between Asia, Europe, the Middle East and Africa.

According to the so-called 'Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road' that was jointly issued by the National Development and Reform Commission, Ministry of Foreign Affairs, and Ministry of Commerce of the People's Republic of China (PRC), the BRI is a systematic initiative and significant development strategy launched by the Chinese government. It aims to promote land and sea connectivity along Asia, Europe, the Middle East and Africa (EMEA) and their adjacent seas (''the B&R region'') to establish and strengthen economic partnerships and cooperation along these regions. The aim here is for win-win cooperation that promotes common development and prosperity.

"Long-term fixed income investment themes have arisen with China's Belt and Road Initiative."

Connecting Asia, Europa and Africa
The B&R region runs through the continents of Asia, Europe and Africa. It connects the vibrant East Asian economic area and the well-developed European countries and encompasses countries with huge potential for economic development.

The Silk Road Economic Belt focuses on bringing together China, Central Asia, Russia and Europe. It links China with the Persian Gulf and the Mediterranean Sea through Central Asia and West Asia, and it connects China with Southeast Asia, South Asia and the Indian Ocean.

The 21st-Century Maritime Silk Road is designed to go from China's coast to Europe through the South China Sea and the Indian Ocean via one route, and from China's coast through the South China Sea to the South Pacific via the other.

Key component of China's new economic growth model
China has been very successful with its export-driven economic growth model since it started opening up its economy in 1978. This model required the country to import large quantities of raw materials such as iron ores via sea routes from far-away places such as Latin American countries to supply its factories concentrated in the eastern and southern coastal provinces. The manufactured products were then exported to the rest of the world.

This export-driven economic growth model is no longer working well for China for several reasons. Firstly, it has resulted in major economic imbalances, with wealth and income inequality between its western, south-western, north-eastern and coastal provinces. Secondly, there are many substandard factories in the country, which are a cause of significant pollution. Thirdly, over-capacity in some industries such as steel and metals has led to trade tensions with the US and other developed countries. Furthermore, China has to rely heavily on shipments via sea routes for both raw material imports and the export of goods, making it subject to risks around sea-route security. China's ageing population has also been making the labor-intensive manufacturing driven economy less sustainable, driving the Chinese government to change its economic growth model.

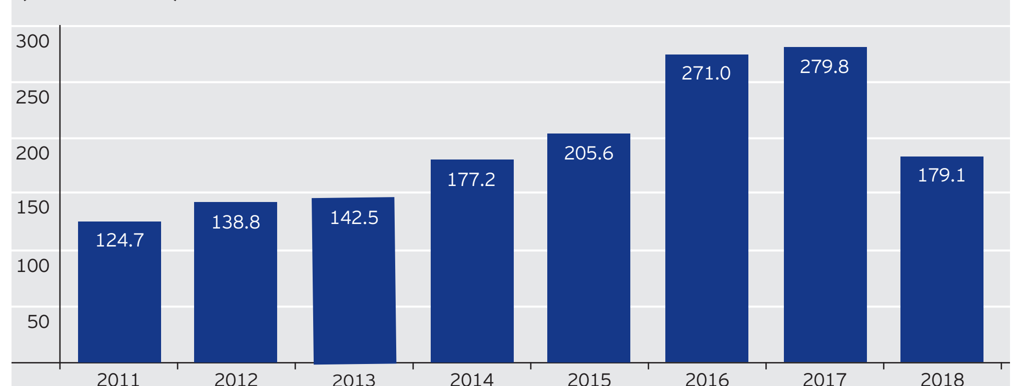
"Through the B&R Initiative, China aims to transform its export-oriented economic model into one that focuses more strongly on services, consumption, innovation, high-tech and higher value-added manufacturing."

The region is expanding
Through the B&R Initiative, China aims to transform its export-oriented economic model into one that focuses more strongly on services, consumption, innovation, high-tech and higher value-added manufacturing. During the transformation period, China will relocate raw-material- and labor-intensive factories to the B&R region to make use of the young workforces and natural resources available in particular countries, such as Indonesia and Vietnam. These new factories in the B&R region may be more advanced than the outdated factories in China that produce high levels of pollution. The Chinese capital (mainly from state-owned enterprises) has increasingly been investing in commodities projects, infrastructure construction such as power plants, ports, railways, highways, airports, wireless telecommunication towers and gas and oil pipelines.

It appears that the Chinese authorities are keen to increase trade by improving infrastructure in the B&R region, amid escalated trade tensions with the US. The improved land transportation routes with Southeast Asian countries, Europe via Central Asia, and the Middle East via South Asia will mean the western and south-western parts of China will benefit from a rebalancing of economic activities, helping to address the economic imbalances between coastal and inland regions.

The BRI has been expanding since its inception. At the end of June 2018, 75 countries were included in the BRI. By mid-October of the same year, there were 117, including some in Africa.[1] The total value of China's outward direct investment and construction contracts has risen from USD 122.9 billion in 2011 to USD 270.6 billion as of 2017 (Figure 1). We expect China to continue to invest USD 150 to 200 billion in the form of direct investments in the B&R region per year.

Figure 1: China's outward direct investment and construction contracts (2011-2018) (in USD billion)



Source: American Enterprise Institute, data as at 31 December 2018.

“We see the increasing competition for influence among China and other economic powers is positive for the countries in the B&R region in terms of more availability of capital and funding sources.”

US, EU, and other major economic powers compete with China
To counter China's ambitious overseas plans, major economies such as the United States, the EU, the United Kingdom and Japan have announced more direct investments in the Belt and Road region.

In October 2018, the US Congress passed a bill to create a new USD 60 billion agency to focus the US federal government's efforts on lending money to developing countries for infrastructure projects. The new unit, called the International Development Finance Corporation (IDFC), consolidates several other American agencies that work on international development. The aim is to incentivize private-sector investments in emerging economies. The creation of the IDFC comes amidst protracted trade tensions between the US and China. In the US, backers of the bill to create the IDFC argued that US lending in general should be more efficient to keep up with China's increasing investment throughout the world.

In addition, as part of Trump's "Indo-Pacific Economic Vision", the United States has committed itself to investing USD 113 million in new technology, energy and infrastructure initiatives in emerging Asian countries. This was announced by Secretary of State Mike Pompeo in late July 2018. Initial agreements have already been signed. In addition to this, the United States has also signed a USD 350 million investment deal with Mongolia to develop new sources of water.

In September 2018, the European Commission proposed funding EUR 60 billion for the European Union's External Investment Plan to enhance connectivity between Europe and Asia. The UK has indicated its vision of making the UK the biggest G7 country to invest in Africa by 2022. Japan has been competing with China in Southeast Asia for infrastructure projects. Saudi Arabia, UAE and India are providing countries along the Belt and Road region with capital support to stay relevant. And the list goes on…

We see the increasing competition for influence among China and other economic powers as positive for the countries in the B&R region in terms of more availability of capital and funding sources. The transparency and effectiveness of infrastructure projects and governance of countries in the B&R region may also improve, especially when the voters, politicians and government officials in less developed countries in the B&R region can choose their sources of capital, joint-venture partners, business investors and contractors among China and its competitors.

2. Economic scope

Asian Development Bank (ADB) estimates that the Asia-Pacific region will require an average of USD 1.7 trillion per year of additional infrastructure investment, while Global Infrastructure Hub, a G20 Group initiative, estimates that investment of USD 621 billion by 2030, and a total of USD 2 trillion between 2018 and 2040, is necessary to meet the demands of Africa's growing populations and economies. This huge potential represents structural and long-term investment themes under the banner of the Belt and Road Initiative, no matter whether the capital and expertise transfers come from China or competing countries.

3. Investment themes

We have identified five concrete themes that we find especially interesting for investors. Given the scope of the initiative, we believe there will be more themes to evolve.

Improving financial strength
The countries in the B&R region that receive strong capital inflows and are able to turn them to sustainable and productive uses will tend to improve their sovereign credit profiles and credit ratings.

If the capital inflows of a country in the B&R region result in productive factories, sustainable commodities, effective infrastructure, high-yielding agriculture, etc., its job market, government revenues and budget balances will tend to improve. Increased inter-regional connectivity among these countries will also help boost their trade volumes, leading to rising exports and trade surpluses.

We expect selected countries in the region to improve their solvency and liquidity factors, leading to sovereign credit rating upgrades in the next few years. The sovereign credit rating upgrades may extend to quasi-sovereign agencies, policy banks, state-owned or state-controlled enterprises and even to big corporations in these countries. As such, we expect their funding costs and hence credit spreads may improve, bringing capital gain potential in their bond prices.

Mongolia in Asia and Ghana in Africa are two good examples. Both countries have been receiving strong capital inflows – not only from China, but also from other economically powerful countries like the US. In addition, both Mongolia and Ghana are able to put capital inflows to sustainable and productive uses, resulting in improving sovereign credit profiles. Hence, Mongolia's sovereign credit rating was upgraded to B by Fitch in July 2018 and by Standard and Poor's in November 2018. Ghana's sovereign credit rating was also upgraded by Standard and Poor's in September 2018. Mongolia and Ghana's sovereign, quasi-sovereign and corporate bonds have been out-performing their Emerging Market and Asian peers.

Expanding infrastructure
The development of more efficient railways, highways, ports, airports and telecommunications in the B&R region will facilitate the transport of goods and passenger traffic.

The continued expansion of transportation networks is good news for selected transportation companies, exporters, manufacturers, real estate developers and governments in the B&R region. This will also indirectly benefit companies in related industries, such as local banks and insurance companies that engage in trade finance and accident insurance.

Rail transport is becoming increasingly important for trade between Europe and China as the latter promotes industrial hubs in cities further inland in its territory. For example, a new freight train service linking Chengdu, an inland city in south-western China, to Vienna, Austria, came into commercial operation in 2018. It takes 10 to 13 days to transport electronic products from Chengdu, an important industrial area in China, to Europe, with the flow in the opposite direction including automobiles, machinery and consumer food products. Most cargo shipments currently travel by sea. Transportation by train is much quicker compared to sea-route shipments from the coastal parts of China to Europe. Improved transport and access will boost economic growth, manufacturing activities and real estate developments in inner China. The railway also benefits the economies of countries such as Russia, Kazakhstan, Belarus and Poland, which it runs through.

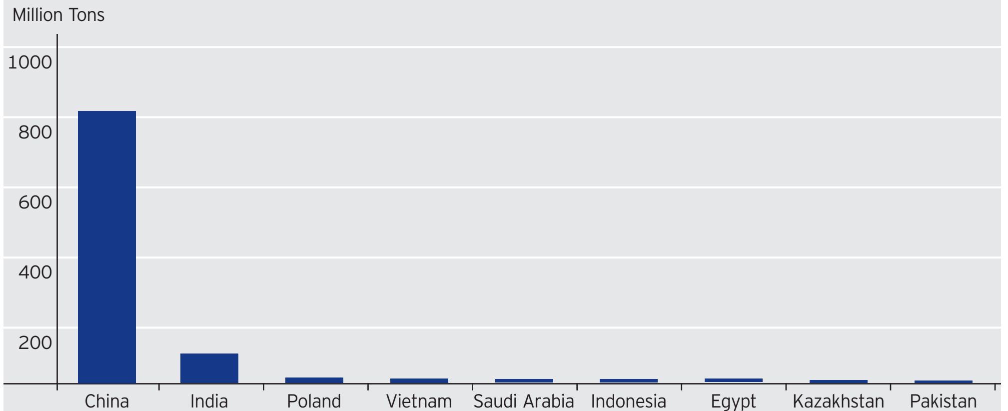
"Bonds issued by information technology companies are in a position to gain from infrastructure enhancement and business momentum."

In addition to transportation, telecommunications are an important part of infrastructure. In most of the developing countries in the B&R region, digital infrastructure is underdeveloped and internet penetration rates are low. This starting point provides many opportunities for companies focusing on mobile communications equipment, fixed-line broadband upgrades, internet data centers (IDC) and other related areas to expand business and implement advanced technology within the region. As the development of the information technology industry varies in each country, companies with a competitive advantage can implement a niche market strategy and expand their profit margins. Bonds issued by these companies are in a position to gain from infrastructure enhancement and business momentum. Elsewhere, Chinese companies have also been working on digital infrastructure in BRI markets. China Telecom plans to invest USD 15 billion in Africa on telecommunications infrastructure, for example.

Energy, commodities and agricultural products
China has been expanding and diversifying its sources of energy, commodities, and agricultural product imports in the B&R region.

The BRI builds a mutually complementary relationship that facilitates production and exports of energy and commodities within the region. China is increasing direct investments in oil and gas mines, pipelines and storage facilities in the region through a variety of channels such as turnkey projects, joint ventures, subsidiaries, co-investments and leasing. Rising production and exports in the energy and commodity sectors may contribute to an increase in GDP and employment in selected countries in the B&R region. We believe the sovereign credit profiles and ratings of these countries will improve and have a positive impact on their sovereign bonds. Quasi-government agencies, policy banks and state-owned enterprises may also tap into the growth potential, so their bond prices will likely appreciate.

Some Asian and emerging market countries in the B&R region are short of domestic steel production capacity. With the implementation of the BRI, the demand for steel will rise. According to the Financial Times, the B&R infrastructure projects will lead to additional demand for 15 million tons of steel per year over the next 10 years. The Chinese government is encouraging Chinese steelmakers to "go global" and set up new steel plants in Southeast Asia-Pacific, Central Asia and Africa in the B&R region while demolishing sub-scale and environmentally substandard steel plants in China in order to help ease air pollution within the country. New plants in the B&R region will be more economically efficient than sub-scale plants in China as they will enable transportation costs to be saved. These plants may be closer to iron ore mines and/or infrastructure construction sites. New plants may also help stimulate local job markets and consumption sectors in selected areas of Southeast Asia-Pacific, Central Asia and Africa.



Source: Financial Times, World Steel Association 2016 Data, INVESCO, data as at 31 December 2016.

The B&R's infrastructure projects may drive a total of 500 million tons of cement demand per year over the next five years, according to the Chinese Ministry of Industry and Information Technology. We expect more cement plants to be set up in the B&R region to capture new business opportunities.

Potential growth in the agriculture sector in countries in the B&R region is noteworthy as their agriculture land usage and efficiency are low. For example, Kazakhstan has more than 30 million hectares of arable land available, but only half of it is planted. In light of this, China's rich experience in production and application of technology in soil improvement, drip irrigation, crop cultivation and agricultural fertilization could help these countries to produce and export agricultural products.

According to the Director-General of the United Nations Food and Agriculture Organization, "Agriculture is a crucial sector. It accounts for more than 25% of GDP, as well as for more than 40% of employment in developing countries in the B&R".

Local consumption
The persistent capital inflows into the BRI region mean more job opportunities. According to a former Chinese top official, the BRI has created more than 200,000 jobs for those living in BRI countries between 2014 and 2017.[2] With improving job markets and rising household incomes, the demand for consumption goods and services in the region is on a structural uptrend.

"We are positive on the food, leisure, banking, insurance and real estate sectors in both developing and developed countries in Europe and Asia."

We are positive on the food, leisure, banking, insurance and real estate sectors in both developing and developed countries in Europe and Asia. For example, a certain French food and beverage company has been generating more than 60% of its total revenue from the Belt and Road region.

Modernizing economic corridors
According to a joint statement issued by the National Development and Reform Commission, the Ministry of Foreign Affairs, the Ministry of Commerce of the PRC and State Council authorization dated 28 March 2015, the BRI focuses on six international economic cooperation corridors connecting China with Asia, Europe and Africa. We expect more favorable policies to be rolled out in areas of China to support developments in these six economic corridors.

Economic corridors	Areas of China benefiting
1. The New Eurasia Land Bridge Economic Corridor (a railway connecting China, Kazakhstan, Russia, Belarus, Poland, and Germany)	Xinjinag, Lanzhou, Lianyungang, Jiangsu, Henan, Gansu, Shaanxi, Ningxia
2. China-Mongolia-Russia Economic Corridor	Inner Monoglia, Heilongjiang, Jilin, Liaoning, Beijing
3. China-Indochina Peninsula Economic Corridor	Guangxi, Yunnan
4. China-Central Asia-West Asia Economic Corridor	Xinjiang
5. China-Pakistan Economic Corridor	Kashgar, Xinjiang
6. Bangladesh-China-India-Myanmar Economic Corridor	Yunnan

Source: HKTDC Research "The Belt and Road Initiative" dated 17 September 2017.

For example, improving land-route transportation with Southeast Asian countries, Europe via Central Asia and the Middle East via South Asia will mean that inland areas, especially the western and south-western parts of China, will benefit from a rebalancing of economic activities, helping to address the economic imbalances between coastal and inland regions. The western and north-eastern parts of China will become energy hubs as China imports increasing amounts of energy via gas and oil pipelines connecting these areas to Central Asia and Russia respectively.

4. Investment opportunities

While equity and private investment opportunities are available in the Belt and Road region, we see uniqueness in fixed income markets in the region. On a top-down basis, we see country selection as one of the most important factors for investing in developing countries. This is because the first round of benefits would usually go to the sovereign credit profile, then trickle down via quasi-sovereign entities, policy banks, commercial banks and state-owned enterprises, before reaching private enterprises. While sovereign governments, quasi-sovereign entities and policy banks usually have bonds available for trading in fixed income markets, they do not issue equity securities. Also, only some state-owned and private-owned enterprises have listed equity shares traded on stock exchanges, while most have issued bonds that are traded on fixed income markets.

“We believe systematic considerations of ESG factors in both country selection in portfolio construction and corporate credit research will help mitigate investment risk in Belt and Road fixed income markets.”

Focusing ESG factors can help to mitigate risks

We believe systematic considerations of environmental, social and governance (ESG) factors in both country selection in portfolio construction and corporate credit research will help mitigate investment risk in Belt and Road fixed income markets. By filtering out the worst-in-class sovereign and corporate bond issuers, we aim to avoid countries and companies that may run into ‘debt traps’, major corruption and social and environmental issues.

[1] Be wary of spending on the Belt and Road'', American Enterprise Institute, Nov. 14, 2018. Retrieved on Jan. 7, 2019.
[2] ''B&R adds 200,000 foreign jobs'', China Daily, Jan. 20, 2018.

Contact

Amsterdam
+31 20 561 62 61
www.invesco.nl

Brussels
+32 2 64 10 17 0
www.invesco.be

Frankfurt
+49 69 29 807 0
www.de.invesco.com

London
+44 207 065 4000
www.invesco.co.uk

Madrid
+34 91 78 13 02 0
www.invesco.es

Milan
+39 02 88074 1
www.invesco.it

Paris
+33 1 56 62 43 77
www.invesco.fr

Stockholm
+46 8 463 11 09
www.invesco.eu

Vienna
+43 1 316 20 0
www.invesco.at

Zurich
+41 44 287 90 00
www.invesco.ch

Risk Warnings for the Invesco Belt and Road Debt Fund
The value of investments and any income will fluctuate (this may partly be the result of exchange-rate fluctuations) and investors may not get back the full amount invested. Debt instruments are exposed to credit risk which is the ability of the borrower to repay the interest and capital on the redemption date. Changes in interest rates will result in fluctuations in the value of the fund. The fund uses derivatives (complex instruments) for investment purposes, which may result in the Fund being significantly leveraged and may result in large fluctuations in the value of the fund. As a large portion of the fund is invested in less developed countries, you should be prepared to accept significantly large fluctuations in the value of the fund. Investments in debt instruments which are of lower credit quality may result in large fluctuations in the value of the Fund. The fund may invest in a dynamic way across assets/asset classes, which may result in periodic changes in the risk profile, underperformance and/or higher transaction costs.

Important Information
This marketing document is exclusively for use by Professional Clients and Financial Advisers in Continental Europe (as defined below), Qualified Investors in Switzerland and Professional Clients in Isle of Man and the UK. By accepting this document, you consent to communicate with us in English, unless you inform us otherwise. This document is not for consumer use, please do not redistribute. Data as at 31.12.2018, unless otherwise stated. This document is marketing material and is not intended as a recommendation to invest in any particular asset class, security or strategy. Regulatory requirements that require impartiality of investment/ investment strategy recommendations are therefore not applicable nor are any prohibitions to trade before publication. The information provided is for illustrative purposes only, it should not be relied upon as recommendations to buy or sell securities. Where individuals or the business have expressed opinions, they are based on current market conditions, they may differ from those of other investment professionals and are subject to change without notice. For more information on our funds, please refer to the most up to date relevant fund and share class-specific Key Investor Information Documents, the latest Annual or Interim Reports and the latest Prospectus, and constituent documents. This information is available using the contact details of the issuer and is without charge. Further information on our products is available using the contact details shown. This marketing document is not an invitation to subscribe for shares in the fund and is by way of information only, it should not be considered financial advice. This does not constitute an offer or solicitation by anyone in any jurisdiction in which such an offer is not authorised or to any person to whom it is unlawful to make such an offer or solicitation. Persons interested in acquiring the fund should inform themselves as to (i) the legal requirements in the countries of their nationality, residence, ordinary residence or domicile; (ii) any foreign exchange controls and (iii) any relevant tax consequences. As with all investments, there are associated risks. This document is by way of information only. Asset management services are provided by Invesco in accordance with appropriate local legislation and regulations. The fund is available only in jurisdictions where its promotion and sale is permitted. Not all share classes of this fund may be available for public sale in all jurisdictions and not all share classes are the same nor do they necessarily suit every investor. Fee structure and minimum investment levels may vary dependent on share class chosen. Please check the most recent version of the fund prospectus in relation to the criteria for the individual share classes and contact your local Invesco office for full details of the fund registration status in your jurisdiction.Please be advised that the information provided in this document is referring to Class A (accumulation - USD) exclusively. This fund is domiciled in Luxembourg. For the distribution of this document, Continental Europe is defined as **Austria, Belgium, Finland, France, Germany, Italy, Luxembourg, Netherlands, Norway, Spain and Sweden. Germany, Austria and Switzerland:** This document is issued in Germany by Invesco Asset Management Deutschland GmbH. This document is issued in Austria by Invesco Asset Management Österreich – Zweigniederlassung der Invesco Asset Management Deutschland GmbH and in Switzerland by Invesco Asset Management (Schweiz) AG. Subscriptions of shares are only accepted on the basis of the most up to date legal offering documents. The legal offering documents (fund & share class specific Key Investor Information Document, prospectus, annual & semi-annual reports, articles and trustee deed) are available free of charge at our website and in hardcopy and local language from the issuers: Invesco Asset Management Deutschland GmbH, An der Welle 5, D-60322 Frankfurt am Main, Invesco Asset Management Österreich – Zweigniederlassung der Invesco Asset Management Deutschland GmbH, Rotenturmstrasse 16-18, A-1010 Wien, and Invesco Asset Management (Schweiz) AG, Talacker 34, CH-8001 Zurich, who acts as a representative for the funds distributed in Switzerland. Paying agent for the fund distributed in Switzerland: BNP PARIBAS SECURITIES SERVICES, Paris, succursale de Zurich, Selnaustrasse 16, CH-8002 Zürich. **Belgium, Finland, France, Italy, Luxembourg, Netherlands, Norway, Spain and Sweden:** This document is issued by Invesco Asset Management S.A., 16-18 rue de Londres, 75009 Paris, France. www.invesco.eu
Isle of Man: Issued by Invesco Management S.A. 37A Avenue JF Kennedy, L-1855 Luxembourg. The Invesco Belt and Road Debt Fund is an unregulated scheme that cannot be promoted to retail clients in the Isle of Man. The participants in the scheme will not be protected by any statutory compensation scheme. **UK:** Issued by Invesco Fund Managers Limited, Perpetual Park, Perpetual Park Drive, Henley-on-Thames, Oxfordshire RG9 1HH, UK. Authorised and regulated by the Financial Conduct Authority. For the purposes of UK law, the fund is a recognised scheme under section 264 of the Financial Services & Markets Act 2000. The protections provided by the UK regulatory system, for the protection of Retail Clients, do not apply to offshore investments.
www.invesco.eu

EMEA753/2019