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The New Silk Road routes: Why investors should care

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Promoting regional and global integration

Unprecedented times. *The global outbreak of Covid-19 has brought the world and its economy to a standstill, highlighting the importance of sustainable and resilient infrastructure (healthcare, water, power, telecommunications). Countries with fragile infrastructure have less capacity to handle crises, so they will need to increase their infrastructure investments. This is especially crucial in the context of health security and rapid urbanisation.*

The New Silk Road routes. *A significant first step in this direction was the Belt and Road Initiative (BRI, also referred to as the New Silk Road), which was proposed by the Chinese government in 2013 with the aim of promoting regional and global integration along two main conduits, each underpinned by significant infrastructure investments: the Silk Road Economic Belt (the 'Belt') and the New Maritime Silk Road (the 'Road'). China's global development project has continued to grow in the years since, with the BRI extended beyond just infrastructure construction to embrace also technology infrastructure (the* ***Digital Silk Road****) and it is now moving to a new phase called the* ***Healthcare Silk Road.*** *It has been stated that more than 130 countries have officially signed collaboration agreements so far,* ***representing more than 70% of the world's population, 55% of global GDP, 75% of energy reserves and 30% of the world's good and services.***

Investment opportunities. *Opportunities surrounding the New Silk Road are numerous and spread among all participating countries, especially those with a relatively large demographic dividend and a rapid urbanisation process. For these countries, spending under the BRI represents an opportunity to close their infrastructure gaps and contribute to broader economic development thanks to positive spillover effects from infrastructure and foreign direct investments.* ***It is important to look at the sectors that are set to directly or indirectly benefit from the trade and economic growth the BRI will generate.*** *Within those sectors, investors should favour highly profitable companies with solid balance sheets, sound multiplies and double-digit revenue growth.*

Investment approach. *Investing in the BRI countries by adopting an unconstrained, flexible approach gives investors the maximum potential to access a varied set of opportunities across a range of geographies, sectors and asset classes. The same approach helps to exploit relative value opportunities across the capital structure of companies and manage drawdown in different cycles. When approaching such investments, investors should combine a blend of top-down and bottom-up approaches to identify those companies that are best placed to capture sustainable economic growth.*

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THE NEW SILK ROAD

A great potential to reshape world equilibrium

INVESTMENT INSIGHTS INFOGRAPHIC

A GLOBAL INITIATIVE SETTING THE STAGE FOR A NEW MULTIPOLAR WORLD

More than **130** countries involved

70% of world population

55% of World GDP

75% of global Energy Reserves

30% of global Goods & Services

A WAVE OF INVESTMENTS TO IMPROVE CONNECTIVITY AND COOPERATION*

"The ambitious programme to build the Economic, Maritime and Digital Silk Road is advancing and has already mobilised massive investments"

- Reduce travel times along economic corridors by 12%
- Increase income by up to 3.4%
- Increase trade between 2.7% and 9.7%
- Lift 7.6 million people from extreme poverty

SCRUTINY AND RISK ASSESSMENT OF PROJECTS IN FOCUS

AREAS OF IMPROVEMENT

- High-quality and less-expensive projects
- Greater transparency and governance
- Reforms on environmental and corruption

AREAS OF IMPROVEMENT

- Financial: low returns vs huge debt levels
- Geopolitical: areas of instability & trade war
- Execution: possible project restructuring

Source: Amundi, World Bank. Statistics refer to the economies along the corridor.

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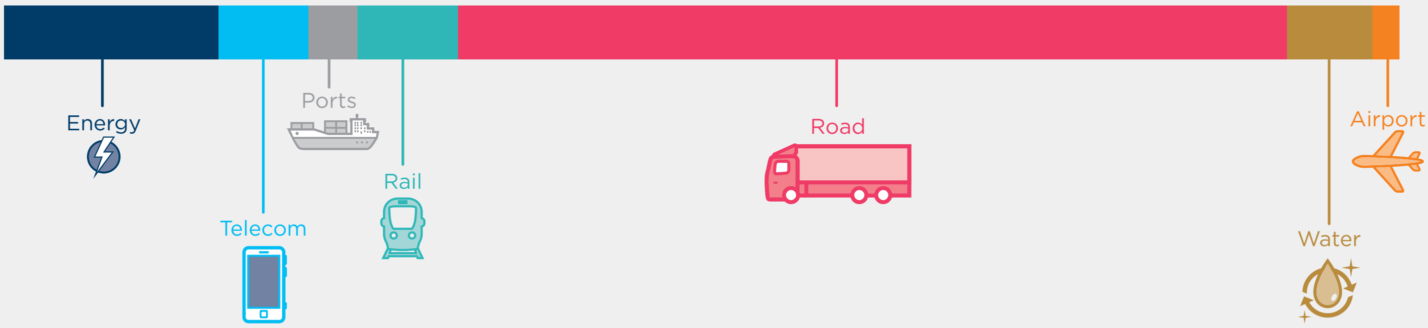
THE NEW SILK ROAD
A new thematic opportunity for investors

INVESTMENT INSIGHTS INFOGRAPHIC

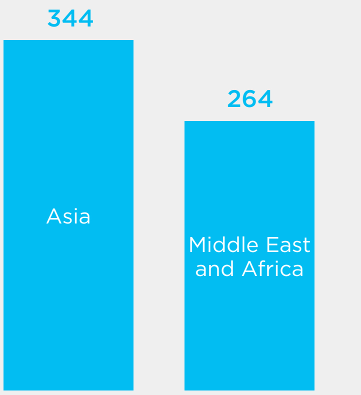
OPPORTUNITIES FROM PROJECTS AIMING TO CLOSE THE INFRASTRUCTURE GAP

0.9% of annual GDP
Average gap between current annual infrastructure spending and infrastructure need up to 2040 in the 25 main Emerging Markets



"Spending under the Belt and Road Initiative - a catalyst to promote regional and global integration along the New Silk Road - represents an opportunity for countries to close their infrastructure gaps, with a beneficial impact on trade and GDP growth."

BEYOND CHINA



Selection based on

Demographic dividend Urbanisation trends Potential growth Financial stability Geopolitical stability External vulnerability Central bank credibility Ability to implement reforms Environmental protections

730 USD BLN
INVESTMENT AND CONSTRUCTION CONTRACTS IN THE NEW SILK ROAD PROJECTS BY REGION (2013-2019)

ACROSS INDUSTRIES

"It is important to look at the sectors set to directly or indirectly benefit from the trade and economic growth the New Silk Road will generate."

- Energy
- Transport
- Technology
- Industrials
- Construction materials
- Financials

Source: Bloomberg, Amundi. Data as at as of 30 June 2020.

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BRI the catalyst – understanding the potential

"Countries involved in BRI projects represent more than 70% of the world's population, 55% of global GDP and 75% of energy reserves."

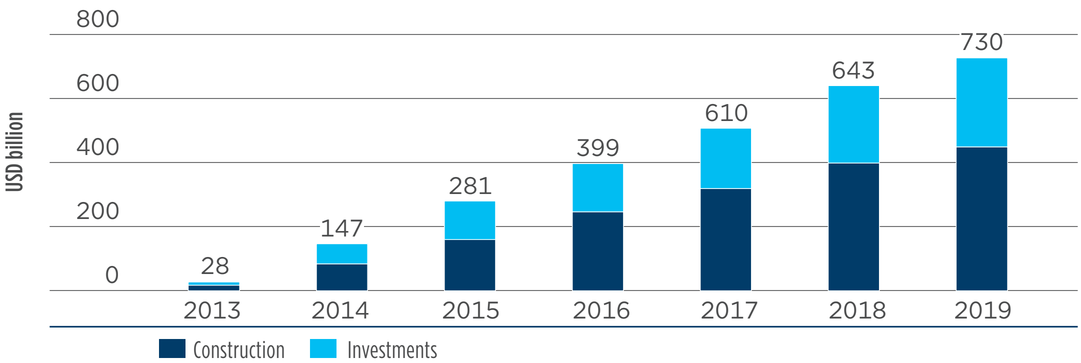
The global outbreak of Covid-19 has highlighted the importance of sustainable and resilient infrastructure (healthcare, water, power, telecommunications). Countries with fragile infrastructure have less capacity to handle crises, so it will be crucial for them to increase their infrastructure investments.

A significant first step in this direction was the Belt and Road Initiative (BRI or 'the Initiative'). It has been seven years now since China first proposed the Belt and Road Initiative in 2013, with the aim of promoting regional and global integration via land and maritime networks (the Silk Road Economic Belt and the New Maritime Silk Road, respectively). An official list of participating countries does not yet exist, but China has stated that more than 130 countries have officially signed collaboration agreements so far, representing more than 70% of the world's population, 55% of global GDP, 75% of energy reserves and 30% of the world's good and services.

With global trade tensions limiting growth opportunities, the BRI provides economic stimulus to participating countries and acts as a catalyst for new trade routes and growth across Asia, Europe, the Middle East and Africa. The Initiative represents an opportunity for China to increase its own exports, as well as strengthen its geopolitical and commercial influence, while for countries along the routes the programme represents the opportunity to fund their infrastructure deficit and provide capital injections via foreign direct investments (FDI) that will stimulate economic activity.

China's global development project has continued to grow since 2013. The chart below shows China's outward direct investment in BRI participating countries reached the cumulative amount of $730 billion at the end of 2019, accounting for 54% of the value of all of China's global activity. Finished or underway projects under the Initiative number more than 2,100 to date.

Figure 1. China's cumulative activity in the BRI, 2013-19



Source: Amundi, American Enterprise Institute and Heritage Foundation. As of 30 June 2020.

"China's cumulative activity in the BRI had reached $730 billion at the end of 2019, having also embraced infrastructure technology from 2015."

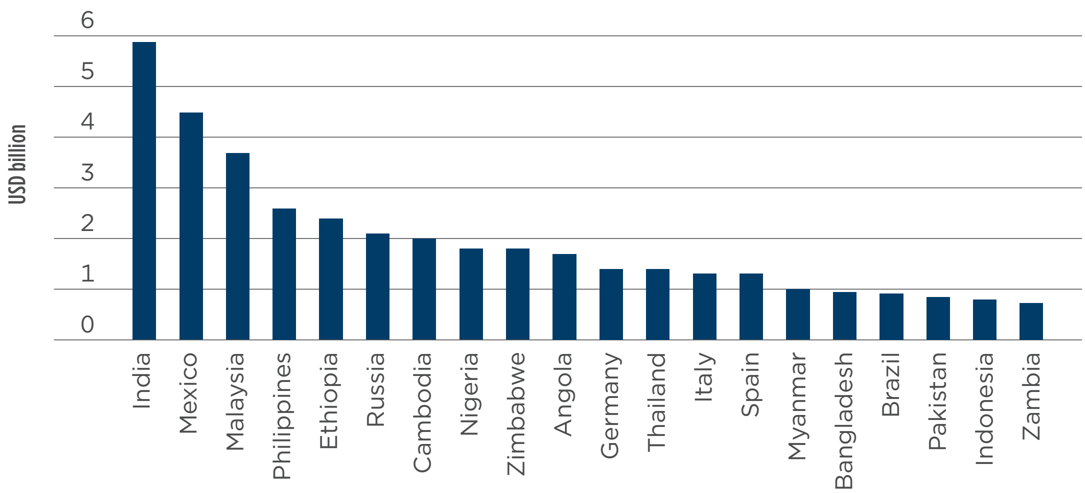
In 2015, the Initiative was extended beyond just infrastructure construction to embrace infrastructure technology (the so-called **Digital Silk Road**) and it is now moving to the new phase, the **Healthcare Silk Road**.

The Digital Silk Road aims to upgrade internet connections with optical fibre cable, 5G networks and satellites in countries where technology infrastructure is underdeveloped or even non-existent. According to RWR Advisory Group data, **the digital component of**

the BRI is estimated to involve investments worth nearly $200 billion so far, $79 billion of which has already been invested in technology-led projects around the world.

The Healthcare Silk Road is expected to lead to an increase in investment in healthcare and public health infrastructure. Without health security and epidemic preparedness, emerging economies will remain vulnerable to disease outbreaks. This is especially true in the context of increased global connectivity (trade and travel) and rapid urbanisation.

Figure 2. China's spending on Digital Silk Road projects by country (since 2012)



Source: Amundi, RWR Advisory Group. As of 30 June 2020.

Risks to watch

"Countries with a relatively large demographic dividend and a rapid urbanisation process may benefit the most under the BRI."

One of the main risks is related to financial viability, which is the risk that governments assume a huge amount of debt for (non-economic) projects that are not able to generate an adequate return to repay government debt, with negative implications for the country. Concerns about unsustainable debt burdens have eventually led some governments (such as Malaysia, Myanmar, Pakistan and Sierra Leone) to cancel or scale back some BRI projects.

This risk is now being exacerbated by the Covid-related shocks to economies. **An important recent step toward debt sustainability is being provided by the debt service suspension initiative** (DSSI), which provides for the temporary suspension of debt repayments falling due between May-December 2020 for emerging countries in dire economic conditions. Such multilateral global debt relief efforts will allow countries under pressure to ease near-term liquidity pressures and generate new credit for investments in infrastructure, healthcare and education.

On top of that, the approach to the BRI has substantially evolved over the years, to the point that we now see greater scrutiny and more appropriate risk assessments of BRI projects, much more of a focus on higher quality and less expensive projects, and more emphasis on transparency and due diligence. Projects are also likely to be increasingly sponsored by international agencies, favouring a better assessment of the financial, sovereign and geopolitical risks, and also paving the way for much greater private sector involvement.

Some major steps towards greater transparency and governance have included the call for member countries to adopt deeper policy reforms to mitigate the environmental, social and corruption risks and the establishment of the International Commercial Courts (CICCs), a dedicated chamber set up to handle BRI disputes. These positive developments have allowed the BRI to become much more international and inclusive, with several developed nations joining the initiative (Italy being the first of the G7 bloc of advanced economies).

Adverse geopolitical events are another big risk to consider as the BRI includes economies in unstable parts of the world. One pre-requisite for BRI projects to succeed is the presence of stable institutions backing the projects.

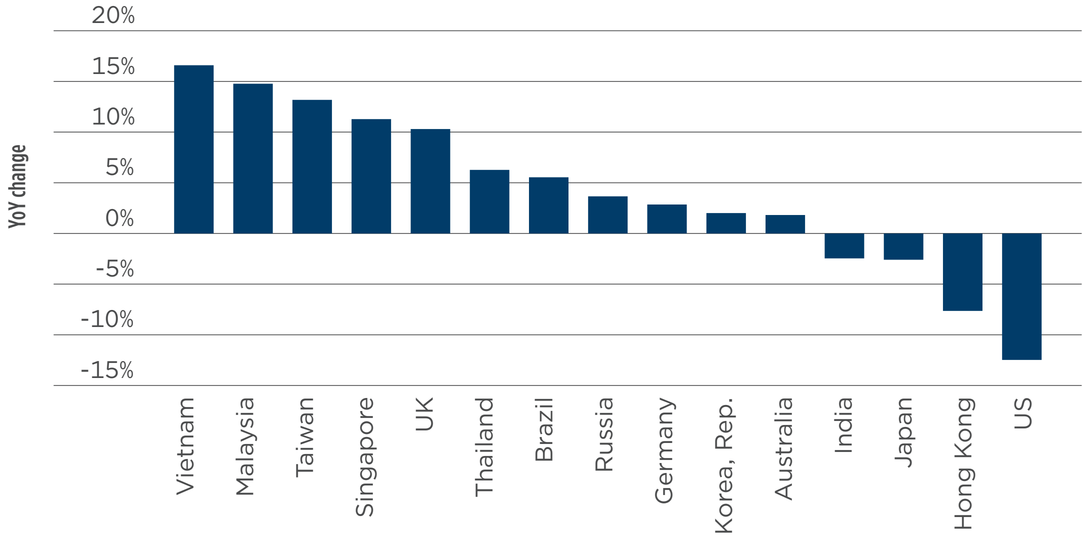
Last but not the least, the negative impact on the environment caused by certain megaprojects is a big issue. Because the environmental damage can be so profound, it can offset the benefits of improved infrastructure in some cases.

"The recycling of capital globally for investments is positive in countries that have been overlooked or could not ordinarily attract investments."

Finallly, another risk to consider is the trade war. The US is the main driver of this dispute, with the purpose of encouraging China to instigate reform in many areas, including IP protection, government subsides, state-owned assets and market access, areas where the US sees current practices as being unfair. This has led to an escalation in tariffs on various different products involved in the bilateral trade between the two nations. This trade war has also expanded to the restriction of supply of some technological IP to China. **Longer term we believe China will focus on diversifying both its sourcing of inputs and end markets to reduce its reliance on the US and in that sense, this should further boost the trade relationships between China and other nations, including those joining the New Silk Road project.**

We believe overall the recycling of capital globally for investments is positive, especially in countries that have been overlooked or could not ordinarily attract investments. The winners will be those countries that can most productively use the investments and not overinvest, where investment can release the economic potential. Clearly, the execution will not be perfect everywhere and there have and will be examples of project restructuring. However, we do believe that China is sensitive to these issues and where warranted there may be partial debt forgiveness.

Figure 3. Growth rate of China exports with top 15 largest partners



Source: Amundi, GACC. Latest observation as of December 2019. As of 30 June 2020.

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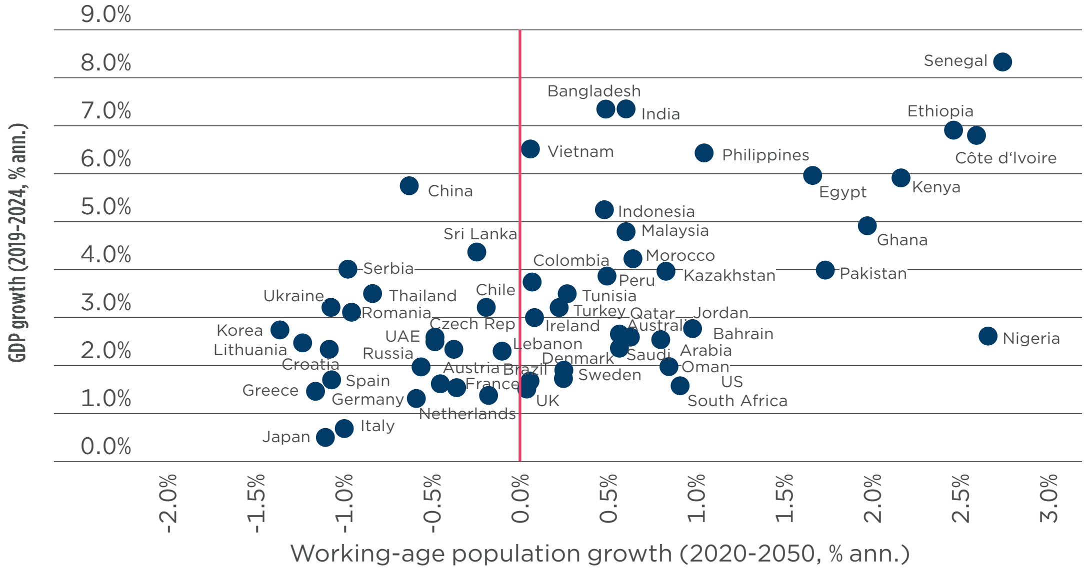
Investment opportunities on the New Silk Road

"BRI projects will most benefit those countries with appealing demographic dividends."

Opportunities along the New Silk Road are numerous and spread across many countries. When looking for the most compelling opportunities, the **demographic dividend** is a key factor to consider among the broad list of countries targeted by the BRI. The change in the working-age structure is positioning countries such as Nigeria, Kenya, Egypt and the Philippines to reap relatively large economic growth and receive strong capital inflows from FDI. These countries will have a greater likelihood of triggering self-reinforcing growth dynamics in a younger population.

Figure 4. Demographic dividend

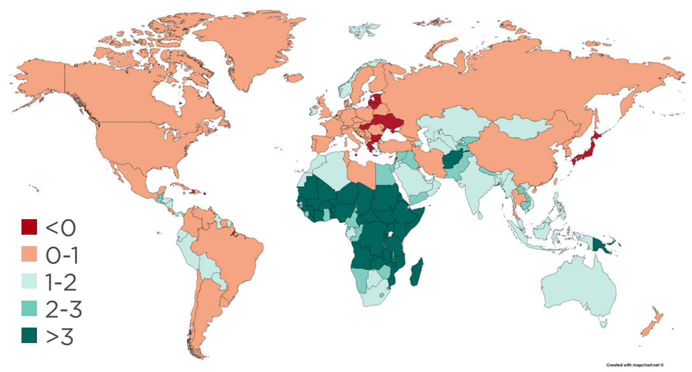


Source: Amundi, United Nations, IMF. As of 30 June 2020.

"Urbanisation trends will also support investment in human capital, businesses and infrastructure."

Demographic shifts generally lead to higher levels of **urbanisation,** which in turn result in higher levels of economic growth. The higher the rate of urbanization, the greater the investments in human capital and businesses, as the rapidly growing middle class is likely to push for infrastructure and technological progress. However, many developing countries that are experiencing a rapid urbanisation process have poor and/or inadequate infrastructure that needs to be improved. Urbanisation is also linked to changes in consumption patterns, with higher income and education being important drivers of this process.

Figure 5. Urbanisation rate (2020-2050, % ann.)



Source: Amundi, United Nations. As of 30 June 2020.

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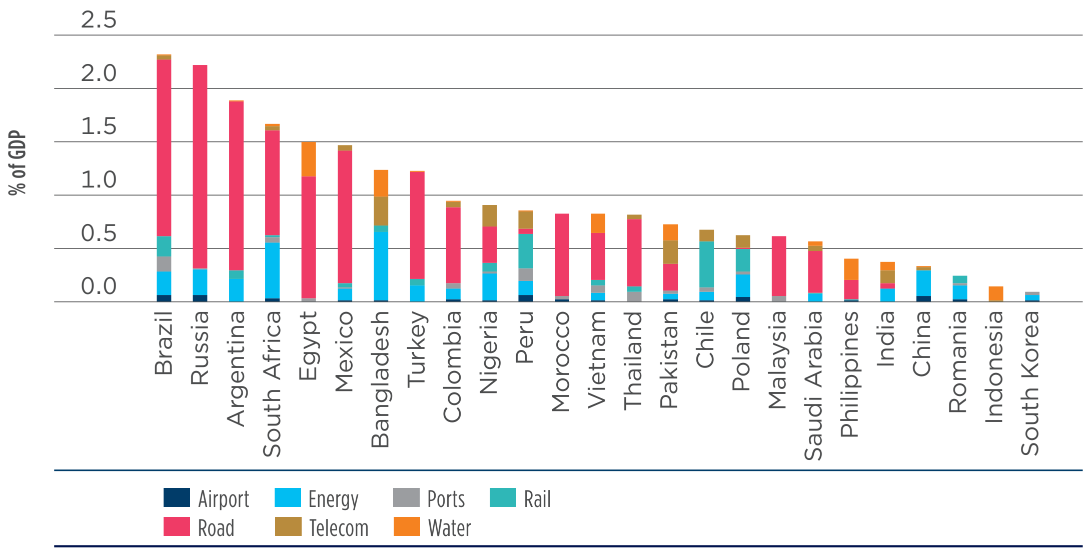
"Spending under the BRI represents an opportunity for countries to close their infrastructure gaps, with a beneficial impact on trade and GDP growth."

For these countries, the BRI represents an opportunity to obtain infrastructure financing – which they might not otherwise get – to close their infrastructure gaps. Furthermore, spending under the BRI strongly contributes to broader economic development thanks to the positive spillover effects from infrastructure investments: when connectivity improves, the cost of trading comes down, with a beneficial impact on trade and GDP growth. **Moody's Analytics has estimated that increased investments under the BRI may add up to 0.8% to the average annual real GDP growth in BRI participating countries until 2038.**[1]

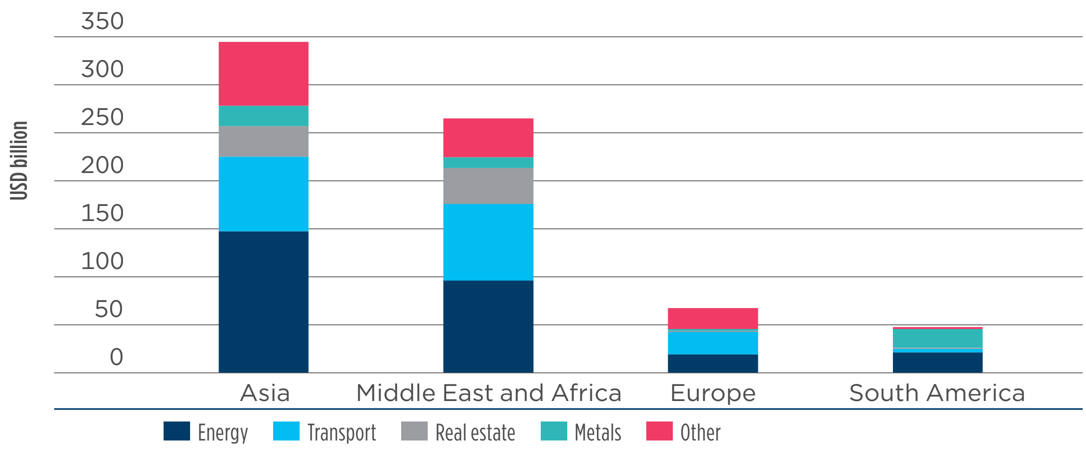
Figure 6. Infrastructure gap projections towards 2040



Source: Amundi, Global Infrastructure Hub. As of 30 June 2020.

So far Asian, Middle Eastern and African countries have attracted the majority of BRI-related investments, receiving more than 80% of such activity since 2013. We believe the BRI is likely to keep having a major impact on these regions considering their demographic growth, their urbanisation rates and the economic role of China in these areas. In particular, in Asia we look favourably on countries such as Vietnam, South Korea, India, the Philippines and Taiwan, while in other regions we closely monitor countries such as Kuwait, the UAE (Middle East), Nigeria (Africa), Russia, Hungary and Greece (Central/Eastern Europe), Mexico and Brazil (Latin America). After all, we think that opportunities may show up from time to time in each of the countries involved in the Initiative. Finally, the BRI can no longer be considered only an emerging markets story and opportunities may also increasingly arise in more advanced economies.

Figure 7. Investment and construction contracts in BRI projects by region (2013-2019)



Source: Amundi, American Enterprise Institute and Heritage Foundation. As of 30 June 2020.

[1] Moody's Analytics, The Belt and Road Initiative – Six Years On, June 2019.

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The benefit of an active investment approach

In order to take advantage of opportunities while also hedging against idiosyncratic risks related to countries and projects, when approaching such investments, investors **should combine a blend of top-down and bottom-up approaches to identify those companies that are best placed to capture sustainable economic growth.**

"An unconstrained, flexible approach gives investors the maximum potential to access to a varied set of opportunities."

Investing in countries along the New Silk Road by adopting an unconstrained, active flexible approach gives investors the maximum potential to access a varied set of opportunities across a range of sectors (from infrastructure and energy to technology and telecommunications), geographies (from emerging and frontier markets to developed markets) and asset classes (equity and fixed income). The same approach helps to exploit relative value opportunities across the capital structure of companies (choosing the most attractive combination of dividend and bond yields) and manage drawdown in different cycles. Within the fixed income space, investors may benefit from tactically choosing debt instruments denominated either in local or hard currency by any category of issuers.

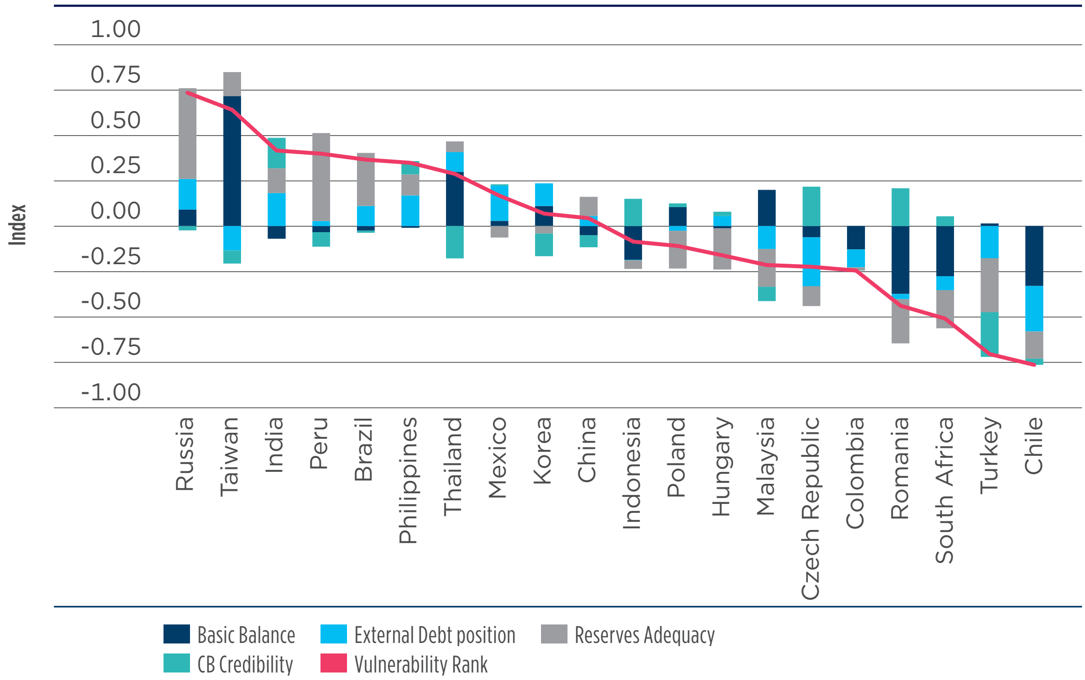
Country selection

In the top-down analysis, investors should focus on a country's macroeconomic situation, through the assessment of external account dynamics, FX valuation and support, the debt burden and dynamics, the monetary policy outlook and the fiscal situation. At the same time, they have to monitor geopolitical issues and the political influence on the economy and the market, as well as the relative capacity to implement policy reforms and manage the economic transition. Finally, it is important to move beyond the current macroeconomic situation by looking at long-term economic growth drivers, such as demography and social inclusion, technological and/or natural advantages, respect of property rights and the quality of legal institutions, the quality of the financial system and the level of corruption.

"Investors should ascertain that some basis standards are met, such as financial and geopolitical stability as well as environmental protections."

In conclusion, it is crucial for investors to ascertain that some basis standards are met: financial sustainability, geopolitical stability and environmental protections.

External vulnerability index and central bank credibility



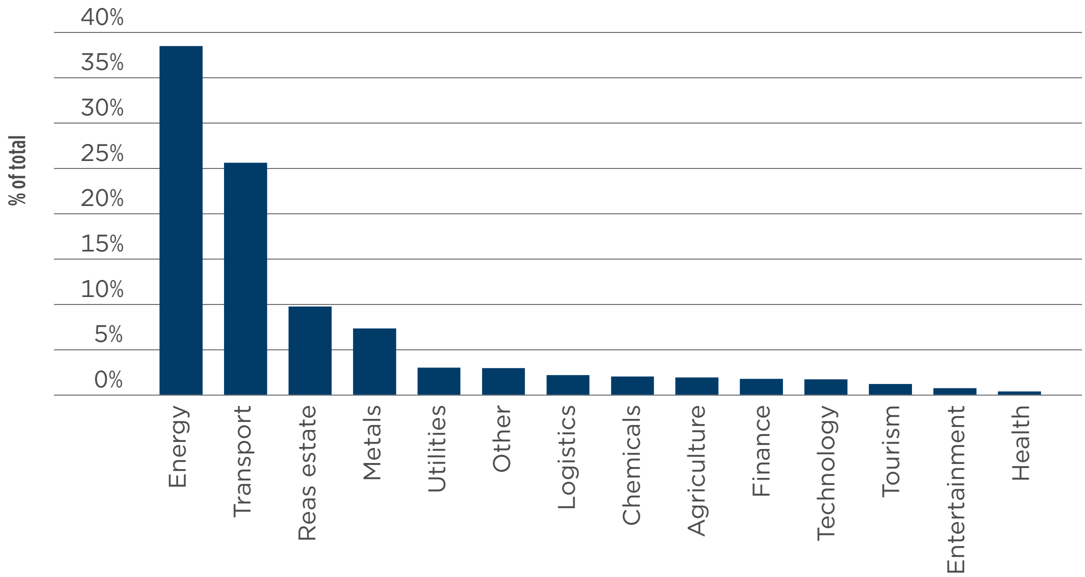
Source: Amundi Research. As of 3 July 2020.

"It is important to look at the sectors set to directly or indirectly benefit from the trade and economic growth the BRI will generate."

Sector selection

When it comes to sector selection, it is important **to look for sectors that are set to directly or indirectly benefit from the trade and economic growth the BRI will generate.** Looking at data provided by the American Enterprise Institute, the largest investments lie in energy and transport, which have accounted for 39% and 26%, respectively, of total BRI investments. They are followed by real estate, metals and utilities. As the Initiative progresses, we think other areas are worthy of consideration. For example, we believe that areas such as healthcare, education, technology, industrials and financials have high potential.

Figure 8. Investment and construction contracts in BRI projects by sector (2013-2019)



Source: Amundi, American Enterprise Institute and Heritage Foundation. AS of 30 June 2020.

Serious downward setbacks in prices due to the coronavirus could create attractive entry points in sectors related to tourism and consumption, which are businesses likely to benefit from the strong improvement in connectivity and cooperation once the impact of the virus fades away.

Within those sectors, we assess the comprehensive view of a company's financial attractiveness to select resilient stock that is well positioned for long-term growth. We look at highly profitable companies with solid balance sheets, sound multiples and double-digit revenue growth. We also look for companies that are involved in higher quality projects, preferably those sponsored by multiple agencies. We have observed that many BRI initiatives with primary effects, like infrastructure projects, are often managed with something other than a purely "for profit" objective in mind and hence may not offer a viable investment opportunity. We believe investors should exclude from their selection baskets companies that may fit with the theme, but that do not offer an attractive enough investment case. We pay a lot of attention to liquidity risk and liquidity analysis; for this reason, we first filter the investment universe by daily liquidity. Likewise, we aim to understand how much effort companies put into ESG practices through an ESG analysis. On the governance side, for example, we look at the quality of the management strategy and whether or not the right access to various information sources is granted (transparency).

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