MyStratWeekly
Market views and strategy

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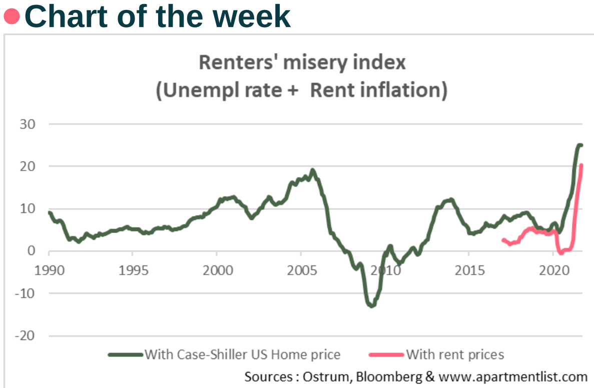
Topic of the week: «The New climatic Silk Roads»?

- **China is a leader in renewable energy but remains highly dependent on coal because of the risk of lack of energy to boost its economy;**
- **China has the opportunity to improve global infrastructure networks in a sustainable and inclusive manner;**
- **B3W and BRI must be complementary to achieve this goal.**

Market review: Coming up for air

- **As uncertainties are lifted, equities move up again;**
- **Putin alludes to increase in Russian gas exports;**
- **Higher yields amid stagflation fears;**
- **High yield under pressure, Chinese contagion?**

Chart of the week



The misery index is an antiquity that was used during the stagflation period of the 1980s and 1990s. It simply summed up the unemployment rate and the inflation rate.

On this chart we calculated the renters' poverty index by simply replacing consumer inflation with rent inflation.

This sums up one of the Fed's current dilemmas: it must maintain a lax policy because the unemployment rate has not fallen as much as desired, but at the same time it creates very strong inflationary pressures in the real estate sector.

Figure of the week

75k

Source : Ostrum AM

The number of people who have come out of "absolute poverty" today.

Or 1.3 billion since 1990.

Stéphane Déo
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Global strategist

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Topic of the week

«The New climatic Silk Roads»?

This week at COP26, we will focus on the Belt and Road Initiative (BRI). Criticized for being responsible for the excessive indebtedness of poor countries, the BRI is also a major obstacle to achieving the objectives of the Paris Agreement on Climate. Officially launched in 2013 by President Xi Jinping, this mammoth infrastructure project in 140 countries highlights the impact of such projects on the ecosystem and biodiversity. China has taken important policy initiatives to improve the image of the BRI. Speaking at the UN General Assembly on 21 September, Xi Jinping pledged to stop the construction of new coal mines and support emerging countries in their transition to green and low-carbon energy. However, the recent energy crisis has highlighted the importance of coal for the Chinese economy.

Belt and Road Initiatiative and the Paris Agreement

Introduction to the Belt and Road Initiative

Officially launched in 2013 by Xi Jinping, the Belt and Road Initiative (BRI), or "Nouvelles routes de la soie" in French, which also refers to One Belt, One Road (OBOR), is the personal priority of the Chinese president.

140 countries[1] (about 60% of the world's population) are participating in this huge project of investments in transport, energy and telecommunications infrastructure linking Europe, Africa and Asia.

The amount needed for this vast project is estimated at more than $8000 billion!

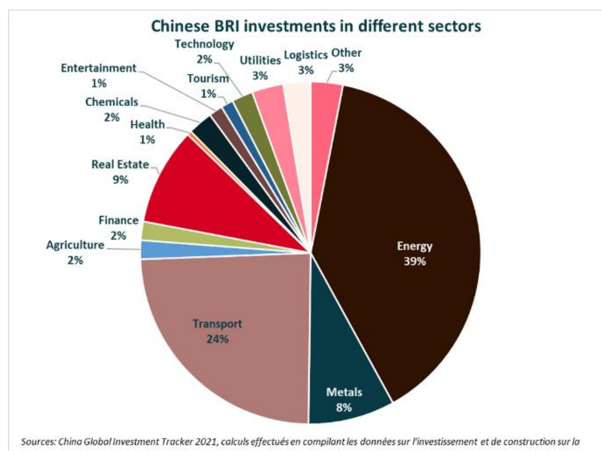
The BRI meets several objectives for the Chinese authorities:

- **Economic:** give outlets to Chinese companies that have become in overcapacity (heavy industries) because of the structural economic slowdown. Dominate global trade with the creation of economic corridors that provide rail, marine, road and energy connectivity, among other things.

- **Geopolitics:** BRI is also a way for China to increase its global influence. China has always been an international lender with strategic objectives and its role has grown over the past 20 years. The amount of its receivables amounts to $5000 billion, or 6% of global GDP. The 50 countries most indebted to China, which are mainly sub-Saharan African countries, owe on average 40% of their external debt to China. [2]

- **Security, especially energy.** The goal is to secure its energy supplies because China is still very dependent on the rest of the world in this area.

Moreover, the energy (39%) and transport (24%) sectors are the priorities of Chinese investment under the BRI, as shown in the chart below.



Between 2013 and 2020, China has already invested more than $770 billion in many sectors across the BRI[3].

Investments in energy result in the development of infrastructure in conventional and renewable energies.

However, most of the Chinese financing in the energy sector goes to non-renewable sources.

[1] 140 countries were included in the BRI in January 2021 according to the « Green Belt and Road Initiative Center ».

[3] According to the data from « China Global Investment Tracker 2021 ».

Between 2014 and 2017, 91% of the loans granted by the six major Chinese banks to the energy sector were for fossil fuel projects.

In 2018, coal-related projects accounted for 40% of energy sector loans[4]. In 2016, China was involved in 240 coal-fired power plants in the BRI countries, and this proportion had to increase.

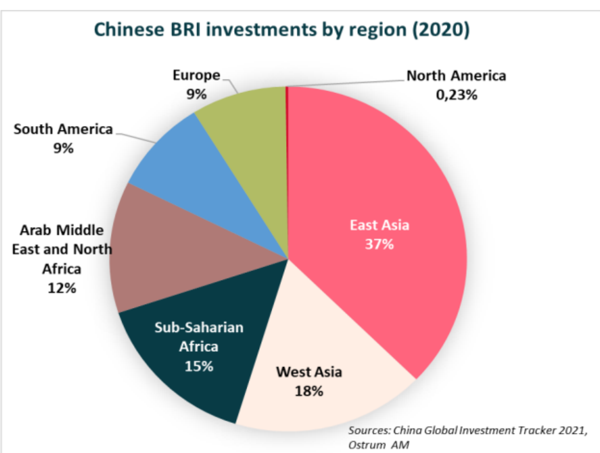
South-East Asia, a strategic region and privileged in Chinese investments

One of the other challenges of the BRI is to block the Asian “pivot” mentioned in 2011 by Barack Obama. The goal for the Obama administration was a rebalancing of US diplomatic relations to priority areas to counter China’s rise to power

South-East Asia has long been neglected by the United States because the region was poor and unstable and therefore had no economic or strategic interest at the time.

China took advantage of the void left by the United States in the region to strengthen its economic and financial presence by integrating these countries into the BRI.

This can be seen in the geographical distribution of Chinese investments under the BRI, as shown in the chart below.



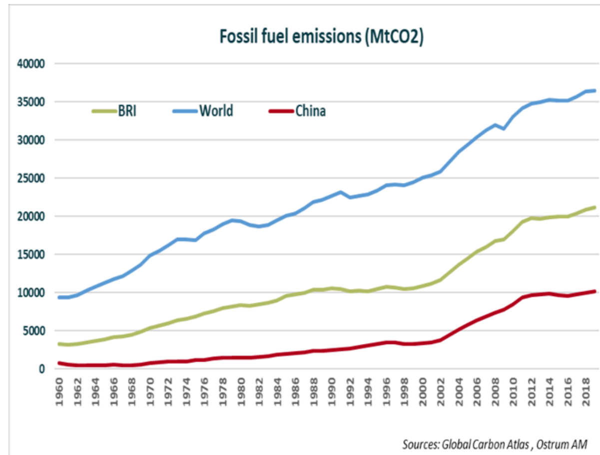
Asia receives the largest share of investments (54%) while Africa received about 27% of Chinese investments under the BRI.

As part of the new regional agreement, the Global Regional Economic Plan, signed on 15 November 2020, Chinese investments should continue to be concentrated in the region as well as in transport infrastructure.

The BRI and the Paris Climate Agreement

The BRI highlights the climate impact of infrastructure development.

Indeed, the BRI (including China) accounts for nearly 60% of global CO_2 emissions, as shown in the graph below.



The Chinese initiative is therefore a major obstacle to achieving the objectives of the Paris Climate Agreement.

According to the September 2019 “Decarbonizing the Belt and Road” study, even if non-BRI countries met their greenhouse gas emission targets, non-compliance by BRI-related countries would still lead to a 2.7° C increase in global temperatures.

Moreover, the countries through which the BRI passes are for the vast majority emerging countries, which are the most exposed and the most vulnerable to the effects of climate change.

This is particularly the case for Southeast Asia, which is highly exposed to climatic hazards such as storms, floods, sea-level rise, heat waves and water stress.

The Chinese initiative is starting to be challenged by local people because of its devastating effects on ecosystems and biodiversity.

Examples include the construction of the hydroelectric dam in the Batang Toru rainforest in Indonesia, which threatens

[4] “Moving the Green Belt and Road Initiative from words to actions”, Working Paper, Lihuan Zhou, Sean Gilbert, Ye Wang, Miquel Munoz Cabré, and Kevin P. Gallagher.

the extinction of the last 800 Tapanuli orangutans, the rarest species of great apes, and which brought the Indonesian Environment Forum challenged the project. [5]

The construction of such dams requires blocking the water of the rivers for most of the time to the detriment of the agriculture and fishing activities of the local populations, which causes social tensions.

In order to improve the reputation of the BRI, China has taken important political initiatives.

China's signing of the Paris Climate Agreement in 2015 was a great relief to the international community, as it made it easier to achieve the goals.

In 2016, Xi Jinping committed to creating a green and sustainable BRI, that is to say, in compliance with environmental standards for infrastructure projects.

Last year, China said it was aiming to become carbon neutral by 2060.

Finally, on September 21 at the United Nations General Assembly, China committed to stop building new coal-fired electricity projects.
China began to move away from these projects and did not invest in any new coal-fired power plants in the first half of 2021, according to the Beijing-based International Institute for Green Finance.

So the commitment was made by China. The question that now arises is: How will China turn green and make the BRI sustainable? This is the question we will try to answer in this second part.

Towards a green and sustainable BRI?

China is the world leader in the renewable energy sector…

China's investment in renewable energy is primarily a response to an emergency: air pollution.

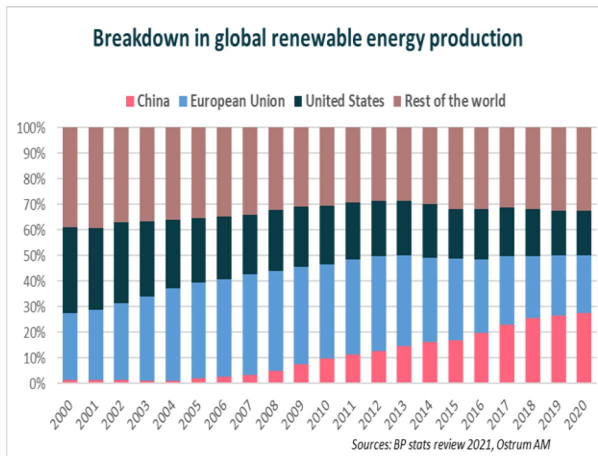
According to the study "The 17-y spatiotemporal trend of PM2.5 and its mortality burden in China", published on September 21, 2020, in Proceeding of the National Academy of Sciences (Pnas), air pollution has caused the premature death of 30.8 million adults since 2000 in China!

Switching from fossil fuels to renewables therefore allows the Chinese authorities to tackle the problems of air (and water) pollution and mitigate the risks of social instability.

In addition to the health consequences, air pollution also has economic effects.

For example, the impact of fossil fuel-related air pollution is estimated at $900 billion per year for China, or 6.6% of GDP[6].

As a result, China has invested heavily in the sector to already be at the top of renewable energy production figures, as shown in the chart below.



In 2020, China accounted for nearly 30% of global renewable energy production and surpassed the US (see chart below).

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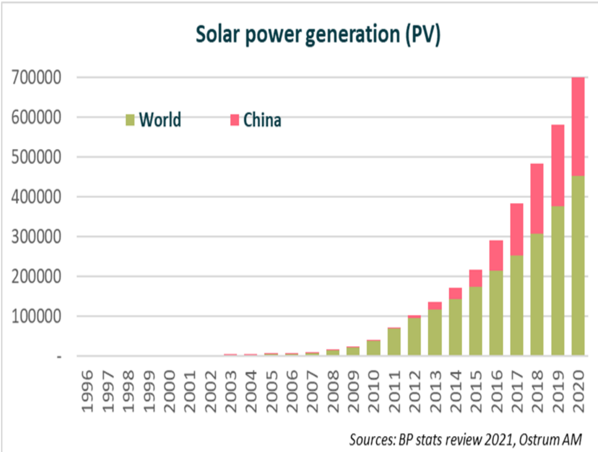
[5] The World Bank had also refused to finance the project for environmental reasons. However, this did not prevent the local court from giving its green light for the continuation of the project. After the court challenge was rejected, Bank of China, which is funding the project, said it "took note of the concerns expressed by some environmental organizations"…

[6] According to the first study to evaluate the economic cost of air pollution due to fossil fuels: "Quantifying the Economic Costs of Air Pollution from Fossil Fuels", February 2020, CREA (Center for Research on Energy and Clean Air), quoted by the World Economic Forum.

It is currently the largest producer of wind and solar energy, and the largest national and international investor in renewable energy through its investments under the BRI.

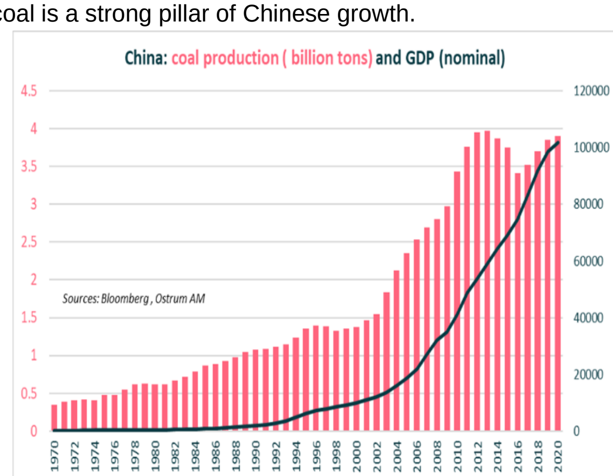


…But coal continues to have a central place in its energy mix.

China is the world's largest producer and importer of coal.

Coal continues to have an important place in its energy mix (65% of its electricity production in 2019) and to be developed by the country on its territory and abroad via the BRI. Renewable fuels (hydro, wind and photovoltaic) account for only 27% and nuclear only 5% of its electricity production.

The reason for this is economic. The chart below shows that coal is a strong pillar of Chinese growth.



A major risk for China to maintain "a moderately prosperous society" remains the lack of energy to stimulate its economy.

Despite attempts by the Chinese authorities to suppress the construction of coal plants and shift demand to other fuels, local governments continue to build to create jobs.

On the other hand, the recent energy crisis, which has led to soaring prices for coal, gas and oil, has highlighted China's close dependence on coal in its energy mix. Faced with a high economic and social risk, the Chinese authorities have stepped up their financial support for coal and electricity production in order to guarantee supply and stabilize prices.

Does China's heavy dependence on coal call into question the green and sustainable BRI project?

BRI: Chinese investments in renewable energy meet an energy security target

In 2020, China's BRI investment reached $55.2 billion, down 50.2% from 2019 and 52% from 2018, linked to the COVID-19 pandemic[7].

However, investments in renewable energy for the first time made up the majority of Chinese energy investments under the BRI, rising from 39% to 57.5%, as shown in the chart below.

This shift in Chinese energy investment in renewable energy is primarily in line with an energy security target for China.

By increasing the share of renewable energy in its energy mix, China mitigates geopolitical tensions by making the country less dependent on unstable regions for its energy security.

[7] MyStratWeekly : Emerging economies, at a crossroad.

A fossil fuel market depends on securing roads for the delivery of oil and gas and therefore requires extensive military protection. On the other hand, the wind, where solar energy, has a much greater availability than fossil fuels and is much more evenly distributed among the different countries.

China has the opportunity with the BRI to improve infrastructure networks around the world in a way that is both sustainable and inclusive.

The BRI is an opportunity for China to export its renewable technologies to poor countries, especially in photovoltaics, where the country is a leader, which will have the advantage of improving the profitability and efficiency of energy projects.

The development of renewable infrastructure in developing countries is also an opportunity to reduce their dependence on fossil fuels, which will have an impact on their balance of payments, by reducing their external vulnerability.

However, the withdrawal of coal-fired power plants in some countries could disrupt their electricity production. Some countries, particularly in South-East Asia, may not be able to retire their plants on time due to the relatively young age of their plants.

The authorities recently published the "Green Development Guidelines for Investment and Cooperation Abroad", a set of voluntary guidelines produced by Chinese university experts, governmental and non-governmental organizations and international experts.

The report urges Chinese investors to comply with the host country's environmental standards. When these standards are lower than those of China, the guidelines recommend the use of international environmental standards.

It should also force governments in BRI-related countries to reduce their use of natural resources in the name of "business as usual" at the expense of environmental considerations.

"Ecological civilization"

The deployment of renewable energy is also part of a broader goal for China to develop "ecological civilization" beyond its borders.

Enshrined in the Chinese constitution since 2000, and recalled by Xi Jinping in 2017, this concept is part of respect for the environment and planetary boundaries.

Ecological civilization is an inter-industry approach to reducing pollution and the use of fossil fuels, mitigating climate change and improving energy efficiency.

One of the main challenges that China faces in implementing the BRI is to deal with the complexities resulting from its interactions with diverse cultures, ecosystems, societies, and their local laws and practices.

"Ecological civilization" as an ecological framework and integrated into the green development of the BRI will allow China to standardize all these laws and practices to facilitate the development of its initiative.
It will also allow China to have more control over its foreign investment.

The B3W, rival or ally of the BRI?

Emerging countries need about $40 trillion in infrastructure financing and development to bridge an investment gap and enable them to achieve long-term sustainable growth, particularly after the Covid-19 pandemic.

China has been the main donor of infrastructure investments for its countries, notably through the BRI.

At the first G7 summit since the pandemic, on June 11-13, U.S. President Joe Biden announced the creation of a new infrastructure financing mechanism for poor countries that should be a solution to climate change problems.

The $35 trillion Build Back Better World (B3W) program aims to help poor countries finance greener, more transparent projects to address the impacts of climate change.

G7 members have pledged to distribute $100 billion a year to the poorest countries to help them access greener technologies and be less dependent on coal and other polluting energies.

The B3W was presented as a competitor to the BRI, yet major differences exist between the two economic systems.

Differences in approaches

If details on the operation and funding of the G7 initiative have not yet been released (possibly at next year's G7 summit in Germany), major differences between the two economic systems can already be noted.

The B3W places human infrastructure at the heart of its global development ambitions, while China continues to develop physical infrastructure.

For example, the United States and the G7 are focusing on the promotion of health security, digital technology and gender equality, which are in line with the objectives of other initiatives such as global vaccine distribution, decarbonization and expanding education for girls.

However, the biggest difference between the two systems is "good governance".
The White House and the G7 are committed to transparency, financial, environmental and social sustainability. On the other hand, the BRI reveals important governance problems, whether they are financial (corruption, unsustainable debt of countries, etc.) or social and environmental.

These differences in the objectives of the two initiatives indicate that the two systems are diametrically opposed and cannot compete.

On the contrary, B3W and BRI appear as complementary. The objectives of the G7 Climate Initiative where gender equality is outside the BRI and vice versa.

An opportunity for developing countries?

The B3W could accelerate the improvement of the BRI, which has already made enormous progress in terms of transparency and compliance with environmental standards.

They are also new opportunities for emerging countries to finance their development and modernize their infrastructure.

The B3W complements the many other financing mechanisms to promote their development, such as the World Bank, the Development Banks and some aid programmes from developed countries.

It could also encourage China, as part of the BRI, to offer more favourable financial terms to countries seeking its support.

Emerging countries must be able to choose freely between the two systems. However, the growing tensions between the US and China are likely to lead to two separate economic systems with no interactions and no benefits for emerging countries.

Conclusion

China is a leader in renewable energy, but remains highly dependent on coal because the lack of energy remains the major risk to boost its economy. However, China has the opportunity to improve infrastructure networks around the world in a sustainable and inclusive way while ensuring its economic and geopolitical interests. The emergence of the B3W should prompt China to accelerate the improvement of BRI. Both initiatives appear to be an opportunity for developing countries to finance their development and modernize their infrastructure. Provided that these two economic systems are complementary.

Zouhoure Bousbih

● **Market review**

Coming up for air

The lifting of uncertainties allows equities to rebound, but the risk of stagflation looms.

The outlook for financial markets has brightened somewhat over the past week. In the United States, it seems certain that the debt ceiling will be suspended until December 3. The risk of a default around October 18 has been ruled out. In Europe, Vladimir Poutine finally proposes a way out of the crisis by promising an increase in gas exports. Russia has substantial room for maneuver to reduce the shortage which had brought the natural gas price up to € 155 per MWh at the start of the week. At the same time, the Biden administration is pressuring Saudi Arabia to increase production beyond the announced 400k barrels per day. The gas crisis indeed induces a demand shift on oil equivalent to 500k additional barrels. The US government is also warning Russia against using energy resources as a political weapon. A few weeks before COP26, these tensions remind us of the challenges associated with a rapid decarbonization of the economy. In China, the authorities have decided to resume coal production despite the recent announcement of the end of funding for coal-fired electricity production abroad. The situation in financial markets remains nevertheless fragile. Indeed, the inflationary surge is finally raising awareness among central banks. New Zealand (+ 25p) and Poland (+ 40bp) raised policy rates. Canadian 2-year yields now imply a higher probability of a rate hike as early as 2022. BoE chief economist Huw Pill believes that inflation could last, fueling expectations of monetary tightening. The debate also concerns the ECB where several voices question the official inflation projections. In Latin America, inflation is above targets forcing central banks to act.

On the economic front, US employment increased by 317k in the private sector in September after 332k (revised upwards) in August. The seasonal adjustment of public employment in education wipes out some of the improvement, so that total employment only increased by 194k in September. The unemployment rate fell sharply (from 5.2% to 4.8%) under the effect of the decline in the working population. The contraction in the labor supply entails a considerable brake on economic looking out a few months. As mentioned above, inflation is a major issue. The next CPI release will partly incorporate higher energy prices, renewed tensions on used car prices and possibly a further adjustment in the prices of services responding to wage pressures. Anecdotes about housing developments point to very strong demand, with rent increases as high as 10%. The shelter component of the index will be a very big contributor to inflation next year. Tensions are visible in Europe as well. German inflation stands at 4%. Consumer prices also rose 3.3% in the euro area. While surveys depict a modest economic slowdown, the latest data on industrial production and the trade balance in Germany are weakening significantly (August).

The momentum in government bond markets is clearly bearish. The US 10-year note ended last week above 1.60% (+ 14bp over five trading days) despite a swift pullback towards 1.56% following the publication of the monthly US payroll data. The deterioration in bond prices went hand in hand with increasing breakeven inflation rates and a steepening of the US yield curve. These developments seem consistent with a tapering announcement in November but also with a scenario in which the Fed would be unable to act preventively in the face of inflationary risk even as oil prices burst through the $ 80 mark. Attention should also be paid to potential convexity hedging flows by federal mortgage agencies. The rise in long-term interest rates reduces refinancing flows and requires a duration adjustment in the form of Treasury bond sales or swap rate paying. These hedge flows could indeed add fuel to the current rise in US yields. In the euro zone, the Bund cannot escape the global bond trend. The German 10-year bond yield ends the week at -0.15%. Rumors of an overhaul of the ECB's quantitative easing programs aimed at greater spread stability provided support to Italian debt markets. The 10-year BTP spread hence shrank from 107bp to 103bp. Spread volatility remains minimal, however, and European sovereign debt are still in high demand as bond yields increase. French and Spanish bond auctions of long-dated bonds were indeed well received. There is quite strong buying interest from institutional accounts around 1% on 30-year OATs.

Investment grade credit spreads denominated in euros remain relatively inert. The average spread keeps trading within a narrow range around 85bp vs. Bund. Euro high yield, on the other hand, is under pressure. The decompression trend can be observed in CDS index markets, as the iTraxx Crossover index reached 260bp. High yield fund outflows have been observed in the past three weeks now so that European high yield spreads (320bp) are now up by 32bp from a month ago. The behavior of euro high yield may reflect a risk of contagion from Chinese real estate woes. Fantasia and Evergrande already seek debt restructuring after their failure to pay coupons on local and external debts. CNY high yield is now offering yields of 17 to 20%. As in the US, euro stocks had a volatile but positive week. Chinese risk weighs on the consumer sector as stagflation fears buoys energy and banks and the secular growth theme (technology). Companies did not communicate much ahead of the earnings season, but there were two notable profit warnings. Finally, the dollar stabilizes at a high level. The yen, on the other hand, suffered from the rebound in risky assets.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	11-Oct-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.67 %	+3	+3	+3
EUR Bunds 10y	-0.12%	+9	+21	+45
EUR Bunds 2s10s	55 bp	+6	+18	+42
USD Treasuries 2y	0.32 %	+4	+11	+20
USD Treasuries 10y	1.61 %	+13	+27	+70
USD Treasuries 2s10s	129 bp	+9	+17	+50
GBP Gilt 10y	1.19 %	+18	+43	+99
JPY JGB 10y	0.09 %	+4	+4	+7
€ Sovereign Spreads (10y)	**11-Oct-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	35 bp	0	+2	+12
Italy	104 bp	-1	+1	-8
Spain	65 bp	0	-2	+3
Inflation Break-evens (10y)	**11-Oct-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	164 bp	+5	+13	-
USD TIPS	251 bp	+12	+12	+52
GBP Gilt Index-Linked	392 bp	+4	+20	+92
EUR Credit Indices	**11-Oct-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	86 bp	+1	+2	-6
EUR Agencies OAS	43 bp	+0	+2	+2
EUR Securitized - Covered OAS	40 bp	+1	+4	+7
EUR Pan-European High Yield OAS	319 bp	+10	+30	-39
EUR/USD CDS Indices 5y	**11-Oct-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	53 bp	+2	+9	+6
iTraxx Crossover	272 bp	+13	+44	+31
CDX IG	54 bp	+1	+7	+4
CDX High Yield	308 bp	+5	+33	+15
Emerging Markets	**11-Oct-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	360 bp	-3	+18	+8
Currencies	**11-Oct-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.157	-0.4	-1.98	-5.33
GBP/USD	$1.364	+0.21	-1.44	-0.1
USD/JPY	¥112.95	-1.84	-2.61	-8.54
Commodity Futures	**11-Oct-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$84.4	$3.1	$12.1	$33.6
Gold	$1 757.7	-$11.4	-$36.1	-$136.7
Equity Market Indices	**11-Oct-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	4 391	0.79	-1.51	16.91
EuroStoxx 50	4 049	1.31	-2.92	13.97
CAC 40	6 531	0.82	-2.00	17.64
Nikkei 225	28 498	0.19	-6.20	3.84
Shanghai Composite	3 592	0.25	-3.01	3.42
VIX - Implied Volatility Index	20.29	-11.63	-3.15	-10.81

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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