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A Forward-Looking View of China A shares Amid Economic Transition

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Chin Ping Chia
Head of China A Investments, Invesco

Kevin Chen
Head of Investments, Invesco Great Wall

Weilun Soon
Thought Leadership Manager, Invesco

Chris Liu
Senior Portfolio Manager, Invesco

Yingying Su
Client Portfolio Manager, Invesco Great Wall

Key takeaways

- The Chinese economy has undergone several phases of transitioning. Recent geopolitical developments are accelerating China's strategic transformation of its economy to a consumption growth and innovation-led one;
- Demographic trends, technology and digitization, reforms and market opening are key catalysts that drive long-term equity performance;
- Some sectors will stand to benefit from these trends while others will see their prominence wane – a cap-weighted portfolio on China equities has proven to be volatile historically. Correctly understanding the trajectory of the transformation is key to understanding the beta that can drive future performance;
- China capital market remains nascent and inefficient, and we believe that an active-investing approach focusing on understanding business model sustainability and company fundamentals remains, in our view, the best approach to harness potential returns in China.

China has been actively pursuing a strategic economic transformation. It once followed an investment-led and export-oriented model of growth that was based on its role as an integral member in the global supply chain. In the past few years, it has been shifting its growth model to one that is led by consumption growth and innovation. As such, Beijing has been embarking on reforms to sharpen the competitiveness of its private sector, causing China's corporate landscape to change rapidly. The COVID-19 outbreak and latest geopolitical disruptions are hastening these shifts. Understanding implications brought about by these shifts is crucial for Chinese equity investors.

Historically, the China A-share market has offered a rich source of alpha based on average active manager performance. However, equity investors have been frequently disappointed by the market's beta performance. This is largely due to the huge market volatility linked to the large presence of retail investors, market micro mechanism such as limited ability to hedge and short as well as the closed nature of the capital market.

As China's economic transformation accelerates and its capital market continues to open up, the nature of the beta that China brings may again evolve. How should equity investors think about their China strategy amid the changing landscape? Which macro secular trends are the ones likely to sustain China's economic transformation, and how could investors position their portfolios to tap into these shifts?

China's road thus far

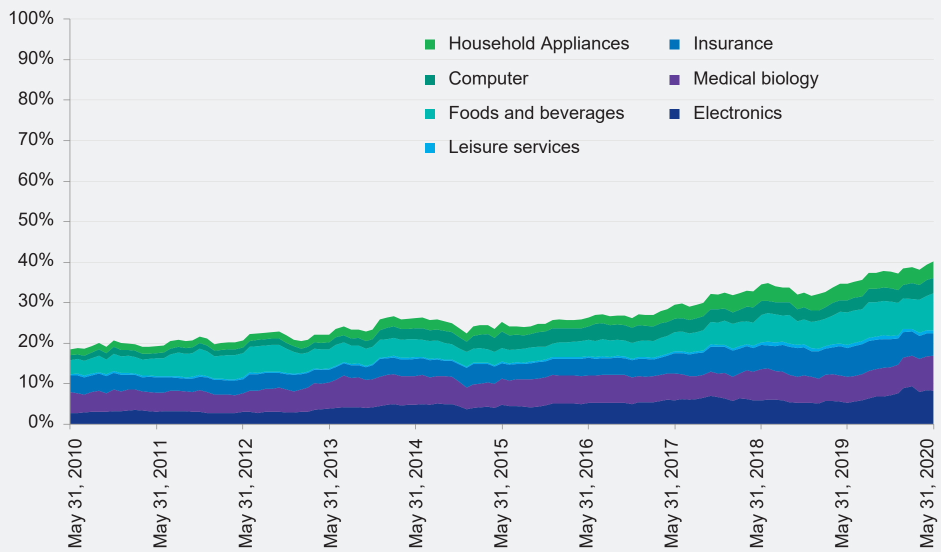
China's early days of opening its economy to the world involved privatization of industries and trade liberalization. It pursued an export-oriented model and was an integral link in the global supply chain. It also engaged in large-scale infrastructure projects. This provided jobs and raised incomes for its massive population.

As China moved up the global value chain, Beijing saw the need to transform its economy to ensure that growth was sustainable. China's rising middle class and growth of its homegrown technology sector were driving a consumption boom. These provided good conditions for Beijing to strategically transform China's economy towards one that is domestic consumption- and technology-led.

At the same time, China is keen to develop its capital markets to reduce the reliance on bank-led financing. Policymakers acknowledge that healthy and robust capital markets are crucial in facilitating the flow of capital and supporting economic growth, especially since asset-light private enterprises have had difficulties in securing financing from banks. Beijing has taken a series of concrete steps in addressing the country's capital allocation needs, for example by introducing the STAR board in Shanghai[1] and reforms for Shenzhen's ChiNext, both aimed at making China's stock markets more market-oriented and efficient.

We can already see how China's economic transformation is being reflected in its equity markets. Seven selected sectors that represent drivers of China's consumption growth on the CSI 800 index have seen their weighting grow from a combined 18% to the more than 40% now (Figure 1).

Figure 1: Change in market capitalization of CSI 800's "growth industries" between 2010 – 2020



Source: Invesco Great Wall, Wind. Data as of May 31, 2020.

1. For more insights, please read *China's Science and Technology Innovation Board a bold step for capital-market reforms,* published June 2019, by Ruiwen Yang and Chen Zhan of Invesco Great Wall.

However, recent global developments are accelerating the pace China's economic transformation and intensifying the impact of these three trends. Trade tensions, rising protectionism, the unexpected rapid spread of COVID-19 and the changing nature of international relations are increasing the urgency with which China needed to rely on its own consumers and technological upgrade to drive growth. Beijing also sees the need to step up efforts to liberalize its capital markets and integrate them with global ones, as it views capital markets as essential to support liberalization and spur economic growth.

All these have added to the sense of urgency to complete China's economic transformation, thereby placing significant pressures on industry dynamics and prompting traditional and new industries alike in China to rethink their business models.

We highlight three major drivers amid China's economic transformation that will drive companies' performance in China. They are:

- Demographic trends; the rise of China's middle class and the accompanying increased levels of urbanization and consumption "upgrade" (the consumer sector's continued expansion as demand shifts towards higher-quality, higher-priced goods and services);
- Technological disruption and digitization; and
- Reforms and market opening.

Technology: it's all the buzz

We see three major catalysts that are propelling China's tech companies rise to prominence.

New infrastructure paves the foundation for China's technology leap
National policy is a big thrust. Beijing has elevated the need to sharpen China's technological eminence to a national level. The central government launched the "Made in China 2025" blueprint in 2015 to guide the country's industrial modernization based on China's technological innovation.

While focus has since shifted away from the blueprint, we continue to see high-level pronouncements from Beijing to focus on high-tech infrastructure (termed as "New Infrastructure" in China) (see box 1). These sectors are seen as crucial drivers for China's economy, as projects in these sectors can bring high positive multiplier effects to the economy. They could also create new consumption demand in the areas where China has clear technology advantages, such as: 5G, charging stations for new-energy vehicles, Internet data centers, etc (Figure 2). We therefore expect Chinese tech companies to further benefit from the country's focus on innovation-led economic transformation.

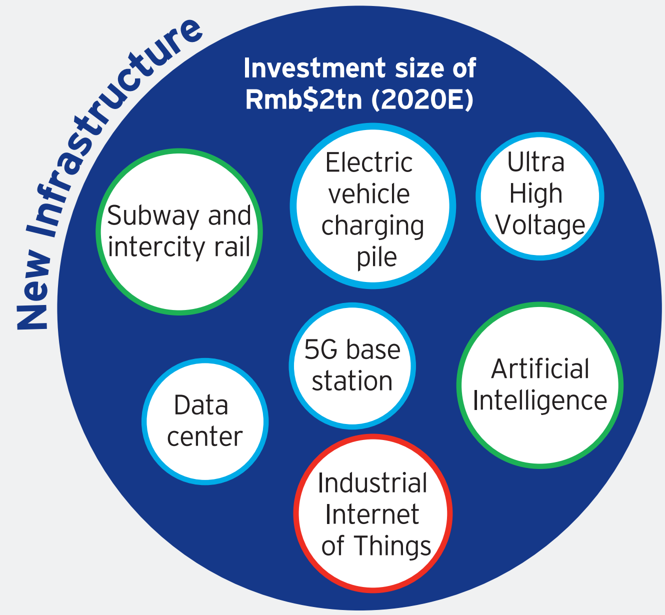
Box 1: Beijing's recent key decisions on "New Infrastructure"

March 2020: The Politburo that represents China's top leadership proposed to accelerate the construction of new infrastructure such as 5G networks and data centers.

May 2020: The State Council, which is China's central government, issued a work report that exhorted the need to focus on supporting the "two new and one heavy" sectors – new infrastructure construction, new urbanization construction, and heavy industries including transportation, water conservancy and other major engineering projects.

June 2020: The National Development and Reform Commission – the State Council's macroeconomic management agency – clarified what "New Infrastructure" meant by stating that such projects should be guided by new development concepts, driven by technological innovation, and based on information networks, facing the needs of high-quality development, to create industrial upgrading, integration, and innovation.

Figure 2: Overview of China's "New Infrastructure"



Source: NBS, State Council, Gao Hua Securities Research, 2020.

Import substitution accelerates technology upgrade

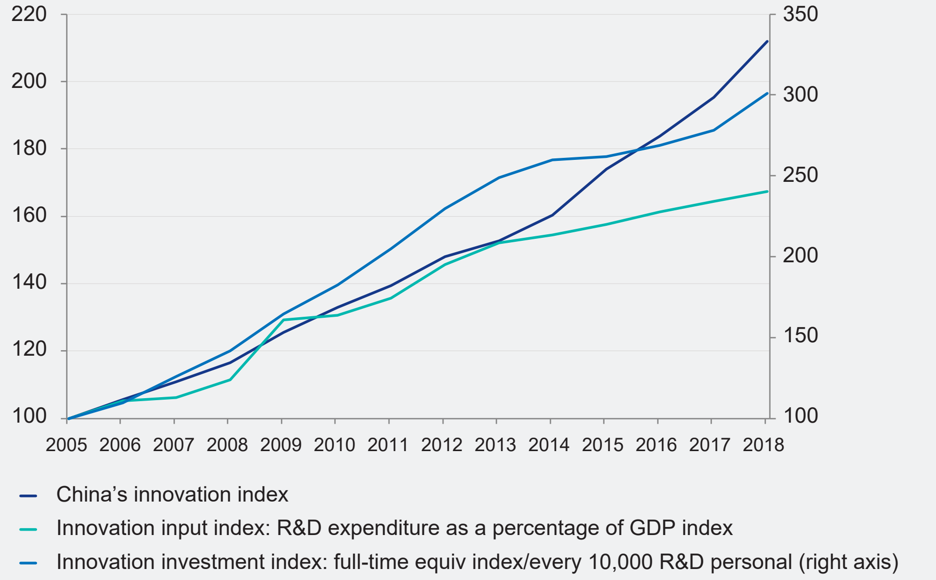
Import substitution is another major trend, initially driven by China's desire to reduce foreign technology reliance and to spur product innovation. While China still has gaps to fill in terms of cutting-edge technological capabilities, intensifying geopolitical tensions and the US' restrictions on chip sales to Chinese only reinforce China's determination to be more self-sufficient. For example, in late May, it was reported that Beijing was thinking of raising investment in the integrated-circuit sector and speed up import substitution of chips in a bid to achieve the goal of mass-producing 7-nanometer semiconductors in two years,[2] which could motivate Chinese companies to replace imported chips with domestic ones earlier than planned. From a domestic consumption angle, a rising wave of nationalism and patriotism is also stoking domestic demand for homegrown products. We see this import substitution as a combination of rising innovation and quality of Chinese products, trade tensions, rising nationalism and patriotism to reduce foreign exports.

R&D spending and science and technology talent pool

A third driver is China's heavy investment in research and development (Figure 3). Deep funding into research and development (R&D) is crucial in bringing research to market more quickly and is key to China's technological advancement. We have seen early fruits of this approach: when we compare the number of Patent Cooperation Treaty (PCT) patents between China and the US, we see that China has already filed more patents than the US in telecommunications, optics, and in the electrical machinery, apparatus and energy segments, to name a few (Figure 4). This heavy investment into R&D is also expanding its talent pool in technology. Every year, millions of students specializing in technology and engineering graduate from its universities. A study by the World Economic Forum reported that China had 4.7 million new STEM (science, technology, engineering and mathematics) graduates in 2016 while the United States had only 568,000.

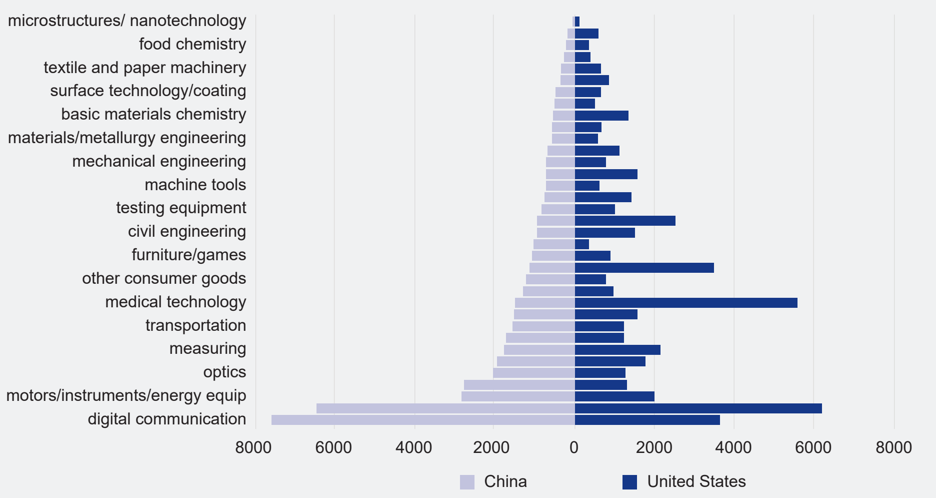
2. "China able to mass produce 7-nm chips in two years, replace imports: analyst", Global Times, published May 26, 2020.

Figure 3: China's R&D has been gaining more prominence in its economy (base year = 2005)



Source: China's National Bureau of Statistics as of Dec. 31, 2018. China's innovation index is divided into three levels. The first level is used to reflect the overall development of China's innovation and is achieved by calculating the total innovation index; the second level is used to reflect China's development in the four areas of innovation environment, innovation input, innovation output and innovation effectiveness. The calculation of sub-field index is realized; the third level is used to reflect the specific development of all aspects that constitute innovation capability. Past performance is not a guide to future returns.

Figure 4: China's number of filed PCT patents in some sectors exceed those in the US



Source: WIPO, Guosen Securities, 2019.

Healthcare: heading into its prime

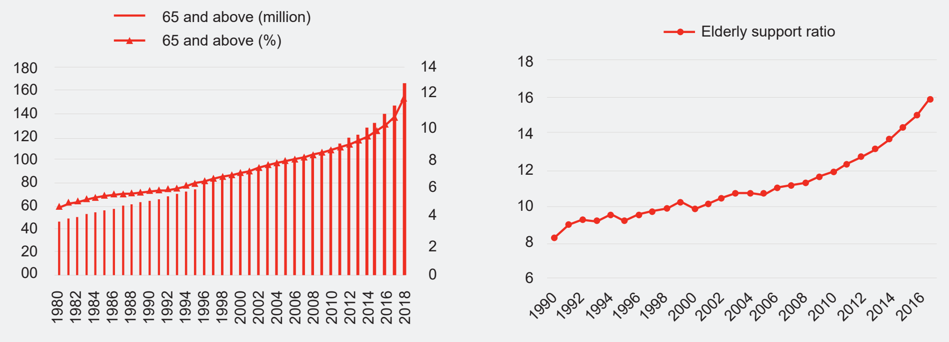
We believe that prospects are looking bright for healthcare amid China's economic transition. Structurally, there is a lot of room for growth of China's healthcare sector. The country's total health expenditure accounts for only 5.15% of GDP as of 2017, far below the high-income countries average 12.53%[3]. China's healthcare spending – between 2010 to 2018 have been growing at a CAGR of 15.3%, exceeding nominal GDP growth at 13.1%[4].

We see three drivers as important to the health of this sector.

Aging population drives need for better healthcare

Demographic trends – specifically China's aging populatio and higher life expectancy – are a big tailwind for the sector. China's population is aging rapidly, with the number of elderly aged 65 and above at 152.1 million in 2018, representing 11% of the population[5](Figure 5). Looking ahead, there are estimates that Chinese people aged 65+ would more than double to 366 million in 2050, with their share in the total population up to 26%[6]. Healthcare companies should be able to find bountiful opportunities.

Figure 5: China has a rapidly aging population



Source: World Bank, National Bureau of Statistics, China CITIC Securities, 2018.

Urbanization drives premiumization of health care

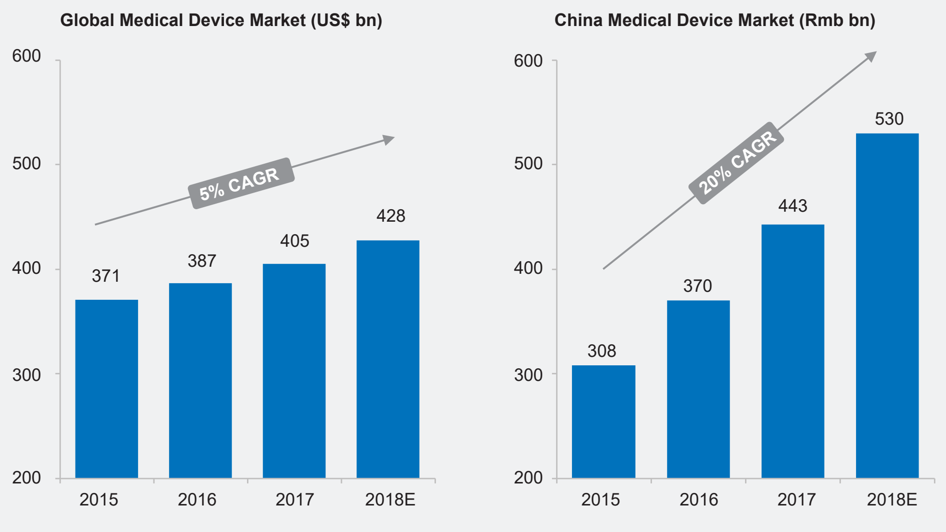
Increased levels of urbanization together with higher levels of incomes are also driving the growth of this sector. As more Chinese move to urban centers, they are likely to demand better product quality and more willing to pay for better-quality healthcare products and services. Therefore, we foresee that not only would the sector find it necessary to cater to this growing need for more products, services and infrastructure, we think that the sector is likely to introduce more higher-value services and goods, resulting in its premiumization.

Technology upgrade aids healthcare innovation

China's focus on innovation and research and development are giving the healthcare sector a boost. Not only are healthcare professionals able to reach more patients in more places than before, the entire sector is moving up the value chain. For example, the advent of 5G technology now even paves the way for remote surgeries. In March 2019, a patient in Beijing suffering from Parkinson's disease received China's first 5G-based remote surgery conducted by a surgeon in Hainan, southern China[7]. At the same time, while drug producers have driven much of the sector's growth, we are now also seeing the rise of the pharmaceutical outsourcing segment of contract research organizations and contract manufacturing organizations. Its medical-device makers are also producing higher-value products. This is driving the segment's accelerated growth at 20% CAGR from 2015 to 2018, outstripping the global average (Figure 6).

3. World Health Organization database, as of June 25, 2020.
4. "An Aging China: Turning Adversity into Opportunity", Citi Research, published June 2020.
5. Source: World Bank, data as of Dec. 31, 2018.
6. "An Aging China: Turning Adversity into Opportunity", Citi Research, published June 2020.
7. "China performs first 5G-based remote surgery on human brain", China Daily, published March 18, 2019.

Figure 6: Premiumization of China's medical device solutions is driving growth of the segment



Source: Evaluate Medtech, China Medical Device Research Academy. J.P. Morgan, Private and public measures to improve healthcare - 2020 Outlook, February 2020.

Consumer: in the driver's seat for China's economic transition

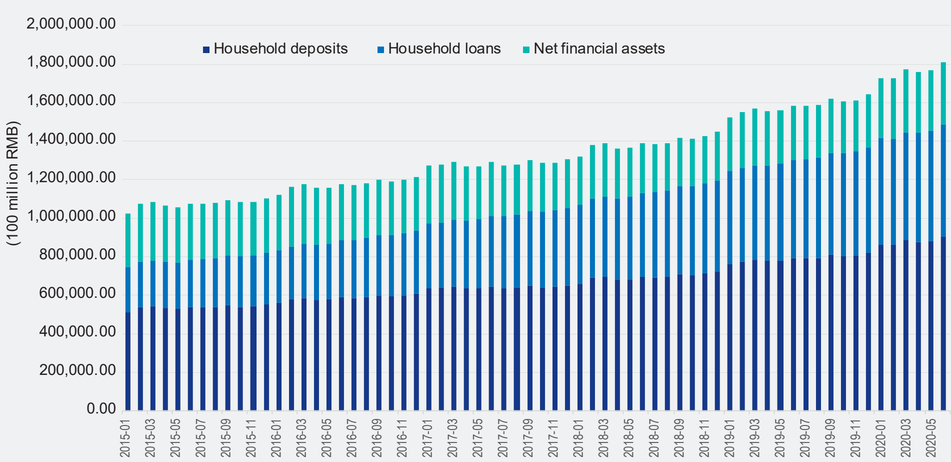
China has the world's largest population, and prioritizing consumption-led growth to drive economic development would provide tailwinds for the consumer sector's growth. Aspirations for a better life penetrates all aspects of the 1.4 billion consumers' lives as they continuously seek to upgrade their standard of living.

The two major trends - the rise of China's middle class and digitization - are shaping the future of the consumer sector.

The rise of China's middle class

Firstly, companies that tap into the consumption upgrade trend - where consumers increasingly demand higher-quality, higher-priced goods and services (Figure 7) - have proven to be able to stay ahead of competition. This trend has altered the landscape for the consumer-discretionary segment such as home appliances, for example. The home-appliances segment has been traditionally dominated by domestic brands, and therefore the next phase of growth should come not from increase in sales volumes, but upgrades to the product mix by catering to the Chinese consumer's increasingly sophisticated buying habits. At the same time, consumers' increased awareness of product safety and quality is also encouraging Chinese companies to invest more in product design, leading to a premiumization of the sector.

Figure 7: Chinese consumers are becoming more affluent and willing to spend



Source: Wind, data as of June 30, 2020.

Similarly, Chinese brands are enjoying more recognition these days and that leads to more demand from domestic consumers. A homegrown sportswear brand reported a 44.4% growth in revenues in 2018 from a year before, higher than the average annual growth rate of China's sportswear market of about 10%[8].

Digitization influences consumption behavior

The other major trend is digitization, where big data, the Internet of Things and artificial intelligence are some of the innovations that allow companies to explore new ways to engage customers. For example, a smart home appliance maker that launched in 2014 is investing to develop next-generation robotic home cleaners and a data analysis platform. In a sign of investor confidence in its prospects, the company managed to raise 4.5 billion yuan in its IPO for the Shanghai STAR board in February amid the Covid-19 pandemic[9].

But we stress that not all consumer companies will benefit equally from China's economic transformation. We think retailers are likely to bear the brunt from this transformation. As more and more companies turn to warehousing and delivering their goods, together with the ease of setting up online shops, retailers will take a hit from China's shift towards technological innovation.

Financials: not all gloom and doom

We think financial institutions' role in China's economy will change as the capital market's development picks up speed. While policy development will weigh heavily on the sector's – especially for the traditional banks – future, the consumer sector's expansion and digitization can provide some upside to Chinese lenders.

China's banking sector has traditionally played an outsized role in financing China's economy activities, in part due to the relatively less developed capital market. However, Beijing's push to liberalize China's capital markets offers companies, especially small- and medium-sized ones (SMEs), better access to tap into capital markets to support their growth. Therefore, in the structural sense, we think that the traditional banking sector's role in financing growth will be significantly reduced or gradually replaced by more efficient and sophisticated capital markets. Also, in the foreseeable future, their margins continue to be pressured by the current low interest rate environment

Yet there are still bright spots for financials. Chinese banks are extremely well capitalized and non-performing loans (NPL) ratio is low in comparison with other banks in the world. This is despite the central government's recent call for Chinese banks to perform "national duties" by providing cheap financing to SMEs as they recover from the pandemic outbreak. Chinese banks also enjoy a wide reach of access to billions of consumers. Retail banking is still in its nascent stage in China, and banks should find a deep pool of increasingly sophisticated customers open to fee-based services such as credit cards or the larger wealth-management advisory services. At the same time, the rise of digital banking services and fintech open new ways for banks to provide financial services and to reach out to new markets.

Prospects for non-bank financials are also looking up. Insurers can benefit from China's pension reform as Beijing unlocks China's trillion-dollar worth of pensions monies. Going back to our theme of technological innovation, we believe that the use of fintech will help insurance companies improve efficiency, reduce costs, and strengthen risk control. A major Chinese insurer has rich application scenarios of fintech, for example, rapid insurance loss determination, use of AI to assist agent training and so on. For brokerages, the opening up of the market could bring about competition, but this should also make it easier to separate winners from the laggards.

8. "Going global", CKGSB Knowledge, published March 19, 2020.
9. Mainland China and Hong Kong 2020 Q1 review: IPOs and other market trends, KPMG, published March 30, 2020.

Positioning for emerging China A-share opportunities

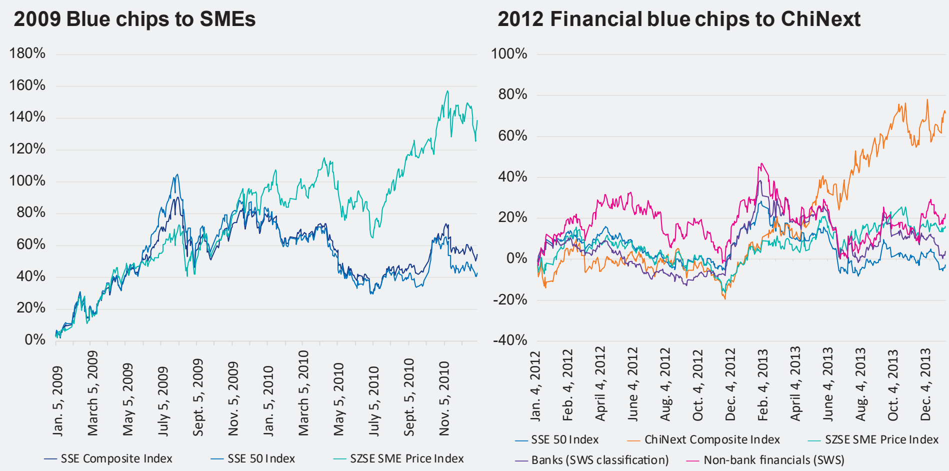
We believe that the approaches below can help us unearth and seize the above-mentioned opportunities amidst China's economic transformation.

Taking an active view on the beta
Historically, a cap-weighted allocation to China equities has proven to be volatile regardless of the choice of benchmarks. While investor behavior, market microstructure and the closed nature of the capital market have all contributed to the observed volatility, the real driver could be linked to the fast-changing nature of China economy.

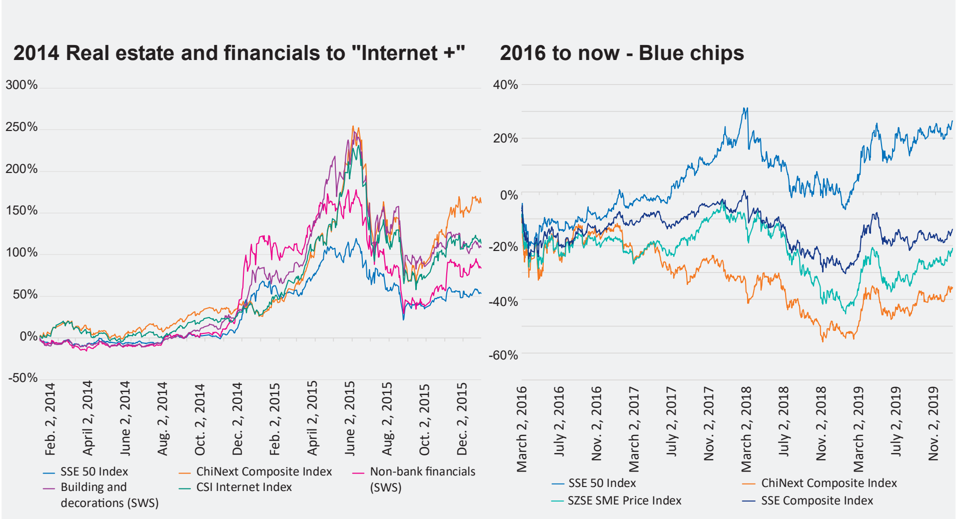
We strongly believe that one needs to be sensitive to the systematic risks present in China by understanding the major phases of macro transformation and fundamental drivers in economic sectors. This is particularly crucial for China investors because what could provide opportunities today could become irrelevant tomorrow.

Looking at the A-share market, we witness episodes of style and sector rotations. For example, the 2009 sell-off in blue chips with the Shanghai stock market falling by 23% led to almost a decade of investor preference towards smaller companies[10]. The decline of financial stocks at the end of 2012 paved the way for the innovation-focused high-tech stocks to rise in early 2013. In 2015, internet stocks started to gain more prominence as investors switched out from financials and real-estate exposure. Lastly, index inclusions driven by better market accessibility saw rotation back to blue chips as international investors generally favor quality stocks with better fundamentals. (Figure 8).

Figure 8: Historical turning point of China A style rotation



10. Source: Wind, calculated by Invesco Great Wall, data from 2009-2019.

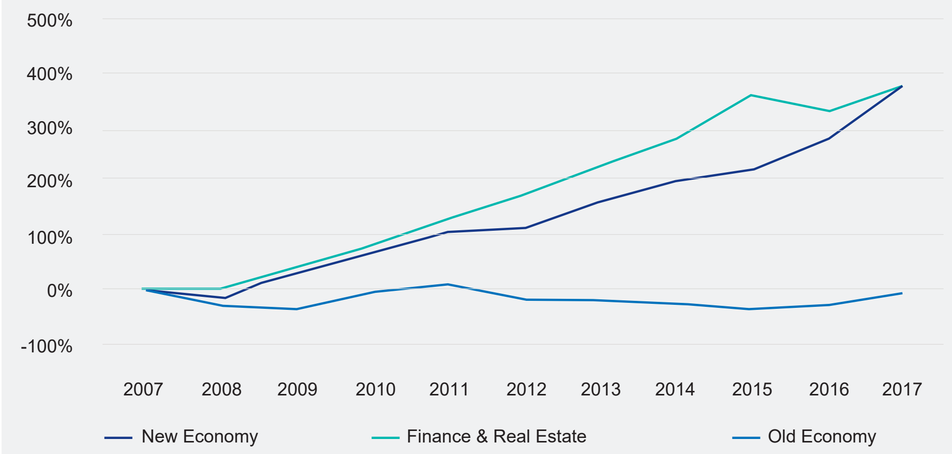


Source: Wind, calculated by Invesco Great Wall, data as of Dec. 31, 2019. "SSE" refers to the Shanghai Stock Exchange. "SZSE" refers to the Shenzhen Stock Exchange. "SSE 50 Index" represents the top 50 companies by "float-adjusted" capitalization and other criteria on the SSE. "SZSE SME Price Index" comprises the 100 largest and most liquid A-share stocks listed and trading on the SZSE Small- and Medium-Enterprise Board Market. The "ChiNext Composite Index" is comprised of listings from the SZSE's tech-heavy startup board. "SWS classification" refers to sectoral classification by SWS Research, a key securities research institute in mainland China. "CSI Internet Index" selects companies listed on the SSE and SZSE such as the terminal providers, internet technology and software providers, the internet platform operators and other companies which benefit from the internet as constituents.

A study on how China's old economy measures up to the new one also helps to illustrate the same point. Stocks that represent the new economy (defined as those belonging to the consumer discretionary, consumer staples, and information technology sectors) saw their cumulative returns increase by 103% over 2007 to 2017, compared to the old economy which fell by 29% (Figure 9)[11].

Therefore, we believe getting the right China beta means knowing what constitutes the right earnings growth[12]. Sectors and companies that can achieve growth in the midst of economic transformation can get duly rewarded by the market.

Figure 9: New economy registers good cumulative earnings growth

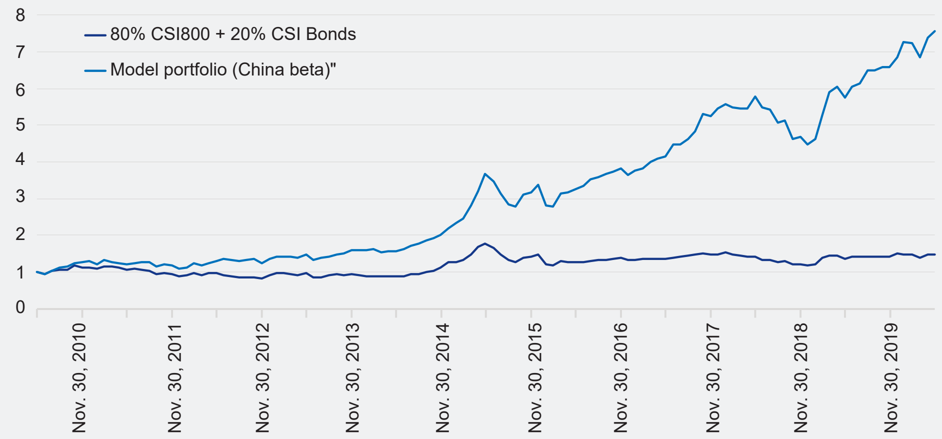


Source: Wind, calculated by Invesco Great Wall, data as of Nov. 19, 2018.

11. Source: Wind, calculated by Invesco Great Wall as of Nov. 19, 2018.
12. For in-depth analysis, please read *China A-share market to thrive on economic growth and market improvements,* published January 2019, by Kevin Chen of Invesco Great Wall.

As discussed in this paper, we believe the China beta that will reap rewards in the future is likely to be related to the beneficiaries of changing demographic trends, consumption behavior, technological innovation and market reforms. To illustrate this point, we constructed a model cap-weighted beta portfolio of selected growth industries linked to the various themes describe in the earlier section of the paper[13]. The portfolio produced an annualized excess return of 18.49% (between 2010 to 2020) against the benchmark that is made up of the CSI 800 and the CSI Composite Bond index (Figure 10)[14].

Figure 10: Our model portfolio on growth achieved excess return against benchmark



Period	June 2015 to May 2016	June 2016 to May 2017	June 2017 to May 2018	June 2018 to May 2019	June 2019 to May 2020
Benchmark	-28.52%	5.31%	5.90%	-4.15%	7.35%
Model portfolio	-11.44%	27.61%	39.21%	-0.37%	31.40%

Source: Invesco Great Wall, data from June 2010 – May 2020. **The figures relate to simulated past performance and past performance is not a reliable indicator of future performance. The model portfolio refers to a cap-weighted beta model portfolio of selected growth industries. It is provided for illustrative purposes only and does not represent the performance of an Invesco strategy. Figures are in RMB and gross of any fees or charges.**

On the other hand, we think that the inefficient nature of the China A-share market means that it could still offer many alpha opportunities for institutional investors. While institutional participation is increasing, the A-share market continues to be dominated by a large base of retail investors.

We believe that going active will continue to be the right approach for allocating to A shares, and stress that a bottom-up approach remains a key building block in portfolio construction. Disciplined analysis of each company's fundamentals remains crucial when looking at tapping into opportunities offered by China's economic transformation. Paying attention to the "quality", or robustness of company fundamentals, and "speed", or competitiveness and growth prospects, are key to assessing any company's performance.

13. The model portfolio on China beta refers to a cap-weighted beta model portfolio of seven growth industries representing the trajectory of China's economic growth and transition. These industries are based on SWS Research's classification, namely: biopharmaceuticals, food and beverage, computing, electronics, household appliances, leisure services and non-bank financial institutions.
14. Source: Invesco Great Wall, data from June 2010 – May 2020.

In doing so, pursuing a fundamental-based analysis approach is important – just as we would expect in any other equity market. As such, we consider the following when looking at opportunities in China A shares:

- Analysis of corporate financial data such as cash flow, profitability, operating capacity, financial stability, shareholder returns, etc. is key;
- The company's business models, value proposition, profit model, business characteristics, product characteristics and differentiation, are also important to consider;
- In-depth research on the company's sector – how much market share it has, pricing power, if it could benefit from structural upgrade, and prospects for new business and expansion;
- Analysis of company management, including incentives structure, corporate culture, talent training ability, team initiatives, etc;
- Reviewing company risk, including negative report tracking, disadvantage research, etc.

There are many other indicators to consider in order to identify companies that could benefit from China's economic transition, too. As such, we look at the following list of characteristics of companies that we think constitute to a company's attractiveness:

- **High growth:** enterprises that are in line with industry development trends or are in an accelerated upward phase would mean that their investments are at the most cost-effective at that point in time;
- **Growth trajectory:** companies that are developing along their expected growth trajectories are more attractive;
- **Market value and room for growth:** to analyze P/E, P/B and room for its market value to grow in order to ascertain the investment value of the company;
- **Prospects:** invest in enterprises with international competitiveness and huge growth potential.

Lastly, we stress that there can be opportunities even in sectors that are out of favor and where valuation has become cheap. We caution a pure value approach on A-share equities. Instead, we believe that we should be highly selective and focusing only on companies that can embrace challenges brought about by technology disruption and changing consumer needs. Adapting to successful business models could offer such companies or sectors a new breath of life as we have seen in certain segments of the consumer and financials sectors. We look for those that possess the following characteristics:

- Signs of business model adaptation;
- Assets are priced at a big discount;
- Growth potential is far from being realized;
- Level of asset securitization is very low;
- Where the company's market value is close to the cash being held by the company;
- A change in fundamentals, and the valuation is seriously low.

Conclusion

Recent global developments have accelerated the pace of China's economic transformation. This rapid pace is quickly throwing up new opportunities while exposing more unforeseen risks. As such, we strongly believe in the need to embark on a more forward-looking view on how to uncover opportunities through a deep analysis of available data.

Demographic trends, the rise of China's middle class, and technological trends are key drivers that we believe will determine the fortunes of Chinese corporates in the medium to long term. Policy determinations to transform China's economic structure are also important to keep in mind. Together with how recent geopolitical developments are unfolding, we believe that sectors like technology, healthcare, and consumer are sectors likely to outperform, while other sectors could see their influence diminish. But we stress that while some sectors could be negatively impacted these shifts, some companies in these industries may be better positioned to tap into technological trends to thrive and flourish.

We believe that by taking a forward-looking view in structuring the beta in view of these macro trends, together with a deep understanding of market structural limits and robust fundamentals analysis should serve us well and uncover the multitude of opportunities that China's A-share market has to offer.

Contact
Chin Ping Chia
Head of China A Investments, Invesco
ChinPing.Chia@invesco.com

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