The View From The Outer

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EVANS & PARTNERS

China 2.0: New roads to success

Topic

An analysis of China's New Silk Road initiative, the impact for the global economy and investment implications.

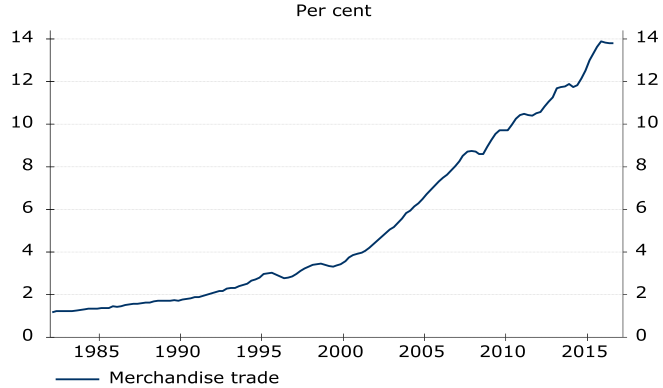
Analysis

The New Silk Road project will rebuild rail, road and maritime links between Europe and China. There will be around 400 separate projects and spending could total around $US 1 trillion by 2025. The banner project will be an 8000 mile high speed rail link that some estimates suggest will cut freight time from 42 days to 40 hours.

In our opinion, the projects will expand and transform trade between Asia and Europe. Freight costs will be lower and a broader range of goods will be shipped. Supply chains will be transformed with a range of implications for retailers, warehouses and logistics companies.

It is speculated that one aim of the New Silk Road is for China to challenge western influence and strengthen its political and cultural status in the region. It may deepen its relationship with its neighbours including Iran and Russia, and become the main architect of regional development.

China share of world exports



Source: Thomson Reuters Datastream, Evans & Partners

Recommendation

During the investment phase, investors can gain exposure to this theme through:

- The Chinese stock market and emerging markets that are linked to Chinese growth. Pakistan and Kazakhstan will be the largest recipients of direct investment. ETF's to play this theme are ishares China ETF (IZZ), ishares emerging market ETF (IEM) and the Vanguard emerging market ETF (VGE).
- Beneficiaries of stronger Chinese consumption including luxury goods, tourism and healthcare. Australian winners will include airlines, casinos, retailers, hotels and attractions.

China 2.0: New roads to success

President Trump's protectionist stance has raised questions about the future of global trade, and the implications for China in particular. Rapidly growing trade has been critical to China's development. Total trade peaked at more than 60% of GDP, about three times larger than other large economies and China's share of world exports has nearly quadrupled to 14% since 2000.

However, such concerns are exaggerated in our opinion. Trump's ambitions may be thwarted or watered down in the US Congress, and there is likely to be another major leg forward in China's exports to Europe in particular as its New Silk Road projects are completed.

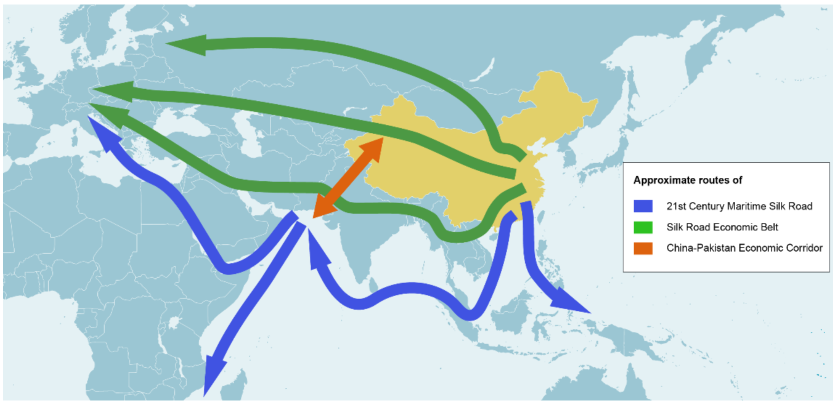
The New Silk Road

Our thesis is that China's New Silk Road (NSR) initiative will expand trade, spearhead regional development and build its cultural and political influence across the globe. After 20 years of rapid development, China's domestic infrastructure is well advanced and the benefits from further domestic construction are diminishing. However there are significant opportunities from accelerating regional development and improving trade links with major markets in Europe. The projects that are being planned are of mammoth scale. Although estimates vary and details are sketchy, broad indications are that there will be around 400 separate projects and spending may total $US 1 trillion by 2025.

Spearheading regional development will also provide a means for China to challenge western influence and strengthen its own political and cultural status in the region. China will be driving the development agenda for a large part of the globe and will deepen relationships with neighbours including Iran and Russia. The role of the US-controlled World Bank will also likely be diminished by the creation of the AIIB (Asian Infrastructure Investment Bank) to fund these projects; at last count this has taken $100 billion in contributions from 57 countries.

The major projects of the NSR are the rebuilding of rail, road and maritime links between Europe and China. New gas and oil pipelines will also be built to the Middle East.

Chart 1: China's planned trade routes into Europe

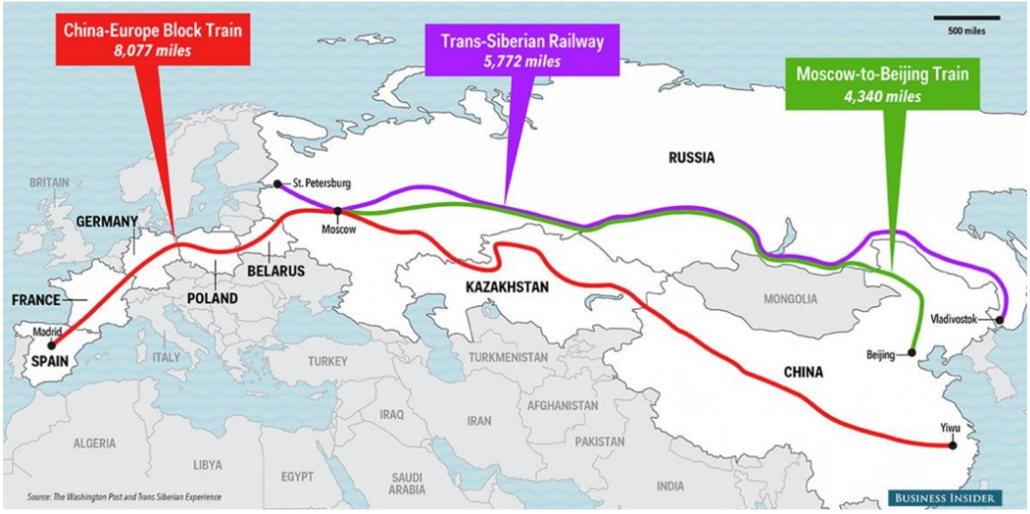


Source: SEI

Rail into Europe

The banner project will be a high speed rail link of 8,000 miles between Beijing and Madrid via Russia and Kazakhstan. Indications are that this will reduce the freight time between China and Europe from 42 days to as little as 40 hours although this will depend on the precise route taken through Kazakhstan. This would substantially cut freight costs and significantly expand the types of goods that China will be able to supply into Europe. Supply chains will be transformed with a range of implications for retailers, warehouses and logistics companies. This project is well advanced. China has mostly completed the link to its borders and Russia recently contracted a Chinese construction company to commence the Russian leg with completion expected in three years.

Chart 2: The High Speed Rail Link to Europe



Source: Business Insider

Maritime route through Pakistan

Maritime routes to Europe and Africa are also being redesigned. In the future, many Chinese goods will be loaded onto ships in Pakistan after travelling the length of Pakistan by rail. This represents a significant short-cut to sea and then a much shorter sea journey for goods produced in inland China. A Chinese company recently purchased the Piraeus port in Greece which will become the main disembarkation point for goods which will then be moved by rail throughout Europe.

China is sponsoring all of these projects. In fact the first major project to commence was a deepwater port at Gwadar. In our view, Pakistan is likely to be the largest beneficiary of the NSR given its convenient geographic position. China is also sponsoring the main rail link, a nuclear reactor, coal mines, highways and a new hydro scheme as part of the $46 billion China-Pakistan Economic Corridor. On the European side, China is funding a rail link between Greece and Hungary to assist the freight journey at the other end, and more links deeper into Europe are likely to follow.

Chart 3: China Pakistan Economic Corridor

Source: Xinhua

Effects of the New Silk Road

In the short term our view is that the NSR projects will provide support to the global economy due to the benefits flowing from $US1 trillion in construction. The longer term economic effects come from productivity benefits from more efficient and cheaper supply chains. With shorter travel times, more goods will be able to be traded across longer routes. Despite the complaints of populist politicians like Donald Trump, further globalisation is inevitable.

Our expectation is also that China's political influence will grow at the expense of the US in a number of ways:

- China will genuinely become the centre of global trade, and the role of the US in driving global trade agreements will diminish.
- China will play a much greater role in regional affairs. It will deepen its relationship with its neighbours and be the architect of regional development.
- China will seek to establish the Renminbi as the main currency of exchange along the route as a direct challenge to the $US.

Some individual countries will be significant beneficiaries. Central Asian countries with an aggregate population around 200 million people will be dragged very quickly into the global economy with Pakistan and Kazakhstan the major winners due to their positions at the hub of these new trade routes.

The impact on Australia

The main benefit to Australia will come during the construction phase as a supplier of raw materials to the projects. Volumes of bulk commodity exports will remain robust, although the Evans and Partners view is that iron ore prices may fall over the next year. The increase in regional construction should cushion the fall in Chinese domestic construction.

However, our contention is that Australia will not benefit as much as other countries in the longer term as our trade routes will not change materially and there are no direct NSR projects being planned in Australia. This might change in the future; PM Turnbull discussed the possibility of some projects in Australia in a meeting with President Xi last May. One possibility might be new port facilities in northern Australia since China has increased its investment in the north through agriculture and mining, and recently took a 99 year lease on the Port of Darwin.

The challenge for Australian companies will be to find other ways to tap into what could be some remarkable changes in the global economy over the next few years.

Investment Opportunities from the New Silk Road

Investors can gain broad exposure to this theme in a number of ways:

- Broad exposure to the Chinese stock market. These projects, and the benefits that flow from them, are one reason why we expect that Chinese GDP growth will stay robust for some time. This can be accessed through the ishares China large cap ETF (code IZZ).
- For the brave, exposure to the two countries that we expect will be the largest beneficiaries of Chinese investment. These are Pakistan and Kazakhstan. Pakistan has already been a major beneficiary from road and rail investment. The road and rail projects that will span the length of the country will be transformational and could spark a broader range of development. The previously fractious northern part of country could be opened up to development.
- A broader range of emerging markets will benefit as they are highly exposed to Chinese demand. Emerging market ETFs tradeable through the Australian stock exchange include offerings from ishares (code IEM) and Vanguard (code VGE).
- Companies in the developed world that are exposed to Chinese growth such as those supplying luxury goods, healthcare, technology or which are beneficiaries of expanding Chinese tourism. This includes a number of companies in Australia such as airlines, casinos, retailers, hotels and attractions. These projects will add to demand for iron ore and coal, although probably not enough to offset falling domestic Chinese demand as the rate steel recycling in China increases.

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