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Oliver Bell
Portfolio Manager, Frontier Markets Equity Strategy

Frontier Markets

THE MODERN SILK ROAD—WHAT IT MEANS FOR FRONTIER MARKETS

KEY POINTS

- In 2013, China President Xi Jinping unveiled plans for one of the largest overseas investment programs ever undertaken by a single country, the so-called One Belt One Road (OBOR) initiative.
- The ambitious plan is aimed at reestablishing China's ancient Silk Road trading routes and, in doing so, securing China's future as a leading player on the world's economic and political stage.
- At its heart, it will see the development of a number of major economic corridors, requiring substantial communication, transport, and associated physical infrastructure in countries along the trade routes.
- Many developing nations stand to reap the benefits of substantial Chinese investment and trade. Many of these countries are in clear need of new and better-quality infrastructure, as rising populations, economic development, and urbanization place ever more pressure on existing frameworks.
- Not all countries impacted by the OBOR initiative will be affected equally. However, the substantial investment will go a long way toward meeting a number of the challenges and opportunities that exist today.
- There is much to be gained from promoting greater connectivity and increased trade along the proposed trade routes while, at the same time, there remains a huge shortfall in adequate, modern infrastructure across these markets.

In 2013, China President Xi Jinping unveiled plans for one of the largest overseas investment programs ever undertaken by a single country, the so-called One Belt One Road (OBOR) initiative. The ambitious plan is aimed at reestablishing China's ancient Silk Road trading routes and, in doing so, securing China's future as a leading player on the world's economic and political stage. Comprising two core components, the "Silk Road Economic Belt" will link China by land with countries through Central and west Asia; the Middle East; and, ultimately, Europe, while the "Maritime Silk Road" will see countries linked by sea along the eastern coast of Africa through the Suez Canal into the Mediterranean Sea.

Ostensibly aimed at promoting better connectivity, closer links, and long-term regional stability, the scale and ambition of the OBOR initiative is nothing short of stunning. At its heart, it will see the development of a number of

FIGURE 1: **The Scale and Reach of China’s One Belt One Road Initiative**

Belt and road infrastructure projects, planned and completed, as of December 31, 2017

Silk Road Economic Belt
Maritime Silk Road of the 21st Century
AIIB Member States
Proposed Economic Corridors
Existing Railroad Connections
Planned or Under Construction Railroad Connections
Existing Ports With Chinese Engagement
Planned or Under Construction Ports With Chinese Engagement

Some elements of the existing and proposed corridors are not shown in order to simplify the image.
Source: MERICS Research.

major economic corridors, requiring substantial communication, transport, and associated physical infrastructure. This will provide a major boost to the construction outlooks for many developing countries along the route. China already has signed cooperation agreements with 71 countries that, including China, represent 65% of the global population and 34% of global GDP. With China keen to progress its strategic interests and exert a greater influence on the global stage, some estimates envisage the OBOR initiative potentially delivering upward of US$6 trillion in investment over the coming years, effectively reshaping global trade.[1]

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Critics are quick to point out that, far from being magnanimous, the country that stands to benefit most from the OBOR initiative is China itself, while the impactful benefits for poorer, regional partners will pale in comparison. Certainly, from an economic perspective, improved interconnectivity allows Chinese corporates better access to export markets, particularly emerging Asian markets. Establishing a large, cooperative outlet for China’s vast production output is essential to China’s long-term growth outlook. As China’s population matures in the coming decades, domestic infrastructure investment will inevitably slow, resulting in excess capacity across various

[1]Source: World Bank, as of December 31, 2016.

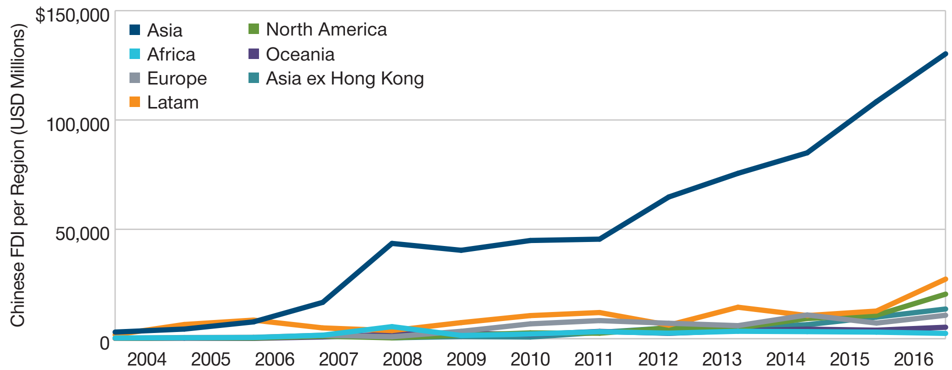
industries. The OBOR initiative is designed to help alleviate this longer-term problem, developing necessary export markets, trade routes, and connectivity to take up the slack in China's production output. Also, in terms of construction projects in developing countries, China largely utilizes its own manpower, rather than local workers, and this is another important consideration, moving forward, given that nominally full employment remains an ongoing government priority.

However, far from it being seen as one-sided or obligatory in some way, Chinese investment has been welcomed by many governments, from Malaysia, Pakistan, and Sri Lanka to as far away as Estonia, Egypt, and Nigeria. While China's motives might be born out of self-interest, there seems little doubt that developing nation partners also stand to reap the benefits of substantial Chinese investment and trade. Many developing countries are in clear need of new and better-quality infrastructure, as rising populations, economic development, and ongoing urbanization place ever more pressure on existing frameworks. Given many of these countries lack the financial capacity, and often the technical capabilities, to develop their own infrastructure, the prospect of Chinese investment represents a welcome solution. Already we are seeing this; China's outbound foreign direct investment (FDI) has grown steadily in recent years, with much of this being channeled toward developing countries across Asia, but also increasingly toward Eastern and central Europe and Africa (Figure 2). This trend is only set to continue, in our view, as China looks to encourage these countries toward manufacturing capability and, consequently, part of the global industry.

However, for developing countries, the OBOR initiative is less about the burgeoning Chinese demand story, in our view, and more about the significant investment being made

FIGURE 2: **Increased Chinese Foreign Direct Investment Coincides With OBOR Initiative**

As of December 31, 2016



Source: Haver Analytics Emerge Database.

into high-cost basic infrastructure in these countries. The opportunity to improve their physical infrastructure stock—from power generation to water provision to communication systems to transportation networks—is vital to the economic development and prosperity of many of these developing countries.

UNEVEN OPPORTUNITIES ALONG THE SILK ROAD

That said, the potential size of investment, and the likely impact on those developing countries affected, will not be uniformly, or equitably, felt. From China's perspective, some countries offer clear opportunities, simply by virtue of their physical location or geographic attributes. Others, however, present challenges and heightened risks due to political instability, corruption, terrorist threats, or poor transparency, and thus are less appealing in terms of prospective investment.

POTENTIAL OPPORTUNITIES TO CAPTURE THE OBOR THEME IN OUR PORTFOLIOS

Given the wide variance in the potential impacts of the OBOR initiative, we remain very much stock specific in the way that we look to play this theme throughout our portfolios. As a principal starting point, we take a top-down view of the overall benefit to the countries involved. A central aspect of our frontier market investment strategy, for example, is identifying those countries where significant FDI is evident and where there is the necessary political stability to be able to capitalize on this and encourage superior economic growth.

Kazakhstan

One area that looks interesting is Central Asia. As part of China's Silk Road revitalization plan, Central Asia is set to play a major role as the principal land route through to Europe. Historically, this corridor was rendered largely inaccessible given the difference in railway track gauge that existed. At the time of construction, the former Soviet Union used a different gauge than the standard gauge common in Europe and internationally. As such, in order to link up with other rail systems, including China's, trains had to go through some sort of conversion between gauges, adding significant delays, cost, and inconvenience. However, investment from the countries themselves, and from China, has seen the previous rail network replaced by new, standard-gauge railway links that have been built throughout Central Asia, effectively opening up the land corridor to Europe and connecting landlocked Central Asia to the Persian Gulf. Kazakhstan is one of the countries that we are currently exploring for potential opportunities. Kazakhstan

Indeed, the OBOR strategy is no magic solution where all impacted countries benefit greatly and in equal measure. However, what it does do is go a long way toward meeting a number of the challenges and opportunities that exist today.

already has seen a noticeable boost in export trade as a result of the new rail network connecting Central Asia to the rest of the world. Meanwhile, the construction of a 22km light railway system in Astana, Kazakhstan's capital, financed by China, is due to be completed in 2018. Kazakhstan looks like it is becoming a key piece in China's OBOR investment strategy, one that has the capacity to help absorb China's excess capacity in cement, steel, and glass—areas that have been hit by the domestic economic slowdown over the past decade.

Pakistan

Pakistan is another direct beneficiary of substantial Chinese investment and, again using the thesis of "following the FDI money trail," an area that we see as worth investigating. Opening the so-called China-Pakistan economic corridor—which many consider to be the showcase of the OBOR project—is expected to see upward of US$50 billion invested in new and upgraded infrastructure, including rail and road networks and power generation facilities. With a target completion date of 2030, the corridor is strategically significant for China, providing a shorter, more direct, route to the Middle East, Central Asia, Africa and Western Europe. The area also has abundant oil and mineral reserves and it is currently China's largest source of natural gas. China is partly funding the project, while it has also arranged cheap Chinese bank loans for Pakistan-specific parts of the project. While there is no doubt as to the significance of this level of investment for Pakistan's economy and long-term development, some concern does inevitably remain that it might just be too much for Pakistan to digest and that the loans from China may become a millstone for this more underdeveloped economy.

Sri Lanka

One of the countries that we are invested in that stands to benefit from the OBOR theme is Sri Lanka. China has already invested significantly in the country as it looks to establish a gateway to the subcontinent. Sri Lanka looks to be a crucial element in China's OBOR plans as, unlike India for example, it sits off the continental shelf and provides access to deep water ports. Close to major Indian Ocean shipping lanes, Sri Lanka's deep water ports can accommodate the world's largest container ships and supertankers, making the country a pivotal link along China's Maritime Silk Road. With billions already invested, and billions more committed, the potential impact on Sri Lanka's GDP, for what is a relatively small economy, is not immaterial.

Drilling down to the market level, Sri Lanka is also appealing in that most of the blue chip-listed companies are high-quality names, and generally speaking, corporate governance is good.

Some 60 to 70 nations stand to be directly impacted, to varying degrees, by China's OBOR strategy and the reestablishment of the ancient Silk Road trade routes. It stands to reason that the countries with the worst infrastructure are likely to be among the biggest gainers—countries like Kazakhstan, Bangladesh, Pakistan, and Sri Lanka—will most likely see greater infrastructure investments via OBOR, and this should, in turn, be positive for their economies. Meanwhile, for those questioning China's motives, seeing the OBOR initiative as a form of economic colonialism designed to exert ongoing pressure on the counties involved, there is little doubt that China's motivation for such a large-scale initiative is far from selfless. Indeed, the OBOR strategy is no magic solution, where all impacted countries benefit greatly and in equal measure. However, what it does do is go a long way toward meeting a number of the challenges and opportunities that exist today. On the one hand, there is huge benefit to be gained from promoting greater connectivity and increased trade along the proposed trade routes while, at the same time, there remains a huge shortfall in adequate, modern infrastructure across these markets.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material: Transactions in securities denominated in foreign currencies are subject to fluctuations in exchange rates which may affect the value of an investment. Returns can be more volatile than other, more developed, markets due to changes in market, political and economic conditions. Investments are less liquid than those which trade on more established markets.

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