July 7, 2010

Dear Clients, Partners, and Friends,

The results for South Ocean Management's Delaware LP, Kong Partners' L.P., before incentive fees, were as follows:

| | Jun 2010 | Year-to-Date |
|---|---|---|
| Hong Kong Partners LP (net)* | -0.72% | 3.35% |
| Hang Seng Index ** | 1.84% | -8.00% |
| BNP Peregrine Greater China Index | 0.36% | -8.44% |
| MSCI HK Small Cap Index | 2.19% | 3.23 % |

Partners' NAV was $2.9559, after accruals/management fees, but before annual incentive fees of 15% on appreciation.

Fear was the dominant market emotion in June. More than 10% of Hong Kong's listed companies declined more than 10% in market value, on low trading volumes. Trading activity in our holdings of smaller/mid capitalized, Hong Kong-listed companies, with earnings geared towards China, was listless. For the second quarter, Hong Kong Partners LP was off 1.6% (net) versus -5.2% for the Hang Seng Index.

There has been little good news to cheer investors. Sentiment became markedly troubled over a plethora of worries; a "double dip", another banking crisis in Europe, excessive debt, China's slowing economy and "Japanese-style policy mistakes across the G7."

The risk today is should any of these fears become reality, asset market corrections could become self-fulfilling and lead to weaker demand. That's the hitch. We are in an environment of an interconnected global financial system congested by IOUs to each other, where fear can become reality very quickly. And this seems to be the main reason why the stock market has been apathetic (hence our heavy cash position of 43% today).

The Chinese government has re-imposed lending quotas, curbed speculative housing prices, controlled excess capacities in heavy industries and instituted other tightening moves. These policies are the unwinding of the fiscal stimulus of 2009, and are, consequently, slowing the economy's growth.

But, that doesn't foretell a crash. As HSBC commented recently in a report;

> China's fiscal position is one of the strongest in the world. On the domestic side, central government debt and the budget deficit stood at 17.4% and 2.2% of GDP, respectively at end-2009. Both these ratios are much lower relative to most of its peers in the same sovereign credit rating bucket of A1/A+/A+ respectively by Moody's, S&P and Fitch. Measured against a RMB33.5trn GDP for 2009, even in the worse case scenario of RMB11.4trn LGD (Local Government Debt) exposure, it appears that the central government would have enough firepower to handle the LGD problem.

China has not used excessive leverage and borrowings to grow. In another development, just before the recent G20 meeting, China announced the opening of the Chinese RMB to a broader range of fluctuation relative to the US dollar. BCA Research says the new "currency basket" or basket crawling-peg approach (like the Singapore dollar peg) is an important step by China;

> The significance of the most recent RMB policy shift is more than symbolic. The RMB's de facto peg with the U.S. dollar that has been in place since the early 1990s may have come to a decisive end…The country's stringent capital account controls, while necessary to regulate volatile cross border money flows in the near term, contradict with policymakers' long-term strategy of further liberalizing capital account transactions and eventually allowing for a freely convertible RMB. A currency basket approach means that the RMB will depreciate when conditions warrant. A key obstacle, however, is whether political pressure from the U.S. will allow any downward adjustment of the Chinese currency.
>
> At minimum, in order to create room for two-way moves of the RMB/USD, the RMB at first needs to appreciate quickly against the dollar, especially if the dollar weakens against other majors. Bottom line: We expect the RMB to appreciate between 5-8% over the next year against the dollar.

I don't believe there is any economist that truly believes an upward revaluation of the RMB does much of anything to resolve the trade imbalances with China. Look for more expensive goods made from China at the local Sam's Club (was that what US politicians wanted, demanding a higher Yuan?).

Goldman Sachs projects China's currency will be fully convertible by 2020, when China's stock market will be 10 times larger than today.

> We estimate that the traded value of equities and futures in China could reach US$455bn/day from US$58bn/day currently, or roughly 70% of regional liquidity, compared with 36% now. The liquidity in Shanghai alone could reach over US$350bn/day by 2020 vs US$47bn/day at present, over 75% of Chinese liquidity, and as much as 53% of regional liquidity. (Global Economics Paper No: 198, June 21, 2010 Goldman Sachs Global Economics, Shanghai in 2020: Asia's Financial Centre)

As the West's outstanding dollar debts have burgeoned, threatening America's own financial future – China stands in contrast.

> … China is not suffering from any of the same secular symptoms. Consumer loans are below 20% of GDP, even after last year's credit boom (Chart 1). Credit card business is trivial, and the majority of Chinese car buyers pay cash, despite explosive growth in car sales since last year. Leverage in the housing sector has increased noticeably from 2009, but the loan-to-value ratio remains healthy. Importantly, the Chinese authorities have already begun to restrict mortgage borrowings and dampen speculative activity.
> Meanwhile, China's fiscal situation remains solid. The country's fiscal deficit is less than 3% of GDP…outstanding government debt is just slightly above 20%, both of which are among the lowest across all major economies. Even taking into consideration the hidden liabilities at local government levels, China's total public sector debt burden remains comfortably manageable. Total borrowing of various state-owned funding firms for local infrastructure developments accounts for about 25% of GDP. Needless to say, it is virtually impossible that all local government borrowing would turn bad.
>
> In short, China does not suffer from those debt problems that haunt the developed world. Rather, what it has is a savings problem, in which the household sector has maintained a massive sum of precautionary savings. Excessive savings are creating a set of macro headaches, but forced deleveraging, sharp consumer recession and an unsustainable fiscal situation are not among them.

(BCA Research, China Investment Strategy, June 2, 2010).

Now that many of the theoretical reasons for buying developed markets have dissipated (with the US and a large part of Europe expected to enter a protracted phase of struggle with large debts, lower liquidity and currency volatility - even sovereign debts facing greater difficulty in financing or re-financing), Asia offers a far more attractive investment landscape.

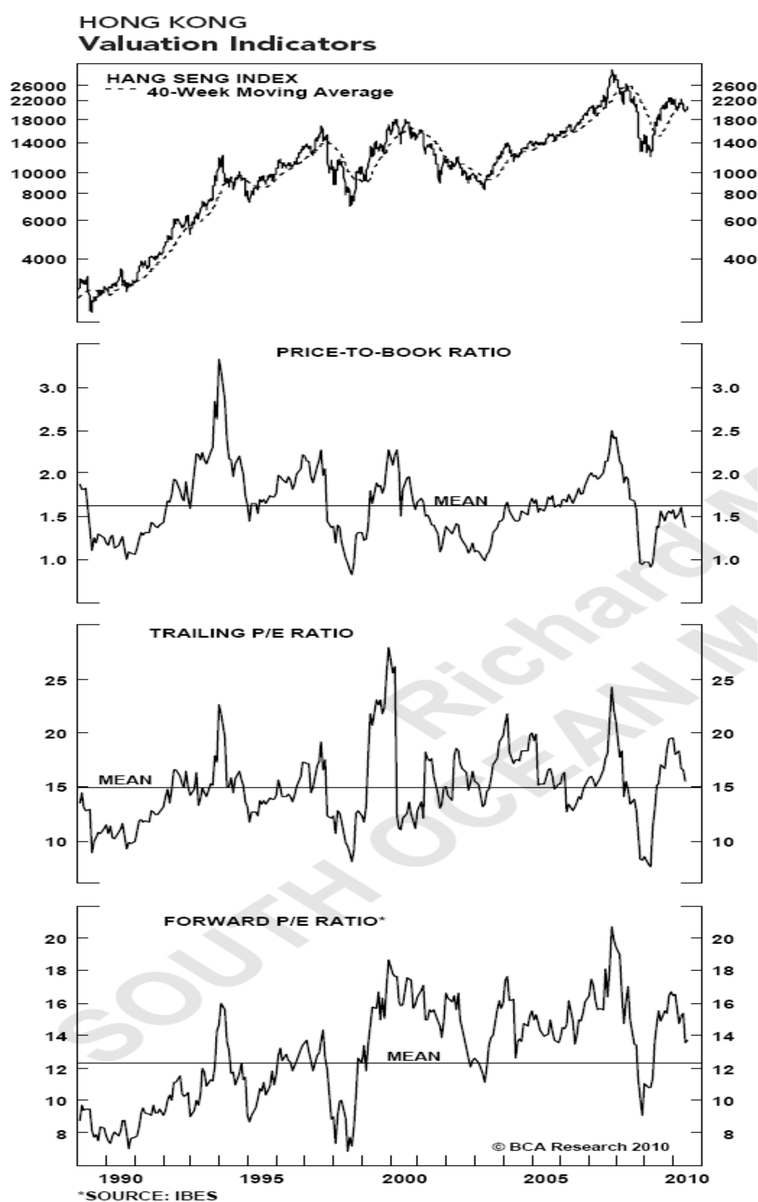
China will continue its transition economically, privatizing its state-owned assets. Remarkably, the mainland's largest bank, Agricultural Bank, just listed in July and was the world's largest IPO. PwC projects for the rest of the year, China will list more new stocks than the rest of the world. The local Hong Kong bourse will raise more than HK$330 billion from 60 initial public offerings this year (versus HK$248.2 billion raised last year).

Further, China has a massive amount of domestic savings, '…an enormous financial resource that can be utilized to strengthen its domestic demand.' Deregulation, privatization and liberalization over the past 30 years is removing structural flaws within the PRC and advancing new growth drivers throughout its economy. China's ~US$3,000 per capita GDP is about where Japan was in 1957. Many US companies, such as Starbucks, The Gap and Ford Motor, continue expanding in this growth market. Foreign direct investment to China

climbed 14% to nearly $39 billion in the first five months of the year (and primarily in manufacturing factories).

Importantly, Asia has already been through its debt crisis and does not share the structural flaws of G7 nations. Templeton Asset Management Ltd.'s Mark Mobius called the slump in emerging-economy shares a "correction" in a bull market. "Despite the fact that a lot of people think that we are entering into a bear market, we don't believe so…"When the time comes, emerging markets will recover faster and in a big way."

Hong Kong is not particularly expensive today.



As we stated in the beginning of the year, we expected choppy, volatile markets. Last quarter exemplified that. Our holdings of fast growing, small/mid cap companies doing business in China are in an ideal market environment to excel/outperform, with low interest rates, recuperating economies, and healthier growth prospects.

Our overall valuations (PE, ROE and PB) are significantly lower than average (see last month's letter here). We are cautious, but hope to become more fully invested by the end of the quarter.

Sincerely,

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Note: Our new administrator, Apex Fund Services, will be mailing all Partner NAV's and account values as of the end of June. You should be receiving in a week or so.

Monday, July 12, 2010 CNBC interview, Hong Kong

Hit Ctrl button and click mouse to follow link

Pockets of Strength in China
Mon. Jul. 12 2010 | 7:40 AM[04:58]
Brook Mcconnell, president, South Ocean Management, sees pockets of strength in China amid the slowdown. He explains why he likes certain se...

*Hong Kong Partners LP risk disclaimer:

- Hong Kong Partners LP (The "Fund") primarily invests in the Hong Kong equity market with a Greater China focus.
- The Fund invests in China-related companies which involve certain risks not typically associated with investment in more developed markets, such as greater political, tax, economic, foreign exchange, liquidity and regulatory risks.
- The Fund is also subject to concentration risk due to its concentration in Hong Kong, particularly China-related companies. The value of the Fund can be extremely volatile and could go down substantially within a short period of time. It is possible that a substantial value of your investment could be lost.
- You should not make investment decision on the basis of this material alone. Please read the explanatory private placement memorandum for details and risk factors.

**Index Descriptions: The Hang Seng Indexes are a widely recognized capitalization-weighted indexes that measures the performance of the three largest-capitalization sectors of the Hong Kong stock market in descending order. The Hang Seng Index measures the largest 52 market capitalized listed companies in Hong Kong's stock market. The Hang Seng Mid Cap Index represents the next 193 largest capitalized listed companies, the Hang Seng Small Cap Index represents the next 187 largest capitalized listed companies in Hong Kong.
The MSCI HK Small Cap Index is a free float-adjusted market cap weighted index designed to measure the performance of small cap equity securities in the bottom 15% of equity market capitalization in Hong Kong. With 69 constituents, the index represents approximately 14% of the free float-adjusted market capitalization of the Hong Kong equity universe.
The Hong Kong Partners LP (HKP) is benchmark agnostic and its corresponding portfolio may have significant noncorrelation to any index. The portfolios may invest in all sectors (within and/or on other stock markets) and the composition of securities in the portfolio may change periodically depending on market conditions at the time. Securities in the portfolio will not match those in any index.
Index returns are generally provided as an overall market indicator. You cannot invest directly in an index. Although reinvestment of dividend and interest payments is assumed, no expenses are netted against an index's returns. Index performance information was furnished by sources deemed reliable and is believed to be accurate, however, no warranty or representation is made as to the accuracy thereof and the information is subject to correction.
Before investing you should carefully consider the Partnership's investment objectives, risks, charges and expenses. This and other information are in the prospectus, a copy for Accredited Investors may be obtained by inquiring to info@south-ocean.com. Please read the prospectus carefully before you invest.
The principal risks of investing in HKP: Equity Securities Risk. The value of the equity securities the Fund holds may fall due to general market and economic conditions. Foreign Securities Risk. Investments in the securities of foreign issuers involve risks beyond those associated with investments in U.S. securities. Industrials Sector Risk. Companies in the industrials sector may be adversely affected by changes in government regulation, world events, economic conditions, environmental damages, product liability claims and exchange rates. Consumer Discretionary Risk. Companies in this sector may be adversely impacted by changes in domestic/international economies, exchange/interest rates, social trends and consumer preferences. Information Technology Sector Risk. Information technology companies face intense competition, both domestically and internationally, which may have an adverse effect on profit margins. Detailed information regarding the specific risks of Hong Kong Partners LP can be found in the prospectus. Additional risks of investing in HKP include equity, market, management and non-diversification risks, as well as fluctuations in market value and NAV. An investment in a private limited partnership is subject to risks and you can lose money on your investment in the limited partnership.
There can be no assurance that HKP will achieve its investment objective. The LP's portfolio is more volatile than broad market averages. Shares of HKP cannot be bought or sold publicly, there is no active market in the Units and there are restrictions imposed on Limited Partnership unit transfers. Partnership redemptions are handled by Authorized Administrators of the Partnership.