June 13, 2012

Dear Clients, Partners, and Friends,

The results for South Ocean Managementøs Delaware LP, Kong Partnersø L.P., before incentive fees, were as follows:

	May 2012	Year-to-Date
Hong Kong Partners LP *	- 6.9 %	0.4%
Hang Seng Index **	-11.7 %	1.1%
MSCI HK Small Cap Index	-10.0%	3.5%

Partnersø NAV for May $2.3618 after management fee, but before annual incentive fees of 15% on appreciation.

The month of May was grueling for the Hong Kong stock market. A perceived slowing economy in China and the staggering mess in the EU capped gains. Despite the recently announced interest rate cut by China, trading in Chinese-related equities remains subdued. In the short term, the markets fear thereøs insufficient funds in the Chinese system, despite the rate cut and other policy easing measures (actually, China reported, weaker, but not that bad growth data in May, along with positive signals in fixed asset investment and lower inflation).

The MSCI small cap index we benchmark has a heavy concentration of property-related issues, a segment we have a tiny exposure in our portfolios (we own a 3% position in CSI Properties, stock code 497 hk, which is an adept investor in various real estate projects in Hong Kong and the mainland. We bought shares at ~HK$0.23 per share with the book value of its property portfolio valued at over HK$1.00 share, or at a very steep discount).

The MSCI HK small cap index has performed relatively well this year in contrast to Hong Kongøs second board, the Growth Enterprise Market (GEM) of 100 smaller growth stock names, which has declined 18.5% year to date. Consequently, outside of Macau gaming stocks, some smaller property related SAR companies and a few domestic jewelers/retailers, a majority of non-index, smaller capitalized stocks have been massively under-performing this year.

China-related stocks have been especially victimized. That is because all China-related stocks, in this investment climate, are guilty, until proven innocent, (i.e., the Sino-Forest/Muddy Waters saga). After short seller firm, Muddy Waters, alleged fraud last year that Toronto-listed Sino-Forest overstated its timber holdings, all mainland Chinese smaller cap listings in Hong Kong have faced increasingly intense and severe investor skepticism. The amount of scrutiny on China companies today is unprecedented.

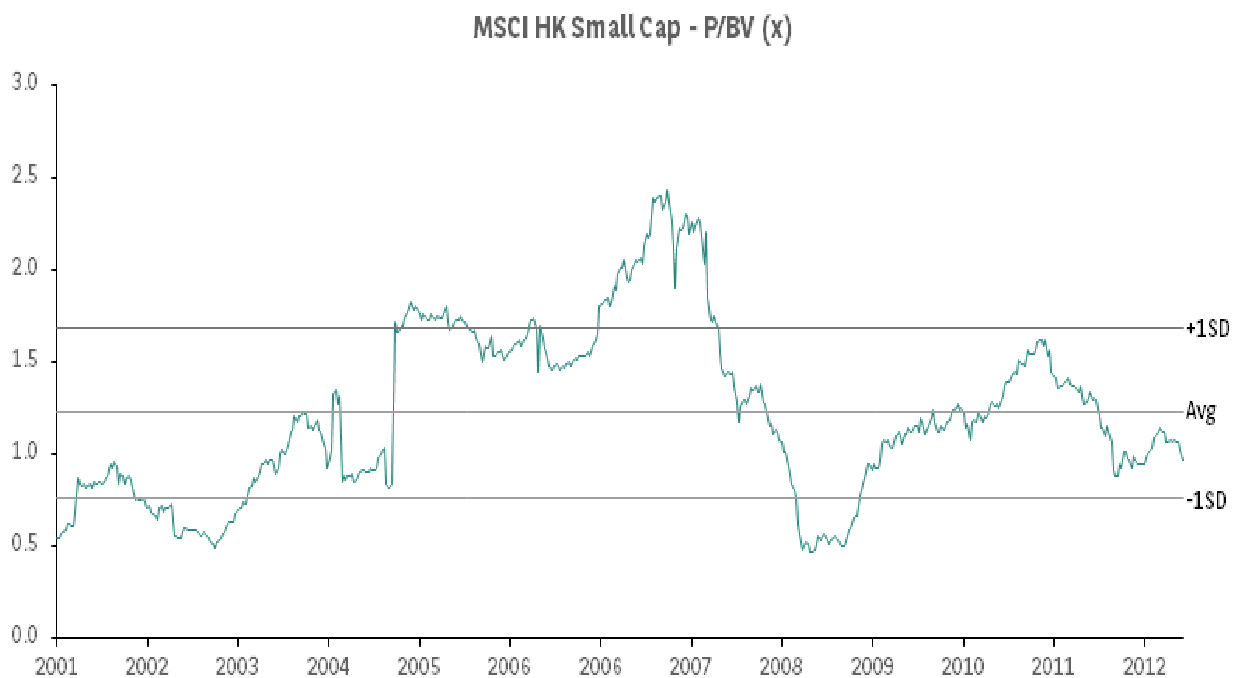
Our results were impacted by all this uncertainty last month, even with our 25% cash holding. The small/mid capitalized segment of the Hong Kong market, where we are most interested, was markedly quiet through-out the month.

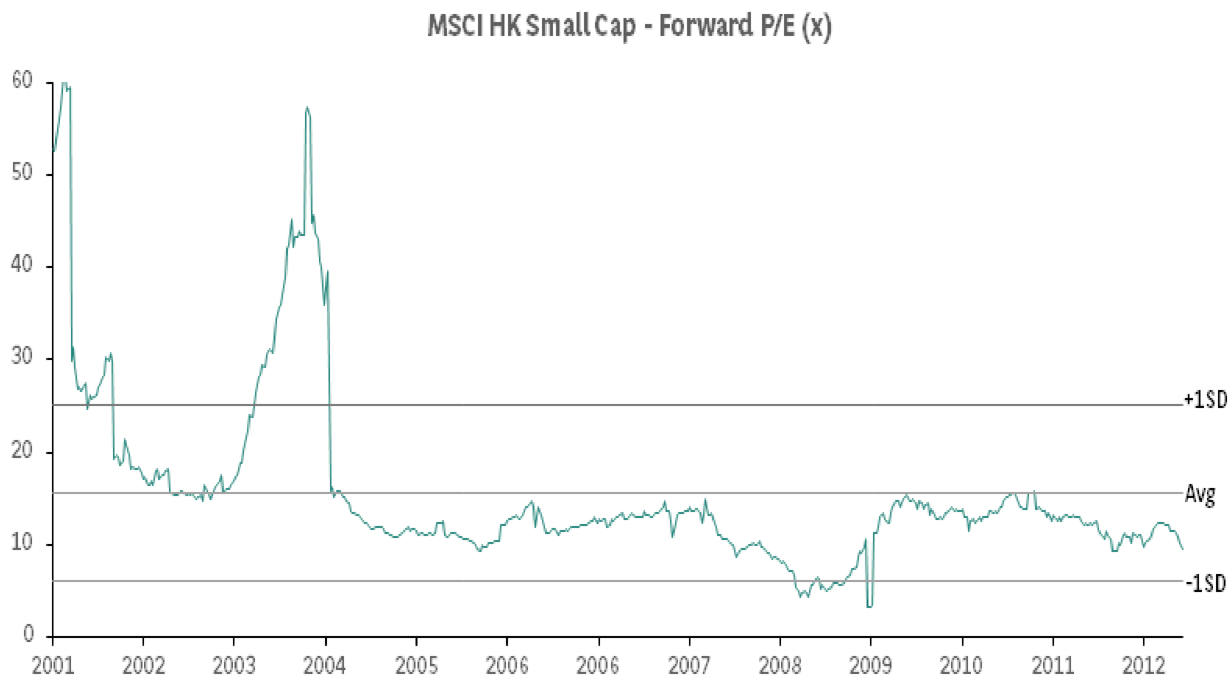
Expectations are not exuberant for most sectors of the market in Hong Kong today. Perhaps this mood in the market is a good contrary indicator of a pending bottom.

Our 8% holding in PRC-based vegetable grower, Chaoda Modern Agriculture, remains suspended by the Hong Kong stock exchange.*

Valuations, generally, are becoming attractive: The HSI (Hang Seng Index) and HSCEI (or China H-share index), which corrected 11.4% and 18% respectively from their YTD peaks on 29 February, are becoming attractive at 9.42x and 7.04x 12-mth forward PE. In terms of P/BV, they are trading at 1.22x and 1.18x.

The following charts are of the average PE and PB levels of the MSCI HK small cap index. We are analyzing and investigating stocks with even lower than these average values. Small cap shares are cheap today, but not to the extreme valuations during the Lehman Crisis;





Former Morgan Stanley economist, Stephen S. Roach, made a speech to the US Congress about its lack of any understanding regarding the issue of the Chinese currency, copied below, if you have a moment.

Sincerely,

Brook McConnell
President
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Hong Kong

Rethinking the U.S.-China Economic Agenda

Stephen S. Roach

Mr. Chairman and members of this committee, I am delighted to weigh in on this timely discussion of the bilateral framework of engagement that now provides great structure to our relationship with China. Since its inception six years ago, the Strategic and Economic Dialogue between the U. S. and China has served the very useful purpose of elevating one of the world's most important economic relationships to the high level it deserves. Much has been accomplished but further progress cannot be taken for granted. That's especially the case if a fixation on the currency issue continues to dominate the economic agenda between the United States and China.

This fixation has arisen out of the combination of bad economic advice, a tough macroclimate bearing down on American workers, and a politically motivated blame game. Actions by the U.S. Congress have provided the most visible manifestations of this one-dimensional approach. Over the past seven years, Congress has repeatedly flirted with legislation aimed at addressing the alleged threat of a cheap Chinese currency. Bipartisan support for such a measure initially surfaced when Senators Charles Schumer (a liberal Democrat from New York) and Lindsey Graham (a conservative Republican from South Carolina) reached across the ideological divide to co-sponsor the first Chinese currency bill in 2005. Over the years, the drumbeat has only grown louder in seeking such remedies. By overwhelming bipartisan majorities, the House of Representatives passed a modified version of this bill in September 2010 and you in the Senate followed suit in October 2011. Fortunately, neither bill became law.

Congress has misdiagnosed America's so-called China problem for seven years - believing incorrectly that a currency fix will solve increasingly tough problems for American workers.

On the surface, the argument for legislative action against China has tantalizing appeal. It rests mainly on America's gaping trade deficit, widely thought to be a principal source of the acute pressures bearing down on U.S. jobs and real wages. These concerns are certainly understandable. A loss of market share to foreign competition squeezes America's companies and their workers. The U.S. merchandise trade deficit has, in fact, averaged 4.4% of GDP since 2005 - the largest and most protracted external gap in modern U.S. history. Moreover, China has accounted for fully 35% of the shortfall over this seven-year interval, by far, the largest portion of the overall U.S. trade deficit. The critics claim foul - maintaining that Chinese inroads into American markets are built on a blatant strategy of currency manipulation that is restraining the renminbi, or yuan, from rising to its "fair" market-determined value. The Chinese, insists a broad coalition of politicians, business leaders, and academic economists, should revalue immediately or face

punitive compensatory sanctions to level the competitive playing field.

This reasoning resonates with the American public. Opinion polls conducted in 2011 found that fully 61% of the citizens sampled believe that China represents a serious economic threat. Politicians have been quick to respond - and, unfortunately, stoke these fears. Indeed, the currency debate could well loom as a major issue in the upcoming U.S. presidential campaign. President Obama has drawn a line in the sand when he replied, "Enough is enough," upon being queried on the contentious currency issue in the aftermath of his last meeting with Chinese President Hu Jintao. Governor Romney has gone even further - promising to declare China guilty of "currency manipulation" the day he takes office as America's next president. Nor should this be dismissed as normal election-year politics. As long as conditions remain tough for American workers - more likely than not in the years ahead - pressures for a Chinese fix to our problems will only intensify.

Flawed Logic

However appealing this logic may appear to be on the surface, it is wrong. Currency adjustments - in effect, altering the relative prices between nations - are simply not the panacea that most economists used to think they were. According to Federal Reserve statistics, the broadest measure of the U.S. dollar is, in fact down about 25% in real effective terms from its February 2002 peak. Yet over the past decade, the angst of the American worker has only intensified. Contrary to conventional wisdom, shifts in currencies are not the answer for all that ails us. That is particularly true of the foreign exchange rate between the U.S. dollar and the Chinese renminbi. Several reasons come to mind:

First, America's trade deficit is multilateral: The United States ran deficits with 88 nations in 2010. A multilateral imbalance cannot be fixed by putting pressure on a bilateral exchange rate. It's like squeezing one end of a water balloon. Without addressing the sources of this multilateral imbalance, pressuring one of its bilateral pieces will merely redirect that portion of the trade imbalance elsewhere - quite conceivably to a higher cost foreign producer. In other words, this strategy would probably backfire - it would be the functional equivalent of imposing a tax hike on hard-pressed middle-class U.S. families.

It's no dark secret as to the primary sources of our multilateral trade imbalance - an unprecedented shortfall of national saving. America's so-called net national saving rate - the combined depreciation-adjusted saving of individuals, businesses, and the government sector - fell into negative territory in late 2008 and has remained near or below zero ever since. This is unprecedented in the annals of modern global history. Never before has the world's leading economic power run a negative net national saving rate. Lacking in saving and wanting to grow, the U.S. must them import surplus saving from abroad - and run massive current account and

multilateral trade deficits in order to attract the foreign capital. That's where China and our other 87 trade deficits enter the U.S. macro equation.

The politically expedient blame game rests on the flawed logic of a bilateral fix for a multilateral problem.

Yet you in the political arena choose to blame others for our sins - specifically, sins arising from unprecedented budget deficits and sharply reduced personal saving that have forced the United States to turn to foreign saving to fund domestic growth. Pointing the finger at China merely deflects attention away from the heavy lifting that must be done at home. Scapegoating may be politically expedient but it won't work in addressing the fundamental problems of a saving-short U.S. economy. In this vein, America's major threat is from within. If we don't want trade deficits - with China or with anyone else - we must face up to our chronic shortfall of saving. If we don't want to save - and many believe (myself excluded) that's the last thing post-crisis America needs - then we have to accept trade deficits as a steep price to pay for our profligacy.

Second, the renminbi has now appreciated 31.4% against the dollar since mid-2005, when China started to reform its foreign exchange regime. That's well in excess of the 27.5% increase called for by the original Schumer-Graham bill. In other words, the currency hawks have pretty much gotten what they wanted all along. But, as underscored above, the problems bearing down on American workers have only become worse. You would think that might provide pause for thought in continuing to agitate for further Renminbi appreciation. But periodic attempts of you in the Congress to enact anti-China currency legislation say otherwise.

The advice from many leading academics - advice, I might disappointingly add, that has been well received in Congress - is that China should have moved quickly with a large one-off adjustment to bring its currency to fair value. While it is debatable as to whether the time path of any currency shifts makes much of a difference in the long run, the Chinese have long viewed a large one-off revaluation with understandable trepidation.

And with good reason. Mindful of the painful lessons of Japan - especially its disastrous concession on sharp yen appreciation that was the centerpiece of the so-called Plaza Accord of 1985 - the Chinese have opted, instead, for a gradual revaluation. Significantly, the endgame is not in doubt. Recent moves toward the offshore internationalization of the renminbi, a more open capital account, and significantly wider currency trading bands leave little doubt that China is committed

to establishing a market-based, fully convertible renminbi.

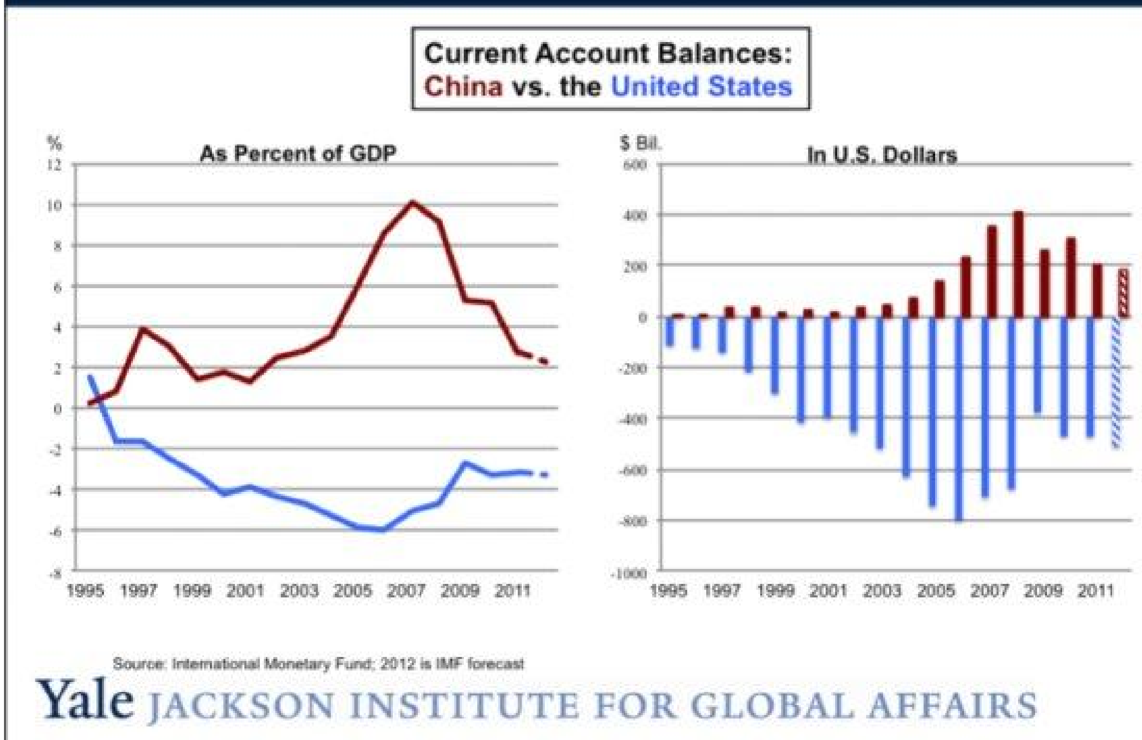
Third, the currency hawks have long maintained that it is in the world's best interest for China to reduce its outside current account imbalance and use the currency lever to accomplish that critical task. They also believe that global imbalances - an ever-present threat to the world economy for the past couple of decades - have been largely made in China. The Washington consensus has been especially adamant in making this case, stressing that China's saving glut has been a major source of global instability.[i] Without a sharp renminbi revaluation, goes the argument, the world will never come to grips with its dangerous imbalances.

America's multilateral problem stems directly from the issue you in the Congress have greatest responsibility for - America's unprecedented budget deficits and the saving shortfall they spawn.

Here as well, the political expedience of the blame game has hijacked this important element of the debate. First of all, the good news is that there has now been significant improvement in China's external imbalance. The International Monetary Fund estimates that China's current-account surplus will narrow to just 2.3% of GDP in 2012, after peaking at 10.1% in 2007. Unfortunately, it's hard to say the same for any meaningful improvement in America's gaping external imbalance. By the IMF's reckoning, the U.S. current-account deficit is likely to be about $510 billion this year - fully 2.8 times greater than China's surplus (see Figure 1, "A Tale of Two Deficits"). As opposed to blaming China as a major source of global instability, you in the Congress should take a long and hard look in the mirror as to the role that America's persistent and outsize external imbalance is playing as a major source of global instability. Far from being a responsible steward of global economic prosperity, an unbalanced U.S. economy has been - and continues to be - a major source of instability in a crisis-prone world.

Figure 1

A Tale of Two Deficits



Finally, China's role in the global economy has changed considerably over the past 30 years. Specifically, it has evolved from the so-called world's factory to more of an assembly line. Research shows that no more than 20% to 30% of Chinese exports to the US reflect value added inside China. Moreover, roughly 60% of Chinese exports represent shipments of "foreign invested enterprises" - in effect, Chinese subsidiaries of global multinationals. This raises important questions about the intrinsic identity of the fabled Chinese export machine: Is it them, or us? Think Apple. The supply-chain logistics of globalized production platforms distort bilateral trade data between the U.S. and China, and have little to do with the exchange rate.

In short, the Chinese currency is not the corrosive problem that you in the Congress have been led to believe over the past seven years. By having the wool pulled over your eyes, you have missed a far more important story. Rather than vilifying China as the principal economic threat to America, the relationship needs to be recast as an opportunity. That's especially the case in a weak U.S. growth environment, plagued by unacceptably high levels of unemployment and underemployment. We need to spend far more time in trying to come up with new and creative solutions to our daunting growth problem. Related to that is the need to think of how China can become an important part of this solution.

Reframing the Agenda

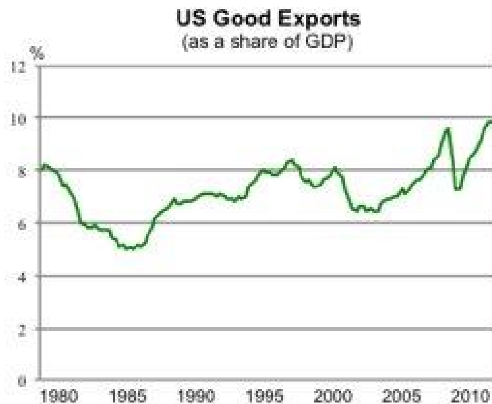
For starters, this requires a frank assessment of America's growth quagmire. Due to the recent crisis - and the years of excess that preceded it - our growth calculus has been turned inside out. Over most of our modern history, we have relied on internal demand as the sustenance of economic growth and prosperity. That approach is now in tatters. The largest component of U.S. aggregate demand - the consumer - is on ice. With households focused on the post-crisis repair of severely damaged balance sheets, inflation-adjusted private consumption has expanded at an anemic 0.6% average annual rate over the past 17 quarters. Moreover, consumer deleveraging has only just begun, suggesting these headwinds are not about to subside. The U.S. is in desperate need of new sources of economic growth and job creation.

With the American consumer on ice, the United States needs to rethink its growth agenda.

Exports top the list of possibilities - a view underscored by Nobel Prize winning economist, Michael Spence, in a recent comprehensive study of America's job challenge.[ii] There are grounds for encouragement that an adaptable U.S. economy may already be rising to the challenge. Merchandise exports have now risen to a record of nearly 10% of our GDP - up dramatically from the 6.5% share prevailing a decade ago (see Figure 2, "America's Opportunity: The Export Revival"). According to the Department of Commerce, U.S. exports supported fully 9.7 million American jobs in 2011 - up 1.2 million from 2009. In an era of unacceptably anemic job creation, that impetus to hiring stands is especially impressive.

Figure 2

America's Opportunity: The Export Revival



Top 10 Markets for U.S. Exports

	$ Value: 2011 (bil.)	5 Year growth*
1. Canada	280.9	2.4%
2. Mexico	197.5	3.7
3. China	103.9	15.6
4. Japan	66.2	0.4
5. U.K.	56.0	6.0
6. Germany	49.1	7.9
7. Korea	43.5	2.8
8. Brazil	42.9	15.3
9. Netherlands	42.8	6.9
10. Singapore	31.4	n/a

* Average annual export growth: 2005-09

Source: U.S. Department of Commerce, BEA

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The Obama Administration has set the ambitious goal to double U.S. exports in five years. But with trend export growth to our largest external markets - Canada and Mexico - hovering at close to 3% over the past five years and stagnation long evident in Japan and now likely in crisis-torn Europe, America's export-led growth agenda will need to turn to new markets.

China could well hold the key in meeting this challenge. It is now America's third largest and most rapidly growing export market. There can be no mistaking its potential to fill a growing portion of the void left by U.S. consumers. As such, Chinese domestic demand - not its currency - should be featured as a prominent element of America's new growth agenda. Yet congressional enactment of anti-China currency legislation could backfire in this regard - undoubtedly triggering retaliatory moves by China that would immediately choke off shipments to America's third largest export market. You in the Congress must be vigilant in guarding against this risk.

The key to realizing the opportunities of America's new export-led growth agenda lies in market access - specifically, access to China's future sources of economic growth. This is precisely the time to focus on this issue - as China's own growth imperatives shift away from exporting into weakened U.S. and European consumer

markets toward sourcing the demand for its own pro-consumption rebalancing. Unlike Japan, modern Asia's first growth miracle, China is far more likely to satisfy this incremental consumption growth from foreign production. Chinese imports have been running at 28% of GDP since 2002 - nearly three times Japan's 10% import ratio during its high-growth era (1960-1989). As a result, for a given increment of domestic demand, China is far more predisposed to draw on foreign production.

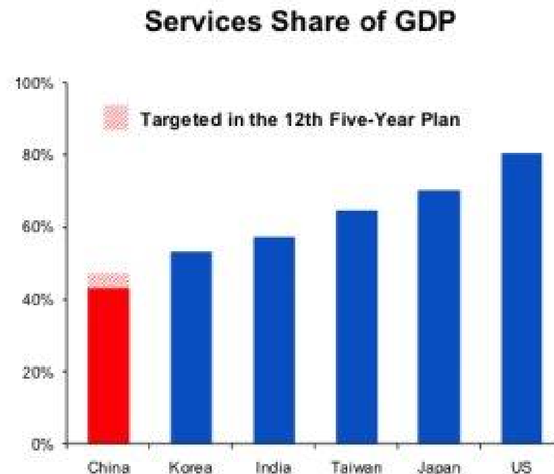
Exports have great potential to fill the void - especially those to China, America's third largest and most rapidly growing export market.

As the Chinese consumer emerges, demand for a wide variety of U.S.-made goods - ranging from new-generation information technology and biotech to automotive components and aircraft - could surge. And this plays very much to America's competitive strengths: Capital goods and motor vehicles products currently account for 42% of total U.S. goods exports - our largest export category. The key for U.S. trade negotiators is to make certain that leading American exporters have fair and open access to these new and potentially enormous Chinese markets.

A similar opportunity is available in services. At just 43% of GDP, China's services sector is relatively tiny when compared with other major economies in the world (see Figure 3, "The Potential in Chinese Services"). Services are, in many respects, the infrastructure of consumer demand, and the Chinese services share of its economy will only grow in the years ahead. By contrast, the United States is the world's quintessential services-based economy, with much in the way of process design, scale, and managerial expertise to offer China. There is enormous scope for America's global services companies to expand and partner in China, especially in transactions-intensive distribution sectors - wholesale and retail trade, domestic transportation, and supply-chain logistics, as well as in the processing segments of finance, health care, and data warehousing. The recent Strategic and Economic Dialogue made significant progress in opening up Chinese financial services to increased foreign investment. Attention now needs to be turned to nonfinancial services, as well.

Figure 3

The Potential in Chinese Services



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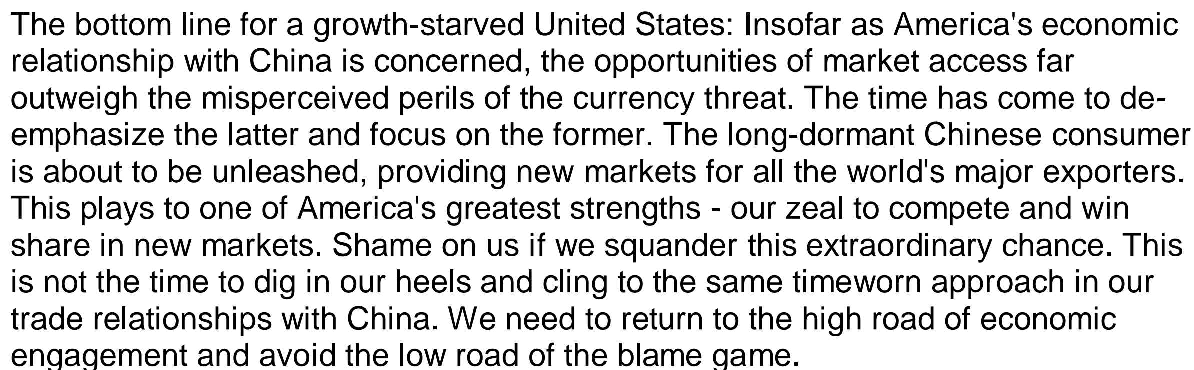
The U.S.-China trade agenda must be refocused toward expanded market access in these and other areas - pushing back when necessary against Chinese policies and government procurement practices that favor domestic production and indigenous innovation. Some movement has occurred, but more is needed - for example, getting China to sign the World Trade Organization's Government Procurement Agreement. At the same time, the U.S. should reconsider antiquated Cold War restrictions on Chinese purchases of high technology-intensive items.

The good news is that important progress was made on both of these counts at the just completed May 2012 Strategic and Economic Dialogue with China. As such, the focus must now shift to follow-through, implementation, and enforcement. Both of these breakthroughs have potentially important implications for the Chinese piece of America's export-led growth and employment agenda.

The United States needs to be forward looking in seizing the opportunities provided by an extraordinary consumer-led rebalancing of the Chinese economy in the years ahead.



The bottom line for a growth-starved United States: Insofar as America's economic relationship with China is concerned, the opportunities of market access far outweigh the misperceived perils of the currency threat. The time has come to de-emphasize the latter and focus on the former. The long-dormant Chinese consumer is about to be unleashed, providing new markets for all the world's major exporters. This plays to one of America's greatest strengths - our zeal to compete and win share in new markets. Shame on us if we squander this extraordinary chance. This is not the time to dig in our heels and cling to the same timeworn approach in our trade relationships with China. We need to return to the high road of economic engagement and avoid the low road of the blame game.

Accordingly, it is also time to rethink the basic thrust of our Economic and Strategic Dialogue with China - the subject of this important hearing today. Specifically, we need to recast this exchange as an integral pillar of America's new growth agenda. The emphasis should be placed on opportunities - not on hollow threats. With respect to China, my recommendations are simple: End the currency fixation. Focus on market access as the key to U.S. growth and jobs.

Thank you very much.

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[i] See the March 10, 2005 speech by then Fed governor, Ben Bernanke, "The Global Saving Glut and the U.S. Current Account Deficit."

[ii] See Michael Spence and Sandile Hlatshwayo, "The Evolving Structure of the American Economy and the Employment Challenge," a Council on Foreign Relations working paper, March 2011.

Stephen S. Roach, a member of the faculty at Yale University, was formerly Chairman of Morgan Stanley Asia, and is the author of The Next Asia*.*

* Our 8% holding in PRC-based vegetable grower, Chaoda Modern Agriculture, remains suspended by the Hong Kong stock exchange.

The companyøs auditors, BDO International, resigned last month and the company is trying to establish a new relationship with a new auditor. Quite frankly, even though the auditor said it had, õno matters í that need to be brought to the attention of holders of securities of the Company,ö yet its resignation, after being paid for the June 2011 year-end and the December 2011 interim accounts, but not producing the audited results, was a bit ridiculous to us. Chaoda stated: õit was very surprised and disappointed with the decision and the reasons of BDO to resign their position.ö (Maybe, õPeople Who Know, Know BDOö would go, as soon as they got their pay. Rather cheeky of them).

Unlike other instances of resignations by auditors in Hong Kong, Chaodaøs accountant insisted it had no dispute with Chaoda over any of the financial data or with any of the companyøs information. Importantly, Chaoda has no debt (it paid off all US$200mn in its outstanding convertible bonds) and, unlike fraudulent companies that have been uncovered in the recent past, no managers or directors of Chaoda have resigned the company.

We await further news of the companyøs appointing a new auditor.

*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.