November 11, 2014

Dear Clients, Partners, and Friends,

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

	Oct 2014	Year
Hong Kong Partners LP *	2.1 %	5.9%
Hang Seng Index **	4.6%	3.0%
Hang Seng Small Cap Index	1.7%	-4.8%

Partnersø NAV $3.02 after management fee, but before annual incentive fees of 15% on appreciation.

South Ocean Managementøs small/mid cap holdings of Hong Kong-listed companies doing business in China (a country that accounts for a quarter of global savings today) gained during a choppy month of trading. Uncertainty over the launch date of the stock-connect scheme (linking the Hong Kong and Shanghai stock exchanges), hopes of more reforms to state-owned enterprises (SOEs) and ongoing pro-democracy protests in Hong Kong added volatility to the market in October.

During the month, we added one name to our portfolios: TCL Communications (code 2618, US$1.2 billion market cap), a leading producer of low-end smartphones. TCLøs shares were tarred, along with all phone makers, after Samsung (in fierce competition with Apple) reduced prices in September for its high-end phones. In alliance with Europeøs Alcatel, the mainland company markets $50 (ASP) smartphones in Africa, an emerging cell phone market. It announced in the first 9 months of 2014, consolidated revenue of HK$19.996 billion (US$2.6 billion), up 69%. The company aims to produce 55million smartphones next year.

TCL has negligible debt on its balance sheet, a 4.4% dividend yield and the shares sell for just 6.4x estimated earnings.

We screen, using our proprietary, in-house software, to buy fundamentally strong companies whose shares sell at reasonable discounts to our calculated, long term intrinsic business values. Some thoughtful analysis on China below by Stephen Roach.

Sincerely,

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Hong Kong

China-US at critical turning point, says economist Stephen Roach

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Philip Baker
Stephen Roach, Yale professor and former chief economist of Morgan Stanley, believes the relationship between China and the US is at a critical turning point, and how it unfolds will be the decisive factor in shaping the global economy and financial markets over the next decade.

"I'm nervous about the relationship for one reason," he said in an interview with Financial Review Sunday on the Nine Network. "China's changing, America is not. In a personal relationship, when one partner in a co-dependant relationship goes its own ways, it's usually nasty for the one who's scorned and left behind. I worry more about America being unable to deal and cope with China's new-found sense of self and identity."

In the interview, Mr Roach covered a wide range of topics, including the outlook for China, how the US is setting itself up for another crisis, the sell-off in tech stocks, high-frequency trading, and why, since the mid-1990s, the US Federal Reserve has gone through a "reckless and irresponsible phase that will go down in history as possibly one of the darkest moments of independent central banking the modern world has seen".

He also wondered how countries in the G20 could achieve and agree on ambitious targets for global economic growth as they had done this year.

"I think these guys, you know, they need to have their heads examined," he said. "How do you hit it? I want to know more about what they're going to do to move the global economy back to its long-term trend. We've had the weakest recovery in the global economy in the post-World War II period. We have unacceptably high levels of unemployment across the developed world, especially for the youth and especially in Europe. How are we going to address it?

"It's one thing to say we want higher growth and the number is 3.8 or whatever the magic number is, it's easy to do that. Numbers are cheap, targets are cheap."

But it was the relationship between US and China that Mr Roach was keen to highlight, pointing out how much

its budget deficits, while China depends on the US as a source of demand for its exports that has led China down the road of creating its own economic imbalances.

Since the late 1970s, the two economies have been served well by these mutual benefits but they now risk losing their sense of self and could turn on each other in a destructive fashion.

‘Spectacular opportunities for investors’

“Both economies need to rebalance,” Mr Roach said. “China is doing it, America is not and that is going to be problematic in the years ahead.”

A way to fix the problem would be for the US to reduce its debt and save more and for China to grow its services sector, which it is.

The problems of China and US are the subject of a book Roach has just written. Titled *Unbalanced: The Codependency of America and China*, it goes into great detail about the changes both economies need to undertake.

As for all the talk of a shadow banking system and a lack of credit growth in China that could dramatically slow down the world’s second largest economy, Mr Roach is not concerned.

“The fears are exaggerated,” he said. “China is going through a critical, once-in-a-20-year transition to a different model of economic growth that will eventually be more balanced and more stable and more sustainable, but most importantly, a more slower-growth model.”

Mr Roach said that as the consumption share of the Chinese economy was set to go from 36 per cent of its gross domestic product to as high as 60 per cent, “China is about to unleash the biggest consumer story that the world has ever seen”.

“Investors need to think services. They need to think the Chinese consumer. The growth of the middle class and all of the ancillary characteristics of that from retail trade to wholesale trade, domestic transportation and hospitality and leisure, finance and the big one – healthcare. China has a rapidly ageing Chinese population rapidly in need of a broader array of healthcare choices. These are spectacular opportunities for investors, not today but over the next couple of years.”

He said that for the next 15 years there would be 20 million people a year moving from rural to urban cities that would keep commodities demand happening for Australians – but not, of course, at the same growth rates of the past decade.

Flash Boys ‘sensationalist journalism at its worst’

The outlook for the US is not so good.

“I think the US has been relying too much on monetary policy to accomplish much on a lot of objectives that the fiscal authorities have been unwilling or unable to take on,” Mr Roach said. “We can’t keep on running our economy on the back of easy money with zero interest rates and liquidity injections through quantitative easing.”

He warned that the US needed more than easy money to manage its economy.

“We need to get our act together on resource policy and fiscal policy so that we can spend … like infrastructure, human capital, manufacture capacity, it can only be supported with more savings in the United States. Central banks have done the heavy lifting but what have they gotten for it? We have the weakest recovery that the world has ever seen.”

Mr Roach dismissed the Fed’s strategy of pumping up the value of risky assets and trying to stimulate the economy through the wealth effect, pointing out that wealth effects are just for wealthy people. He thinks the real problem in America is middle-class structurally unemployed workers and their families, and that worsens an already seriously imbalanced income distribution in America.

“The wealth effect is the wrong way to go,” he said. “The Fed is not the instrument of economic recovery. We have this mistaken idea that the central bank can do everything. They can’t. This is not the central bank’s job, this is a job for the fiscal authorities. The less the Fed does the more pressure there is on the fiscal authorities

He also thinks the Fed has played a role in rigging the sharemarket. Taking a dig at the latest Michael Lewis book *Flash Boys*, which claims high-frequency trading has distorted the sharemarket, Mr Roach said that was "just sensationalist journalism at its worst".

'That's the thing that scares me the most'

To him, the force that has "rigged" the market, to use the Michael Lewis connotation, is the Fed, not flash traders.

"What Michael Lewis has done with this book is to fuel – again – the anti-Wall Street sentiment as being at the heart of America's problems. Wall Street certainly played a role in the crisis, but so did the Federal Reserve, so did the lack of regulatory oversight and so did the reckless behaviour on Main Street. The system is really guilty of egregious negligence here, this is not just Wall Street perpetuating crimes on humanity and society. And a book like *Flash Boys* makes it look more and more like Wall Street is the culprit here, and I think that's a gross distortion."

He worries that the Fed, through its aggressive focus on liquidity injections as the answer to all that ails America, is setting itself up for another reckless policy mistake – and this is not atypical of the central bank.

"We have an explodable [share]market in the context of the weakest economic recovery on record," Mr Roach said. "Over time, the economy and the markets converge, so one of two things has to happen. The markets were brilliant and the economy will now spring to life miraculously, or the markets will correct back down to the sluggish economy. I tend to favour the latter because I tend to think that the US economy still faces very stiff headwinds five years after the great financial crisis."

He also worries that markets these days are so connected, and globalisation has made such enormous progress – not just in financial systems, but in connecting real economies through trade flows, capital flows, information flows and cross-border labour flows – that the world in many respects is a smaller place even though it has grown dramatically since then.

"The complexity factor every year seems to get larger and larger and larger," he said. "And so when you have more complex instruments, more complex connectivity across markets and across instruments, you take gambles on policy like unconventional monetary easing in a complex environment, that's the thing that scares me the most."

Asked if overvalued tech stocks could be the catalyst for a big sell-off on Wall Street, Mr Roach said: "The technology sector is more substantial today than it was during that first phase of dotcom. It's run up a lot and there's still a lot of hot air and fumes underpinning the stories of sustainable growth we hear in technology."

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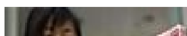

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**Index Descriptions: The Hang Seng Indexes are a widely recognized capitalization-weighted indexes that measures the performance of the three largest-capitalization sectors of the Hong Kong stock market in descending order. The Hang Seng Index measures 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.

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