June 17, 2016

Dear Clients, Partners, and Friends,

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

	May 2016	Year-to-date
Hong Kong Partners LP *	2.5%	-2.4%
Hang Seng Index **	-1.2%	-5.0%
Hang Seng Small Cap Index	-3.5%	-10.4%

Partners' NAV $2.9341 after management fee and provisions, but before annual incentive fees of 15% on appreciation.

Since we established South Ocean Management in 1992 in Hong Kong, our investment mandate has been and is to invest in the growth of China, focusing on well managed companies listed in Hong Kong. Our disciplined, intrinsic-value approach selects and invests in undervalued small/mid cap companies benefiting from operations in China.

Late last month, positive US housing starts kindled a short covering rally in Hong Kong's oversold blue chip index. Rumors of a pending Shenzhen/Hong Kong stock connect program and the possible inclusion of China A-shares in the MSCI Indexes brought further speculative buying, but transaction volumes remained subdued throughout the month. Our weighted average estimated 2016 P/E for our holdings stands at 6.8 times today with a 4.7% weighted dividend yield.

Some general observations below.

Sincerely,

Brook McConnell
President
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Hong Kong

Fresh macro-economic data from China slackened a bit from March's strong readings. Credit growth, for example, slowed, and the markets read that as a negative (rather than interpreting it as a deleveraging of too much credit growth, which has been one of the key concerns). Overall, the data reports showed a steady macro environment on the mainland.

Still, China stocks remain particularly unloved today. According to Goldman Sachs, money managers' concerns over capital outflows and worries about market positioning have hurt demand for Chinese stocks. Aggregate investor positioning in China offshore equities is extremely light. It is the largest underweight position in China relative to benchmarks in a decade, even after including exposure to Hong Kong, which many funds use as a way to own Chinese stocks. "Out of our sample of the largest 200 EM funds, around three-fourths of funds are either underweight China banks or don't own them at all, indicating positioning is extremely light on the sector," Goldman says.

Katie Koch, global head of client portfolio management at Goldman Sachs Asset Management, commented in like vein: "We see more upside in Japan, Europe and emerging markets," citing high valuations in the U.S.; "U.S. valuations are in their top decile of being the most expensive."
http://www.cnbc.com/2016/05/23/go-overweight-on-equities-but-watch-out-for-valuations-goldman-sachs-asset-management.html

Investors see China's economy as having a hard landing and the U.S. as strengthening. Yet those preconceptions could reverse. Should the American economy and dollar weaken, could China be viewed favorably by comparison? As the Chinese currency is primarily linked to the US$, there would be a 'quiet' devaluation of the Yuan with a declining US$, resulting in less trade friction issues.

China could easily re-rate with investors from the widespread pessimism held towards it today. There are two positive, contrarian buy signs:

1. International fund managers are underinvested in China equities, potentially missing a huge opportunity.

http://www.scmp.com/business/money/markets-investing/article/1936916/foreign-fund-managers-not-taking-full-advantage

> Bank of America Merrill Lynch, FMS Relative Positioning. The historic extreme investor sentiment toward emerging markets was highlighted in a recent Bank of America Merrill Lynch equity fund-manager survey. "...fund managers are more than 55% underweight EM equities relative to developed market equities."

2. Retail investors in Hong Kong are also sidelined:

http://www.scmp.com/business/markets/article/1936933/contrarian-buy-signal-hong-kongs-retail-investors-remain-wary-and

As we cited last month, US stocks are dear, China-related stocks are cheap. The CapShiller P/E valuation table below rates China as one of the highest return major global markets:

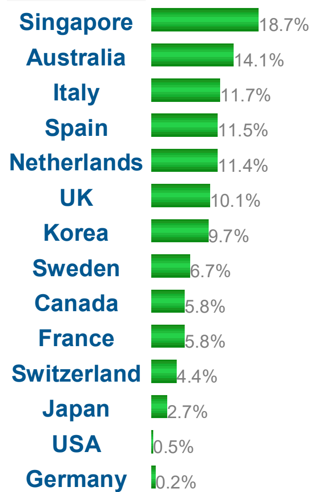
The implied future returns of the world’s 18 largest stock markets, sorted from the highest return to the lowest for developed markets and emerging markets.

Global Market Valuations

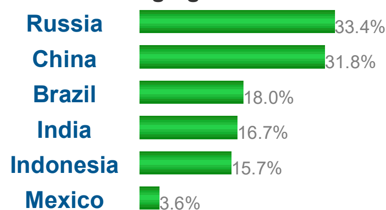
Global Overview

Ratio of GDP/Total Market CapShiller P/E Valuation

Projected Annual Return (%)



Emerging Market:



The Chinese economy is either reaping the whirlwind and falling into a deep slump, or continuing a 35-year megaboom — depending on who you ask. Morgan Stanley postulated; China’s growth story is, in terms of its scale and speed, probably the most impressive episode of economic development in human history. Can it really double down on that and move so quickly from its industrial revolution to a modern, services-driven economy? The potential entry of Chinese A-shares into MSCI's Emerging Markets (EM) Index and relative attractiveness of renminbi assets will be the larger drivers of medium-to-long-run inflows into China, Morgan Stanley added.

http://www.marketwatch.com/story/sell-gold-now-as-recent-rally-isnt-justified-says-goldman-sachs-2016-02-16/print

Investor caution and reticence today is a global phenomenon. I thought GE's Chairman's recent commencement speech well summed the explanations for this jaundiced attitude.

Brook McConnell

On May 20th, GE Chairman and CEO Jeff Immelt delivered the keynote at New York University's Stern Business School convocation. Here are excerpts from his message to the graduates.

We're in a volatile, global economy – the most uncertain I have ever seen. There is distrust of institutions. Protectionism is rising. Globalization is being attacked as never before. For those looking to succeed, the playbook from the past just won't cut it. It's time to pivot, be bold, and not fear criticism.

I built my career at GE in a time when productivity, innovation and globalization were the way to win. When I joined the company in 1982, 80 percent of our revenue came from the U.S. Now, 70 percent of our revenue will be global. We have customers in more than 180 countries. We export over $20 billion worth of goods to the world each year. We have become woven into the global economy.

You would think that companies like GE that give people good jobs, make good products, and contribute to their communities would be valued. That governments would try to nurture growth and address big problems like income inequality and unemployment. That global integration would be seen as a force of good and would continue to grow.

You would be wrong. Today, big companies are distrusted; governments and global institutions are failing to address the world's challenges; and globalization is being attacked as never before.

This is not just true for the U.S., but everywhere. These sentiments have traction in Europe and Latin America, on both the right and the left. The future of the EU is an open question. Protectionist barriers are rising in Asia and Africa. China is repositioning its economy to be more sustainable and inclusive.

The global economy is growing too slowly, and many people feel left behind. Some workers have been displaced by outsourcing, the middle class has been squeezed, and income inequality has risen to unacceptable levels. As technology and globalization race forward, people understandably fear their impact on jobs and incomes, and distrust the motives of companies and government.

There are many causes, and business bears some blame. Productivity has slowed to a crawl and capital investment is declining. Financing is more difficult to get, particularly for infrastructure projects. Investment is required for productivity, which in turn, supports higher wages.

Part of the fault also lies with technology. Innovation has driven growth but also leads to greater instability. The internet can connect people, but doesn't necessarily give them jobs.

Technology has raised the competitive requirements for companies and people. This exacerbates economic insecurity.

Finally, Government is also responsible. In the U.S., regulation has expanded while infrastructure has lagged. Our trade deals are languishing in Congress, and we remain the only developed country in the world without a functioning Export Bank. Our tax code is 30 years old; our immigration system is broken; and a huge structural deficit clouds the future. In the face of this headwind, we are having a raucous Presidential election where every candidate is a protectionist, and globalization is being blamed for unemployment and wage inequality.

Globalization is still essential to growth. But, the globalization I knew, based on trade and global integration, is changing, which is why it's time for a bold pivot. And in the face of a protectionist global environment, flexible thinking is required, and companies must navigate the world on their own. We must level the playing field, without government engagement. This requires dramatic transformation. This is how we will lead:

We will localize. In the future, sustainable growth will require a local capability inside a global footprint. At GE, we will always be a strong American manufacturer, but we also have built factories in China, India, South Africa, Nigeria, Hungary and elsewhere around the world. We are managing extended supply chains. We are not pursuing low wages; we are using a manufacturing strategy to open markets. We will produce for the U.S. in the U.S, but our exports may decline. At the same time, we will localize production in big, end-use markets like Saudi Arabia.

Our competitive advantage is digital productivity. When we digitize power plants and hospitals by connecting them to the Industrial Internet, we improve global productivity. In Pakistan, we are using analytics to improve energy efficiency and expanding capacity. In India, we can use the internet to deliver healthcare to remote regions. In China, engine analytics are improving airline productivity. Every industrial company must also be a digital leader. This is the next wave of competitiveness.

We accelerate growth by solving local problems. We can make the world work better when we innovate to solve problems with local capability. Our GE technologists around the world have come up with new ways to produce cleaner energy that's more accessible and to give remote communities access to healthcare. Solutions from the developing world improve outcomes in developed markets.

Financing is the new oxygen of global growth. Capital is the fuel for globalization of the future. We have positioned GE to capitalize on investment flows from new sources. China's "One Belt One Road" initiative is building new relationships in Central Asia, the Middle East and Africa. Most countries are increasing their export financing. We've learned how to invest in these countries, access those pools of capital to support export growth. This is critical as we cannot count on the U.S. EXIM Bank. Companies need to globalize on their own and control our destiny.

Winning requires simpler organizations. Change requires new business models that are leaner, faster, more decentralized. Complex and centralized bureaucracies are obsolete. GE

is pushing capability to local teams who are empowered to take risks without second guessing.

We tend to think of globalization as a philosophy, but it is much more about what you do on the ground. Success requires hundreds of little things, and decisions made with a local context. A good global leader has an appreciation for how people do their work in a local culture. They try to make a teams' work meaningful to their country. This allows us to hire the best talent in every country where we compete.

By taking these bold actions – by pivoting – I am confident we can continue to grow. One thing I know about globalization is that there will always be plenty of critics. Early in my career, I worried way too much about what people thought. Over time I realized that progress counts for more than perfection and that anything worthwhile takes persistence and resilience.

My shield consists of competency, hard work and fairness. I run a meritocracy with the highest standards. Discrimination has no place in business – in the U.S. or anywhere else in the world. Similarly, our factory teams know that, while we cannot guarantee markets, we can guarantee effort; we always play to win.

So be flexible, be bold, don't fear criticism. We are going through a transformational change in globalization, which will require fresh, new thinking. Our goal is to build an economic ecosystem that is the most competitive in the world. To create great jobs through private enterprise and ingenuity. To give back competency and innovation directed at solving the world's toughest problems. There is nothing elitist, or establishment, about this task. Only by being in the arena can you create work for others.

The discord we see in the U.S. today is primarily due to slow growth and the wealth discrepancy it creates. This problem will not be solved by any bureaucracy. It requires leaders who see the world as it is and are willing to drive change.

This story originally appeared on LinkedIn.

*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.