July 16, 2018

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:

	Jun 2018	Year-to-date
Hong Kong Partners LP*	-10.4%	-12.9%
Hang Seng Index **	-5.0%	-3.2%
Hang Seng Small Cap Index	-8.4%	1.5%
MSCI HK Small Cap Index	-8.3%	-13.3%

Partners' NAV $ 2.8134 after management fee and provisions, but before annual incentive fees of 15% on appreciation.

The month of June in the Hong Kong stock market reminded me of an experience years ago. We were motoring a 19-foot Boston Whaler on a clear day through the notorious Jupiter Inlet in Florida to fish in the Atlantic. The inlet was calm, but as we approached the sea, our skiff dropped suddenly and a mountainous wall of clear, blue/green-colored ocean water washed over us. Though we could just make out the calmer ocean waters ahead, we decided to head back to the safety of the inlet than risk another violent, surging wave.

The story of June was the US -Europe- Asia trade wars, instigated by the Trump Administration at the start of the month. Volatility increased and our holdings of Hong Kong-listed small/mid cap stocks with operations in China, knee-jerked lower as confidence fell sharply due to a weaker Yuan, rising US interest rates and fears of the escalating US-China trade war.

Our portfolios were doused in the wave of selling.

There was a disappointing development affecting our renewable energy holding last month as a surprise policy change in China shocked the market. The entire solar sector was adversely affected by this new regulation:

> *The National Development and Reform Committee (NDRC) issued a notice in early June that (1) capped distributed (solar) generation projects (20 GW last year) at 10 GW for 2018; (2) cancelled the 13.9 GW utility scale project target for 2018; (3) cut feed-in tariffs (FITs) by Rmb0.05/kWh across the board.*

The surprise announcement capping solar investments certainly wasn't because the skies over Beijing had abruptly cleared of heavy air pollution. China has been moving away from polluting fossil fuel usage towards renewable energy faster than any other country. There has been market talk of higher peak electricity use this summer, that will see

brownouts in sections of the country, and that even longer-term contracts for coal were being inaugurated by power producers to meet the demand. Though solar costs have plummeted, it is possible the massive Renewable Investment Fund run by the Chinese government has been overloaded and needs time to 'catch-up' with its commitments, partially explaining this unexpected, disappointing policy change.

Our long-term holding in leading low-cost PV glass and solar farm company, Xinyi Solar, will continue to be under pressure due to these regulations, as the solar sector in China consolidates and inefficient producers are winnowed out. Though we had taken profits earlier in the quarter in one other related solar holding (Xinyi Glass), we decided to exit this once promising high growth company at a loss on the news.

Our investment program seeks to own stocks selling below their intrinsic values based on 5-10-year growth expectations. Importantly, the system demands a maximum price to pay for that growth (and not *way-over* pay). For example, one highly touted stock, which sold at HK$23 last August, had as many as 11 analyst buy recommendations, as recently as last April. Yet, our proprietary Banquet System had a maximum buy limit below HK$2 a share on the stock.

Then, in May, the company issued a profit warning and the shares sank sharply to $7:

Price targets by analysts for this once highly favored, high flyer have fallen to $3.

Though we may not be invested in many of the 'flavors of the day', our disciplined system also keeps us from getting clobbered by overly-optimistic themes of the day too.

Our screen typically identifies out of favor sectors and stocks to own. Sometimes, these names are not always in the limelight of investors' attention. Since we benchmark our results against the main indexes in Hong Kong, it is useful to understand the 'make-up' of these indexes and how they work.

Through what is known as the 'Stock Connect Program,' mainland Chinese investors may invest in Hong Kong-listed shares, but only those stocks that are constituents in the main Hang Seng Indexes. Foreign investors, conversely, may buy mainland stocks through the program but just those listed in the mainland indexes.

The China Nasdaq-like market, the Chinext Index, is a gauge of smaller, high growth listings with a total market cap of US$154 billion. The trailing price earnings ratio of that Shenzhen index stands at 34.8 times. The Hang Seng Small Cap Index of Hong Kong, a US$200 billion market cap index, sells at 10.8 trailing earnings.

China growth stocks are not cheap and we do not own any mainland-listed holdings.

There are two Hong Kong small cap indexes (the Hang Seng Small Cap Index and the MSCI HK Small Cap Index). These two indexes have diverged in results due the stock connect program. Not all of the MSCI small cap constituent stocks are included in the stock connect program and don't receive the mainland investment inflows.

Both these Hong Kong indexes are heavily weighted in the financial/real estate sectors (the MSCI has a 31% weighting and the Hang Seng Small Cap Index has a 37% weighting in these interest rate-sensitive sectors). We own no holdings in these sectors. Also, our results further diverge as we only own 2 stocks listed in the small cap index, 4 stocks in the Hang Seng mid cap index and just one holding in the large cap index (out of 19 total holdings). ETF and passive investment programs do not participate in stocks outside the main indexes either.

Most global bourses in June were affected by the trade war concerns. Specific problems in the emerging markets of Argentina and Turkey sent ETF holders redeeming in record amounts, which heavily affected Asian markets.

The indiscriminate sell-off came as Asian exports are booming, the global economy still grows fast and to where stock values have now declined to attractive levels. China's stock market declined 13-14% in the first half. The Shanghai bourse of 1,470 companies today is valued at 13.1 times earnings, almost matching the lowest level touched in the aftermath of a 2015 rout that erased US$5 trillion in market value. Mainland-traded companies, by the first week of July, had proposed 103 buy-back plans worth 36 billion yuan (US$5.43 billion), an amount more than the annual volume for any one year in history, according to Guosen Securities. The oversold large cap Hang Seng Index sells at 11.2 times trailing earnings today and the Hong Kong small cap index sells at 10.8 times. That's 1/3rd less than US valuations.

When asked if we bought into the dip in June, our reply was no, we are sitting in calmer waters to let things clear, perhaps for as long as over the summer. But, after this year's rout in the China markets, these are certainly good waters to start fishing for bargains (I seem to recall it was even rougher that day in the Jupiter Inlet than in this incident).

We note several articles below that are relevant to concerns today regarding the Yuan depreciation and China/US trade wars.

Our core holdings are companies which are leaders in their respective fields, that deliver what China is in need of, such as water management, electricity/energy and consumer items/services for its growing middle class. We are confident in our fundamentally strong holdings, even with our cautious near-term stance.

Sincerely,

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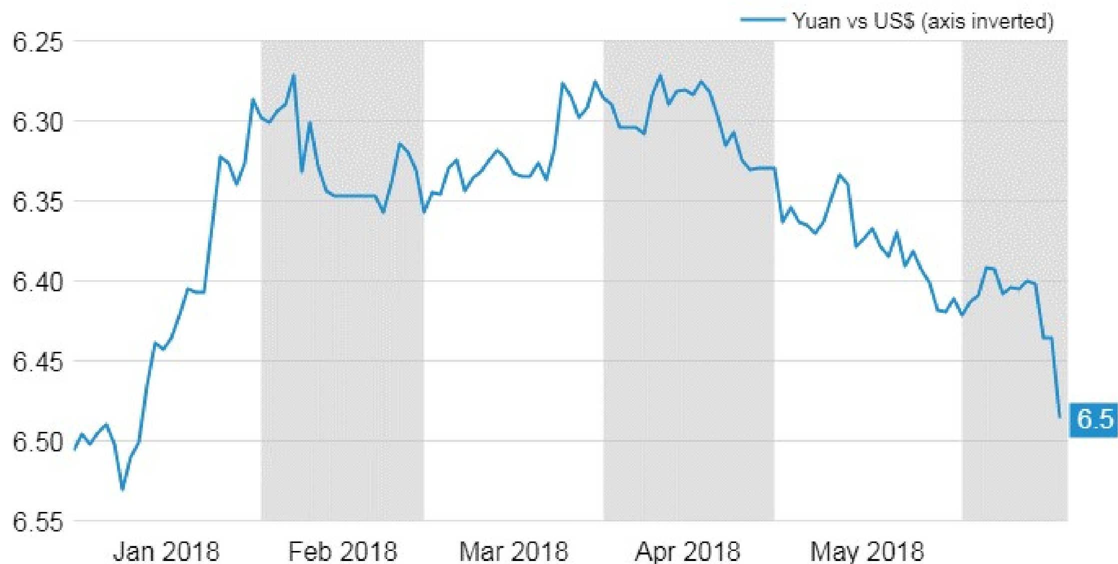
Much handwringing about a Chinese RMB devaluation has many New York floor traders concerned.

Long-time friend, Chief Asia Pacific Strategist for Goldman Sachs, Tim Moe, commented recently on CNBC New York that the market's fear of an imminent devaluation of the Chinese Yuan are likely overblown and explains why in the short video;

> *Timothy Moe, Goldman Sachs co-head of Asia macro research and chief Asia Pacific equity strategist, discusses how trade tensions between the U.S. and China are affecting stock markets and the Chinese yuan currency.*

https://www.cnbc.com/video/2018/06/28/china-wont-back-down-on-trade-tensions-says-strategist.html

Yuan concerns perhaps overdone as it's actually well behaved;



As for the yuan, there is some concern it is being pushed down for trade war purposes. The idea doesn't stack up. Nearly every emerging-market currency is declining. And Bank for International Settlements data suggests the yuan had overheated against its peers, so this cooling realigns it with neighbours. The People's Bank of China has rebuilt hard currency reserves to $3.1 trillion: plenty of firepower to hold off a sharper crash.

These resets do, however, coincide with rising tensions between Beijing and Washington, and slowing growth thanks to the crackdown on financial risk. In 2015, officials threw government money at shares, closed down derivatives and arrested "malicious shorters." A return to such ham-fisted measures could derail deleveraging efforts. And for good reason, it also would scare off foreign investors.
https://www.reuters.com/article/us-china-market-breakingviews/breakingviews-chinese-markets-have-much-to-fear-from-fear-itself-idUSKBN1JU0XE

Why China is unlikely to start a currency war amid escalating trade tension

PUBLISHED : Friday, 06 July, 2018, 6:15pm
Xie Yu and Zhou Xin yu.xie@scmp.com
Beijing will not use a sharply devalued yuan as a weapon to gain an upper hand in its trade war with the US, as it will do more bad than good to China's economy and hurt its image as an upholder of free trade, according to analysts.
https://www.scmp.com/business/banking-finance/article/2154137/why-china-unlikely-start-currency-war-amid-escalating-trade

Renminbi's worst month ever sparks US-China currency war fears

By Gabriel Wildau and James Kynge ,F.T.

China's currency suffered its largest ever monthly fall against the US dollar in June, sparking concern that Beijing is prepared to use currency devaluation as a weapon in an escalating trade war with the US.

From 2005 to mid-2014, China systematically intervened in its currency markets to weaken the value of the renminbi, sparking accusations that Beijing was seeking an unfair competitive advantage for its exporters.

US president Donald Trump revived those accusations during his 2016 campaign, despite the fact that China had already switched to a policy of supporting the renminbi to prevent capital flight.

But the renminbi weakened by 3.3 per cent against the dollar in June, the worst single-month decline since China established its foreign exchange market in 1994. Analysts say that so far the move looks more like market forces than an act of currency war. Still, they warn that continued weakness could further inflame trade tensions.

"In the context of rising trade and economic frictions between the two countries, exchange-rate movements take on greater symbolic significance than in normal times," said Eswar Prasad, economics professor at Cornell University and former head of the International Monetary Fund's China division.

"*The renminbi's depreciation relative to the dollar could serve as a Rorschach test. It could either be seen as a sign of a more market-determined exchange rate or as an attempt by Beijing to send a message to Washington about another tool in its trade war arsenal*."

The renminbi had been an island of strength earlier this year, even as the dollar strengthened against the euro and many emerging market currencies. The recent declines are partly a catch-up effect, analysts say.

In late 2015, China's central bank announced it would begin targeting renminbi stability against a broad basket of global currencies, shifting away from a narrow peg to the dollar. That policy implies the renminbi should weaken alongside other currencies in periods of broad dollar strength. *"For now, it's relatively easy to explain the renminbi's move in the context of China's efforts to manage its currency against a basket,"* said Brad Setser, former deputy assistant US treasury secretary for international economics and senior fellow at the Council on Foreign Relations.

"But if it starts to look like a conscious effort to depreciate significantly to offset the impact of tariffs, there's a much greater chance it will attract attention."

The renminbi's 1.9 per cent fall last week was its second-biggest weekly decline, trailing only mid-August 2015, when the People's Bank of China shocked global markets by announcing a sudden policy change that unleased a 2.8 per cent depreciation in a single week.

But market reaction to recent renminbi weakness has been more subdued, even though — as in 2015 — renminbi declines have coincided with a sell-off in the mainland stock market. The Shanghai Composite Index fell 8 per cent in June amid signs of an economic slowdown in China.

Bo Zhuang, chief China economist at TS Lombard, a research group, said that Beijing was probably allowing a tactical depreciation to send a signal to Washington but that a deep devaluation would be counterproductive for China. *"Many market participants speculate . . . that China may have weaponised the renminbi, opting for a devaluation to offset the impact of US tariffs. We disagree, though policymakers are now considering devaluation as an option,"* said Mr Bo.

The PBoC burnt through roughly $1tn in foreign exchange reserves in 2015-16 in order to fight market expectations of depreciation. Reviving those expectations now would carry big risks, Mr Bo cautioned.
"Any benefit from a major renminbi devaluation would be far outweighed by the negative consequences: accelerated capital flight, domestic liquidity tightening and the possibility of increased credit stress," he said.

Trade War Concerns

China, Korea, Taiwan, India, and Russia, each in its own way presents political or economic risks—that's what makes them emerging markets. How much of that risk is unknown to the market? How much is fully priced into these nations' valuations? According to our analysis, none presents any measurable risk of a funding crisis. All have low external-debt-to-GDP ratios and ample FX reserves, and most run current account surpluses. (India runs an immaterial current account deficit.) Together, these large, low-crisis-risk markets compose about 60% of the MSCI Emerging Markets Index.
Beyond the US$50 billion worth of imports, the US also began studying US$200 billion more in Chinese goods for an additional 10 per cent tariff after China retaliated. Trump has also threatened another US$200 billion if China's countermoves continue.

In theory, China cannot keep matching the scale of the American tariffs. Last year, China imported about US$130 billion worth of goods from the US but exported US$500 billion worth.
https://www.scmp.com/news/china/diplomacy-defence/article/2154014/us-china-trade-war-begins-beijing-strikes-back-tariffs

Lastly, we thought the following article presented a balanced viewpoint on China/US trade issues.

Why China 'holds all the aces' in a full-blown US-China trade war
https://cnb.cx/2JRXbNr

The Trump administration announced on Friday it will impose a 25 percent tariff on up to $50 billion in Chinese goods in an effort to protect U.S. intellectual property and technology.
China in retaliation said it will introduce taxation measures of the same scale and strength.
The objective is to reduce the size of the U.S.--China trade deficit from an estimated $370 billion to $200 billion by 2020.
The administration says these alleged IP appropriations along with corporate espionage have cost the U.S. economy between $225 to $600 billion a year.
While this may hurt China in the short-term, it has other markets to sell to in Asia and elsewhere.
Teresa Barger, co-founder and CEO of emerging markets activist fund Cartica Management

Published 11:52 AM ET Fri, 15 June 2018 Updated 1:09 PM ET Fri, 15 June 2018
CNBC.com

White House implements new China tariffs 12:15 PM ET Fri, 15 June 2018 | 03:06

On Friday the Trump administration announced it will impose a 25 percent tariff on up to $50 billion in Chinese goods in an effort to protect U.S. intellectual property and technology. The decision brought an immediate backlash from Beijing. China in retaliation said it will introduce taxation measures of the same scale and strength. As the world's two superpowers inch closer to a trade war, market experts are asking: Is this a game the United States can win?

I suspect the real answer is twofold: In part, the president wants to be seen as reversing the loss of jobs and intellectual property to China between 2001 and, say, 2010. But since that horse has left the barn, he needs some other animals to round up.

His stated objective is to reduce the size of the U.S–China trade deficit from an estimated $370 billion to $200 billion by 2020.

Fred Dufour | AFP | Getty Images

China's President Xi Jinping (L) and US President Donald Trump. As the world's two superpowers inch closer to a trade war, market experts are asking if this is a game the United States can win.

There are two obvious ways to play this: (1) China could buy more U.S. goods and services, and/or (2) America could buy fewer Chinese goods and services. Both come with drawbacks for the U.S. economy and the American people. It is hard for U.S. companies to ramp up to export more to China when they are operating at full capacity and have close to no unemployment.

But before evaluating the policy prescriptions for this problem, we must first consider the starting point, which is flawed. The current $370 billion deficit estimate does not account for value-added. When looking at the value-added content of Chinese exports, the U.S. deficit with China is actually only half of what it seems. And if we then add back the U.S. surplus in "invisibles" and how much money the United States brings back from investments in China, the U.S.–China deficit shrinks from 2 percent of U.S. GDP to 0.8 percent, a report from Oxford Economics revealed.

More from Global Investing Hot Spots:

China determined to steal A.I. crown from US

Trade war with US could be a tipping point for China

In the case of the Apple iPhone, this means that China's exports balance accounts for the full $500 iPhone value, when China adds only approximately $15 to $30 of the value to the phone. Most of the iPhone value accretes to Samsung in Korea ($150) and to Apple — the brand owner and engineer. This highlights how the normal accounting of trade flows is inherently distorted under the current trade-deficit estimates. So maybe the deck has only 25 not 52 cards.

The iPhone example also points to an area of weakness in the president's policy prescription: If the United States introduces tariffs on China's high-tech goods, U.S. companies and consumers could indirectly end up footing part of the bill. This is because the high-tech industries that Trump's tariffs are focused on is where Chinese value-added has the lowest share. If Trump were really interested in impacting the true trade imbalance and not just the misleading headline estimate, he would introduce tariffs on those sectors where China's value-added is highest. This would include sectors like textiles, where 75 percent of value-added is really "made in China."

This brings us back to the president's other objective, which is to gain political credit by addressing historical areas of imbalance in the U.S.–China trade relationship. A key area of focus here is China's appropriation of the intellectual property (IP) of American businesses. This comes from three activities: corporate espionage, cybertheft and technology in exchange for market access.

The latter results from a longstanding Chinese policy that requires any foreign company wishing to do business in China to first form a joint venture with a Chinese firm. A common complaint about these joint ventures is that they open the door for Chinese companies potentially to steal trade secrets and then use that IP to build and grow Chinese industries in everything from cars and phones to medicine.

The U.S. government estimates that these alleged IP appropriations, along with direct corporate espionage, which go back as far as the 1990s, have cost the U.S. economy a lot, somewhere between $225 billion to $600 billion a year. China indeed appears to have been the better poker player.

While these are valid concerns that should be addressed, it's too little too late. The truth is, China no longer needs these joint-venture rules in many industries, with several sectors and companies already competitive with their counterparts in the United States. In fact, in April 2018 China agreed to ease its rules on foreign auto companies operating in China, a clear signal that the quality of Chinese cars, including autonomous and electric vehicles, is rapidly increasing. It also just announced that foreigners would no longer need specific permissions to invest; they would just be prohibited from investing in a "negative list" of industries.

What is China trying to accomplish?

For China a trade war with the United States is likely to be more like the loss of a five-of-spades than the queen-of-hearts. China exports more than $2 trillion of goods a year, only about $400 to $500 billion of which goes to the United States. (On a value-added basis, only two-thirds of that is "made in China".) While the United States is indeed China's biggest trading partner, China has plenty of other markets to sell to, including the increasingly wealthy regions of Southeast Asia and India.

China also has made significant inroads into Latin America and Africa via its funding of major government-sponsored and private infrastructure projects, an investment that could pay significant dividends down the road, since these potential consumers would already be familiar with many Chinese brands.
"China exports more than $2 trillion of goods a year, only about $400 to $500 billion of which goes to the United States."
President Xi Jinping has a longer-term vision for China 2025, which includes a blueprint for moving China up the value chain and increasing the domestic content of core materials in Chinese products. The goal is to lead the world in advanced technologies, like artificial intelligence, autonomous vehicles, electric cars, green technologies and biotechnology.
The early results show this plan is paying off and China is already emerging as a global leader in AI, renewable energy and electric vehicles, among other sectors. This technological advancement is tied to the recent trade talks in that China is increasingly incentivized to protect its own IP rather than trying to steal foreign IP. We are reaching the critical crossover point in China where the return on IP theft is falling toward zero and the return on IP protection may soon rise above zero.
The reality is that many of the Trump administration's articulated demands are things that China is already doing, albeit at a somewhat slower pace. The United States wants China to buy more American goods and services — and so does China. Trump wants to impose stiff tariffs to prevent China from flooding the American market with increasingly less expensive technological products, like smartphones, computers and related accessories, which collectively comprise China's biggest exports to the United States. And China agrees — they want to export higher value-added goods, especially those with a high innovation content. Interests are much more aligned than either country wants to admit.
The Chinese government believes the problem they are trying to solve is how to be a vibrant economy over the next 20-plus years and to be the global leader in dynamic industries with technology self-sufficiency.
On the other hand, the United States has not acted as if the problem they are trying to solve is how to create a dynamic economy based on innovation that keeps the United States vibrant over the next 20 or 30 years. It looks a bit more like the United States is trying to improve domestic polling numbers before the midterm elections in November 2018.
Above all else, the Trump–Xi trade shenanigans seem to underscore the different agendas at play here: one oriented toward political posturing and "winning" against a dubious scorecard, and the other focused on economic realities and a long-term development strategy. While the United States will undoubtedly declare victory, China seems to hold all the aces.

—By Teresa Barger, co-founder and CEO of emerging markets activist fund Cartica Management

*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.