March 21, 2019

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:

	Feb 2019	Year-to-date
Hong Kong Partners LP *	1.2 %	6.0%
Hang Seng Index **	2.5%	10.8%
Hang Seng Small Cap Index	4.6%	12.5%
MSCI HK Small Cap Index	4.6%	11.0%
HS Mid Cap Index	5.6%	14.7%

Partners' NAV $2.5889 after management fee and provisions, but before annual incentive fees of 15% on appreciation.

Hong Kong shares climbed the last week of February after President Trump delayed tariffs on Chinese imports. One of our mid-cap holdings, smartphone casing manufacturer, Tongda Holdings (code 698hk, market cap HK$5.6 billion, US$717 billion) was volatile in February and held back overall portfolio results of our small/mid cap, Hong Kong-listed holdings for the month.

China is the world's largest manufacturer and consumer of smartphones. 2018's smartphone shipments in China were down a surprising 15-17%. In point of fact, Apple CEO Tim Cook announced in January a 5 per cent fall in fourth quarter revenue, attributed in large part to weaker demand for new iPhones in China. (However, Apple Inc.'s falloff in demand for iPhones in China shows the company's leading product is hurt more by its high price in the world's biggest hand phone market. For perspective, the average monthly white-collar salary in China was 7,850 yuan (US$1,140) in the third quarter of 2018. Most new iPhones would cost office workers more than a month's work!).

We continue to hold the shares of Tongda as the company recently presented a positive outlook for this year, having completed development on new base station antennas, 5G enabled antennas for autos and an expanding

collaboration with its largest client, Samsung. The shares sell at just 5.8 times 2019's estimates.

Last year, the Shanghai Composite was the world's worst performing index, but has climbed 18 per cent so far in 2019, making it the world's best performing major benchmark. This year's turnabout emanated as China introduced policy supports for the economy, an improved outlook for the yuan after its 8% decline in 2018 and an upbeat mood on the *China-US trade talks*. *SCMP Mar 2, 2019.*

China recently introduced tax cuts with the aim to further stimulate its economy to grow by 6+% in 2019 (which, in absolute terms, is an additional net growth in excess of Australia's entire GDP). That growth potential stands in contrast to the US's potential, with the latter's aging capital stock, low savings and need for improved infrastructure (see two points on this below).

Economists have assessed that Washington's tariff war against its trading partners, particularly China, has produced a cost to American companies and consumers of US$4.4 billion a month last year.

President Trump and Xi will meet soon to hopefully conclude an end to the conflict.

Sincerely,

Brook McConnell
President
Email: *brook@south-ocean.com* Website: *www.south-ocean.com* Hong Kong

I have always wondered how they've managed this bridge construction:

Photo taken from the SCMP

A section lifted into place…at 11km (6.8 miles) long, the Hutong Yangtze River Bridge will be the longest cable-stayed main span in the world, with the tallest pylons at 325 meters (1,066 feet) high. It will carry four railway lines and a six-lane expressway, cutting travel time between the two cities to an hour.

On a smoggy day in Nantong, an industrial town bordering Shanghai, workers are building the world's longest railroad steel arch bridge, part of a multibillion-dollar investment to form a new economic zone around China's financial hub.

The Bridge will measure 11,072 metres (38,393 feet) in length – ***four times that of the Golden Gate Bridge in San Francisco*** *– and is expected to be completed this year. While Nantong, 150km (93 miles) north of Shanghai in the eastern Jiangsu province, may not be the most well-known city in China, it is betting on an ambitious infrastructure spending programme spanning the next few years to help transform its sleepy economy.*

The construction of the double-deck bridge… is estimated to cost more than 36 billion yuan (US$5.34 billion)… "These are amazing assets and the engineering is astounding, it does improve the quality of life, among other things," said Dr Atif

Ansar, a lecturer at Oxford University's Saïd Business School, who led a team of researchers to examine the economic benefits based on a sample of 95 road and rail infrastructure projects in China between 1984 and 2008. *SCMP Mar 2, 2019*

Stephen Roach

How US trade negotiators are misreading China while ignoring America's dangerously low savings rate

China's recent economic slowdown is less a result of the trade war than its domestic deleveraging campaign, which can be adjusted as needed.

Meanwhile, US economic strength is likely to be short-lived as the effect of its tax cuts fades.

Stephen Roach

Updated: Tuesday, 26 Feb, 2019 1:41pm

US President Donald Trump's administration has underestimated China's resilience and strategic resolve. With the Chinese economy slowing, the US believes that China is hurting and desperate for an end to the trade war.

But with ample policy space to address the current slowdown, China's leadership has no need to abandon its longer-term strategy. While a cosmetic deal focused on bilateral trade appears to be in the offing, the sharp contrast between the two economies' fundamental underpinnings points to a very different verdict regarding who has the upper hand.

Yes, the Chinese economy has weakened significantly in the past few months. But, contrary to US perceptions that this is due to its successful tariff strategy, China's downturn has been largely self-inflicted.

It was initially brought on by a deleveraging campaign aimed at neutralising the mounting risks of debt-intensive economic growth.

To their credit, Chinese policymakers have moved aggressively to avoid the dreaded Japan syndrome - not just a debt overhang, but also a profusion of zombie companies and related productivity challenges. Largely as a result of this effort, credit growth has moderated from around 16 per cent at the start of 2016 to about 10.5 per cent in late 2018.

This has had marked repercussions for China's once-powerful investment engine, the largest component of the economy, which has slowed from 20 per cent growth in late 2013 to about 6 per cent in late 2018.

Meanwhile, the effects of US tariffs are only just starting to bite. While exports to the US fell by about 3 per cent year on year in December 2018 and January 2019, shipments to the rest of the world have continued to expand, owing largely to resilience in emerging markets, especially Asia.

To the extent that exports may have been front-loaded ahead of both the Lunar New Year holiday and potential further increases in US tariffs, some fallback can be expected. While that could temper near-term prospects, it is hard to pin the slowdown of the past few months on exports.

To hedge its risks, China has been quick to exploit its intrinsic advantage: much greater policy flexibility than Western economies, which have largely hit their limits on fiscal and monetary stimulus.
Cutting reserve requirements five times in the past year has led to higher bank lending and a pick-up in credit growth in early 2019, which should support an improvement in overall economic activity by mid-year.

For China, tax cuts may work where a massive stimulus failed.

By contrast, the US economy is more of a short-term momentum story. Thanks to the outsize tax cuts of late 2017, economic growth picked up to about 3 per cent in 2018, nearly one percentage point faster than the anaemic 2.2 per cent pace of the prior eight years.

But with fiscal stimulus fading, GDP growth should follow suit - consistent with the Congressional Budget Office's latest projection of just a 2.3 per cent rise in 2019.

Risks of an even weaker outcome are mounting. The rebound in US equity prices in early 2019 has not offset the sharp decline in late 2018, which took a heavy toll on household wealth and consumer confidence, prompting an outsize decline in retail sales in December.

With jobless claims starting to inch higher, the housing sector already weak, the global economy on increasingly shaky ground, and the Federal Reserve having limited ammunition, the US economy's resilience looks increasingly tenuous.

The likelihood of contrasting economic growth trajectories - a policy-induced improvement in China and a policy-constrained slowdown in the US - reinforces a more serious mismatch of longer-term fundamentals. China's domestic saving rate in 2018, at 45 per cent of GDP, was nearly 2½ times the US rate of 18.7 per cent. Although China's saving rate has fallen from its 2008 peak of 52 per cent, it still has a cushion that the US would die for.

Moreover, 85 per cent of America's gross saving goes towards replacement of obsolete and worn-out capital stock. Adjusting for depreciation, the US had a net national saving rate of just 3 per cent in 2018 - less than half the 6.3 per cent average in the final three decades of the 20th century and even further below the net saving position of China, where the capital stock is considerably newer and in less need of replacement.

These saving disparities underscore a critical difference in the investment underpinnings of both economies' growth potential. China's investment was 44 per cent of its GDP in 2018, more than double the 21 per cent share in the US.

And, given America's ageing capital stock, the disparity between the capacity-enhancing net investment positions of the two economies is even wider. That underscores China's relative advantage in funding its longer-term growth imperatives such as urbanisation, investment in infrastructure, human capital, and research and development, and the shift to indigenous innovation.

Moreover, the saving gap between America and China is likely to widen further in the years ahead, as seemingly chronic US budget deficits push

domestic saving even lower. A further complication is that in funding its limited investment potential, the US will require equally chronic current-account deficits to augment depressed domestic saving.

And, of course, with the current-account deficit comes an outsize multilateral trade deficit, underscoring the weakest link of the pending trade deal: reliance on a bilateral Chinese fix for a far more insidious deficit problem with over 100 trading partners.

In the end, economic strength is relative. The US economy's current strength appears fleeting. Its short-term resilience is already faltering and, in view of worrisome long-term fundamentals, may fade further.

China is in the opposite position: today's short-term weakness should run its course by mid-year, against a backdrop of relatively solid longer-term fundamentals. This reality will come as a rude awakening to US negotiators, who are misreading China's strength and the hollow benefits of a cosmetic trade deal.

Stephen S. Roach, a faculty member at Yale University and former Chairman of Morgan Stanley Asia, is the author of Unbalanced: The Codependency of America and China.
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- 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.
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