SOUTH OCEAN MANAGEMENT, LTD.
HONG KONG
南海管理有限公司

May 10, 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:

	Apr 2019	Year-to-date
Hong Kong Partners LP *	0.1 %	7.0%
Hang Seng Index**	2.2%	14.9%
Hang Seng Small Cap Index	-0.4%	11.7%
MSCI HK Small Cap Index	0.1%	11.3 %
HS Mid Cap Index	-0.3%	16.2%

Partners' NAV $2.6124 after management fee and provisions, but before annual incentive fees of 15% on appreciation.

The Hong Kong stock market consolidated in April. We made few changes in our portfolios of small/mid capitalized holdings of Hong Kong-listed companies with operations directed at China.

We find it puzzling and confounding to listen to today's media comments back and forth about China and the trade negotiations currently being hammered out with the US. 'Punishing' China is a lose-lose situation as manufacturing jobs in China won't ever be coming back to the US, even with 25% tariffs. This has been the supposed argument from the Trump administration for the restrictive tariffs.

This writer, though, suspects the issues behind the scenes revolves more around China's escalating dominance in new fields of technology… in areas such as artificial intelligence, quantum computing, medical advances, telecommunication's lower costs and efficiencies, and perhaps importantly, military applications.

We believe the issues will be resolved and an all-out trade war will not be lasting. It's in nobody's interest to halt trade. The Oracle of Omaha commented that the increase in tariffs on China are "rational," and is a high stake, "dangerous game."

> "If we actually have a trade war, it would be bad for the whole world, and could be very bad, depending on the extent of the war," Warren Buffett said, but added: "There are times in negotiations when you talk tough."

Prevailing misunderstandings by the West with China have been evident ever since we began investing through Hong Kong in the progress of China in the early 1990s. The perplexing misinterpretations are summed well in an article by long-time China observer and former Morgan Stanley Asset Management executive, Stephen Roach, below.

We screen for out of favor, fundamentally strong companies to own using our proprietary Banquet intrinsic value system. Our weighted average price-to-earnings ratio is at a cheap 6.6 times this year's estimates.

Sincerely,

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

America's False Narrative on China

Apr 26, 2019 **STEPHEN S. ROACH**

Washington has been loose with facts, analysis, and conclusions about China, and the American public has been far too gullible in its acceptance of this false narrative. The point is not to deny China's role in promoting economic tensions, but to stress the need for objectivity and honesty in assigning blame – especially with so much at stake in the current conflict.

NEW HAVEN – In a rare moment of bipartisan agreement, America's Republicans and Democrats are now on the same page on one key issue: Blaming China for all that ails the United States. China bashing has never had broader appeal.

This fixation on China as an existential threat to the cherished American Dream is having serious consequences. It has led to tit-for-tat tariffs, escalating security threats, warnings of a new cold war, and even whispers of a military clash between the rising power and the incumbent global hegemon.

With a trade deal apparently imminent, it's tempting to conclude that all this will pass. That may be wishful thinking. Sino-American trust is now in tatters. The likelihood of a superficial deal won't change that. A new era of mutual suspicion, tension, and conflict is a very real possibility.

But what if the US chattering class has it all wrong and the China bashing is more an outgrowth of domestic problems than a response to a genuine external threat? In fact, there are strong grounds to believe that an insecure US – afflicted with macroeconomic imbalances of its own making and fearful of the consequences of its own retreat from global leadership – has embraced a false narrative on China.

Consider trade. In 2018, the US had a $419 billion merchandise trade deficit with China, fully 48% of the massive overall trade gap of $879 billion. This is the lightening rod in the debate, the culprit behind what US President Donald Trump calls the "carnage" of job losses and wage pressures.

But what Trump – and most other US politicians – won't admit is that the US ran trade deficits with 102 countries in 2018. This reflects a profound shortfall of domestic saving, owing in large part to the reckless budget deficits approved by none other than Congress and the president. Nor is there any recognition of supply-chain distortions – arising from inputs made in other countries but assembled and shipped from China – that are estimated to overstate the US-China trade imbalance by as much as 35-40%. Never mind basic macroeconomics and new efficiencies from global production platforms that benefit US consumers. Apparently, it is much easier to vilify China as the major obstacle to making America great again.

Leaving aside the ridiculously broad range of such an estimate, the figures rest on flimsy evidence derived from dubious "proxy modeling" that attempts to value stolen trade secrets via nefarious activities such as narcotics trafficking, corruption, occupational fraud, and illicit financial flows. The Chinese piece of this alleged theft comes from US Customs and Border Patrol data, which reported $1.35 billion in seizures of total counterfeit and pirated goods back in 2015. Equally dubious models extrapolate this tiny sum into an aggregate guesstimate for the US and impute 87% of the total to China (52% to the mainland and 35% to Hong Kong).

Then there is the red herring emphasized in the Section 301 reportpublished by the US Trade Representative (USTR) in March 2018, which provides the foundational justification for tariffs levied on China: forced technology transfer between US companies and their Chinese joint venture (JV) partners. The key word is "forced," which implies that innocent US companies that enter willingly into contractual agreements with Chinese counterparts are coerced into surrendering their proprietary technologies in order to do business in the country.

To be sure, JVs obviously entail a sharing of people, business strategies, operating platforms, and product designs. But the charge is *coercion,* which is inseparable from the presumption that sophisticated US multinationals are dumb enough to turn over core proprietary technologies to their Chinese partners.

This is another shocking example of soft evidence for a hard allegation. Incredibly, the USTR actually admits in the Section 301 report (on page 19) that there is no hard evidence to confirm these "implicit practices." Like the IP Commission, the USTR relies instead on proxy surveys from trade organizations like the US-China Business Council, whose respondents complain of some discomfort with China's treatment of their technology.

The Washington narrative also paints a picture of China as a centrally planned behemoth sitting astride massive stated-owned enterprises (SOEs) that enjoy preferential credits, unfair subsidies, and incentives tied to high-profile industrial policies such as Made in China 2025 and Artificial Intelligence 2030. Never mind a large body of evidence that underscores the low-efficiency, low-return characteristics of China's SOEs.

Nor is there any doubt that comparable industrial policies have long been practiced by Japan, Germany, France, and even the US. In February, Trump issued an executive order announcing the establishment of an AI Initiative, complete with a framework to develop an AI action plan within 120 days. China is hardly alone in elevating innovation to a national policy priority.

Finally, there is the time-worn issue of Chinese currency manipulation – the fear that China will deliberately depress the renminbi to gain unfair competitive advantage. Yet its broad trade-weighted currency has risen over 50% in real terms since late 2004. And China's once-outsize current-account surplus has all but vanished. Still, the currency grievances of yesteryear live on, getting prominent attention in the current negotiations. This only compounds the false narrative.

All in all, Washington has been loose with facts, analysis, and conclusions, and the American public has been far too gullible in its acceptance of this false narrative. The point is not to deny China's role in promoting economic tensions with the US, but to stress the need for objectivity and honesty in assigning blame – especially with so much at stake in the current conflict. Sadly, fixating on scapegoats is apparently much easier than taking a long, hard look in the mirror.

STEPHEN S. ROACH

Writing for PS since **2011**
102 Commentaries

Subscribe

Stephen S. Roach, former Chairman of Morgan Stanley Asia and the firm's chief economist, is a senior fellow at Yale University's Jackson Institute of Global Affairs and a senior lecturer at Yale's School of Management. He is the author of *Unbalanced: The Codependency of America and China*.

*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.