December 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:

	Nov. 2019	Year-to-date
Hong Kong Partners LP*	-3.2 %	-2.3%
Hang Seng Index **	-2.1%	1.9%
Hang Seng Small Cap Index	-2.3%	-4.0%
MSCI HK Small Cap Index	-0.9%	-5.1%
HS Mid Cap Index	-0.8%	5.3%

Partners' NAV $2.385 after management fee and provisions, but before annual incentive fees of 15% on appreciation.

Hong Kong's Hang Seng Index fell sharply the last day in November after US President Donald Trump signed the Hong Kong Human Rights and Democracy Act in support of the protesters, ratcheting up tensions with China. Trump signed a bill into law that requires the State Department to certify annually that Hong Kong has sufficient autonomy to retain special U.S. trading consideration. Though largely symbolic (see article below), the news subdued investor sentiment, especially in the small/mid cap sectors where South Ocean concentrates its portfolios.

One of our poorest performing holdings last month was sports brand retailer Xtep International (code 1368hk, market cap HK$10.1 billion, US$1.3 billion). Retail sales in Hong Kong have been wounded by the ongoing protests and even though Xtep has most of its retail shops in China, the shares were dragged down along with the city's other struggling retailers. (Hong Kong October Retail Sales value declined 24.3% Year-over-Year; another largest single month decline on record. This was the 9th month of downtrend, with jewelry, watches and clocks -42.9% Year-over-Year and department stores -31.1% YoY. The HKSAR government announced further stimulus measures worth HK$4 billion (US$511 million) after the report. The latest boost brings the government's total pledged amount of relief this year to HK$25 billion or US$3.2 billion).

Xtep International designs, manufactures and sells sportswear on a wholesale basis under its Xtep brand. Marketed as a fashionable sports brand, Xtep is focused on running and other sports, sponsoring a number of national and international marathons, as well as various entertainment events. The company sells through 6,312 authorized outlets and recently, in a strategic multi-brand restructuring, Xtep set up joint ventures with Wolverine World (US) to provide retailing of the Saucony (US) and Merrell (US) brand shoes in China. The company also acquired E-Land Footwear USA, which owns K-Swiss (US), Palladium (FR) and Supra (US), specifically for the growing China market. (China had 1,581 certified running marathons last year, up 44%, and China is a runner's paradise).

The joint ventures and acquisitions were funded by internal resources for US$260 million in cash and were completed in July 2019. The company is poised for strong growth when these ventures are fully executed and operational next year.

Hong Kong's stock market has been under pressure since the protest movement began in June. As reported in the November 30 issue of the South China Morning Post:

> *The city's biggest stocks have cheapened with investors willing to pay 9.9 times for their earnings in 2020, and 9.2 times for 2021, according to Bloomberg data. The price-earnings multiple has dropped from 13.7 times in 2017 to 11.2 times this year*.

South Ocean's portfolios sell at just 8.2 times this year's estimates and 7.4 times next year's estimates. These are cheap valuations. Once trade war concerns lessen, our China-geared holdings stand to re-rate significantly upwards. Further thoughts below on current events and circumstances affecting China, Hong Kong and the US and why those apprehensive trade war conditions may diminish sooner than expected.

We wish everyone a safe and happy holiday season.

Sincerely,

Brook McConnell
President
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The US trade war with China is dislocating many entities and will certainly affect US prices if enacted. US consumers can expect to pay more for cell phones, PCs, toys and other electronics, like modems, if the US's December 15 tariffs on Chinese imports go into effect.

A Credit Suisse December 5th report underscored the implications:

> *Since the announcement on 11 Oct regarding a US-China preliminary 'Phase 1' agreement, the market has attached a high probability that such a deal would get finalised soon, obviating the need for tariffs scheduled for 15 Dec (List 4B) to go into effect, and maybe even some roll back in previously imposed tariffs.*
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> *With uncertainty now rising regarding a Phase 1 deal, we think it is important to note that List 4B comprises ~US$170 bn of Chinese goods. We estimate ~US$87.5 bn of these are tech products such as smartphones, notebooks, external monitors and other tech products.*
>
> ▪
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> *As opposed to previous tariff rounds, this round will predominately impose duties on tech end products.* ***Such tariff imposition will almost certainly lead to a rise in consumer selling prices****, potentially leading to negative demand elasticity (US is 20-30% of the global demand).*
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> ▪
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> *Given that such an 'indirect tax' on US consumers isn't exactly the policy goal of the US administration,* ***our base case still remains that this 15 Dec round of tariffs is likely to be postponed again****, even in the absence of a Phase 1 deal. However, given the importance of this tariff round for tech, it is something investors should watch closely.*
> **(My emphasis)**

Apart from the imposing US trade restrictions, manufacturers in China have been trying to move factories to Vietnam and other Southeast Asian countries to lower costs for many years. But moving out of Guangdong Province, China's main manufacturing center, has been far from plain sailing.

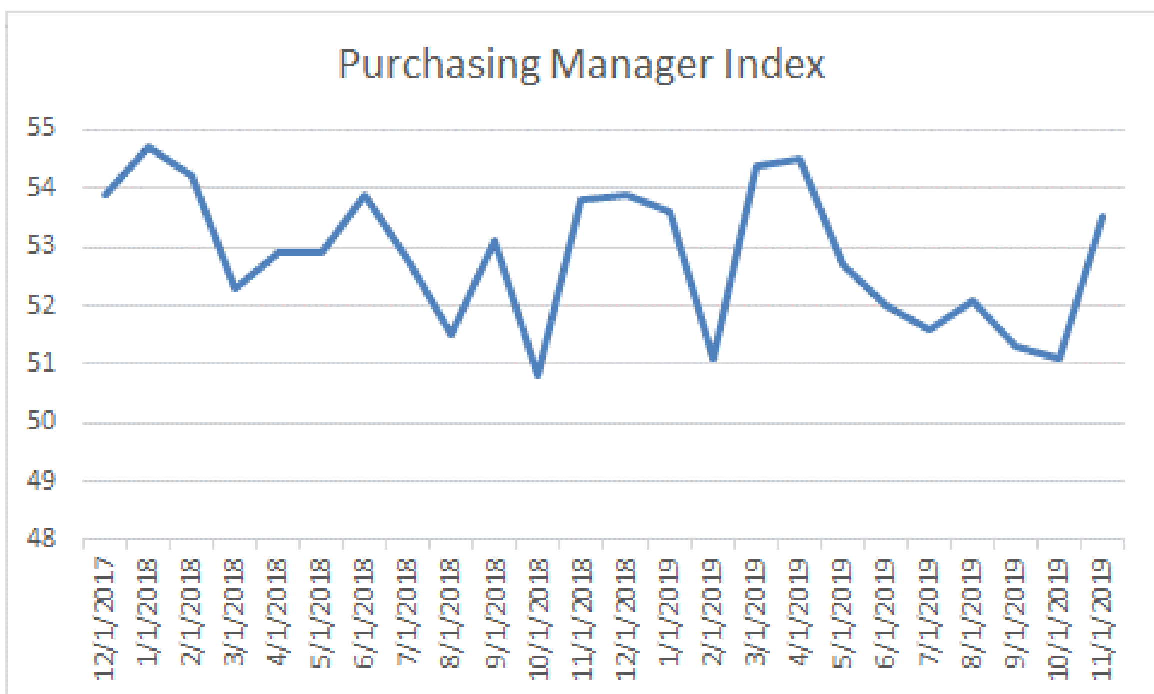
As described in the South China Morning Post:

> SZ Telstar, a Guangdong producer of Bluetooth projectors, moved its factory from Shenzhen to Bac Giang province in Vietnam in July to avoid paying tariffs on its sizeable US exports. "The 'Made in Vietnam' label requires 40 per cent of the value to be added locally. However, raw materials cost 30 to 60 per cent more in Vietnam than in China, as the supply chain is not complete there. We are trying all possible means to purchase more materials from China," said Amy Chen, key account manager for SZ Telstar.

Chen added that infrastructure and logistics in Vietnam also lag behind China, with SZ Telstar still having difficulties in finding logistics providers three months after the relocation, a common challenge for Chinese manufacturers shifting to Southeast Asia.
https://www.scmp.com/economy/china-economy/article/3033358/chinas-electronics-exporters-desperately-look-escape-us-trade?utm_medium=email&utm_source=mailchimp&utm_campaign=enlz-scmp_today&utm_content=20191018&MCUID=64ca9eb011&MCCampaignID=4ceb5419b4&MCAccountID=3775521f5f542047246d9c827&tc=6

As to China's broader economy, we highlight three charts below.

China's stimulus measures initiated for small/medium sized enterprises last year are starting to gain traction. The latest figures from Caixin/Markit showed its services PMI rising to 53.5 last month (from 51.1 in October), helping alleviate concerns of China's slowing economy. The Index rose sharply in the latest release:



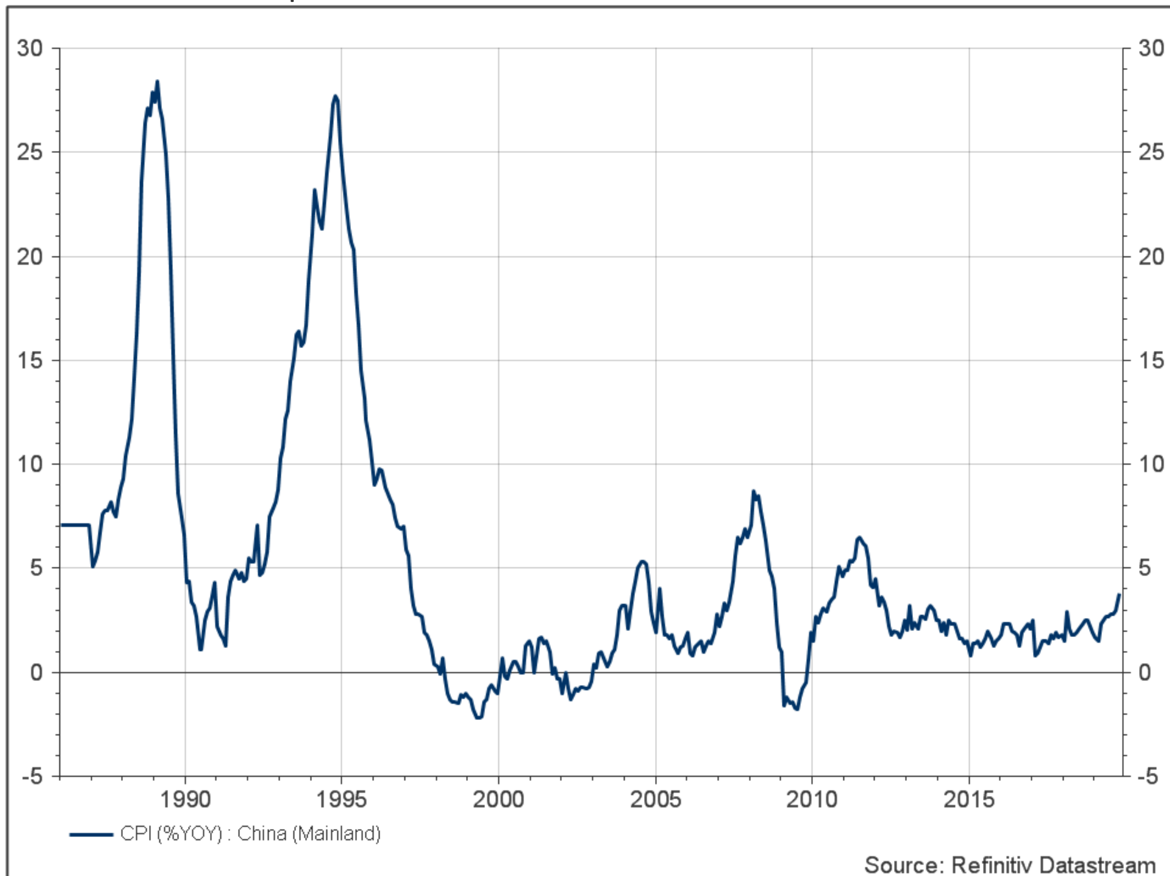
The Caixin China Composite PMI™ data (which covers both manufacturing and services) signaled a solid increase in total business activity across China in November, the steepest rate of growth in 21 months. The expansion is strongly above the 50 mark which separates growth from contraction.

The November Manufacturing PMI improved to 50.2 (consensus was only 49.5). A Credit Suisse analyst noted that the improvement was predominantly driven by new orders.

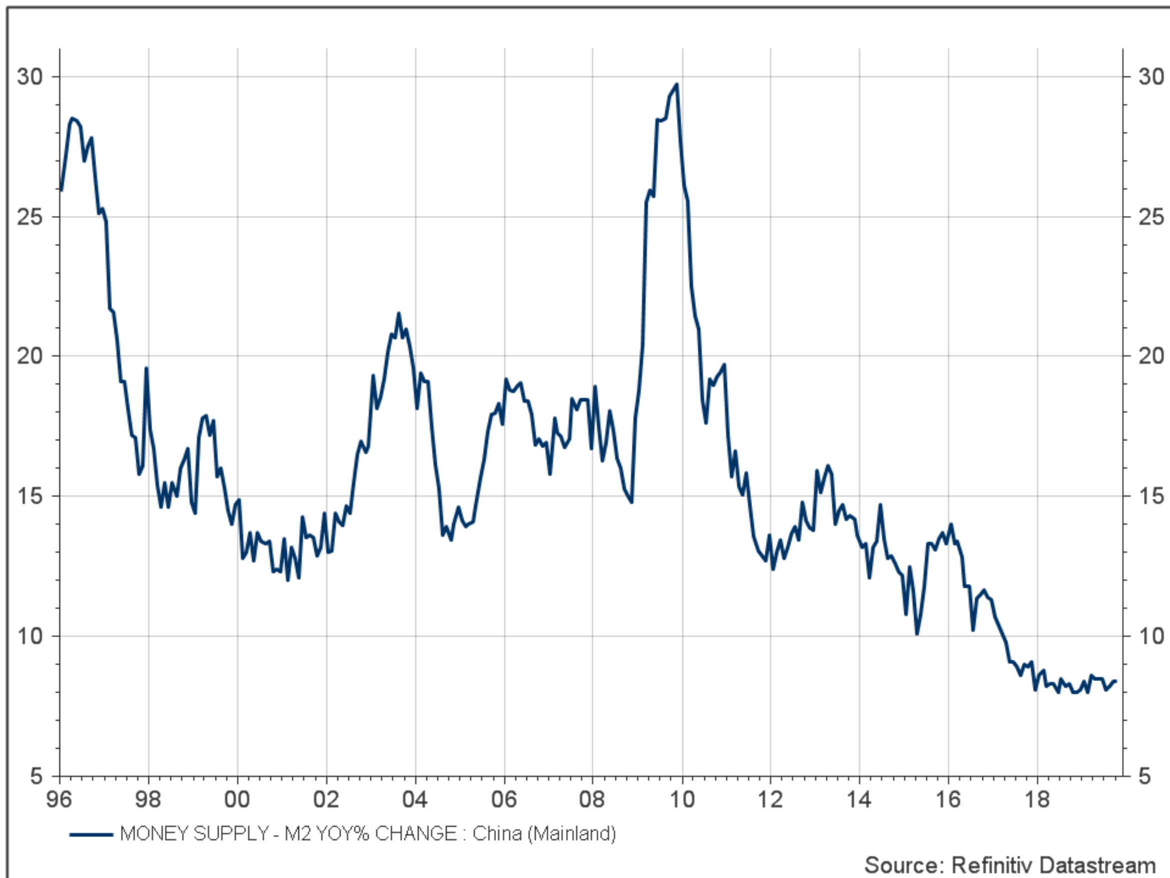
External demand is still deteriorating, but at a slower pace, while domestic demand is finally improving. Expect December PMI to

show further increase, as manufacturers gear up for CNY, which arrives earlier than usual in Jan 2020.

In the next chart, China's overall inflation rate remains tame, even though pork prices (a major component) have escalated recently due to the African Swine flu epidemic:



The last chart we highlight indicates China has been holding back from initiating excessive stimulative policies in order to keep its economy from overheating. Money supply growth in the system has been very restrictive:



With the service/manufacturing data rebounding, inflation tame and monetary policy tight, taken together, China can take its foot off the brake to thwart any serious downward business conditions and has room to initiate policies to help its economy as and when needed.

Another recent SCMP economic opinion article further articulated on this:

> The escalation of the trade war with Washington has prompted Beijing to step up policy easing. However, the easing has so far been more restrained than in past cycles, for two reasons.
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> The first is the discrepancy between the intention and scope of certain policy tools. On the monetary side, the People's Bank of China has plenty of room to cut interest rates and banks' reserve requirement ratios.
>
> But the actual policy easing has been timid, due to Beijing's desire to avoid worsening the structural and cyclical issues, which could destabilise the financial system and hamper the trade negotiations.
>
> Those issues include high debt levels, food price inflation, a housing market bubble and excessive depreciation of the yuan. Also, besides an overall lack of liquidity, there is concern about the ineffective transmission of cheap credit to the private sector. Structural defects cannot be fixed by simply cutting interest rates or reserve requirement ratios.

While the authorities have more leverage than willingness to ease monetary policy, they have the opposite problem on the fiscal side. The aggressive tax cuts and fee reductions of the past two years suggest Beijing is keen to use fiscal policy as its primary tool...

The other reason for Beijing's policy restraint may be the resilience of the labour market. While official labour market data has somewhat moderated, it is far from alarming. This is partly because more jobs have been created in the consumption and services sectors as a result of China's economic rebalancing than in trade and manufacturing.

In other words, the reorientation of the economy towards domestic consumption is insulating the labour market against external shocks.

Overall, we think Beijing can afford to maintain a prudent policy so long as the labour market stays resilient. We estimate that monetary and fiscal boosts will add 0.3 percentage point to growth in 2020...
https://www.scmp.com/comment/opinion/article/3040411/2020-outlook-chinas-economy-remains-gloomy-there-one-bright-spot?utm_medium=email&utm_source=mailchimp&utm_campaign=enlz-scmp_today&utm_content=20191205&MCUID=64ca9eb011&MCCampaignID=2a1154ed99&MCAccountID=3775521f5f542047246d9c827&tc=9

As mentioned above, US efforts to counter China's 'threat' through legal means are not without repercussions. This last article points out there are important ramifications of any measures cutting out Hong Kong's 'unique' status.

Thank you for reading. Brook McConnell.

US law backing Hong Kong protests could end up hurting everyone — the US, China and Hong Kong

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Yen Nee Lee
https://www.cnbc.com/2019/11/29/what-trump-bills-on-hong-kong-rights-protections-means-for-china-hk-and-us.html?__source=twitter%7Cmain
KEY POINTS:
-The Hong Kong Human Rights and Democracy Act of 2019, signed into law by U.S. President Donald Trump, is touted by Congress as a way to deter Beijing's influence and interference in Hong Kong's internal affairs.

-But if Hong Kong's so-called special status is compromised as a result of the law, the city's economy could be damaged — bringing down with it the U.S. and China.

-The U.S. and Hong Kong have a tight trade and financial relationship that's largely built upon the city's trusted position as a relatively safe place to access China.

-While Hong Kong’s economic growth contribution to China has diminished through the years, the city has remained an important financial center for mainland businesses.

U.S. President Donald Trump signed into law two bills supporting Hong Kong protesters on Wednesday.

The laws were introduced to preserve Hong Kong’s rights and autonomy, but one of them actually contains provisions that could end up hurting the economies of the U.S., China and Hong Kong.

Trump signed two bills on Wednesday pertaining to Hong Kong: One involves an annual review of the city’s autonomy from China; the other bars the sale of munitions to Hong Kong police, such as tear gas and rubber bullets.

It is the first — the Hong Kong Human Rights and Democracy Act of 2019 — that could lead to the removal of the so-called special status that Hong Kong currently enjoys, and that could hurt the Chinese territory’s economic prospects and businesses that operate there.

Hong Kong, a former British colony that returned to Chinese rule in 1997, has seen widespread demonstrations since June, some of which have led to violent clashes between protesters and the police. The protests were initially sparked by a proposed law that would have allowed extradition to mainland China, but the unrest later morphed into broader anti-government demonstrations that include demands such as greater democracy and universal suffrage.

The two U.S. laws come amid widespread criticism of heavy-handed treatment of protesters by the Hong Kong police and government, which Beijing supports.

Protecting Hong Kong
The Hong Kong Human Rights and Democracy Act of 2019 include the following provisions:

Requiring the U.S. State Department to annually review whether Hong Kong is “sufficiently autonomous” from China to justify its “unique treatment” under U.S. law
Requiring the American president to impose sanctions on individuals found violating human rights in Hong Kong by freezing their assets and denying them entry into the U.S.
U.S. visas to Hong Kong applicants may not be denied because they’ve been arrested or detained for taking part in pro-democracy protests

The bill was touted by Congress as a way to deter Beijing's influence and interference in Hong Kong's internal affairs. But many analysts have said it's largely "symbolic" in nature.

US' Hong Kong rights bill is 'significant but symbolic': Lowy Institute
"I think it's (a) significant but symbolic step," Ben Bland, director of the Southeast Asia Project at Australian think tank Lowy Institute, said last week before Congress passed the two bills.

"It's really important for the Hong Kong democracy movement. Many people on the streets have been calling for the U.S. to signal its support and to signal its dissatisfaction with what the Chinese government has been doing in Hong Kong over the last few years: Squeezing the city's freedom and autonomy," he told CNBC's "Squawk Box Asia."

Losing special status
As a special administrative region of China, Hong Kong is governed under the "one country, two systems" principle. Under that structure, Hong Kong is given self-governing power, a largely separate legal and economic framework from China, and various freedoms including limited election rights.

Such a system underpins Hong Kong's status as a global financial and business center, especially as a middleman between China and the world. The city's autonomy from China is also a reason why the U.S. treats it differently from other Chinese cities. For example, elevated U.S. tariffs imposed on China in the trade war don't apply to Hong Kong.

Hong Kong's importance to the Chinese economy is disproportionate to its size. Losing that special treatment would damage the city's economy, and its repercussions could potentially feed through the global financial system.

To be sure, the Hong Kong Human Rights and Democracy Act of 2019 by itself doesn't mandate the removal of the territory's special status if the U.S. finds that Hong Kong is not sufficiently autonomous from China. The revocation has to come from Trump through an executive order, or Congress via the United States-Hong Kong Policy Act of 1992, which spells out Washington's special treatment of the city.

Nevertheless, analysts said Washington is not likely to go so far as to revoke the city's special status, given the economic stake the U.S. has in Hong Kong.

US interests in Hong Kong
One reason why Washington wouldn't cancel Hong Kong's special status is the tight trade and financial relationship between the two, observers said.

On its website, the State Department said that more than 1,300 American firms operate in Hong Kong, of which 300 base their Asian regional operations there. Nearly all major U.S. financial firms have a presence there.
On trade, Hong Kong has been a major destination for U.S. legal and accounting services, according to the State Department. Last year, the U.S.'s largest goods trade surplus worldwide — at $31.1 billion — was with Hong Kong, the State Department said.

Many of those relationships were built on Hong Kong's trusted position as a relatively safe place to access China — the world's second-largest economy with much untapped business opportunities.

The American Chamber of Commerce in Hong Kong has said that anything that changes the status of the city would have “a chilling effect” on U.S. trade and investment in the city, reported Reuters.

Hong Kong's importance to China
Hong Kong's economic growth contribution to China has diminished through the years, but the city has remained an important financial center for mainland businesses.

Given its openness to foreign investors, Hong Kong has for years been the place where mainland Chinese companies raise funds through listing on the Hong Kong stock market and issuing bonds.

Hong Kong's role as the China's financial arm for the rest of the world has helped mainland China in keeping its financial sector insulated ...
In recent years, Hong Kong has become the gateway for foreign investors to buy Chinese financial assets through the stock and bond connect programs. The city is also one of the few places where the Chinese yuan is traded outside the mainland, facilitating the internationalization of the currency.

“Hong Kong's role as the China's financial arm for the rest of the world has helped mainland China in keeping its financial sector insulated without suffering the negative consequences of such isolation, i.e. limited access to finance or difficult access to assets in the rest of the world,” French investment bank Natixis wrote in an August report.
In addition, Hong Kong is China's “most important springboard” for foreign direct investment, the Natixis report said. Much of China's outward investments are channeled through Hong Kong “due to the trust of Chinese and foreign firms on Hong Kong's institutional framework,” the bank said.

In all, “Hong Kong's importance to the Chinese economy is disproportionate to its size,” Tianlei Huang, a research analyst at the Peterson Institute for International Economics think tank, wrote in a July report.

“Beijing must know that preserving Hong Kong’s unique economy means more than allowing free enterprise. It entails a strong and unwavering commitment to its rule of law, the key to Hong Kong’s economic success,” he added.

*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.