October 18, 2021

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:

	Sep. 2021	Year-to-date
Hong Kong Partners LP*	-3.2%	12.6%
Hang Seng Index	-5.0%	-9.8%
Hang Seng Small Cap Index	-6.1%	-0.2%
MSCI HK Small Cap Index	-9.0%	4.4%
HS Mid Cap Index	-5.5%	-5.9%

Partners' NAV $2.6249 after management fee and provisions, but before annual incentive fees of 15% on appreciation.
Please refer to footnotes at the end of this commentary for descriptions of the Fund's indexes and Fund risk disclosures.

South Ocean's portfolios of small/mid cap, Hong Kong-listed companies with earnings benefiting from operations in China, declined 1.3% in the quarter ending September versus a decline of 14.8% for the Hang Seng Index.

Last month, stock trading turned negative in Hong Kong as growth concerns in China weighed on sentiment. The blue chip Hang Seng Index declined 6.6% in the last three weeks of September. Market breadth (referring to how many stocks are participating in a given move in an index or on a stock exchange) was quite weak as just one-quarter of the top 500 capitalized listed stocks gained during the month (mostly energy-related names).

A power crunch in China (31 Provinces are under power rationing due to lack of coal for electricity generation) and increased material costs hurt producers. Our holding in leading glass manufacturer, Xinyi Glass (code 868HK, market cap HK$86.0 billion, US$11.0 billion) underperformed as glass prices declined sharply. Our holding in small cap engeneering and environmental materials construction supplier, FSE LIFESTYLE (code 331HK, market market cap HK$3.2 billion, US$410 million) was a top performer for the month, gaining 17.1%.

As a short review, our long-only approach to investing seeks long-term gains in well managed, Hong Kong-listed companies doing business in China. We rely on holding for future gains rather than seeking possible short term gains by shorting stocks or using directional derivative trades. Our results don't always produce month over month gains. Nevertheless, we are deligently, actively monitoring all holdings daily to keep abreast of developments with our holdings. We have managed portfolios in the Hong Kong market for 30 years and recognize the many rudiments particular to Hong Kong that affect stock prices. At various times in the past, we have raised cash levels in our portfolios when we haven't found opportunities or believe that elevated risks exist (such as in the 4th quarter of 2007).

As of this writing, we have less than 10% cash, having added to our holdings during the recent market decline.

The past quarter has been volatile as the Chinese Communist Party has implemented a widening set of curbs targeting financial institutions that offer cryptocurrencies, e-commerce businesses, ride-hailing companies, education enterprises, to name a few. Chinese children can play video games for only three hours a week. This, coupled with the over-levered Evergrand Property company debt implosion, foreign investors have been left unsettled.

Our value-oriented approach of not over-paying for exuberant themes in the market has been an key factor in our out-performance year-to-date. Under the new regulatory environment imposed by the PRC, we believe this approach of owning out of favor stocks will continue to deliver rewarding returns.

Recently, BlackRock (world's largest private asset manager with $9 trillion of assets under management) recommended that investors boost their allocations by two to three times to China. The firm beleives China is an undiscovered market and that foreign investors own only a minuscule share of Chinese stocks and bonds.

More insight on China's new regulatory direction in the following article. Our management philosophy is further detailed, with various past investing examples, in my book, now available on Kindle free: Insights of an American Investment Manager in Hong Kong).

Sincerely,

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South Ocean Management, Ltd. Hong Kong
Email: brook@south-ocean.com Website: www.south-ocean.com
South Ocean Management, Ltd. was started in 1992 in Hong Kong, has ~$14 million under management, with 6 team members. South Ocean is registered with the SFC and SEC regulators.

The following article is written by Simon Hunt, who writes for TIS Group's Frontline China Report. If you are interested in articles similar to today's piece, please contact Larry Jeddeloh at tis@tisgroup.net

"China's economic and political development in the past 40 years can best be understood as a relentless search to strike a balance between political control, market efficiency and social justice to sustain party legitimacy. These dynamics will continue to define its future directions." **Tan Kong Yam**, Professor of Economics at Nanyang Technology University, Singapore & former Advisor to Deng Xiaoping on China's Economic Development Strategy.

President Xi's objectives for China are partly molded by how the economy was operating when he came into office and partly by his own beliefs. As we stated in our report of 14th September, 'Xi's mission is to clean up the entire corrupt system, provide incentives for households to participate better in the country's growth, thus narrowing the income divide and, in the process provide a stable social and economic environment.'

In fact, China's government philosophy is a balance between Leninism and Confucianism, meaning that China has borrowed from Lenin the idea that the CCP is the governing authority from which all directives are issued, however dictatorial there are the checks and balances and, from Confucius the traditional values of morality, the family, respect, altruism and humility are taken.

'Common Prosperity' is a natural evolution from 40-odd years of opening-up China. It signals the birth of a more egalitarian society from the pyramidal structure which had grown from Deng's famous remark that 'To get rich is glorious.' Common prosperity does not mean that getting rich is wrong but it does mean that those at the top of the tree should give back some of that wealth. This becomes integral to the egalitarian structure which is evolving.

In sum, Common Prosperity means raising household incomes, improving social welfare and narrowing the wealth divide. In fact, as we look around the world it does seem as though China is leading the way – once again – but this time towards a more egalitarian society across the developed world.

This process has been ongoing for decades. For instance, in 2010, there were 489 million people earning under $20,000/year; by 2020, the number had fallen to 330 million and should fall to 270 million in 2030 according to Global Demographics data.

The Gini Coefficient data tracks this process showing that actually China's Gini ranks about halfway in the world with S Africa's being 63, Hong Kong's 53.3 and towards the bottom end Germany 29.0.

For the last two years, the overarching policy has been to deleverage the economy by reducing private sector and local government debt. Infra-projects have been cancelled because they added to the debt pile.

The list of failed go-go private sector conglomerates is a long one but the clean-up process is continuous. For instance, Wanda is stabilized, Anbang Insurance has been taken over and HNA is being broken up into pieces.

Now, the clean-up process has turned on the most important sector, housing. Important because of most real estate developers' high level of debt, because real estate touches all households and because of the involvement of important stakeholders.

Xi has long said that homes are for living in not for speculation. Current prices are out of the reach of most households without undue leverage which limits a household's ability to spend. For instance, households with $10,000 or less annual income number:

Last year, China's households with annual income of $10,000 or below was the equivalent of the entire population of Bangladesh and in 2030, the whole population of Russia just to put China's move into a more egalitarian structure into perspective. The remaining 270 million households may have the ability to spend outside their essential needs but not 40% of all. Future policy will be focusing on the bottom end of the income pyramid.

Now with Evergrande in bankruptcy in all but name, Xi has the opportunity of breaking the incestuous relationship between real estate developers and local governments where the one has fed on the other. Housing is the core that binds government with households or the people. It is a core ignored by earlier governments and is one reason why there was such populous discontent in 2012.

Breaking this relationship between developers and local governments won't be easy and will be with considerable risks given the sums involved. What is at stake is not just the $120 billion of bonds, some of which is held by foreigners, but the total of $305 billion owed to equity and bondholders, banks, shadow banks and supply contractors etc. according to Bloomberg.

If Xi's government refuses to bail out the company, it would provide government with the opportunity of taking over most of home building via some SOEs such as the railway construction companies (see last year's reports). In this way they would be able to manage the real estate cycles and to ensure that home prices became stable.

As an example of the huge rise that has taken place in home prices, since early 2010 up to the first quarter of this year, the real increase in average home prices after adjusting for CPI was 12.3% (source FRED) but the total nominal increase was about 41%.

Refusing to bail out Evergrande would cause widespread repercussions not just across China but around the world. So large would those repercussions be that government must have prepared or must be preparing contingency plans to support, for instance, the thousands of supply chain contractors covering sectors such as steel, cement, copper, aluminum and their downstream product manufacturers.

And who then finances the overhang of unfinished buildings which some say is a large multiple of completions. Last year, completed floorspace was 912.2 million square meters of which 72% was residential. The overhang of unfinished floor space could be as much as 6,500 million square meters according to some sources.

To complete that overhang of floor space would cost some US$3.5 trillion equivalent to close to one-quarter of the country's GDP. It surely won't be done quickly which probably means companies in the supply chain if they have begun producing against those orders will be forced to liquidate those stocks.

In summary, China has the opportunity of really getting to grips with housing which is a core issue for households, but are they prepared to run the risks of the unexpected consequences however much contingency planning is done?

The temptation must be there because by breaking down the relationship between developers and local governments and so taking control of the housing market would appeal to those at the lower end of the income ladder. And October 2022 is a key date.

Longer-term, there is a central issue on how to balance the government's books without increasing its budget deficit of 3.5%, apparently an avowed objective. Local governments will have much reduced revenues from land sales and central government will incur the added expenditures for health, education and social security. Additional revenues of some $120 billion will be needed next year and a multiple of that sum by 2023.

Where will the new revenues come from apart from general growth. One avenue, of course, will be higher taxes for those earning above a certain figure. A second avenue will be taxes on households having more than one home. A third and the most important will stem from Digitalization. By nationalizing or confiscating the databases of the private sector, government will have the ability to monitor and tax the entire cash flow chain.

What these developments are indicating, at least to us, is the continued historic battle between local and central government. The Leninist philosophy is that power resides with the center. One consequence of remodeling the real estate sector is that more authority will reside in Beijing and that local governments will ultimately receive their budget funding from Beijing without the recourse of land sales and local taxes.

Who controls the sources of money gains the economic and political power is an obvious statement.

These developments are occurring at a time when the economy is weakening both from industry with investment continuing to soften and from consumers with retail sales growing only 0.9% in price adjusted terms in August. Both the Caixin and NBS PMIs were hardly encouraging.

Housing is also slowing as the following table shows.

Monetary policy, as noted in earlier reports, will provide added liquidity in a very targeted approach primarily to the rural sector and to SME and private companies probably knowing that these sectors will be hurt by whatever actions governments will take with real estate companies.

There is unlikely to be any early solution to Evergrande and other developers which means that there will be a shadow overhanging markets, households and industry. It is not a time yet to be brave.

The path that China’s government has chosen to remodel its economy and social balance will ultimately lead to higher consumer spending, though less at the top end of the income pyramid, but getting there will have its hurdles not least because of the involved stakeholders.

**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.
The S&P 500 Index is a market capitalization- weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard and Poor's chooses the member companies for the 500 based on market size, liquidity, and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies.

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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