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

September 13, 2012

Dear Clients, Partners, and Friends,

The results for South Ocean Managementôs Delaware LP, Kong Partnersô L.P., before incentive fees, were as follows:

	Aug 2012	Year-to-Date
Hong Kong Partners LP (net)	-0.7 %	-4.2 %
Hang Seng Index	-1.6 %	5.7 %
MSCI HK Small Cap Index	2.9 %	4.9 %

Partnersô NAV for Aug $2.2547 after management fee, but before annual incentive fees of 15% on appreciation.

"Big companies have small moves, small companies have big moves."

Peter Lynch

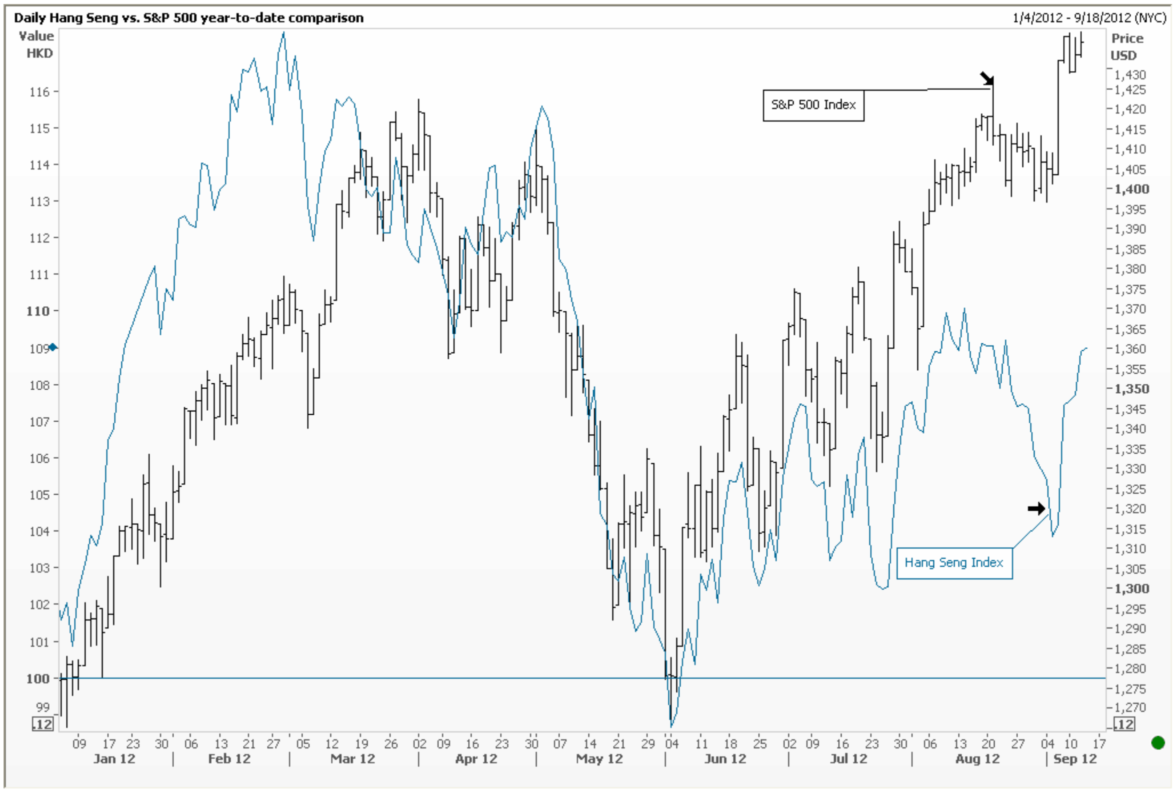
Trading volumes in the Hong Kong stock market have been very subdued this summer. Our portfolios of small/mid cap companies listed in Hong Kong, with earnings geared towards China, have suffered *investor neglect*.

According to the Hong Kong Stock Exchange, the average daily turnover for the first eight months of 2012 was HK$53,235 million (US$6.8 billion), a decrease of 28.0% when compared with HK$73,492 million (US$9.5 billion) for the same period last year. August 2012 daily turnover was HK$43,806, a decline of 44.4% versus a year ago (August 2011 daily turnover was HK$78,783).

Trading in the non-index, smaller/mid capitalized sectors of the market, where we focus our investment activities, declined even more precipitously.

Low turnover in smaller capitalized shares can accentuate/magnify price changes, as Peter Lynch notes above. For instance, a Hong Kong- listed fund management firm, with a similar investment strategy to ours, reported its profits declined 55.6% in the first half through June.

The overall Hong Kong market has notably lagged this summer.



This lagging rate of return is not usual for Hong Kong either.

The directionless market in small/mid cap stocks this summer, in a lack luster trading environment, isnôt particularly meaningful though, especially when the retail investor segment is almost entirely absent.

Credit conditions remain tight on the mainland today. The Chinese government recently approved programs for new roads, railways and urban infrastructure, having a combined value of about 1 trillion yuan (US$150 billion) to help alleviate the tight conditions. As noted by Goldman Sachs: *We find that China is investing at an unprecedented rate (in proportion to GDP), however, China still has a long way to go – its capital stock/worker is only 6% of Japan's level and 16% of Korea's.*

This investment in infrastructure building has important ramifications, as noted in 13D research:

> China has played and will keep playing an important role in driving the EM infrastructure building boomô both as a major consumer of commodities and as a major source of funding for EM building projects. Chinaôs outbound foreign domestic investment (FDI) grew from $ 2.7 billion in 2002 to $ 74.7 billion in 2011, an annual average growth rate of 45% during the period. This trend continued in the first half of 2012, with Chinaôs

outbound FDI (non-financial sector) rising 48% year-over-year to $35.4 billion. A significant part of Chinaôs overseas investment has gone to resource-rich emerging markets.

Beijing also has less obvious motives to promote EM infrastructure development. It stands to reason that China wants to facilitate the transportation of goods out of the country and exports of commodities into the country. By facilitating the development of infrastructure and sustainable growth in other emerging markets, China hopes to create a whole new population of customers that will purchase its exportsð thus enabling it to reduce its dependence on developed economies.

Capital flows from China to emerging markets are particularly important now as they fill the void left by the two major crises since 2008ð the Global Financial Crisis and this sovereign debt crisis in the eurozone. For example, during his visit to Latin America in June 2012, Chinaôs Premier Wen Jiabao announced a plan to set up a $10 billion credit line to support infrastructure projects for countries in the region. At the same time, Premier Wen also announced the creation of a cooperation fund, with Chinaôs initial contribution of $5 billion intended to promote the development of manufacturing in the Latin America region.

Worries over Chinaôs domestic economic health are misplaced, too:

In an attempt to clear up some of the confusion, Andy Rothman at brokerage house CLSA has set out to explode some of the more common misconceptions foreigners hold about China's economy.

Rothman inclines very much towards the sustainable growth camp and makes a strong case that China's economy is much healthier than the bears believe.

Rothman points out that China's economy is powered by dynamic entrepreneurs rather than the state. In this he is surely right.

According to the People's Bank of China, small private companies account for 60 per cent of gross domestic product, employ 75 per cent of the work force and create 90 per cent of new jobs.

And in global terms they are highly competitive. Although manufacturing wages have risen by around 15 per cent a year over recent years, productivity has grown almost as quickly at a rate of around 12 per cent. As a result, China has lost little of its competitive advantage.

Meanwhile, the growth in incomes has ignited a boom in consumer demand. Rothman dismisses worries that private consumption is fatally weak in China, pointing out that consumer spending is growing at a 12 per cent rate in China's cities and even faster in the countryside.

He also has little time for talk of a dangerous property bubble, arguing that the residential market is driven by owner-occupiers rather than by speculators, and that leverage among buyers is low.

Similarly, Rothman has few fears of an impending financial crisis. He argues that the shadow banking system has evolved only under the close supervision of the regulators, and that it remains small.

At the same time he says that although local governments' debts - typically estimated at around 10 per cent of gross domestic product - are a burden, thanks to Beijing's strong fiscal position, they are not a ticking time bomb.

In consequence Rothman believes there is little chance of a banking crisis in the near future. Closely controlled by the state, and insulated from international markets by strict capital controls, China's banks are simply not as vulnerable as those in the United States or Europe.

As a result, CLSA is forecasting robust growth of around 8 per cent for 2012. That's slower than last year's 9.2 per cent rate but well above the 7 per cent rate bearish analysts would consider a hard landing.

The following chart of the Dow Jones Industrial Average reveals an interesting, rare occurrence. In the past 100 years, a negative 10-year trailing return for the Index has occurred during only three previous periods to today.

(a little better copy of the chart available at this link: http://www.btigresearch.com/wp-content/uploads/2012/08/trailingreturns09ipoj2k3we123wregdtg1.png) Extreme negative sentiment that dominates today is a result of this state of decline.

August has become one of the busier months in Hong Kong as new regulations (instituted last year) require listed companies to make interim reports announcements earlier, within two months of the period end. Itôs no longer a leisurely summer holiday month anymore, as most all hotels and meeting venues in town become fully booked with companies presenting their results.

We attended many of these reporting sessions and we are busy this month catching up with results. Though slower growth was generally reported for the first half by many companies (not surprising), much more optimistic second half 2012 (surprisingly) and 2013 outlooks were outlined by our companiesô managers. We added to several of our existing positions on the down drafts over the summer.

As Ron Baron, Baron Capital CEO, recently said, ñEveryone's trying to guess and time the market and trade news, and I think that's a foolish game.ò The Hong Kong stock market remains deeply undervalued today. We wait for more favorable market sentiment to replace the general malaise towards China-related stocks here in Hong Kong. As long as our cash-rich companies continue along solid growth trajectories, we remain optimistic our portfolios will outperform.

Below, a prediction about what labeling China a ócurrency manipulatorô might look like.

Sincerely,

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Hong Kong

August 28, 2012 7:43 pm

How Romney could go wrong from Day 1

By Stephen Roach

True to his word as a candidate, a few hours after taking office as US president on January 20, 2013, Mitt Romney issued his first executive order, declaring China guilty of currency manipulation. In accordance with the Omnibus Trade and Competitiveness Act of 1988, President Romney's act triggered immediate negotiations between US and Chinese officials. But the negotiations stalled and both parties blamed the other in press releases.

In early February, in his first State of the Union address, Mr Romney said: "Enough is enough. It is high time for China to play by our rules." Congress roared its approval and within a week, overwhelming bipartisan majorities of both houses passed the Defend America Trade Act of 2013. Modelled on the currency manipulation "remedies" of countervailing tariffs first proposed in 2005, DATA was signed into law on President's Day, February 18 2013. China was quickly deemed to be in violation of the new statute.

At that point negotiations took on a new urgency. But the new leaders in both countries were in no mood for compromise and the talks failed. In accordance with the provisions of DATA, Washington slapped immediate tariffs of 20 per cent on all Chinese products entering the US.

As plants shut down across China, Beijing declared this to be an act of economic war and filed a complaint with the World Trade Organization. Li Keqiang, newly installed as premier, announced after the National People's Congress in March that China had no patience to endure a WTO dispute process that could take anywhere from two to five years to run its course.

China's Ministry of Commerce then announced retaliatory tariffs of 20 per cent on all US exports to China. This hit growth-starved America right between the eyes. With $104bn of American-made goods sold in Chinese markets in 2011, China had become the US's third-largest and its fastest-growing export market. To add insult to injury, China-dependent Walmart announced average price increases of 5 per cent. Other retailers followed suit. Talk of stagflation was in the air and hard-pressed American consumers hunkered down further.

US financial markets swooned. The stock market was hit by pressures on profit margins, growth and inflation. The bond market was also unnerved by the realisation that the Federal Reserve was seriously behind the curve. With good reason. After its meeting in June 2013, the Fed reaffirmed its ever-extending commitment to keep its benchmark policy rate near zero through 2015, and even dangled the possibility of yet another round of quantitative easing, QE4. Yields on 10-year Treasuries moved back above 4 per cent and stocks fell sharply further.

Feeling the heat from financial markets, Washington turned up the heat on China. Mr Romney called Congress back from its Independence Day holiday into a special session. By unanimous consent, Congress passed an amendment to DATA – upping the tariffs on China by another 10 percentage points.

At that point an indignant China turned to its own version of the big bazooka. The biggest foreign buyer of US debt was nowhere to be seen at the Treasury's August 2013 auction. Long-term interest rates spiked and within weeks yields on 10-year Treasuries hit 7 per cent. The dollar plunged and the US stock market went into free fall.

Just like that, the so-called exorbitant privilege of the haven asset vanished. When asked at a press conference why China would willingly engage in actions that would undermine the value of more than $2tn in Treasuries and other dollar-based holdings, Zhou Xiaochuan, retiring governor of the People's Bank of China, said: "This is not about risk-adjusted portfolio returns. We are defending our people against an act of economic war."

By the autumn of 2013 there was little doubt of the severity of renewed recession in the US. Trade sanctions on China had backfired. Beleaguered American workers paid the highest price of all, as the unemployment rate shot back up above 10 per cent. A horrific policy blunder had confirmed that there was no bilateral fix for the multilateral trade imbalance of a savings-starved US economy.

In China, growth had slipped below the dreaded 6 per cent threshold and the new leadership was rolling out yet another investment stimulus for a still unbalanced and unstable Chinese economy. As the global economy slipped back into recession, the Great Crisis of 2008-09 suddenly looked like child's play. Globalisation itself hung in the balance.

History warns us never to say never. We need only look at the legacy of US Senator Reed Smoot and Representative Willis Hawley, who sponsored the infamous Tariff Act of 1930 – America's worst economic policy blunder. Bad dreams can – and have – become reality.

The writer is a senior fellow at Yale University and a former chairman of Morgan Stanley Asia. The article is based on an essay for Caixin online