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

March 10, 2014

Dear Clients, Partners, and Friends,

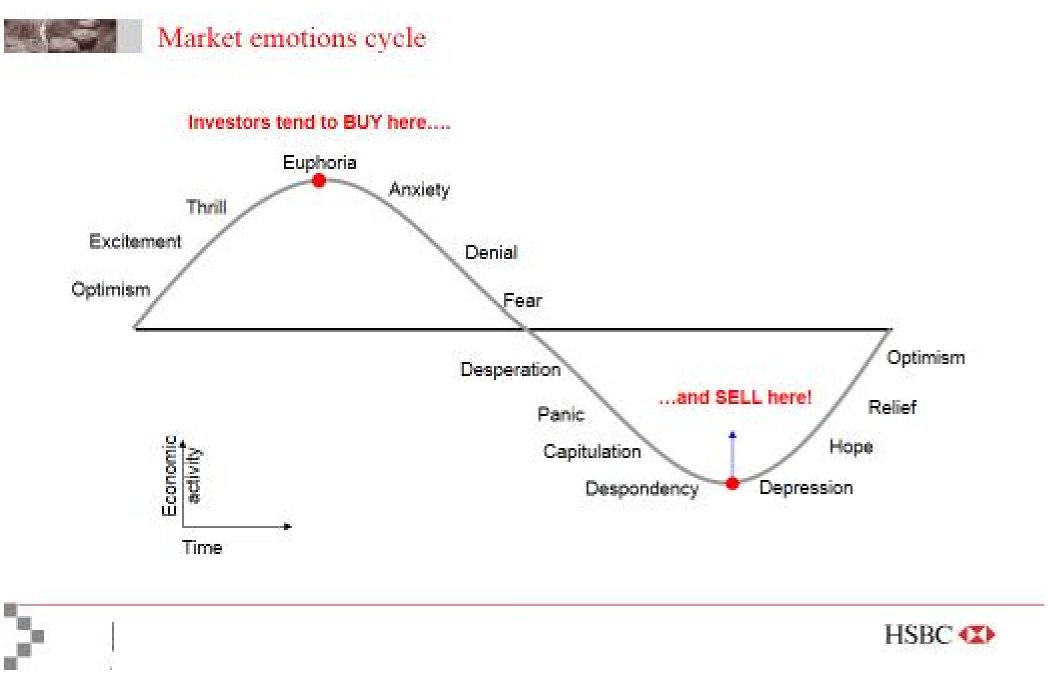
The results for South Ocean Managementôs Delaware LP, Kong Partnersô L.P., before incentive fees, were as follows:

	Feb 2014	Year-to-Date
Hong Kong Partners LP (net)	3.7%	6.6%
Hang Seng Index	3.6%	-2.0%
Hang Seng Small Cap Index	1.5%	0.3%

Partnersô NAV $3.039 after management fees, but before annual incentive fees of 15% on appreciation.

Our holdings of undervalued. small/mid cap, Hong Kong-listed companies doing business in China out-performed (slightly) last month. Our gains are widening in early March, as of this writing.

Our portfolios tend to perform better when the market isnôt, probably because the index stocks outshine when heavy inflows of foreign capital arrive and scramble into the blue chips. Foreign investors, though, are avoiding Emerging Markets today. The Hang Seng Index trades at a single digit P/E on this yearôs expected earnings. But, what appeals most about Hong Kong shares today is that investors care/expect the least. Market sentiment falls somewhere between the Despondency/Depression phases of the following chart (kindly sent by one of our clients):



All in all, investors are still hiding out in the hills and have yet to begin climbing the ówall of worry.ô

Our large holding, Chaoda Modern Agriculture, recently reported it intends to meet its deadline, at the end of March, to release its audited financial statements (the main prerequisite to the lifting of suspension on its shares by the HKSE). We wrote the position to zero in our portfolios one year ago, March 31.

With todayôs ótaper tantrums,ô monthly PMI fits (Chinaôs February Purchasing Managers Index hit a 8-month low of 50.2 versus an estimated 50.1 and Januaryôs reading of 50.5), China slowdown fears and sluggish trading conditions in Hong Kong aside, the following Stephen Roach article cuts through the noise and hits the nail square on the head.

Sincerely,

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The Chinese economy is moving on, and so must America's

Friday, 21 February, 2014, 12:05pm
CommentÜInsight & Opinion
SINO-US RELATIONS
Stephen Roach

Stephen Roach says the days of Sino-US mutual dependency are nearing an end, as China strikes out on its own towards a consumer-led economy. And, if it is to prosper, the US must also find a new growth strategy.

Once again, all eyes are on China. Emerging markets are being battered early this year, as perceptions of resilience have given way to fears of vulnerability. And hand-wringing over China is one of the major reasons.

Of course, US Federal Reserve tapering has also been a trigger. But the China factor looms equally large. Long-standing concerns about the dreaded hard landing in the Chinese economy have once again intensified. If China falls, goes the argument, reverberations to other emerging markets and the rest of the global economy will be quick to follow.

While generalisations are the norm in the throes of most crises, in the end, differentiation pays. Such has long been the case with China. China was Asia's most resilient economy during the wrenching pan-regional crisis of the late 1990s and it could turn out to be just as tough today. Yes, the Chinese economy is now slowing, but the growth downshift is not well understood. A slowdown is actually a welcome development.

There continues to be a superficial fixation on top-line Chinese gross domestic product growth - dwelling on a 10 per cent growth machine that has slowed into the 7 to 8 per cent zone. The knee-jerk reaction presumes that this downshift is but a prelude to more growth disappointments to come - especially in light of fears over a long-standing list of China disaster stories, from social unrest and environmental catastrophes to housing bubbles and shadow banking blow-ups.

While none of these concerns should be dismissed out of hand, they're not the source of the current slowdown. At work, instead, is a long-awaited rebalancing of the Chinese economy - a major shift from export- and investment-led growth to a model much more reliant on consumer spending and services. Indeed, last year, the Chinese services sector actually overtook the combined shares of manufacturing and construction as the largest segment in the economy.

Long dependent on 10 per cent Chinese growth, the US in particular and the world in general is not prepared for the slower growth that will emerge with an increasingly consumer- and services-led China.

China's export-led growth miracle couldn't have achieved its extraordinary success without the external demand from the American consumer. China also relied heavily on the US dollar to anchor its undervalued currency to boost export competitiveness.

The US, for its part, drew greatly on cheap goods made in China to boost the purchasing power of consumers; it also relied on surplus Chinese savings to help fill the void of the world's largest shortfall of domestic saving and took advantage of China's voracious demand for US Treasury securities to help fund budget deficits and subsidise American interest rates.

In the end, however, this codependency was a marriage of convenience - not love. Frictions have developed over a range of issues. And, just as the psychologist would predict, one of the partners has decided to go its own way. And that, of course, is China.

For the past seven years, the Chinese leadership has debated a major shift in its growth and development strategy. It started with former premier Wen Jiabao's famous 2007 characterisation of the Chinese economy as increasingly unstable, unbalanced, unco-ordinated and unsustainable. That critique gave rise to the pro-consumption 12th five-year plan enacted in 2011, which provided a broad framework of structural rebalancing.

But the plan lacked specific policies that would provide impetus to bring the Chinese consumer to life. That shortcoming was addressed in last November's third plenum. Of the some 60 reforms ratified at that meeting, the ones aimed at altering the behavioural norms of long-insecure Chinese families were especially important - namely, modifications in the one-child family planning and residential permit, or *hukou*, systems; a shift to market-based interest rates that would boost long depressed yields for Chinese savers; and a 30 per cent tax on state-owned enterprise profits that would provide funding for safety net programmes such as social security and health care.

The third plenum also established a new and powerful implementation mechanism that should be especially effective in putting these reforms into action.

My new book, *Unbalanced: The Co-dependency of America and China*, was written without benefit of the knowledge of the stunning results of the third plenum. The crisis of 2008-09 and its aftermath was an extraordinary shock to China's external markets, and internal imbalances - excess resource consumption, environmental degradation and pollution, mounting income inequalities, and a fear-driven surge of precautionary saving - suggested the old model was running out of time. I argued that urgent action was needed on the structural rebalancing agenda. The third plenum delivered on this count - and in a manner well beyond my expectations.

That, in my view, seals the fate for the codependent relationship between the US and China. China is locked on a course that will transform it from surplus saving to saving absorption - no longer inclined to lend its capital to the US but increasingly focused on putting its savings to work in building a social safety net and funding the wherewithal of its own populace. Long the world's Ultimate Producer, China is now determined to emerge as a consumer, too.

How will the US, long the world's Ultimate Consumer and still reliant on China for cheap goods and capital, respond? For a growth-starved US economy, this could well be a critical fork in the road. One path is risky: if savings-short America stays stuck in its old ways, but finds itself without the goods and capital from China, the US will suffer higher inflation, rising interest rates and a weaker dollar.

The other path is one of great opportunity: America can adopt a new growth strategy - moving away from excess consumption towards a renewal based on saving, and on investing those savings in people, infrastructure and capacity. In doing so, the US can draw support from exports, especially to China, where demand for US-made products and services could provide a bonanza for a refocused US economy.

The days of codependency are nearing an end. China is striking out on its own. We can only hope Washington seizes the moment and converts Chinese rebalancing into a new source of growth and prosperity. Financial markets, long fearing the worst out of China, will need to come to the same realisation.

Stephen S. Roach is a faculty member at Yale University and former chairman of Morgan Stanley Asia. **Copyright: The Whitney and Betty MacMillan Centre for International and Area Studies at Yale**

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