May 12, 2016

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:

	April 2016	Year-to-date
Hong Kong Partners LP	0.8%	-4.8%
Hang Seng Index	1.4%	-3.9%
Hang Seng Small Cap Index	2.8%	-7.1%
MSCI HK Small Cap Index	1.2%	-7.3%

Partners' NAV $2.8624 after management fees, but before annual incentive fees of 15% on appreciation.

Our small/mid cap holdings of HK-listed, China-geared shares generally rose in April. Bank and property shares in Hong Kong (where we have no exposure) rose the most in April after the federal reserve delayed an interest rate increase.

We invest in shares of companies listed in Hong Kong that have earnings generated from growth in China. Our disciplined approach screens for fundamentally strong businesses and calculates an intrinsic value for each. For each stock position we seek to own, we demand an annual 20% price appreciation (to reach our targeted 10-year intrinsic value target).

Though positive, green-shoot economic data points were released in March (Chinese industrial profits jumped 11.1% year-over-year and exports soared 11.5% year on year -- both reports well above market forecasts), fears continue to plague investors on China's slowing economy, its volatile currency and rising credit conditions.

Those fears, however, may be misguided.

I read a recent report outlining a far-reaching, encouraging outlook for stocks in our region. In essence, the report declares we are now at a critical turning point in the Greater China markets.

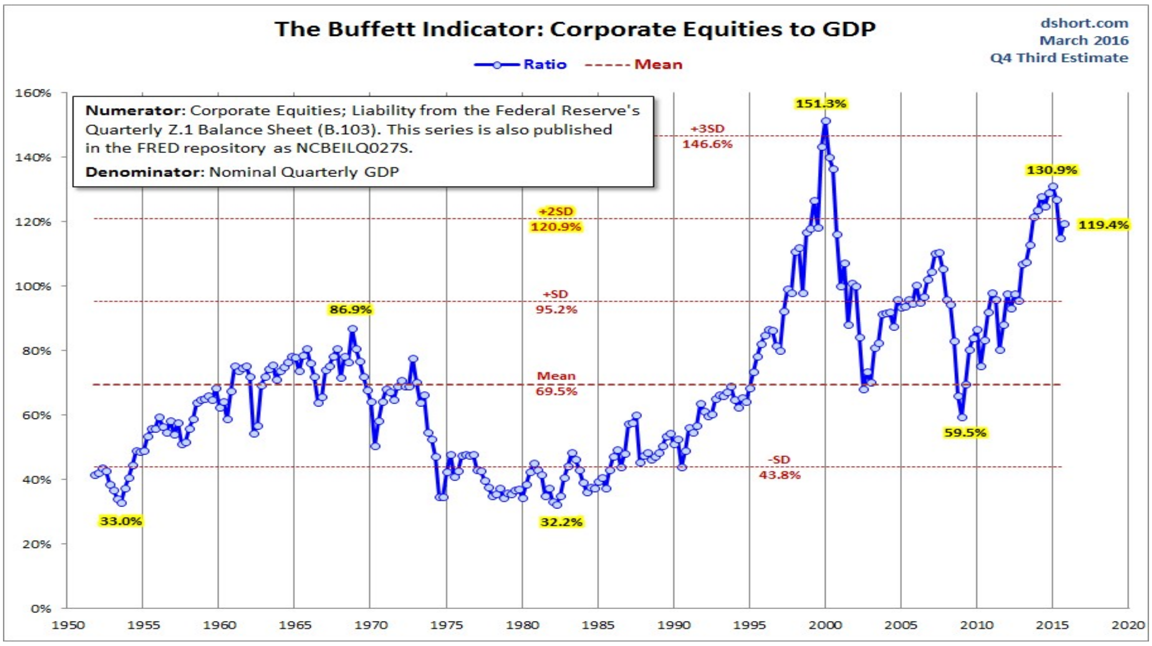
In the April 17th Bank of America Merrill Lynch report, *Changing stance on Asia/EMs from tactically to structurally bullish*, Merrill Lynch's top-rated equity strategist, Ajay Singh Kapur, did an about face and argues investors may be missing a significant turnaround:

> *…we now believe investors should make a longer-term bullish commitment to both Asia ex-Japan and Emerging Market (EM) equities. Only 29% of investors are Overweight EMs in the latest Fund Manager Survey. We are at an inflection point that is likely to challenge the winners of the past five years and boost the losers.*

We are reversing our five-year bearish views on Asia and Emerging Markets (EMs). *While we made a tactically bullish call at end-February, we now believe investors should get out of the bunker and off the fence and make a longer-term bullish commitment to both Asia ex-Japan and EM equities. We appreciate that the grinding underperformance of these two assets versus global equities has created exhaustion, cynicism and elegant bearishness. Every market participant, including those with a peripheral interest, should by now be ready with at least three bullet points on what ails these markets. The anchoring effect of five-year's underperformance is a powerful downer. We think that the balance of risks is exactly the opposite.* ***We are at an inflection point that is likely to challenge the winners of the past five years and boost the losers*****.*

Because Hong Kong stock valuations are cheap, any positive economic surprises will ignite price rallies (such as the April 13th upsurge of 3% and 4% for the blue chip Hang Seng Index and China H share Index, respectively, on China's better-than-expected economic reports). The credible turnaround forecasted by Merrill Lynch, on a five-year outlook, bodes well, especially for cheap stocks; the prospects for Hong Kong stocks are greater than at any time since the Great Recession of 2008.

Stocks today in the US are dear and China-related stocks are cheap. For the US markets, McKinsey articulates investment gains of the past three decades won't be repeated (see article [here](#)). Another gauge showing the US being expensive is the market value to GDP indicator:



As pointed out by Warren Buffett, the percentage of total market cap (TMC) relative to the U.S. GNP is "probably the best single measure of where valuations stand at any given moment." China's Corporate Equity to GDP ratio, though, stands at only [31.3%.](#)

Merrill Lynch's reversal of opinion is based on a confluence of 7 major fundamental trends transpiring now, summarized below (Ajay Kapur echoes many of the salient points we've been making in our monthly letters for the past year or more).

It is critical for long term investors to understand that these trends are bullish for China investors and potentially dangerous for US investors.

We are positive on the outlook for our quality, Hong Kong-listed small/mid cap holdings.

Sincerely,

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Bank of America Merrill Lynch report, *Changing stance on Asia/EMs from tactically to structurally bullish*

We cite seven reasons for our new, structural bullishness:

1. Valuations are attractive
Asian P/Sales relative to the world is in the 17th cheapest percentile since 1995 (EMs in the 19th cheapest percentile since 1995). The absolute Asia ex-Japan P/B of 1.3x is in its 8th percentile of the past 41 years, the EM P/B of 1.4x is in its 12th percentile since 1995.

2. Asia/EM currencies more competitive, US dollar reaching a peak/stabilizing?
About 40% of these 23 markets have currencies in their most competitive quartile, potentially boosting EBIT margins. Collectively, this breadth of competitiveness for Ems doesn't get much better than this, in our view (the crises of 1997-99 and the TMT bust of 2002 were the only periods that were even better).

3. Prior 33% inflation-adjusted appreciation in USD from 2011 lows likely to increase the US current account deficit=> more USD liquidity to Asia/EMs

4. Capex leads EBIT margins. Less capex => higher future margins => higher P/E
*Our five-year bearishness was partly driven by the massive capex binge in Asia/EMs pre-2010, hurting margins from 2011 to now. This has reversed – in India, **capex/GDP is down** 8.3% points from 2011, in Russia 6.3% points, in Brazil 5.1%, in Korea 4.3%, **in China 3.9% points**. Conversely, in both the US and Japan, the capex/GDP restraint of the Global Financial Crisis has been reversed (up 2.2% points and 1%, respectively) – presaging lower EBIT margins, in our view. We would get ready for a re-rating for both Asia and Ems relative to DM stocks, just based on prior capex differentials.*

5. The miserable run of Asian/EMs EPS growth/revisions is likely ending.

6. China's Monetary Policy is gaining traction, a key driver of Asia/EM equities

Monetary policy in China is working exactly as it should – by boosting property prices (a USD22tn market, accounting for 57% of Chinese household wealth). Imposing negative real deposit rates of -0.8% on China's savers to financially repress them makes sense given China's 250% non-financial sector debt to GDP. Don't fight this.

7. Option value in SOE reforms?
We think that a renewed public backlash against perceived corruption, more expensive and less available capital, and deteriorating fiscal positions are likely to drive an inflection point in emerging market SOE reform. Brazil is a potential example.

Risks to our view: USD strength; Chinese monetary policy stops easing/debt deflation risks; global recession/policy regime change turbulence; no SOE reform.

On point 2 above, regarding the rising US$ reversing, another respected analyst called "…this reversal the greatest money-making opportunity in memory… and if the U.S. dollar is truly reversing, will the losers of the past five years become the new winners? So those who are last now will be first then, and those who are first will be last*."

*First are last, last are first: both analysts see a similar flip flop ahead.