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

November 17, 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:

	Oct 2016	Year-to-date
Hong Kong Partners LP	+3.9%	-0.8%
Hang Seng Index	-1.6%	4.7%
Hang Seng Small Cap Index	-0.5%	-6.0%
MSCI HK Small Cap Index	-0.7%	-7.5%

Partners' NAV $2.983 after management fee and provisions, but before annual incentive fees of 15% on appreciation.

South Ocean's portfolio holdings of small/mid cap, Hong Kong-listed companies with earnings benefitting from operations in China, out-performed in October. One long term holding, a textile manufacturer, announced a reorganization which sent the share price up ~100%. We own numerous other depressed, quality companies in our portfolios we think are worth holding for such events as this in the future.

There is strong evidence of green shoots sprouting and a bottoming in the long, drawn-out slowing of China's economy. Recent data supports this view. For example, the Caixin manufacturing index (PMI) rose strongly to 51.2 in October. Annual GDP growth has remained steady at 6.7 percent in the second and third quarters. Deflating producer prices turned and increased for the first time in nearly five years. Power consumption on the mainland posted impressive growth of 6.9% in September, and car sales were strong +26%.

With all these data points, confidence may be returning, as the Shanghai Composite Index has increased 17.2% from the January lows this year.

Importantly, reforms to China's economy appear to be gaining traction as the change from a predominately industrial/exporting economy to a consumption economy bears fruit. Consumption contributed 71.0% of GDP growth during the first three quarters of this year, 13.3 percentage points higher than last year.

> *In the 1950s and 1960s the world economy was transformed by the emergence of the American consumer. Now China seems poised to become the next consumption superpower.*
> http://www.economist.com/news/briefing/21595019-market-growing-furiously-getting-tougher-foreign-firms-doing-it-their-way

With the surprise US elections having a huge impact on world stock markets, we found Bridgewater Chairman, Ray Dalio's general thoughts (below) interesting.

Sincerely,

Brook McConnell
President
Email: brook@south-ocean.com Website: www.south-ocean.com
Hong Kong

Reflections on the Trump Presidency, One Week after the Election

- Published on November 15, 2016
- Featured in: Banking & Finance, Economy, Editor's Picks

Ray Dalio

Chairman & Chief Investment Officer at Bridgewater Associates, L.P.

Before and immediately after it was clear that Donald Trump had been elected, the markets (especially the stock market) had negative votes on the man (thinking he might be irresponsible), while after he got elected, the markets reacted to the man's policies—so the correlations reversed. That shift was due to the changing complexion of market participants—those who drove the markets after his election were largely those who kept their powder dry until they saw the outcome and chose to process (and bet on) the policies themselves. As for us, we chose not to bet on whether or not he would be elected and/or whether or not he would be prudent because we didn't have an edge in predicting these things. We try to improve our odds of being right by knowing when not to bet, which was the case.

Having said that, we want to be clear that we think that the man's policies will have a big impact on the world. Over the last few days, we have seen very early indications of what a Trump presidency might be like via his progress with appointments and initiatives, as well as other feedback that we are getting from various sources, but clearly it is too early to be confident about any assessments. What follows are simply our preliminary impressions from these. We want to make clear that we are distinguishing between a) the sensibility of the ideology (e.g., one leader's policies might be "conservative/right" while another's might be "liberal/left") and b) the capabilities of the people driving these policies. To clarify the distinction, one could have capable people driving conservative/right policies or one can have incapable people driving them, and the same is true for liberal/left policies. To understand where we are likely to be headed, we need to assess both. To be clear, we are more non-ideological and practical/mechanical because to us economies and markets work like machines and our job is simply to understand how the levers will be moved and what outcome the moving of them is likely to produce.

The Shift in Ideologies

As far as the ideology part of that assessment goes, we believe that we will have a profound president-led ideological shift that is of a magnitude, and in more ways than one, analogous to Ronald Reagan's shift to the right. Of course, all analogies are also different, so I should be clearer. Donald Trump is moving forcefully to policies that put the stimulation of traditional domestic manufacturing above all else, that are far more pro-business, that are much more protectionist, etc. We won't go down the litany of particulars about the directions, as they're well known, discussed in my last *Observations*, and well conveyed in the recent big market moves. As a result, whereas the previous period was characterized by 1) increasing globalization, free trade, and global connectedness, 2) relatively innocuous fiscal policies, and 3) sluggish domestic growth, low inflation, and falling bond yields, the new period is more likely to be characterized by 1) decreasing globalization, free trade, and global connectedness, 2) aggressively stimulative fiscal policies, and 3) increased US growth, higher inflation, and rising bond yields. Of course, there will be other big shifts as well, such as pertaining to business profitability, environmental protection, foreign policies/alliances, etc. Once again, we won't go into the whole litany of them, as they're well known. However, the main point we're trying to convey is that there is a good chance that we are at one of those major reversals that last a decade (like the 1970-71 shift from the 1960s period of non-inflationary growth to the 1970s decade of stagflation, or the 1980s shift to disinflationary strong growth). To be clear, we are not saying that the future will be like any of these mentioned prior periods; we are just saying that there's a good chance that the economy/market will shift from what we have gotten used to and what we will experience over the next many years will be very different from that.

To give you a sense of this, the table below shows that a) these economic environments tend to go on for about a decade or so before reversing, b) market moves reflect these environments, and c) extended periods of movements in one direction (which lead to confidence and complacency) tend to lead to big moves in the opposite direction.

As for the effects of this particular ideological/environmental shift, we think that there's a significant likelihood that we have made the 30-year top in bond prices. We probably have made both the secular low in inflation and the secular low in bond yields relative to inflation. When reversals of major moves (like a 30-year bull market) happen, there are many market participants who have skewed their positions (often not knowingly) to be stung and shaken out of them by the move, making the move self-reinforcing until they are shaken out. For example, in this case, many investors have reached for yield with the upward price moves as winds to their backs, many have dynamically hedged the changes in their duration, etc. They all are being hurt and will become weaker holders or sellers. Because the effective durations of bonds have lengthened, price movements will be big. Also, it's likely that the Fed (and possibly other central banks) will increasingly tighten and that fiscal and monetary policy will come into conflict down the road. Relatively stronger US growth and relative tightening of US policy versus the rest of world is dollar-bullish. All this, plus fiscal stimulus that will translate to additional economic growth, corporate tax changes, and less regulation will on the margin be good for profitability and stocks, though for domestically oriented stocks more than multinationals, etc. The question will be when will this move short-circuit itself—i.e., when will the rise in nominal (and, more importantly, real) bond yields and risk premiums start hurting other asset prices. That will depend on a number of things, most importantly how the rise in inflation and growth will be accommodated, that we don't want to delve into now as that would take us off track.

Let's get back on track regarding whether the Trump administration will be…

…Capable or Incapable?

Our very preliminary assessment is that on the economic front, the developments are broadly positive—the straws in the wind suggest that many of the people under consideration have a sufficient understanding of how the economic machine works to run reasonable calculations on the implications of their shifts so that they probably won't recklessly and stupidly drive the economy into a ditch. To repeat, that is our very preliminary read of the situation, which is too premature to take to the bank. Of course, we should expect big bumps resulting from big shifts regardless of who is engineering this big ideological shift.

So, what are we trying to say? The headline is that the ideological/environmental shifts are clear, their magnitudes will be large, and there's a good chance that the "craziness" factor will be smaller and play a lesser role in driving outcomes than many had feared. In fact, it is possible that we might have very capable policy makers of the previously mentioned ideological persuasion in control. As always, we will keep you posted of our thinking as it will certainly change as we learn more.