ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

February Contents:

US Commentary

By Mark Zavanelli

You will notice that our newsletter has a new look this month. We've moved the numbers to their own expanded table that has the history in the same place. We're planning on one commentary each month from me and one from our Asia investment team at Alfa Research, led by Vaidas Petrauskas, as well as any special features.

January was simply a frightening month. Declines were fast and large, and added to the drop we already saw in December. There was a flight to safety, and smaller stocks did worse. The question on many investors' minds is if this is the start of another "Big One", a serious decline like 2000 or 2008. Or, is it a garden variety market correction that we typically see every couple of years. The label "bear market" doesn't mean much, but the data does support the idea that smaller declines are relatively common while more rarely it continues to be something much deeper and longer. In the time period since the 1987 Crash it's been an either or proposition. The data also argues that it's unwise for longer term investors to try to avoid the lesser declines, since the market has historically snapped back rapidly. By the time they sell the market is ready to go back up, and they are slow to reallocate to stocks in the ensuing rise. The smaller declines are like steps the market climbs as it rises. However there certainly would be a benefit to protecting

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Asian Results

By Vaidas Petrauskas

The fear-greed pendulum swung almost all the way to the fear side in the first three weeks of January. In the face of many uncertainties investor sentiment has changed to risk aversion. The excuse provided for the global sell-off was the slowdown in China and the precipitous fall in the oil price. Junk bonds and stocks sold off globally. In times like these fundamentals do not matter as investors sell indiscriminately. It was one of the worst starts to a new year in history and caught everyone by surprise. Then the turning point came on January 22nd. The day before, Mario Draghi (the President of the European Central Bank) hinted at more stimulus in March. Next day the oil price jumped from $26.50 to $31. The Japanese Nikkei 225 stock index jumped 5.88%. The U.S. stock market closed up 2% as investors scooped up bargains. In the last week of January the markets have calmed down and more or less returned to normal. While this is a relief we cannot be sure that we are out of the woods yet.

Thailand: Our Thai stocks came through beautifully in January. The Thai stock market completely ignored the global sell-off and marched upwards while all the major stock markets sank together. This shows that diversification can work even in times of panic if you are in the right markets. We were too early to buy Thai

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ZPR INVESTMENT MANAGEMENT
1642 N.Volusia Avenue
Orange City, Florida 32763

Phone: (386) 775-1177
Fax: (386) 775-7749

E-mail: zprim@mpinet.net
Web: www.zprim.com

China and Oil

By Vaidas Petrauskas

There are two things on investors' minds these days – China and oil. Will there be a hard landing of China's economy? Will they have to devalue the Yuan more? How far will oil fall? It doesn't help that the statistics coming from the Chinese government are fabricated. But their economy is obviously in bigger trouble than the government is willing to admit. China is the biggest risk to the global economy and global capital markets at the moment. Even though we have never invested in Chinese stocks due to lack of transparency (lousy accounting, fictitious earnings), it is impossible to escape the impact of Chinese economic problems for global investors regardless of where they invest. We got a taste of that in January.

China: China's economic growth in the prior years has been fueled by big investment in fixed assets (factories, hotels, malls) that sit idle because they built more than they actually needed. This was financed using cheap credit. As a result China's debt has ballooned. China accounted for more than a third of total global debt growth since 2007 according to McKinsey Global Institute. The Chinese government and households have relatively little debt. But the Chinese corporate sector is one of the most indebted in the world. The debt is mostly concentrated among property developers and industrial firms. This is a recipe for disaster if there is a real estate crisis. This puts banks at risk and they may eventually need to be bailed out. The local government debt in China also rose dramatically and the local governments are forced to sell land to pay off old loans because local governments are prohibited by law from borrowing directly from banks or investors. China's total debt now stands at a staggering $28 trillion, which is 240% of GDP and is increasing at a breakneck pace. Instead of tackling the debt problem, the central bank, scared about the slowdown in the economy, has been loosening money.

We already saw the reaction of market participants to these problems. Shanghai's stock market sold off dramatically while capital outflows have hit record levels ($1 Trillion in 2015) and the Yuan weakened. The government is trying to put out fires the best they can. China's reserves have been shrinking dramatically because the government has been selling U.S. treasuries to prop up the stock market and the Yuan. The reserves shrank by $513 billion to $3.3 trillion in 2015 (by $108 billion in December alone). A similar drop is expected this year. We think they will have to let the Yuan fall by another 2-3% because their liquid reserves will be drying up, which may force other Asian governments to devalue their currencies.

We are worried about a hard landing of China's economy and a possible debt implosion. Even though the economic impact of that on the U.S. economy would not be very significant, we know that the psychological impact on the markets is always much greater than the economic impact.

Oil: This year the daily correlation between the price of oil and the stock market was 0.97. This means they move in the same direction daily. This is unprecedented. The explanation that I saw was that oil now has become a leading indicator of economic activity. Meaning that if the price of oil is dropping today then the economy must be slowing and if the price jumps tomorrow then the economy must be picking up. This doesn't make a lot of sense. Instead, the oil price is determined by supply and demand for oil. The United States has begun to export oil (although it is still a net importer) and now produces almost as much oil as Saudi Arabia. Iran too has begun exporting oil now that sanctions have been lifted. On the demand side China is the biggest importer of oil in the world. As the Chinese economy slows, they need less oil. So, with oil supply increasing and demand falling, the price of oil has to come down, which it did. There are also power plays going on behind the scenes with Saudis trying to drive out the U.S. shale producers. It's a game of who blinks first.

If you are not an oil company or an oil exporter nation, cheap oil is actually good as it reduces your costs. This is great news for Europe and East Asia which import most of their oil. It makes oil-importing countries more competitive. The benefit from lower oil prices for U.S. is much more muted because consumer savings at the pump came at the expense of domestic oil producers, not foreign producers as before. Eventually supply and demand will rebalance and the oil price will rise again. Any conflict in the Middle East would make the oil price move upward fast. An agreement on cuts in production would do the same. In fact, the harder the price of oil falls the sooner the new cycle will start.

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US Commentary (Continued)

from the bigger drops. That's easier said than done of course.

I'll start with my answer first. I don't think this is one of the serious declines, and we are more focused on how we can prosper in the rebound than battening down the hatches for more declines. If evidence proves this wrong, however, we will change tack. We are active managers and are not afraid to get defensive if we feel it's necessary. Here are some pros and cons of the argument.

The key fear is that we are in a classic debt fueled bust that will take down the US and global economy. Excess leverage is the fuel for the boom and its inevitable decline is the bust. We've had irresponsible central bankers that have taken stimulus to an extreme through super low and persistent interest rates. The economy always cooperates by taking out more debt. The hubris of the central bankers is that they think this is somehow a controlled process and that they are good at acting counter-cyclically. At least some of the borrowing goes bad, usually at the same time as they are raising rates to cope with the boom that the borrowing caused. Data dependent is bad, data projective is good but they typically can't get that right. A downward capital cycle ensues, and in the majority of episodes results in a recession. Are we here now? Some would say yes, because we have energy loans going bad and the Fed just raised rates for the first time. Credit spreads, or the cost of default risk in the bond market, are rising. I say no, primarily because I think the capital cycle is still in recovery mode from the after effects of the Great Recession and Euro crisis despite the impact of energy lending. For example, Wells Fargo reported that their loan book increased 7% year over year in the last quarter, about double nominal GDP. China and oil are busts (discussed later by Vaidas), but these don't take the US economy down. For that we need a downturn in cyclical areas like autos and housing and a pullback by the consumer.

Instead, I think we have different cycles going on that are not in sync with each other. This causes temporary fear as one cycle dominates the data and psychology for a time and then recedes in importance. Thus we have the market correction we are in now. On the downswing we have commodities, China, and at least some excess leverage in financial instruments (primarily controlled in hedge funds). On the upswing are cyclical areas of the US economy, consumers in nearly all developed economies, and potentially non-commodity producing emerging economies as well. There's balance here, and I think we avoid a synchronized downturn. The irony of both a China bust and the commodity cycle is that they actually help us avoid a downturn in a significant way. It delays a rise in inflation, which will awaken the central banks and is the true marker of the start of the historical pattern. I think the cycle lives on to perish of some future boom later, and that we will be happy with market returns as we emerge from this latest scare. That's also the odds on favorite, because it's the small declines that are common and the big declines that are rare.

China and Oil (Continued)

The oil industry is very cyclical. It is a classic boom-bust industry. As the oil price rises it revives oil exploration and production as it becomes very profitable to produce and sell oil. This increases oil supply substantially while demand does not rise as much. As a result the price of oil drops sharply. Weaker oil producers go bankrupt and the other players cut capital spending and exploration. As a result supply drops and now there is a shortage of oil. This causes the price of oil to rise and the cycle repeats. In every single decade going back to the 1980s there was a crash in oil prices:

MOVE IN OIL PRICES

1980s: -67%
1990s: -72%
2000s: -76%
2010s: -80%

Source: wealthofcommonsense.com

So, the current 70% drop is not uncommon. Eventually oil prices will move higher once the current oil glut clears.

Asian Results (Continued)

stocks by a month. That is not unusual as far as timing. We saw positive developments and we bought but the market did not recognize that at once and sold off more. But our increase in Thai allocation paid off for us in January. The explanation of why Thai stocks ignored the global sell-off is that most foreign investors have already exited last year, so the market was left mostly to local players. Foreigners can wreak havoc in small markets when they all decide to leave together. The locals know that things are improving in their country economically. The Thai SET index finished the month up 1.01% (what panic?). Our stocks did even better, gaining about 3% in local currency in January. There was an additional 1% gain on currency appreciation as the Thai Baht strengthened against the U.S. dollar. So, overall we had a very good month in Thailand on both an absolute and a relative basis.

Japan: During the sell-off the Japanese Yen played its part as the safe haven as investors bought the Japanese 10-year government bonds which yield 0.2%. As a result the Yen has strengthened from 120.41 to the dollar on December 31st to 116.76 on January 21st. On the last business day of January (January 29th) the Bank of Japan (BOJ) surprised the markets. BOJ decided to play by the ECB book and adopted negative interest rates of -0.10% and promised to cut further into negative territory if deemed necessary. Not surprisingly, Japanese stocks jumped on the last day and the Yen fell to around 120 to finish the month where it started. So, in January we had two central banks –ECB and BOJ announcing that they will do anything to generate any kind of growth and inflation while the FED is contemplating their plans of four rate hikes this year, which now seems very unlikely.

The Japanese Large Cap index Nikkei 225 finished the month down 7.96%. The Singapore FTSE ST All Share index was down 7.01%. This is a remarkably similar performance to the U.S. S&P 500 index again proving that in times of panic the major markets move together.

Just the Numbers

	Period Ending 1/31/16		Period Ending 12/31/15				
ZPR Composites Names in Bold *Benchmarks in italics*	Month	YTD	1 Year	3 Year Annualized	5 Year Annualized	Inception (if under 5 yrs)	Incep. Date
ZPR Fundamental Small Cap Value	-7.44%	-7.44%	1.15%	14.43%	9.60%		
Volume Winners	-2.49%	-2.49%	10.87%	16.75%	10.82%		
Volume Value	-7.58%	-7.58%	5.61%	19.42%	17.34%		
Volume Momentum	-6.15%	-6.15%	-7.66%	15.18%	11.30%		
Russell 2000	-8.85%	-8.85%	-4.42%	11.65%	9.18%		
S&P 500	-5.07%	-5.07%	1.40%	15.14%	12.57%		
ZPR Global Equity	-6.96%	-6.96%	-2.69%	8.28%	8.58%		
MSCI ACWI	-6.01%	-6.01%	-1.83%	8.26%	6.66%		
ZPR All Asian	-6.39%	-6.39%	-4.21%	5.12%	8.56%		
MSCI EAFE	-7.22%	-7.22%	-0.40%	5.46%	4.10%		
ZPR All Thai Equity	4.21%	4.21%	-9.20%	3.57%		15.29%	1/1/12
Thai Set Index	1.01%	1.01%	-11.23%	0.65%		9.56%	1/1/12

Composite returns are presented net of management fees and trading expenses, and include the reinvestment of dividends and other income. All returns are in US dollars except for the Thai Set Index, which is presented in Thai Baht.

Past performance does not guarantee future results. The table above reflects (1) performance of the ZPR Investment Management, Inc. ("ZPR"), composites named in bold in the first column, (2) performance of the benchmark which reflects the composite's investment mandate, objective, or strategy, and (3) performance of the S&P 500 Index, which is provided for overall comparison and informational purposes. Please see the reverse for important information about composite and benchmark descriptions, how to receive more complete information about the composites, and disclosures regarding the calculation of performance, among other matters. Subsequent markets may perform better or worse than for the periods shown, which will cause the actual results of a portfolio to be better or worse than shown. ZPR does not guarantee or offer any assurance that any portfolio or account will be profitable, meet a client's stated objectives, or prevent or reduce losses. **A client may lose money by investing in a portfolio.**

ZPR Investment Management, Inc. ("ZPR") is an SEC registered investment adviser managing separate accounts that are fully discretionary. SEC registration does not constitute an endorsement of the firm by the Commission nor does it indicate that the adviser has attained a particular level of skill or ability. ZPR claims compliance with the Global Investment Performance Standards (GIPS™). To receive a complete description of the policies and procedures for any composite, a list and description of all ZPR composites, and a presentation that complies with the GIPS standards, please contact us at 386-775-1177 or zprim@mpinet.net.

All composites include fully discretionary, management fee-paying and, beginning on January 1, 2011, non-management fee-paying accounts, including those accounts no longer with the firm. The U.S. Dollar is the currency used to express performance, except for the Thai Set Index, for which performance is expressed in the Thai Baht. Returns are presented net of management fees and include all trading expenses and the reinvestment of all income. Net of fee performance was calculated using actual management fees, except in the case of non-fee paying accounts where model fees have been imputed. Actual advisory fees and transaction fees will vary depending on, among other things, the portfolio, account size, and activity. Fees are described in ZPR's ADV Part 2A.

The benchmark and other data provided was obtained from publicly available reports, including internally derived databases and other resources available to ZPR. ZPR believes such data to be reliable but does not audit, verify, or guarantee its accuracy or completeness. When comparing the performance results to a benchmark, clients should keep in mind that: 1) Indexes are unmanaged and unavailable for direct investment. 2) Benchmark returns include reinvestment of income, but do not reflect taxes, or investment advisory or other fees that would reduce performance. 3) Performance information of benchmark indexes is included for comparison purposes only.

Composite and Benchmark Descriptions:

The S&P 500 and Russell 2000 are market cap weighted indices of large company and small company US stocks, respectively.

The Fundamental Small Cap Value Composite consists of accounts that hold U.S. small cap stocks selected by using ZPR Fundamental Analysis. This analysis identifies undervalued companies using ZPR's GRAPES valuation model and also applies other selection criteria relating to a company's business prospects, management quality, and capital structure. The benchmark for the composite is the Russell 2000 Index, presented in U.S. Dollars. In the past the composite has displayed higher volatility than its benchmark.

The Volume Winners Composite consists of accounts that hold U.S. micro cap stocks selected by using ZPR Volume Winners Analysis. This analysis is a quantitative evaluation system incorporating volume, momentum and valuation measures. The benchmark for the composite is the Russell 2000 Index, presented in U.S. Dollars. In the past the composite has displayed lower sensitivity to market returns than its benchmark, which would cause it to underperform in a strongly rising market.

The Volume Value Composite consists of accounts that hold U.S. micro cap stocks selected by using ZPR Volume Value Analysis. This analysis is a quantitative evaluation system incorporating volume and valuation measures. The benchmark for the composite is the Russell 2000 Index, presented in U.S. Dollars.

The Volume Momentum Composite consists of accounts that hold U.S. micro cap stocks selected by using ZPR Volume Momentum Analysis. This analysis combines two quantitative evaluation techniques; ZPR's price and earnings momentum measure SuperMo, and ZPR's volume, momentum and value system Volume Winners. The benchmark for the composite is the Russell 2000 Index presented in U.S. Dollars.

The Global Equity Composite consists of accounts that hold both U.S. and International stocks selected by using ZPR Fundamental Analysis. This analysis identifies undervalued companies using ZPR's GRAPES valuation model and also applies other selection criteria relating to a company's business prospects, management quality, and capital structure. The benchmark for the composite is the MSCI All Country World (Gross) Index, presented in US Dollars. MSCI ACWI is a market capitalization weighted index comprised of equities from developed and emerging markets, including the US. The composite has historically held small cap stocks from a limited set of countries while the benchmark weighting is primarily composed of larger companies spread across many countries. This is likely to cause the composite to have greater volatility than its benchmark. The composite includes the performance of accounts that may occasionally use margin; however, the use of margin is not part of the overall strategy of the composite.

ZPR All Asian Composite consists of accounts that hold Asian stocks selected by using ZPR Fundamental Analysis. This analysis identifies undervalued companies using ZPR's GRAPES valuation model and also applies other selection criteria relating to a company's business prospects, management quality, and capital structure. The benchmark for the composite is the MSCI EAFE Index, which is comprised of equities from developed markets around the world, excluding the US and Canada. MSCI EAFE is presented in U.S. Dollars. The composite has historically held small cap stocks from a limited set of countries, including emerging markets, while the benchmark weighting is primarily composed of larger companies from developed countries. This is likely to cause the composite to have greater sensitivity to the returns of countries where it invests, and overall greater volatility than its benchmark.

The ZPR All Thai Equity Strategy consists of accounts that hold Thai stocks selected using ZPR's Fundamental Analysis. This analysis identifies undervalued companies using ZPR's GRAPES valuation model and also applies other selection criteria relating to a company's business prospects, management quality, and capital structure. The benchmark for the composite is the Thai Set (TRI) Index, a market capitalization weighted index of securities listed on the Stock Exchange of Thailand and presented in Thai Baht. The composite has historically held small cap stocks while the benchmark weighting is primarily composed of large companies. This is likely to cause the composite to have greater volatility than its benchmark.