ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

October Contents:

US Commentary

By Mark Zavanelli

World stock markets gained just slightly in September, closing out a strong quarter. The primary drivers were faster economic growth this quarter versus the first half of the year, a continuing rebound in emerging markets, and a bounce after the Brexit vote. As I've said before, as long as this economic cycle continues it's a buy the dip kind of market. There will be volatility but also potential for return. Despite all the pitfalls and the things that will eventually come back to bite us, the key factor right now is that the US economy continues to move forward. And indeed it is.

Small cap value as an investment style has led the way in 2016 after lagging previously. This change has surprised many forecasters because overall corporate earnings are doing poorly (this quarter might break the string of 5 straight negative growth quarters), and small caps generally do best during periods of economic acceleration. There are two important changes happening this year that likely have something to do with this. First, there might actually be acceleration. Emerging markets are starting to recover from the crash in commodity prices, and they can add meaningfully to worldwide growth. A confirming indicator for this story is the halt in the rise of the US dollar versus other currencies, which otherwise seems like a mystery. The strength in the

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Asian Results

By Vaidas Petrauskas

After a very calm summer the volatility returned to the global markets in September. Thai stocks started the month with a big drop. We couldn't understand what happened. It was out of the blue and didn't make sense. Then our broker told us there was a rumor floating around about the King's poor health. He is 88. That rumor made much more sense than all the analyst explanations of why the stocks tanked (Thais are not allowed to talk about the King's health, so analysts had to make up their own reasons). The fears about the King's health quickly subsided. Still, Thai stocks couldn't fully recover and couldn't escape the overall global stock market volatility caused by the Fed interest rate drama and the European banking crisis at the end of the month. When the King eventually passes away (he has ruled since 1946), there will be a big sell-off and we are preparing for that. It will be a buying opportunity because nothing will change in the economy. The King's role is largely ceremonial.

The Thai SET index dropped 3.97% in September and the Small Cap index FTSE SET Small Cap lost 6.84%. We lost more than 4% in Thailand. All our stocks were down across the board. Only our favorite real estate developer managed to close up for the month. Thai stocks are still having a great year. With the appreciation of the Thai Baht taken

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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

European Banking Crisis

By Vaidas Petrauskas

We finished the month with a full blown European banking crisis. In reality the banking crisis in Europe has been dragging for 9 years now. We wrote in the previous Investment Report that European banks found themselves between a rock and a hard place thanks in part to actions taken by the ECB. Negative interest rates are hurting banks' profits. They are being charged for "excess" deposits held at the central bank. They cannot profitably invest their un-lent funds because the government bonds that they can buy have negative yields. Add to that a huge level of non-performing loans, declines in trading volumes, more stringent regulation and capital requirements, and never ending multi-billion dollar fines, and one might wonder how they are still standing. The CEO of Credit Suisse Tidjane Thiam acknowledged that because of all these issues the European banks are "not really investable". So far the banks are the ones suffering the most from the actions taken by central planners and it won't get any easier in a near future. The new Basel IV bank rules will introduce another significant increase in bank capital requirements. The banks are finally revolting against the new rules.

The latest casualty in this never-ending mess is Deutsche Bank which has been dropping like a stone in September. The initial scare came after the US justice department told the bank it was seeking $14bn in fines over how it packaged and sold mortgage-backed securities prior to the 2008 financial crisis (the bank's market cap is $17bn). All of the settlements around this issue have been ridiculous (and all the banks have been fined). These bonds were rated by credit rating agencies and disclosed according to the standards of the time – it was the buyers of the debt who believed that mortgages could never go bad. Instead of looking for wrongdoing, the government is looking for scapegoats for the financial crisis and the banks are of course easy targets. Deutsche didn't originate these loans either, they simply repackaged and sold them, providing an investment banking and brokerage service. The size of the proposed fine is also crazy. From 2005-2007 Deutsche was involved in issuing about $67 billion in MBS, as compared to over $400 billion for J.P. Morgan. JPM's fine to the DOJ was $2 billion. Regulators never realize the consequence of their actions. The bank said they will not pay anywhere near that amount. Still investors got scared that Deutsche Bank will need to raise additional capital to cover the fine. The situation quickly snowballed after some big hedge funds reduced their exposure to Deutsche Bank. A loss of confidence can bring down even a healthy bank. This is an effective shakedown, as on the last day of the month Deutsche was reportedly close to a settlement with DOJ for $5.4 billion. Deutsche Bank may need support from Germany if this panic continues. The situation with European banks is reminiscent of what happened in US in 2008. People remember 2008 and will be quick to react. It won't take much for the European financial system to collapse and the panic to spread elsewhere. The European bank stocks are down 25% this year.

Another big German bank Commerzbank AG is in a similar situation and they are eliminating a fifth of their workforce. The oldest bank in Italy, Monte dei Paschi di Siena (established in 1472), faces a third bailout. Almost all Italian, Spanish, and Portuguese banks are in shambles. Credit is the lifeblood of an economy. Is it any wonder that Europe has zero growth despite all the monetary policy shenanigans? I agree with Credit Suisse CEO – the European banks are not really investable. Their business model is no longer viable.

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US Commentary (Continued)

dollar, along with weak foreign economies and commodity prices, has been a major source of the earnings weakness. So all of this could be turning together.

Second, there is a pendulum swinging within the US economy. Labor is starting to get a greater share of the economic pie, and wage growth and incomes are rising faster than the overall economy. Capital spending by businesses is being squeezed out as a result, and corporate profit margins are starting to slip. Consumer spending is taking up the slack. While most people will cheer this outcome, it risks upending the apple cart of this expansion. Inflation is rising, especially in the areas of supply constraint, like housing and healthcare. Some companies will feel the cyclical benefits of the higher spending, while to others it will feel like stagflation. The market is fixated on the short term and was happy the Fed didn’t raise rates in September. This is irrelevant since it will have to deal with higher rates sooner rather than later. Bonds have essentially been pulling stock prices up as longer term yields have gone lower and lower. That will also stop and it will have a large impact on the makeup of the market’s winners and losers. There are more twists and turns for the investing landscape ahead. We are keeping an eye on risk, as always, and working to be positioned one step ahead.

Asian Results (Continued)

into account, we are up over 16% in Thailand in 2016.

Our Japanese investments had a big month. The Nikkei 225 index was down 2.59%. Our Japanese holdings were up almost 6%, handily beating the Nikkei (Japanese small cap indices were also up for the month). In addition, the Yen appreciated 2% against the USD for a total return of over 7%. Opposite to the Thailand situation, all of our holdings were up across the board, except for one stock which has a minimal weight in the portfolio. When diversification works it’s a beautiful thing.

The Singapore part of the portfolio also did well. The FTSE ST All Share index closed 1.80% up for the month. We beat the index with the return of around 2.70%. Our new favorite Singapore gold stock is responsible for the whole gain. Putting it all together our All Asian portfolios finished September 1.97% higher.

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Just the Numbers

ZPR Composites **Names in Bold** *Benchmarks in italics*	Period Ending 9/30/16 Month	Quarter To Date	YTD	Period Ending 6/30/16 1 Year	3 Year Annualized	5 Year Annualized	Inception (if < 5 yrs)	Incep. Date
ZPR Fundamental Small Cap Value	1.80%	8.18%	26.75%	11.92%	14.81%	11.37%		
Volume Winners	0.79%	6.07%	13.40%	16.48%	14.48%	11.13%		
Volume Value	2.27%	11.61%	15.32%	5.76%	14.36%	16.28%		
Volume Momentum	1.08%	10.93%	11.20%	-3.61%	5.26%	11.26%		
Russell 2000	0.95%	8.87%	11.28%	-6.73%	7.08%	8.35%		
S&P 500	-0.12%	3.71%	7.69%	4.02%	11.67%	12.10%		
ZPR Global Equity	2.01%	7.13%	11.92%	-4.49%	5.09%	8.38%		
MSCI ACWI	0.66%	5.44%	7.09%	-3.16%	6.60%	5.96%		
ZPR All Asian	1.97%	6.56%	2.34%	-13.45%	-0.49%	7.05%		
MSCI EAFE	1.27%	6.50%	2.20%	-9.72%	2.51%	2.17%		
ZPR All Thai Equity	-4.26%	3.34%	16.78%	0.26%	4.01%		16.61%	1/1/12
Thai Set Index	-3.97%	3.69%	18.82%	-0.61%	3.20%		11.78%	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 ZPR All Thai Equity Strategy, 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.