ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

US Commentary

By Mark Zavanelli

US stocks were mixed in August, with large performance differences even as the S&P 500 was little changed. Our own US Small Cap Value stocks took a breather after a very strong performance year to date. Bond yields bounced back up after plunging with the Brexit vote and this sent Utilities down by about 5.5% this month. They were the strongest sector going into the month, and are still very expensive. It's a reminder that volatility is not dead and losses can come quickly even in supposedly safe assets. Forget about yield in stocks for now. When you consider price movements it's a meaningless number.

The Fed was a topic of market obsession during the month as they met in Jackson Hole. Right now it seems like they are getting what they want out of the economy, which is job and wage growth (not part of their mandate, by the way), so they are feeling smug. The thought pieces from the conference were all about how they can be even more creative with stimulus in the future. It doesn't matter if they raise rates in September (which they won't) or December, as long as they do it sometime. So far the Yellen Fed has been notable for its inability to communicate to markets, and this is going to be a problem when that is needed.

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Asian Results

By Vaidas Petrauskas

August was a quiet month, unlike the previous August. I assume everyone was on vacation. Volatility disappeared. Stocks rarely moved more than 1% for the day.

Our All Asian portfolios were down -0.36% for the month.

Thai stocks led the way with the Thai SET index gaining 2.31%. Our stocks were in line with that. The Thai stock market has advanced more than 20% this year and is among the best performing stock markets in the world in 2016.

The Thai baht gained 0.69% against the U.S. dollar. This trend is likely to continue because of Thailand's big trade surplus and the fact that foreign investors are flooding back into the Thai equity and bond markets. Capital inflows into Thailand were the strongest in July and August after the Brexit vote and after Thailand's constitution referendum.

The referendum on the new Thailand constitution was held on August 7th. 61% of Thais voted in favor. The new constitution is seriously flawed as it offers semi-democracy and tightens military rule. Still, the positive vote is a boon for Thai stocks as it removed one big political risk for foreign investors as well as Thai businesses. Investors flocked into Thai stocks and bonds after the vote. The general election is expected to be held in late 2017.

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Commodities & Bonds

By Vaidas Petrauskas

The price of oil continues to rise. It is now about 45 for WTI and 47 for Brent. It is on its way back to $50 a barrel. Saudi Arabia is at maximum capacity with 10.7 million barrels a day. Demand is increasing. The low price has done its work. The greens can't compete. Solar energy, even with massive subsidies, is too expensive. In places where municipalities switched completely to wind and solar energy (Germany, Denmark, some Australian cities), people saw their monthly electricity bills double and they are revolting. Meanwhile the regulators have effectively put every coal company out of business. Nuclear Energy is "no go" everywhere. Our oil related companies continue to make new lows, even worse than when oil was at $25. This disconnect creates opportunity. We have been having hotter weather globally and that spikes the demand for electricity (air conditioning) and the energy needed to generate it.

Elsewhere there are huge distortions. The corn harvest in the US was a record and corn is at $3.2 a bushel with the rest of the world having shortages. The price of wheat is at the lowest level in 10 years.

The big agricultural companies have not benefitted from the big harvest. The low prices and no place to store it has wrecked profits. Nearly all farm products have seen plunges in price. Powdered milk has fallen 50% in world price in just 2 years. New Zealand's exports are especially hard hit because of this. Only in the EU, with their huge subsidies and tariffs against any competitors, has the price stayed up. Dairy farmers elsewhere are having to reduce their herds and are heavily in debt. This is also driving the cost of beef down. Distortions abound. There are big winners and big losers.

Forecasters are also at frequent loss. Inventories of US gasoline were forecast to rise, but instead they fell. Most hedge funds have lost money on just about everything.

Worldwide the foundation of economic growth is rapidly disappearing. Investment in capital goods by corporations is falling. It's been assumed that one reason central banks cut rates is to force investors and companies to move funds from low-yielding assets (cash) into more productive investments that could produce better returns and growth. That's not happening. Corporate treasurers are sitting on a record amount of cash, fearful of the future. Who can invest in big new capital projects in such a climate?

The band plays on. Central banks will not admit failure. No signs of inflation in Europe or Japan despite negative interest rates and huge purchases of both sovereign and corporate bonds. The Bank of Japan is even buying stocks and is in effect nationalizing Japanese companies. Japanese asset managers are busy creating new ETFs specifically designed for the BoJ. The BoJ is on target to own 5% of the market next year. The Japanese government, in one form or another, is now the largest shareholder in a quarter of Tokyo First Section stocks. Helicopter money appears to be the next logical step.

It would appear that both UK and US long bonds are also headed for negative interest rates in this madness. The Bank of England joined other central banks after the Brexit vote and cut the rates from 0.5% to a record low of 0.25% and pledged to introduce a 70bn pound quantitative easing program. The rate on benchmark 10-year gilts is now a mere 0.60% while short-term notes have turned negative. The U.S. 10-year bond, with a yield of 1.5%, is considered to be a high yield bond when compared to the rest of the world. It will continue to attract interest from foreign investors because of its relatively high yield.

According to the Financial Times, the total global volume of sovereign and corporate bonds with negative nominal yields rose close to $13tn. That represents almost half of all western debt! Investors continue to gobble up those notes, even though they will lose money on redemption. In today's inverse universe, bonds are far more risky than stocks. Take the new 40 year Microsoft bond. Just a one percent increase in interest rates brings an immediate loss of a quarter of face value. Negative interest rates abound, but far worse is the huge potential losses of any increase in interest rates.

The only way you can justify owning bonds is to believe this:

1. The bigger fool theory. The rest of the world will drive down US long treasuries to also negative interest rates creating a temporary nice gain.
2. You have to own some fixed income security. So you have a choice of taking credit risk, in an environment where debt levels are high, or

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Commodities & Bonds (Continued)

extending duration a long way, taking massive interest rate risk, or accepting what you get with a short or medium term bond

3. Rates will stay low for a very very long time, so you won't be hurt by rising rates, and can grab a tiny yield.

Never in history have returns been so low and so far from compensating for risk. Pension plans are being squeezed. Of course some assets fueled by leverage and "free money" will grow to the sky. Real estate will take off because of free loans. But one day a wind will blow and houses made out of straw and paper will just blow away.

All this is starting to look like a one way street for gold. Before it was the gold ETF's and financial speculators that drove up the price of gold. Now we may see physical gold lead the way and soaring prices as this situation unravels. With the talk of restricting cash, will central banks and governments take a page from the past, outlawing gold as Franklin Roosevelt did during the depression, making it a criminal offense for an American to own gold for the next 40 years?

Destroying the Banks

By Vaidas Petrauskas

The ECB seems to be well on the way to wiping out the profits of European banks. First, there is a draconian levy of 0.4 percent on all "excess" deposits. This will cost the German banks alone close to 800 million euros this year according to the Financial Times. Banks are being penalized for the high savings rates and earnings of their citizens. Such a policy encourages riskier loans. In the banking chronicles, a bank with a lot of deposits is considered a joyous thing and many banks struggle to gather assets which is a major marketing function. This turns all logic upside down where deposits are a problem.

Secondly, the negative interest rate regime is badly hurting bank profits. Due to regulatory capital requirements a bank can only invest its unlent funds in government securities that now have negative yields. As their old loans roll off, they make new loans at lower rates given the fierce competition of other banks and much lower interest rate environment. Profits are sharply squeezed. German banks are barely profitable with a trailing return on equity of only 2.6%. By the next year, if the current situation continues, German banks may be reporting losses. That means they can't add to capital. Fortunately, most German banks are very sound as they have only a relatively small amount of non-performing loans at 3%. Compare this to Italy's 17% non-performing loans which is likely to be underreported. If Italy had to mark to market and follow normal accounting rules, most of their banks would be declared bankrupt. Portugal's non-performing loans are at 19% and Greece tops the charts again at 47%!

This level of non-performing loans is insurmountable. In the US banking system, a loan loss reserve for many banks of 2% is considered adequate in normal economic times. In a recession or for banks with weak local economy or for megabanks doing global loans a 3% loan loss reserve is normal. This is a good rule of thumb for the default rate on commercial loans. Personal loans and mortgages have a much higher default rate. Compare this to the average non-performing rate of 5.7% in the EU during what must be classified as "good" economic times given a 1% GDP growth rate is the best in years. Imagine what the loan loss rate would be if the EU went into a recession!

Banks are trying to pass on their negative rates as charges to big deposits of their corporate and institutional clients. What else can they do? However, this will not work with smaller customers who will vote with their feet. European banks are also planning to withdraw cash of their depositors and hoard it, thereby avoiding the high tax on cash by the ECB. We will see what the ECB does to stop it. Amazingly, at the same time that they introduced negative rates, the ECB started an assault on cash. They squashed the 500 euro bill and other higher denomination bills will likely follow. The end of cash gives more power to the central bank.

There is another problem where banks are a big fat target for every regulator, prosecutor, and politician. Everyone loves to fine the banks billions as free money as they don't put up a fight. Hurt the shareholders, the depositors and the safety of the bank. These are worse than bank robbers.

US Commentary (Continued)

One unusual event this month has been the sharp rise in Libor. This is a critically important short term rate that a lot of floating debt is priced in relation to. What's happening is that money market funds are facing a large movement of money from funds that invest in commercial paper to funds that invest only in government notes. This is due to upcoming regulations that make non-government money market funds into a different animal that won't always be redeemable at a fixed NAV. So the upshot is that what we think of as money market today will be restricted to government only debt so that it can function the old way. Predictably, this has caused the required yields for commercial paper dated "beyond the cliff" to rise. It remains to be seen what happens next. One likely possibility is that the market will adjust once the shift is complete, with other short term debt buyers swooping in to capture the higher yields and take the place of the money market funds. The reason this is important is that it affects the interest costs of a mountain of floating rate debt immediately.

We've talked a lot about credit markets in this month's report, because this has been a key force driving stocks as well. Long term Treasury Bond yields break down to new lows, and P/E multiples for stocks break out to new highs for this recovery. No mystery there. Earnings have been poor since oil prices fell, with S&P 500 earnings posting negative year on year comparisons for five straight quarters, but now seem poised to resume growing. The market likes that setup. The cycle continues, and the path of least resistance for US stocks is still higher. However, it won't be a straight line, and there will be more events like we saw earlier this year and in 2015. Like those episodes, I think the dips to come will be buying opportunities as well. With regard to longer term allocations, moments like the present are great times to check and see if you are positioned more aggressively than you really want to be. Valuations are high for US stocks, and that means longer term returns will again be low (although we don't know the path). Diversification should be a key focus in this market.

Asian Results (Continued)

The Japanese Nikkei 225 index was up more than 1.92% in August. But this index is now distorted by the BoJ buying of stock ETFs based on the Nikkei 225 index. A more representative Japanese large cap index is Topix, which rose 0.51% while Japanese small caps, as measured by Topix Small Cap index, dropped 3.46%. The BoJ is apparently not buying small caps. Our Japanese stocks also dropped over 3%. The Yen was relatively stable, gaining 0.10% against the USD.

Just the Numbers

	Period Ending 8/31/16			Period Ending 6/30/16				
ZPR Composites Names in Bold *Benchmarks in italics*	Month	Quarter To Date	YTD	1 Year	3 Year Annualized	5 Year Annualized	Inception (if < 5 yrs)	Incep. Date
ZPR Fundamental Small Cap Value	-2.49%	6.26%	24.51%	11.92%	14.81%	11.37%		
Volume Winners	1.48%	5.24%	12.51%	16.48%	14.48%	11.13%		
Volume Value	2.91%	9.13%	12.76%	5.76%	14.36%	16.28%		
Volume Momentum	2.23%	9.74%	10.02%	-3.61%	5.26%	11.26%		
Russell 2000	1.64%	7.71%	10.09%	-6.73%	7.08%	8.35%		
S&P 500	-0.12%	3.56%	7.54%	4.02%	11.67%	12.10%		
ZPR Global Equity	-1.51%	5.02%	9.72%	-4.49%	5.09%	8.38%		
MSCI ACWI	0.39%	4.75%	6.39%	-3.16%	6.60%	5.96%		
ZPR All Asian	-0.36%	4.50%	0.36%	-13.45%	-0.49%	7.05%		
MSCI EAFE	0.08%	5.16%	0.92%	-9.72%	2.51%	2.17%		
ZPR All Thai Equity	2.31%	7.94%	21.98%	0.26%	4.01%		16.61%	1/1/12
Thai Set Index	2.31%	7.98%	23.73%	-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.