ZPR Investment Report

December 2017 Volume 23, Issue 12

A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

There were several important developments this month as global equities extended recent gains. Most importantly, economic data in the US, Europe, and much of Asia (ex-China) continues to surprise to the upside and is now showing faster growth than we have seen for the past several years. This really is a very significant change with important implications. While the US is far along in its economic cycle, these foreign economies are just getting going - in some cases only now recovering from the commodity price weakness of 2015. This is great news for foreign stock markets where returns have been strong in 2017 but are coming off a period from 2014 through 2016 which generally showed losses. In the case of emerging markets, it has been a lost decade for stock prices as the 2007 peak was only recently eclipsed. These economies and markets are at a very different point in their cycle than the US. A rebound in growth after a prolonged slowdown typically translates into fast profit growth that can last for a while.

In the US, economic news was not the center of attention. The prospects for

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Asian and UK Results

By Vaidas Petrauskas

November was a difficult month for our Thai investments while Japanese stocks continued to march higher. Almost all Asian companies reported quarterly earnings in November, so we experienced greater than usual volatility in stock prices. The US Dollar continued on the same path – further depreciating against Asian currencies. Thankfully our Japanese stocks and a weaker Dollar managed to offset most of the losses from our Thai stocks and as a result All Asian portfolios finished with a slight loss of -0.30%. Our All Thai accounts took the full brunt of the Thai stock weakness. We also got a boost from UK stocks and the currency. UK stocks are only included in our Global portfolios.

Thailand

It was a disappointing earnings season for Thai companies. There were some bright spots and we bought some shares on good reports (construction, automotive, and real estate sector results were solid), but results for other sectors were disappointing. The Thai economy is booming, but it is not always apparent when looking at corporate earnings. Results vary dramatically by sector and many Thai companies are big exporters and got hurt by a strong Baht.

The Thai stock market became wobbly in November after being very calm (rising steadily) until November. The Thai SET Total Return index (in Thai Baht) lost -1.31%. But Thai Small Cap index FTSE SET Small Cap lost more than 2%. Our losses were much greater. Our official All Thai return, which is expressed in U.S. dollars, was -4.33% for the month. The Baht gained 1.80% against the US Dollar,

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Cash Is Back

By Mark Zavanelli

One of the ways that Fed policy worked during the age of zero interest rates and QE was to turn cash into a wasting asset. Any guaranteed return out to 5 years was guaranteed to leave you with less purchasing power than you started with (in other words, a negative real yield). The point was to get your cash either spent and into the economy or invested in something else with a little more risk to it. It definitely worked in the investment arena, and it added meaningfully to the valuation of those riskier assets. Now, for the first time since those policies were put into place, cash can actually earn about the rate of inflation. The 1-Year Treasury Bond currently yields about 1.6%, up from 1.2% just a couple of months ago. Bank CD rates are slowly resetting towards that level. We don't need to make big predictions about the bond market to know that short term rates are headed even higher with future Fed rate increases.

This is an important change that both borrowers and savers will feel. With normalization, cash can go back to a more traditional role in an investor's portfolio. That role is to cover predictable expenses where any risk of loss is unacceptable, and for tactical reasons to reduce holdings in riskier assets. Cash is always a poor long term investment. Will the return of the viability of cash begin to reverse the positive effect that Fed policy has had on riskier assets like stocks and long term bonds? It would seem obvious that it would have to have some effect, since it's hard to believe the benefit could be one-sided. However, the policy reversal is occurring in a very different environment at a very different speed, so it's hard to know. But the general direction is that during normalization rates will rise by some amount, which will subtract from bond returns and likely stop the overall rise in equity P/E multiples.

For borrowers, there's an important impact as well. With consumer loans, the zero interest rates fueled consumption, since zero percent financing reduced the out of pocket costs for large purchases such as autos. Those heavily financed assets become more expensive with the rise in 2-5 year rates, since consumer loans are generally shorter duration. In the corporate lending market, the zero interest rates incentivized companies to borrow in the form of bank loans with floating rates, typically Libor plus a spread. So now with short term rates rising, those borrowers are paying more in interest costs. Another impact on corporate borrowers might be an interaction effect with credit quality, since riskier borrowers tend to be shorter term, and will feel the impact of higher short rates disproportionately. Some of the current rise in delinquency rates may be related to this effect where riskier borrowers are feeling the effect of higher rates first.

The rise in short term rates is the same policy tool the Fed has used in past cycles, so they see that as a known quantity in terms of reaction for the economy and the markets. I think that there is something special about the move from zero to something visibly higher than zero, which might change behavior in a more significant way than just another tick up in rates. The Fed was going so slow up until now that any extra sensitivity didn't show up, but that all might change now if policy moves get more aggressive. Then finally there is the potential for the cumulative effect of rate hikes and balance sheet reduction to hit hard at the same time, making for significantly tighter monetary policy. That's why there's an extra danger if the Fed gets behind the curve this time, because there's so much potential to overshoot with tightening later.

US Results (Continued)

corporate tax cuts becoming enacted has improved dramatically, with passage of a bill in the House and the Senate about to pass whatever strange concoction can muster 50 votes. The market loves it, and has begun to price it in. From this level the market will fall if corporate tax cuts don't happen, but the odds of that are low. We might still get a "sell the news" pullback, but longer term lower taxes will be very positive for corporate profit growth.

We saw a reversal in favor of value stocks late in the month, and our Small Cap Value strategy benefited from that. The market has seesawed between growth and value since the election, but tax cuts and faster economic growth are positives for value stocks. Both active mutual funds and passive benchmarks in the US are heavily weighted towards large cap momentum stocks, which have seen very big gains this year. That predicts higher volatility and leaves the US market indices vulnerable to the risk of a sharp correction when the trend inevitably reverses. With low correlation to the market leaders, value stocks should handle a correction pretty well. I don't think there's much risk of a wider economic event at this point that would derail the cycle and make all stocks toxic. But after a period of very strong returns, it's a great time to be thinking about your assets in terms of risk exposure and not how much they can make for you (remember the old saying, "when others are greedy, it's time to be fearful"). Speculation in a bull market is a rational activity, as long as it's with money you can afford to speculate with.

Asian and UK Results (Continued)

so our losses in local currency were greater.

Our underperformance in Thailand can be attributed to poor earnings reports by some of our companies and a change in market sentiment towards some sectors – namely real estate developers which reported strong results and gave very good guidance, but were generally sold off on the news. This sector has strong earnings momentum which should continue into 2018. I expect the stocks of developers to fully recover as the 4th quarter will be a record quarter for almost all Thai home builders.

Our largest–weighted Thai company, which is in a stable defensive industry (food), surprised us with dismal results. This caused the stock to drop 25% for the month. We managed to sell a little right after the announcement and will be selling more. The problems for this company will take time to fix it seems. So I don't expect this stock to fully recover.

We had two more bad reports and subsequent losses in those stocks. The problems there may last another quarter, but are temporary for understandable reasons. I expect these stocks to recover in time and we have been adding to our positions.

We did not have many winners in Thailand to offset all those losers. Only one stock was a big winner for us, gaining 16% for the month.

Even after a difficult November our year-to-date return in Thailand is still good at 16.83% in US Dollars.

I view the recent setback as temporary. Thai economy is expected to grow at least 4% next year. The good news is that after a long time some stocks have come down in price to a level where they start to look interesting. We have around 10% cash in Thai accounts for opportunities like this. But we are not buying aggressively yet. We would need a bigger sell-off for Thai stocks to become obviously cheap.

Japan

This Japanese earnings season was more optimistic. Earnings for most Japanese companies are up strongly partly due to the weak Yen and stocks continue to move higher. We gained close to 2% in local currency in Japan. A stronger Yen added another 0.90%. So another good month in Japan. Year-to-date we have already gained more than 40% on Japanese stocks when measured in US Dollars.

Japanese companies are now facing severe labor shortages, which limits their growth opportunities. Interestingly, wages are not growing. I addressed this conundrum in the last monthly report. It will be interesting to see what they do about it.

Currency is obviously a very important component of our total returns. This year stronger Asian currencies (or to be more accurate – weaker Dollar) greatly boosted our returns from Asian stocks. In other years, currency will be a drag. This year is unusually favorable in Japan in a sense that both are helping. Stocks are much higher,

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Asian and UK Results (Continued)

and the currency is stronger. That is rarely the case. A stronger Yen was a big tailwind for our Japanese investments in 2017.

I have no idea what the Dollar will do in 2018. There are arguments for and against stronger Dollar going forward. Because of interest rate differential (higher rates in the U.S.) money should be flowing to Dollar-denominated assets. But it is never as simple as that. There are many moving parts and Central Banks are always playing games with the yield curve – the Fed is not letting the long rates rise and the yield curve has flattened as a result. There are always experts who "know" where a currency is headed, but their analysis is usually based on a recent trend. I don't remember any experts a year ago predicting that 2017 will be the year of much weak Dollar. A year ago almost everyone agreed that the Dollar will continue to get stronger ("parity with Euro!" read the headlines on Bloomberg) and the Euro will disintegrate. That didn't happen and the EUR/USD rate is at 1.20.

Singapore & UK

We lost money on Singapore stocks in November. The Singapore returns are always very volatile. October was great – we gained 8%. Then in November everything reversed and we lost more than 7%. The Singapore Dollar strengthened by 0.90% against the US Dollar. We only have two Singapore stocks and they make up a tiny portion of the portfolios.

UK stocks and the currency gave a boost to our Global portfolios in November. Our UK stocks rose around 1.60%. A stronger Pound added another 1.83%. The UK stock market, as measured by the UK FTSE All Share index, lost -2.04%. Despite the Brexit mess and the economic problems in UK, the results for UK corporations continue to be very good. Homebuilders, equipment rental companies, kitchen builders, restaurants are all reporting solid revenue and earnings growth. No slowdown in sight yet.

Happy Holidays!

All of us at ZPR Investment Management wish you a joyous holiday season and a happy, healthy and prosperous 2018!

Just the Numbers

	Period Ending 11/30/17			Period Ending 9/30/17			
ZPR Composites Names in Bold *Benchmarks in italics*	Month	Quarter To Date	YTD	1 Year	3 Year Annualized	5 Year Annualized	10 Year Annualized
ZPR Fundamental Small Cap Value	5.25%	5.84%	26.01%	22.32%	15.79%	17.82%	8.92%
Volume Winners	1.53%	-1.62%	11.52%	31.91%	19.49%	18.83%	NA
Volume Value	1.49%	2.10%	15.98%	40.23%	23.86%	22.73%	NA
Volume Momentum	0.06%	0.49%	17.61%	31.34%	12.16%	17.59%	NA
Russell 2000	2.75%	3.62%	14.96%	20.75%	12.18%	13.79%	7.85%
S&P 500	2.81%	5.20%	20.20%	18.63%	10.83%	14.23%	7.44%
ZPR Global Equity	1.82%	4.18%	26.25%	23.96%	7.81%	12.72%	11.50%
MSCI ACWI	1.98%	4.12%	22.61%	19.30%	8.03%	10.80%	4.45%
ZPR All Asian	-0.30%	3.60%	27.31%	26.27%	3.70%	10.21%	15.11%
MSCI EAFE	1.06%	2.61%	23.61%	19.68%	5.52%	8.90%	1.83%
ZPR All Thai Equity	-4.33%	-3.02%	16.83%	23.74%	6.38%	12.30%	NA
Thai Set Index	-1.31%	1.55%	13.43%	16.43%	5.12%	8.77%	NA

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 compliance@zprim.com.

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 dependcing 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.