ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

US stocks continued to rise in January, this time led by large caps and tech stocks. This was despite trade and security issues jumping to the top of the Trump agenda. While the market is afraid of protectionist policies that hurt trade, the primary issue is a resurgence of consumer and corporate confidence. Small business confidence, as measured by the NFIB survey, shot up to its highest level since 2004 and weekly jobless claims are near their lowest levels since the 1970's. The consumer has been the steadiest part of the economy, and they continue to spend consistent with rising incomes. Business investment, however, took a positive U-turn in the 4th quarter GDP report, showing its first increase in 5 quarters. This is really the most significant change, since businesses had been very worried about a profit margin squeeze with costs rising faster than sales (that's why profit growth had been negative for several quarters). Now, businesses see the prospect of higher sales and lower taxes and are changing their minds about potential investments. So right now it's safe to bet on economic strength. Repeating what we said last month, a change from caution to optimism moves gradually in the real economy where

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Asian and UK Results

By Vaidas Petrauskas

Our Asian investments are off to a good start in 2017. In January our All Asian portfolios rose 4.48%. The US Dollar weakened against all currencies that we invest in, which was one reason for the good performance, but the main driver behind good results was the appreciation of our Thai and Japanese stocks.

Our Thai stocks gained around 2.80% in local currency compared to a 2.24% gain for the benchmark Thai SET Total Return index. The Thai Baht appreciated by 1.7% against the US Dollar propelling dollar returns even higher. The official All Thai return, which is expressed in U.S. dollars, was 4.53% in January. Our Thai returns are muted by a large cash position. This is due to a lack of new opportunities as the stock market keeps rising (up 20% last year) and we have been doing more selling than buying. The earnings season in Thailand is upon us – that will begin in mid-February. We will look to deploy more cash to Thai stocks as they report.

Japanese stocks had the best performance of our markets this month. Japanese stocks have the biggest weight in All Asian portfolios. Our Japanese stocks rose around 3.3% for the month, easily outpacing the Nikkei 225 index, which fell -0.38%. The Yen rebounded. It gained 3% against the US Dollar and added another layer to Dollar denominated returns. At the end of last

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Uncertainty

By Mark Zavanelli

This is a disconcerting time for many investors, as they sense (correctly) that serious change is afoot. There was an entrenched order of things both economically and socially that is in the process of being overturned by a populist revolt, most recently evident with Brexit and the US election. Regardless of one's political leanings, it's unwise as an investor to assume that the change is either "all good" or "all bad", and to think about investments in that light. Instead we need to work to figure out where and how much the old order is changing, because it's a good bet that the relative prices of assets will change with just as much magnitude.

This may be a particularly bad time to follow a passive investment strategy, even though the investing world is embracing passive investments like never before, through ETFs. The reason is simple. Passive is based on market weights, in stocks, bonds, and even between asset classes. We've seen in the past instances where market weights are precisely the wrong weights when you are about to experience real upheaval. There's a yin and a yang to all of these for investors, and some areas will benefit while others are hurt. I'll discuss some of the potential points of change.

Labor vs. Capital, and the 1%

When the history of this period is reflected on, it will probably be said that the Great Depression taught policy makers that capital had to be stabilized in a financial crisis by any means or the whole system would suffer damage that would take decades to repair. So returns to capital had to be made attractive and risk backstopped to prevent massive deleveraging. When combined with the ability to move capital globally, these policies from central banks and treasury departments succeeded in enabling a quick rebound in the returns to capital. However the labor market was much harder to fix, because a recovery there doesn't usually mirror the decline (finance and home construction employment would be two examples that have been slow to come back). By income measures it has still not fully recovered, over eight years later. The result has been widening income disparity and a class of super wealthy, the 1%ers. It wasn't supposed to happen this way. Now, the populist rebellion will insist on different policies. Interestingly, the Hobbesians among us who might have predicted that the voters would just take the money directly, a la Bernie Sanders, have been wrong. Instead, it's much more driven by the middle class, and practical about how to obtain actual results. Rejected are the Left's policies that transfer wealth from workers to non-workers (watch out France, it's happening to you!), and which favor ideological causes over worker paychecks. Similarly, supply side policies of the Right are useful to them only in a direct fashion, such as tying corporate tax reform to domestic production, and not as "trickle down" effects.

I think there has to be a rebalancing of the corporate sector as a result of these demands. Record profit margins in this recovery will need to be replaced by faster growth. At the least it will mean a switch between winners and losers. We're already seeing it in the pharma sector, where the government has two ways to influence margins, one as the largest buyer and another as a regulator. In theory this is negative for stocks, as labor will garner a larger share of the pie. So the key is for the pie to start growing. But there will be both winners and losers among companies and industries.

Globalization vs. Protectionism

Globalization is an incredibly powerful feature of our modern world, spurred on in recent years by profound technological changes (especially communications and the Internet) and cross border investments by multinational companies. It's not going away. However, a temporary step back is happening. Britons don't really want to be told what to do by a supranational organization, and are willing to sacrifice economically to achieve that. How will the EU need to change to survive? I don't think that cross border bank bailouts will be politically acceptable any more, even though Germany is the prime beneficiary of the EU economic setup. We need to be cognizant of the risk from the EU periphery again this year, because both givers and receivers may not want to continue the same way as before. It doesn't have to be all risk. The EU is actually a protectionist bloc and is economically trapped by its own regulatory and financial problems. A change could actually ignite growth and send their markets flying, provided their banking system can survive.

Next, new policies in the US seem likely to sacrifice some of the benefit from trade that its consumers have seen (in the form of lower prices) in order to protect its production. The upshot may be that China can no longer

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Uncertainty (Continued)

massively subsidize certain industries to protect its own growth and employment (such as steel and other basic industries), because it will no longer be allowed to dump that product on the US market. I have always thought trading real stuff with China in exchange for IOU's was a great deal, but it actually depends on the time frame. Here's an example. If Amazon raises prices on books, will you go to your local bookstore instead? Of course not, you won't be able to because the competition has been wiped out, and isn't coming back without defensible margins. So it was cheaper for a while, but over time you might pay it back. China has been playing a long game. We have to be careful here and watch for shocks that cause a dive in Chinese demand, or with corresponding inflation in the US. Trump likes to move decisively and unequivocally, but if this apple cart is upset it will have a serious impact on the global economy. In any case, we should remember that large multinationals have been the largest beneficiaries of globalization, and they will suffer at least on the margin with its retrenchment.

Interest Rates

Since the 2008 financial crisis, interest rates in developed markets have been determined by a combination of central bank manipulation and a belief in the long term trend of falling rates. Both of these can be undone, and faster than one might imagine. Populism is supportive of reflation, and not of extreme monetary policy antics that redistribute wealth through artificially low interest rates. In the US the Fed is exiting this game, and not a moment too soon. Are they behind the curve? Hopefully not. Rate increases in the US are in the market's expectation already, but higher inflation that pushes the whole curve higher really is not. Bill Gross says he's watching 2.60% on the 10-year Treasury as a level above which would mark the end of the bond bull market (34 years!). There are factors that would keep the rate below that even as the Fed hikes, such as buying from Japanese investors where the 10-year is pegged at zero by central bank promise. The idea is that when rates actually rise past a certain point it will change the perception of the fixed income market and also signal to central bankers that their policies need revision. If a rise in rates happens gradually it can be just a mild headwind for non-fixed income assets, but not if it is too abrupt. In either case, there is a massive amount of investor money in assets whose price depends on these low interest rates. Bonds and bond proxies like REITs and Utilities are obvious, but all stocks actually have a duration component. Both large cap growth stocks, which have a long duration due to the value of their more distant earnings, and highly indebted companies, are at risk from higher rates. But there are a couple of big benefits from interest rates that gradually normalize. The first is a reallocation of capital that benefits investment over financial engineering. In combination with a forecast for growth, money can flow to capital spending that increases production rather than reshuffling existing assets. We have had the odd situation of a capital stock that increased a lot in value (take real estate in the EU, for example) without sparking capital spending to make more of it. This had something to do with the idea that you could make money in this environment as a speculator but not as a long term investor in the underlying assets. A second effect is the rebalancing between borrowers and lenders. When central banks artificially manipulate rates by buying government bonds, especially longer dated ones, they practice an odd form of crowding out. The extreme example of this was negative residential mortgage rates which occurred for a brief time in a few places in Europe. While the borrowers would naturally be all for this, the lenders were not so excited unless they could sell or hedge the loan. So the market doesn't really function well at a point where prices don't make sense and no one expects them to persist. Just because central banks and market participants inflate assets on an exchange doesn't mean that real world transactions will follow. All of this craziness will eventually be part of a chapter on extreme markets in an economics textbook, and if we can rid ourselves of it without another crisis it will increase long term confidence in markets.

US Commentary (Continued)

decisions take time to plan and implement.

Meanwhile the Fed and the bond market are not failing to notice the change in the economy's direction. Interest rates are beginning to normalize, and we finally have a positive 10 year yield in real terms. The Fed knows we don't need negative real short term yields either at this point in the cycle, so we will finally see a more aggressive path of rate increases this year. Ultra-low rates in the US are a thing of the past. It will be interesting to see how this all affects the dollar. Stronger growth and higher rates in the US would suggest that it will continue to rise against the rest of the world, but Trump and his team don't want that and will try to bring out surprises that keep it in check.

Overall, the path of the US stock market should be higher with rising earnings, especially if a corporate tax cut is enacted. Valuations are high overall, but there is no shortage of inexpensive stocks. What valuation tells us at this point in time is that forward 10 year and maybe 5 year returns are likely to be below historical averages for the major indices. Valuations do mean revert over long periods. For the shorter term, they are actually a poor predictor of forward one year returns for the market, because on average they have only indicated if you are presently in a bull or bear market which tends to persist over the next year. Most strategists and pundits predict low returns for this year due to valuation, but I don't think that logic is a good fit with history. That being said, we can expect volatility, and diversification when times are good helps us if things turn unexpectedly sour. In our Small Cap Value strategy we have an unusually large amount of cash, as we have been slow to reinvest funds from positions that rose over the last few months and were sold. The plan is to use the inevitable moments of doubt to pick up the stocks we like at even more attractive prices.

Asian Results (Continued)

year we had a lot of cash in our All Asian portfolios. We greatly reduced the cash position in the beginning of January by buying more Japanese stocks. Our biggest concern with investing in Japan was that the Bank of Japan would do something crazy to weaken the Yen overnight. That no longer seems likely because the Yen depreciated by itself and the BOJ is now promoting buying equities. Also the currency manipulators are now in the crosshair of Donald Trump. He named China and Japan specifically. Japan is now taking a pro-Trump stance and is being proactive in avoiding trade problems with the U.S. They have a lot to lose. The auto industry is very important to Japan. Shinzo Abe was the first foreign official to visit Donald Trump even before the inauguration. They will not do anything to upset the new U.S. administration. With the risk of big currency devaluation by the central bank almost gone, we deployed more cash to Japanese stocks.

The Japanese economy is showing signs of life. Manufacturing activity and exports are improving thanks to the weaker Yen and improved confidence. At the beginning of each year the Barron's newspaper hosts the Barron's roundtable. They invite many well-known investors and market pundits to discuss the outlook for the year. I find it interesting to read even though most of the predictions don't come true. What was interesting this time was that there was a consensus that Japanese stocks are a place to be in 2017. We agree with that. An improving economy and accelerating manufacturing activity bodes well for corporate profits. Stocks are very cheap, so there is plenty of upside.

Singapore was a drag on performance. Our Singapore portfolio is heavily weighted in one gold stock. So when gold comes back into favor it will do well. We lost about half of a percentage point in Singapore, but the Singapore dollar gained 1.78% against the US Dollar pushing our dollar returns into positive territory.

In the beginning of January we started buying UK stocks for the Global accounts. The UK stocks make up 6% of the Global portfolio. The first month was challenging. Our UK stocks lost around 4% in January, but the Pound appreciated against the U.S. Dollar by 2%. So our dollar return is around -2%. It will be a bumpy ride with the upcoming Brexit negotiations. Contrary to what many believed, the U.K. economy did not go into recession after the Brexit vote. The economy is still growing, albeit at a slow pace, thanks to healthy consumer spending.

On January 17th the British PM Theresa May finally unveiled her plans for Brexit. It will be a "hard Brexit". Britain will quit the EU single market and the customs union and will impose limits on immigration from the continent. Access to the single market comes with free movement of goods and people. To the British, control of immigration is of paramount importance, in which case membership of the single market is out of the question. A new free trade agreement will have to be negotiated between Britain and the EU. With EU officials eager to make an example out of Britain that leaving the EU is a big mistake and the British PM saying she will walk away if she cannot get a good deal, the negotiations won't be quick nor easy. It's a game of Chicken.

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Just the Numbers

	Period Ending 1/31/17			Period Ending 12/31/16			
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	2.64%	2.64%	2.64%	30.22%	11.08%	16.63%	8.24%
Volume Winners	-0.08%	-0.08%	-0.08%	31.97%	17.34%	17.47%	NA
Volume Value	0.97%	0.97%	0.97%	42.37%	19.57%	25.79%	NA
Volume Momentum	1.26%	1.26%	1.26%	24.75%	6.94%	17.41%	NA
Russell 2000	0.35%	0.35%	0.35%	21.31%	6.74%	14.46%	7.06%
S&P 500	1.79%	1.79%	1.79%	11.98%	8.88%	14.67%	6.95%
ZPR Global Equity	3.51%	3.51%	3.51%	14.49%	5.56%	13.00%	10.92%
MSCI ACWI	2.76%	2.76%	2.76%	8.50%	3.70%	9.96%	4.12%
ZPR All Asian	4.48%	4.48%	4.48%	5.16%	2.48%	11.27%	14.48%
MSCI EAFE	2.91%	2.91%	2.91%	1.50%	-1.16%	7.05%	1.23%
ZPR All Thai Equity	4.53%	4.53%	4.53%	19.94%	11.09%	16.21%	NA
Thai Set Index	2.24%	2.24%	2.24%	23.85%	9.41%	12.28%	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.