ZPR Investment Report

January 2017 Volume 23, Issue 1

A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

The small cap and value investment styles continued their positive post-election run in December because of strengthening expectations for the economy and corporate performance. This result for 2016 took a lot of people by surprise. Earlier in the year it looked like we were facing risks from a commodity bust and related economic weakness in China and other emerging markets, in addition to high stock prices, zero corporate earnings growth, and rising rates in the US. It was the "new normal" of slow growth facing a potential end of the economic cycle. These consensus expectations drove relative stock prices when investors bid up large cap growth stocks (which are seen as able to weather a weak economy) to extreme levels and shunned smaller value stocks that would have been hurt by an economic downturn. This outperformance by growth had actually been going on since 2014, when the Fed first began tapering QE and then raising rates. Absolute returns for our own small cap value strategy were very low for 2014 and 2015. That all changed in 2016, however, now that surging consumer and business confidence will power the expansion in 2017. Given how entrenched the status quo had become among both investors and in the real economy, these changes in spending and investment will be a powerful stimulus, resulting in more

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Asian Results

By Vaidas Petrauskas

December was a relatively calm month for us in Asia. With all the earnings announcements taken care of in November there wasn't much action on our part. Our All Asian strategy finished slightly higher in December.

Our stocks recorded gains of around 2% in local currency in all three markets of Thailand, Japan, and Singapore. We beat the benchmarks in Thailand and Singapore and lagged in Japan. However the Japanese Yen hurt our results. It lost -3.17% against the U.S. dollar. The Singapore dollar lost -1.29% against the U.S. dollar, but this was more than offset by the gain from our Singapore stocks.

2016 was one of more challenging years for our Asian investments. However we still recorded a gain of 5.16% and managed to beat our benchmark MSCI EAFE index, which gained 1.51% for the year. Breaking down the results by country, Thailand was our best Asian market. In 2016 our Thai stocks gained 19.94% in local currency versus a 23.85% gain for the Thai SET TRI Index. Thai Baht also helped as it appreciated slightly against the U.S. dollar.

Singapore was a disaster. We lost around 30% on Singapore stocks. It was the smallest of our three country weights in the overall portfolio, but still hurt badly.

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Breaking the Bond Bubble, and other 2017 Predictions

By Mark Zavanelli

Forecasting is a tough business. In investing, it's more important to ask the right questions and to understand the expectations that are currently priced than to make accurate forecasts. That way, it turns the low forecasting odds on their head and success is defined as figuring out where the consensus is overconfident or even directionally wrong.

THE GLOBAL BOND BUBBLE

In the summer of 2016 global bond yields hit absurdly low levels, including an all-time low yield for the US 10 Year Treasury Bond and negative 10 year yields on government bonds in Europe. We said at the time that the only way these made sense were using a "greater fool" theory, since prices had risen so high that the only way for bond investors to earn any return after inflation was for the bonds to continue to rise so they could sell them. If you bought at these prices and held to maturity there would be a very high likelihood that you would have less purchasing power at the end. This extreme situation, regardless of the causes, couldn't persist, and has begun to normalize. 10 year yields have risen about 1% in the US and 0.5% in Germany from the bottom. The question for 2017 is how high will they go?

Just like other market bubbles, the more extreme something is the further it will usually mean revert over time. This process can sometimes be fast, usually when an investment has become a popular mania with brand new participants, or sometimes it can play out over many years. I think this one will be more of the second type, since fixed income as an asset class doesn't have very widespread speculation. Even as a slow process, however, a rise in yields will have a profound impact on other asset classes such as stocks and real estate. For example, we may be at peak P/E multiples for US stocks if rates continue to rise. That doesn't mean the market won't go up, just that it has to be backed by actual earnings growth. This is another factor pointing away from growth stocks, since these typically do best when the market P/E is expanding. Stocks that are priced as yield plays, such as Utilities or Consumer Staples, will not likely see the price growth they did when rates were falling. Similarly for global real estate, in a period of rising rates prices will be less driven by prospective capital gains and more a function of their rent or rent equivalent. Real estate is prone to leverage driven speculation, so specific markets that saw significant capital gains may now see a reversal.

EMERGING MARKETS CONTINUED RECOVERY

Emerging market economies stabilized in 2016 due to the improved commodity price environment. Emerging market currencies were still weak, however, and this delayed foreign investment and held back growth. The market right now has a very strong consensus belief that rising rates in the US will continue to propel the US dollar higher, and that as a result emerging markets will continue to be held back by currency weakness. I think that this is too myopic a view, and that global reflation and improved growth will drive flows into emerging markets even with higher US interest rates. Also, the dollar strength against these currencies has already had a very extended run. There is a reason that currencies tend to have large mean reverting moves. Eventually the currency level becomes cheap enough that investments in the country for trade or natural resources can generate attractive returns. Then the cycle shifts and a rising currency speeds up investment demand further. In the current environment there is trade protectionism to slow down this process, but I think that will be mostly contained to politically sensitive industries and overt offshore relocations. Faster growth in emerging markets will be part of a virtuous cycle in 2017 that improves world growth. Starting from depressed levels, investment flows into emerging markets will help to avoid economic overheating in the US and thereby extend the expansion.

Buying UK Stocks

By Vaidas Petrauskas

For our Global strategy investors, we will start buying British stocks - a small starting allocation of only 6%. The volatility associated with the Brexit vote created some bargains among British stocks that were not around before. While most British stocks fully recovered after the Brexit vote and stock indices are trading near all-time highs, there are some stocks that still trade at depressed levels. Some deserve lower valuation, but in other cases the risks are overblown in my opinion. There are not many stocks that we like and that are cheap enough, so a small 6% allocation is appropriate.

This is also a bet on the British Pound which is trading close to an all-time low against the U.S. Dollar. I think the Pound is reasonably valued based on purchasing power parity. Of course one of the biggest factors that will impact the Pound and stocks going forward will be the upcoming Brexit negotiations with the E.U. The process will last a couple of years. We don't know how the negotiations will play out. Right now there is a lot of bickering between both sides, but in the end I believe cool heads will prevail. In the meantime there is certainly more downside risk to U.K. stocks and the Pound. It is also a potential opportunity. We would be happy to buy more stocks if we ever get the opportunity similar to the sell-off after the Brexit vote.

There are some country specific risks with the U.K. One is much cheaper currency. Obviously, an importer that must compete with possible substitutes could be in real trouble because imported goods will become more expensive. Already the prices of everything from groceries to Teslas are going up. Another risk applies to companies that benefit from the U.K. being in the E.U. That's mostly banks and other financial companies that stand to lose easy access to a single market. There is also a possibility of the U.K. economy going into recession. Many market pundits predicted that, but the economy is still growing, albeit at a very slow pace. So purchases of big ticket items like cars might slow down at some point. Real estate prices in London are already dropping, but not in the rest of country.

So when we look for stocks to buy we have to take all these risks into account. For example, one of the companies we plan to buy is a food-on-the-go retailer. They have 1,700 shops across the U.K. and sell sandwiches and drinks and things like that. The stock is down 26% in 2016, but earnings are good. I doubt people will stop buying sandwiches for lunch even if there is a recession.

There are a couple of annoying aspects of investing in the U.K. stock market. Everybody has to pay a 0.50% stamp tax on the purchase. This is in addition to the commission. No stamp tax when selling. Day trading is expensive in the U.K. We intend to buy and hold. Another thing is that U.K. companies report results only twice a year. However, many companies issue what they call "trading updates" in the interim. So we still get to find out how the business is doing about once per quarter for most companies.

This is the first time ZPR is venturing into European stocks. However, I would say the U.K. business culture is more similar to the U.S. business culture than a country like France for example where companies are shackled by regulation and bureaucracy and have low returns on capital. The same problem exists in Japan. France and Japan are often considered comparable to the U.S. in terms of their development – but their business cultures are not comparable. French and Japanese companies do not earn as high real returns for their shareholders as American companies do. The business culture in the U.K. is good. There are U.K. companies that are comparable in quality to U.S. companies. The return on equity of U.K. companies is close to that of U.S. companies.

Right now, I would say the U.K. market offers one of the best combinations of a reasonably low exchange rate and a good history of delivering high returns on capital for shareholders.

US Commentary (Continued)

reflation and continued expansion in 2017. Of course the direction of policy must continue for that confidence to be sustained, even if all the policy changes don't get enacted right away.

In the very near term the economy has to overcome the headwinds of a stronger dollar and sharply higher rates. Regarding the stock market, I think we'll continue to see pop up type volatility events coming from Europe, China, or emerging markets. The dollar's strength in particular is an ongoing issue for China, having already caused market scares in both 2015 and 2016. China wants to devalue against the dollar gradually, but the dollar's rise against other world currencies makes the yuan more expensive in comparison. This makes China's task all the more urgent. The regime also has a political issue now because Trump has labeled them as currency manipulators, and rapid devaluation would put pressure on him to deliver on protectionist policies. The new year also brings a reset in the quota for Chinese citizens to exchange foreign currency, and this means China will spend a lot of foreign reserves to keep their currency from falling too much. While this is all known, if it seems that the Chinese are failing to manage the situation well, we could have another fear moment for the market.

Asian Results (Continued)

We learned from our mistakes, readjusted the portfolio, and we are looking forward to a rebound in Singapore shares.

It was a wild 2016 for Japanese stocks and currency. The year can be divided into 3 episodes:

1. In the first half of 2016 Japanese stocks lost 20% while the Yen strengthened by 17% against the U.S. dollar. This is despite all the shenanigans by the Bank of Japan to weaken the Yen.
2. From the 1st of July through the U.S. Presidential election Japanese stocks went on a huge run, recovering most of their losses for the year, while the Yen stayed pretty much flat;
3. After Trump won the election the Yen experienced a huge sell-off. It depreciated from 103 to 117 to the Dollar. Japanese stocks continued to march higher.

When all the dust settled the Nikkei 225 index finished the year up a meager 0.42%. The Yen appreciated against the U.S. dollar by 3.06% in 2016. Our Japanese stocks gained more than 7% in Yen. In U.S. dollar terms we were up more than 10% in Japan in 2016. After a very weak first half this is a good end result.

I also want to quickly update you on the performance of our quant strategies. There was a lot of interest from our readers to our last month's published research piece. December capped off an outstanding year for our Volume strategies. Volume Value gained 8.99% and Volume Winners gained 5.68% in December compared to a 2.8% gain for the Russell 2000 index. For the year Volume Value gained 42.38% and Volume Winners gained 31.90%.

Happy New Year!

All of us at ZPR Investment Management wish you a happy, healthy and prosperous 2017!

The information contained in this Newsletter is not investment advice for any person. It is presented only for informational purposes to assist in explaining the portfolios and composites. All expressions of opinion reflect the judgment of the firm on this date and are subject to change. The information has been obtained from sources considered reliable, but we do not guarantee that the foregoing materials are accurate or complete. Clients or prospective clients are directed to ZPR's Form ADV Part 2A and its representatives for individualized information prior to deciding to participate in any portfolio or making any investment decision. ZPR does not provide tax advice. All clients are strongly urged to consult with their tax advisors regarding any potential investment. Past performance does not guarantee future results; there is always a possibility of loss.

Just the Numbers

	Period Ending 12/31/16			Period Ending 9/30/16				
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	4.29%	2.74%	30.22%	36.73%	14.94%	20.67%		
Volume Winners	5.68%	16.31%	31.90%	21.98%	13.56%	15.12%		
Volume Value	8.99%	23.46%	42.38%	24.61%	14.98%	21.87%		
Volume Momentum	4.88%	12.20%	24.72%	14.38%	4.55%	17.29%		
Russell 2000	2.80%	8.83%	21.31%	15.46%	6.71%	15.82%		
S&P 500	1.98%	3.83%	11.98%	15.45%	11.17%	16.38%		
ZPR Global Equity	1.98%	2.30%	14.49%	17.38%	6.20%	14.70%		
MSCI ACWI	2.20%	1.31%	8.48%	12.62%	5.75%	11.24%		
ZPR All Asian	0.31%	2.75%	5.16%	4.65%	1.14%	11.32%		
MSCI EAFE	3.44%	-0.68%	1.51%	7.04%	0.92%	7.91%		
ZPR All Thai Equity	1.70%	2.71%	19.94%	7.29%	7.46%		16.47%	1/1/12
Thai Set Index	2.25%	4.24%	23.85%	13.68%	5.79%		11.98%	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.