# ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS


Contents:



## US Commentary

*By Mark Zavanelli*

Small cap stocks had a strong month and caught up a little with the major market averages in June. Technology stocks finally saw a correction after a very large move the past few months (especially for the biggest companies). Whenever momentum becomes extreme or too concentrated in a few stocks, there is risk ahead for those stocks. This event might turn out to be just a correction, but usually time runs out quickly for a crowded momentum trade. It has nothing to do with the companies themselves, just how investors have chosen to speculate on them to go after what seems like easy money. As Vaidas explains in his article, since these stocks are now the largest in the S&P 500 Index, passive investing for now has become a backdoor momentum play. Although there are a lot of exciting things going on in the Tech sector, investors should not be confused about the real driver of recent returns which has been market based. In our own Small Cap Value portfolios we have a lot of cyclical tech stocks which have momentum but are also very cheap due to the cyclical rise in earnings. Our system effectively bets that

*(Continued on page 3)*

## Asian and UK Results

*By Vaidas Petrauskas*

June was another good month for our Asian stocks. Thai stocks again led the way. Our All Asian accounts rose 2.29% in June and are up 13.85% year-to-date.

The first half of 2017 was marked by weak US Dollar, the slump in commodity prices (oil, natural gas, copper), and strong performance of emerging market stocks, Southern European stocks, as well as US tech and healthcare stocks. US technology stocks got sold off in June, but the NASDAQ 100 index is still up over 16% year-to-date. Among US stocks growth stocks outpaced value stocks by a big margin and large stocks beat small stocks. So Large Cap growth stocks were the best style to be in and Small Cap value stocks was the worst style in the first half of 2017 among US stocks. This is driven by a big shift from active to passive investing, which is another major theme of 2017. As new money floods into the market-cap-weighted ETFs (mainly S&P 500), most of the money is invested into the largest companies (Apple, Google, Facebook, and Amazon) which pushes up their stock prices and market caps higher, which increases their weight in the index and ETFs have to buy even more of these stocks next time, which again pushes up their stock prices and market caps higher, and so on. This partially explains why large tech stocks are so hot this year. What will happen during a steep market selloff? Will ETF investors demand liquidity and make it worse or are they really buy and hold investors? We don't know. Never before have passive funds made up such a large portion of total invested capital.

*(Continued on page 4)*


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# Promises Promises

*By Mark Zavanelli*

There are several dramas unfolding right now where we can watch what happens when governments promise more than they can deliver. This is a preview of the future for the US over the next decade as the Baby Boom retirement era gathers steam. It's a here and now problem in much of Europe. The policy of ultralow rates by central banks plays an unsuspected role in this. Initially focused on repairing the functioning of credit markets after the financial crisis, quantitative easing's extended time period and huge magnitude have enabled governments to run ever increasing deficits without penalty. What the central bank economists are missing are the social ramifications of government spending creating dependency which is not easily retracted. In all of the political fights over debt we see that the removal of government transfer payments is in effect breaking a social contract.

**US Health Care**

The debate in the Republican controlled Congress over Obamacare repeal/replace is Exhibit A. The real issue in contention is not actually the substance of the Obamacare insurance market, which is fixable, but the massive expansion of Medicaid that occurred under the law. When it was a symbolic gesture, conservatives were happy to repeal it, but it has now become political suicide to remove the subsidy which provides free healthcare to something greater than 20 million people. Even if a token repeal promises to eliminate it in the future, the actual implementation is doubtful (just like the "doc fix" which is used in the budget process to pretend that spending is lower than it really is). It's become a permanent part of the government budget, like other entitlements. Adding up all levels of government in the US healthcare is around one third of total government spending and is by far the fastest growing piece. It's also just getting going with the demographics at work. Any projections of flattening are complete nonsense as the Boomers will use a lot more healthcare at 80 than they did at 65 (the number of 80 year olds is currently at a low point since births were low during the Depression, but is about to increase significantly over the next 10 years). Taxes will have to go up over time not down, and just like with other entitlement promises it still won't be enough to pay for it.

**Illinois and Puerto Rico**

It's an interesting condition when money is essentially free to borrow and you run out of it anyway. A lesson from the financial crisis is that recklessness by lenders encourages and enables borrowers to put themselves in a position where they can't pay the money back. Remember how it was the bank's fault that the homeowners defaulted? Well, by the same logic Puerto Rico and Illinois are the Fed's fault, with a long line of government deadbeats after them. As each of these goes into debt renegotiation we see the same principles at work, that actual contracts are meaningless, but the contract of promised entitlements is inviolate. It's not hard to predict the path of what happens. Detroit saw bankruptcy coming for years yet was unable to agree to do anything about it (Illinois, which can't use bankruptcy, has had the same leadup). A default of some fashion is inevitable. Afterwards, it becomes time to run a primary surplus (with no interest costs, which won't get paid) in a hurry. From past government bankruptcies we know that in the scramble for money that pensions won't be touched, but current services can be eliminated to whatever extent necessary. Illinois is going to try to raise taxes without spending reform, which is what got it in trouble in the first place. At the end of the day the impossible promises are not free, and even those on the receiving end of them end up as losers when prosperity is reduced.

**Italian Banks**

One of the main goals of the ECB's QE was to calm the capital markets regarding the government debt of the weaker European nations (Greece, Portugal, and Ireland, but most importantly Spain and Italy). This was very successful, and represents the positive role that a central bank can play in short circuiting a crisis. Just like with the Fed, unfortunately, the years of interest rate manipulation have only provided a disincentive for healing the underlying causes of the problem. Recently, the Italian government, with the ECB's support, has made a decision it will regret down the road in order to protect "little guy" investors. They want to tax, borrow, and spend, and now to pick winners and losers in the capital markets. What they would really like is for someone else to pay (like Germany). Italy's banking sector has a very large bad loan problem, something over 20% of gross loan balances. Given that bank capital ratios are somewhere around 10%, if all these bad loans were recognized the banking sector as a whole would be insolvent. There's no question that this will require a bailout, but Italy just took a step that will make

*(Continued on page 3)*

## Promises Promises (Continued)

it harder. Three banks, including the third largest, were recently rescued, but in all of these the government is making senior bondholders and a big swath of junior bondholders (who are mostly retail investors) completely whole, and taking on the bad loans itself. This is not deposit insurance, but investor insurance. This is very different from what the US did in the financial crisis with the TARP program and expedited clearance for emergency mergers. The amounts so far are not that large, but the signal it sends to the whole sector is clear, and it will be impossible not to repeat the same bailout process for the rest of them. While it's important to deal with the problem, this is a promise that Italy can't afford to keep. The ECB is complicit in this, and has to keep Italian bond yields low so that the Italian government can spend at 50% of GDP, run deficits, and borrow money to finance that as well as rollover maturing debt. Soon it will be Italy holding the ECB hostage as they will leave the Euro if they don't get whatever they want.

Taking the sum of the promising and spending, my hope is that somehow the debt can be managed without harming the private sector's faith in the monetary system. The real promise is currency, and if you mess with that you put the whole engine of capitalism at risk. The central banks are already playing a very dangerous game with this, and it isn't even a crisis period. They must believe in their own invincibility, otherwise they would never do this. Let's all hope they are right. In the near term, for smaller government borrowers like Greece, Detroit, Puerto Rico and now maybe Illinois the results are very unpleasant. In the US, there's unlikely to be a bailout for municipal bond investors. In a crisis, as an investor in government securities you can expect to be last on the list to get paid regardless of what the piece of paper you own says.

## US Results (Continued)

the market will pay more for these stocks over time as the companies can reinvest and grow for as long as the cycle lasts. Since these stocks have real earnings, we think that any momentum based selloff will just represent an opportunity to buy more of them even cheaper. As with all cyclical stocks, there's an eventual downturn to watch for.

All momentum markets can be divided into "haves" and "have nots". Value continues to be in the "have not" category this year. While stocks overall are expensive, there are plenty of very cheap companies, many of which are down this year. One other feature of value stocks right now is the low or even negative correlation to the rest of the market. Value and momentum are typically negatively correlated as investment styles, but it takes an extreme market dominated by momentum stocks to create a situation where value stocks and the market overall don't move together. We saw exactly that during the volatility of last month. The result is that it becomes possible to make money here even as momentum reverses.

Fundamentally, the environment for value stocks is fine, and I think the rest of the year sets up positively. There are concerns over slowing growth and consumer spending, especially auto sales, but the underlying economy continues to chug along and corporate earnings growth is strong. The latest economic data puts the brakes on the Fed for further interest rate increases this year. I think they were surprised by the momentum in the market even as they were raising rates. This played a role in the timing of their decision to announce a plan to reduce the overall size of the balance sheet. That's a very positive thing, and is another step on the long road to ending the madness of QE. The fact that inflation is behaving and rates can stay in a stable range is critical. This is more positive for economically sensitive stocks than a surge in growth would be. The most important thing for the US market, as we often have said, is the continuation of the cycle.

Meanwhile, foreign economies continue to get marginally stronger, which has put pressure on the dollar. It's a positive feedback loop, as investment flows into those markets help to sustain growth. We don't see the dollar continuing to fall against the major currencies, however, since it is very important to the ECB and BOJ to have weak currencies. Even without further dollar weakness, there is now a positive catalyst in the form of rising markets to go along with the much cheaper valuations. This continues to be a good time to diversify from US stocks to foreign markets.

# Asian and UK Results (Continued)

Dollar bashing continued in June. This was driven by a change in language among world's central bankers. Until now only the Fed has been raising overnight rates on four occasions by 25 basis points in 18 months while the central banks of other developed countries sat on their hands. But now growth is picking up and central bankers are becoming more hawkish. As a result G10 currencies are making gains against the dollar. Bank of Canada is the first to follow in the Fed's steps as they prepare to start raising rates. The European Central Bank (ECB) is also thinking about tapering the stimulus. Mario Draghi, the ECB president, in a speech he gave said he was growing increasingly confident that "deflationary forces have been replaced by reflationary ones". The Euro leapt more than 1% against the US Dollar after that speech and German government bond prices fell as investors interpreted Draghi's comments as a sign that the ECB is considering gradually withdrawing stimulus in the Eurozone. Since the start of the year the Euro has already gained 8.5% against the US Dollar. However, inflation is missing everywhere, so there is no need for fast rate hikes. Central bankers will be very slow and careful about withdrawing stimulus because markets are very sensitive to any suggestion of a withdrawal of stimulus measures. Going forward we will likely have higher rates but still at very low levels.

**Thailand**

Our Thai stocks continued to advance strongly. The official All Thai return, which is expressed in U.S. dollars, was 3.77% in June. The Thai Baht appreciated by 0.28% against the US Dollar. Our stocks outpaced the benchmark Thai SET Total Return index (in Thai Baht) which was up only 0.87%.

In the first half of 2017 our All Thai accounts are up 19.02% in US Dollar terms. Stronger Thai Baht is responsible for 5.40% of that gain. The Thai SET Total Return index (in Thai Baht) was up only 4.12% in the first half of 2017. It's shaping up to be another great year for us in Thailand.

**Japan**

Our Japanese stocks rose around 3% in local currency in June. The Nikkei 225 index rose 1.95% although small cap Japanese stock performed better – the Topix Small Cap index was up 3.40%. The Yen depreciated by 1.05% against the US Dollar.

Since the start of the year our Japanese stocks are up more than 11% compared to a 4.81% rise of the Nikkei 225 index. A stronger Yen added an additional 4.33% to the dollar-denominated returns. In the future, the Yen is likely to weaken because while most central banks are turning hawkish, any kind of tapering or rate increases in Japan is years away. Weaker yen will mean higher Japanese stock prices as these two move in opposite directions.

**UK**

The UK FTSE All Share index dropped -2.77% in June. Our stocks did slightly better with around a 50 basis point loss. However, the British Pound finished the month stronger, gaining 1.09% against the Dollar. This pushed our dollar-denominated returns into positive territory for the month.

It was a busy month in UK on the political front. The UK general election, which took place on June 8th, was a disaster for the U.K. Prime Minister Theresa May's Conservative party. She called an early election to strengthen her party's majority ahead of Brexit negotiations. The polls showed at the time that she would take seats from the opposition Labour party and strengthen her majority. She couldn't resist and it was a good political move, but the gamble backfired as U.K. voters threw out the script… again. Instead May's Conservatives lost the governing majority and will head into the Brexit negotiations weakened. The Pound fell sharply after the results came out, but quickly recovered their losses and more as investors realized that "softer Brexit" is now in the cards. It will be a long negotiating process with the EU with an unclear outcome for the United Kingdom.

# Just the Numbers

| | Period Ending 6/30/17 | | | Period Ending 3/31/17 | | | |
|---|---|---|---|---|---|---|---|
| **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** | 3.54% | 2.34% | 8.29% | 33.10% | 10.81% | 14.96% | 8.13% |
| **Volume Winners** | 2.95% | 7.83% | 11.16% | 34.75% | 16.55% | 15.97% | NA |
| **Volume Value** | 3.90% | 5.34% | 11.24% | 51.91% | 21.51% | 22.71% | NA |
| **Volume Momentum** | 1.07% | 5.36% | 13.36% | 39.41% | 8.12% | 15.88% | NA |
| *Russell 2000* | 3.30% | 2.31% | 4.83% | 26.21% | 7.21% | 12.35% | 7.12% |
| | | | | | | | |
| *S&P 500* | 0.48% | 2.95% | 9.20% | 17.20% | 10.38% | 13.31% | 7.51% |
| | | | | | | | |
| **ZPR Global Equity** | 2.64% | 4.47% | 11.94% | 24.56% | 6.94% | 11.10% | 10.77% |
| *MSCI ACWI* | 0.50% | 4.45% | 11.82% | 15.71% | 5.66% | 8.97% | 4.57% |
| | | | | | | | |
| **ZPR All Asian** | 2.29% | 5.33% | 13.85% | 19.96% | 4.70% | 9.46% | 14.21% |
| *MSCI EAFE* | -0.15% | 6.67% | 14.23% | 12.25% | 0.96% | 6.35% | 1.54% |
| | | | | | | | |
| **ZPR All Thai Equity** | 3.77% | 7.73% | 19.02% | 20.99% | 12.54% | 14.36% | NA |
| *Thai Set Index* | 0.87% | 1.12% | 4.12% | 15.53% | 7.99% | 9.30% | 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.