ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

May was a month of divergent returns in equity markets, although consistent with the trends so far this year. US large cap tech stocks and foreign equity markets were very strong, while companies that are sensitive to US growth, such as small caps and financials, have been weak. We can see this effect also in the US dollar, which has been falling this year versus most other currencies, and US bond yields, which have declined the last few months. All of this market action relates to a coming down from the high expectations the market had for growth positive policies in the U.S after the election.

The market events actually provide a positive setup for the intermediate term for our style of investing, although I've got plenty of concerns around the longer term returns for stocks. For US small cap stocks, there are more opportunities now as valuations have reset, and we have put some cash back to work this month. I don't share the market's disappointment about growth in the US, because we're better off with modest and steady growth

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Asian and UK Results

By Vaidas Petrauskas

All Asian accounts rose 4.82% in May thanks to great performance by our Thai and Japanese companies. It could have been even better if not for Singapore.

All of our Asian companies reported quarterly results in May and they were generally very good. The market reacted very positively to those results, especially in Thailand, which surprised even us. We had a couple of 40% gainers on good results and those two stocks are almost entirely responsible for our good performance in Thailand, although we had other winners also. We managed to buy more of those stocks before the run-up in price and then managed to take some profits at the top. It was a busy and fast paced month in Thailand with big price moves. One of our biggest long-term winners in Thailand is a company which makes plastic bags and drinking straws. Boring companies make the best long-term investments. This company has grown EPS at 28% per year over the last 10 years and the total return to investors from stock price appreciation and dividends was 38% per year over that period, so some P/E expansion. We watched with amusement how this little and unknown company in such a boring business could continue growing so fast for so long and wondered when the party will end. It seems to have ended in May. The company showed the first unfavorable comparison in year-over-year EPS in a long time and we trimmed our position as the stock price retreated. The company is still very profitable and still very cheap at 10 P/E, but no longer growing earnings.

Our official All Thai return, which is expressed in U.S. dollars, was 5.28% in

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Debt Levels, Economic Growth, and Stock Prices

By Mark Zavanelli

A critical factor in both the economic recovery worldwide and the level of stock and bond prices has been the increase in worldwide debt (government, corporate, and household). In one sense, this is completely normal, as every economic expansion features increasing debt. Similarly, margin debt in the stock market is highly correlated with stock prices, both of which tend to go up during bull markets. The problem this time around is that nothing about this cycle has been "natural", and instead is supercharged. We should consider this an abnormal risk factor that could cause or worsen the next down cycle. Even though central banks seem omnipotent at the moment, it's a mistake to be complacent about the risks. Central banks and other government entities have:

1. Artificially depressed interest rates both short and long term, to the point of negative rates (in the EU).
2. Encouraged governments to run fiscal deficits by buying massive amounts of government debt directly.
3. Artificially compressed credit spreads in the private marketplace (housing in the US and bank debt in the EU).
4. Provided implicit or explicit guarantees on debt repayment which trickle down to private issuers (bank debt in the EU, local government debt in China).

These programs were designed to do whatever it took (to paraphrase Mario Draghi) to stabilize what otherwise would have been nasty default situations. They do this in a non-subtle way, by boosting confidence, markets, and finally to some extent economic growth. Certainly, we have seen the value, both in the US and in the EU, of keeping banks solvent. We also have the counter example of Japan, where they just pretended the banks were solvent after their real estate bust, froze the bad loans in place and took decades to get back to a functioning financial system. Regardless of the motivation, the increase in debt pushes up markets and allows economic activity to happen that otherwise wouldn't without the support. When German bond yields are negative even though inflation is positive, we don't need to look far as to why (The ECB's QE buys government bonds of its members in set proportions). When we measure the trillions of dollars in central bank balance sheets, we are looking at the very least at that amount of excess past production. With the central banks and governments providing the financing, they could have been making Zizzer-Zoof Seeds (which, according to Dr. Seuss, nobody wants because nobody needs), just as well as anything with productive value. The really odd part of this is that it has taken so much debt to produce what appears to be so little activity (of course we can't really measure what would have happened without it). What I think has happened here is that some of the extra government spending has paid people not to work through the form of income contingent transfer payments, which is actually much worse than bailing out the companies they work for. It's supply side economics in reverse gear, destroying productive capacity. The extra credit provided by governments in this case didn't support any extra production, but crowded out private activity.

These big balance sheets at central banks are scary, but so far the central banks have been adept at managing them without big inflationary consequences. For the US, Japan, and China, which can print money, (and in China's case control the currency outright), these balances are a threat for future higher inflation (and in a bad scenario a breaking of the current world monetary system) but otherwise have limited impact in the short or medium term. The ECB may be a different story since by construction they have limited capital and their balance sheet contains active credit risk. While the Fed is essentially a friendly shareholder to the US government, in the ECB's case there is always the possibility that a member state will have a default and exit (such as Greece nearly did), resulting in defaulted assets on their balance sheet. We've seen that as long as a sovereign debt is buyable in a QE program the ECB can save them with massive bond buying (this kept Spain and Italy afloat earlier), so there is a backstop if they can stay ahead of a crisis. All of this has to work politically in Europe, however. Italy can't really withstand a downturn, and the ECB in existing form probably can't survive an Italian exit with a debt repudiation. However, it is true that with enough political will all rules can be changed or circumvented. This is the sad place that excessive debt brings us to. When it can't be paid back it's no fun for borrowers or lenders. Witness the choices that have had to be made in Detroit and now in Puerto Rico. We have seen that there is never an agreement on who will accept loss, it can

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Debt Levels, Economic Growth, and Stock Prices (Continued)

only be imposed.

So far, I've focused on the government debt side, where admittedly the craziest numbers are. On the private side, which is corporate and household, the debt increase is much smaller but likely more of a risk to this business cycle. The increase in debt is mostly coming from the corporate side, except for the special subset of investment debt. Naturally, with rates and credit spreads super low, corporations have significantly increased their borrowing. This has been a benefit to economic activity, but it's not hard to imagine that some of this debt will eventually go bad. Right now, credit quality looks great, so it's not a near term concern. But that doesn't mean there's no cycle.

Investment debt is a special subset that can create its own market events that don't necessarily correlate to the economy. Ultra-low bond yields spawn levered strategies to create an enhanced yield, for example. I worry that a Fed tightening cycle exposes some of these strategies for their actual risk. Investors should note that many fund structures, including some closed end funds and all REITs and MLPs, are solely based on this idea of boosting yield through leverage. If they can't borrow cheaply, or if the assets don't provide the expected income, the structures can have large losses (as seen recently in energy MLPs). It is difficult to observe this type of excess leverage, but we have easy access to equity margin debt data. The good news here is that we have not seen a really big spike yet that would signify a market correction. Margin debt is high and up strongly from a year ago, but it's not really at worrisome levels at this point. Still, I think this is yet another example of how asset prices are pumped up by the low interest rate regime.

Overall, my gut instinct is that while this huge debt party has worked out fine so far, the risk is higher now as we exit the post-crisis period into something different. During this period the central banks effectively rewrote the rules without adverse consequences, contrary to most economic thinking at the time. It's certainly possible that an extended up cycle will give them a chance to exit gracefully, but it's also possible that something in this pile of debt will serve to ignite the next down cycle. Let's be vigilant.

US Results (Continued)

that avoids a sharp jump in inflation. Structural change that supports long term growth would be fantastic but we don't need it to justify the prices of our stocks. Companies have already been shaken out of their prior mode of retrenchment, and earnings growth is back to a strong pace, even with modest GDP growth. The economic cycle is firmly entrenched and assisted by improving conditions in foreign economies. We've got cheap stocks with solid prospects for growth this year and next. So, while I'm not expecting large absolute returns like we've had over the past year, I think we can make money in this environment.

I also think it's an excellent time to be thinking about diversification to protect against unexpected events, at a time when prices are high for the major asset categories. This is the opposite of what many market participants are doing as they pile into momentum plays and exciting growth stories. That's fun while it lasts but there will be plenty of people left holding the bag on the other side of it. By contrast our Asian stocks trade at much cheaper valuations than US stocks do, and have had a different path than the US market over the past few years. Looking forward, that should provide diversification (but not necessarily downside protection) and theoretically allow them to have better longer term returns from this starting point. Two of our quant strategies, Volume Winners and Volume Value, are also designed as lower beta alternatives for US equity exposure. It's just one month, but I was pleased to see these strategies hold up well in a very poor month for financial stocks, which currently make up a large portion of those portfolios.

Asian and UK Results (Continued)

May. A stronger Thai Baht is responsible for 1.59% of that gain. So in local currency our stocks gained around 3.69%. The benchmark Thai SET Total Return index (in Thai Baht) was up only 0.12%.

Our investment in Thailand continues to be very satisfying. Year-to-date our All Thai return in US Dollars is 14.70%. A stronger Baht is responsible for around 5% of that gain. The Thai SET Total Return index (in Thai Baht) is up 3.22% this year. We have demonstrated again and again that we can outperform in Thailand.

Singapore is another story. That market has been very frustrating for our fundamental strategy. We lost more than 4% in Singapore in May. A stronger Singapore Dollar helped somewhat as it gained 0.95%. During May we almost completely sold one of our largest positions overall – a Singapore listed gold miner with operations in Malaysia. This seemed like a rare opportunity when we discovered this company – a highly profitable and growing gold miner with low costs and exclusive rights to vast gold reserves, and which also paid a big dividend! All went according to plan at first as the stock moved up sharply and we took some nice profits at the top. But then operational challenges started to surface and the company has been suffering from poor ore grades in the last two quarters. It means they can’t find enough gold. We decided it is safer to sell the stock and wait on the sidelines until they fix the problems. The company is building a third processing plant which they think will improve their recover rate, but we will believe that when we see the results. This position resulted in a loss for us in May, but that is the nature of the game. We will not be right on every stock. It is important to recognize when we are wrong and cut our losses to prevent potentially larger losses.

Our losses on the gold stock were partly offset by another of our Singapore companies which rose 42% after posting very strong quarterly results. Unfortunately such successes in Singapore are rare. After we are done selling the gold miner stock, we will have only 2 Singapore stocks left. We may find more during our upcoming quarterly research cycle, but our allocation to Singapore is now greatly reduced and that is fine. We have to accept that it is hard for us to succeed in that market and therefore a larger allocation is not warranted. The Singapore stock indexes are actually doing fine this year. The FTSE ST All Share index is up 10.86% year-to-date. But banks and high-flying tech stocks are responsible for all of the gain. These stocks we avoid.

After we finish selling the gold stock, the Asian accounts will have an outsized cash position of around 15%. We feel the extra cash cushion is appropriate given a strong recent run-up and to take advantage of future opportunities if there is a sell-off for any reason.

But back to the positives. The Japanese economy is finally experiencing a run of sustained growth thanks to exports and consumption. Growth for the first quarter of 2017 came in at 2.2% annualized, marking five quarters of continued expansion in GDP. The country has almost full employment. The unemployment rate has fallen from 5.5% in 2009 to 2.8% currently. The ratio of job openings to applicants is at 1.5, which means there are more jobs than applicants. This ratio is near 1990 peak. And Tokyo has more than two job openings for every applicant. The rules on immigration are very strict, so there are no immigrants to fill available positions. This is good news for Japanese job seekers but bad news for companies because they cannot find additional workers if they want to expand the business. And actually some Japanese companies mentioned this problem in their earnings releases.

Japanese corporate profits grew 27% in the first quarter year-over-year and capex surged 4.5%. Better corporate earnings are increased optimism is driving Japanese stocks higher.

Our Japanese stocks rose sharply in May. The Nikkei 225 index rose 2.36%. Our stocks rose around 6.60%. A stronger Yen added another 0.55%. The earnings for our Japanese companies were in general very good and stock prices responded accordingly. It is very satisfying when that happens. And we are having a good year so far in Japan. While the Nikkei 225 index is up only 2.81%, our stocks are up around 8%. The USD-based return is even better because the Yen gained 5.44% against the US Dollar this year.

It is not the strength of the Asian currencies, but rather the weakness of US Dollar which is one of the themes so far in 2017. We believe the Dollar weakness is

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Asian and UK Results (Continued)

temporary. The table below shows the 2017 performance of all the currencies in which we invest against the US Dollar. I added the Euro also because it is a major currency.

Thai Baht	+5.11%
Singapore Dollar	+4.45%
Japanese Yen	+5.44%
British Pound	+5.09%
Euro	+6.80%

So the US Dollar lost 5-6% against most major currencies so far this year and Euro has been especially strong since the pro-EU Emmanuel Macron won the French presidential election.

Our UK stocks took a breather after a very strong performance the prior month. They were down around -0.40% and the British Pound lost -0.50% against the US dollar. The UK FTSE All Share index closed up 3.88%. It was large capitalization UK stocks which rose the most in May and our stocks got left behind. Our year-to-date returns in UK are still very good. Our stocks are up around 8% against the FTSE All Share index's rise of 6.27%. On top of that a stronger Pound added another 4.56% to our US Dollar based returns.

I mentioned last month that an early general election has been called in UK for June 8th by the current Prime Minister Theresa May. I also said it was a shrewd political move to strengthen her party's majority ahead of Brexit negotiations and not to have to face electors again until June 2022, allowing her to concentrate on Brexit negotiations. At the time May's Conservative party had a record 20 point lead in the polls against the main opposition left-wing Labour party. Well, that lead seems to have narrowed to only 5 points now after some blunders by the Conservatives. So it is possible that after the election May will end up in a weaker position than before, although I think they will come out better than the polls suggest. UK polls haven't been accurate. The Brexit poll is the most vivid example. This will be interesting to watch.

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Just the Numbers

ZPR Composites Names in Bold *Benchmarks in italics*	Period Ending 5/31/17 Month	Quarter To Date	YTD	Period Ending 3/31/17 1 Year	3 Year Annualized	5 Year Annualized	10 Year Annualized
ZPR Fundamental Small Cap Value	-1.75%	-1.16%	4.95%	33.10%	10.81%	14.96%	8.13%
Volume Winners	1.16%	4.74%	7.97%	34.75%	16.55%	15.97%	NA
Volume Value	-0.38%	1.39%	7.07%	51.91%	21.51%	22.71%	NA
Volume Momentum	0.72%	4.24%	12.16%	39.41%	8.12%	15.88%	NA
Russell 2000	-2.16%	-1.08%	1.35%	26.21%	7.21%	12.35%	7.12%
S&P 500	1.16%	2.20%	8.41%	17.20%	10.38%	13.31%	7.51%
ZPR Global Equity	1.96%	1.79%	9.06%	24.56%	6.94%	11.10%	10.77%
MSCI ACWI	2.30%	3.94%	11.26%	15.71%	5.66%	8.97%	4.57%
ZPR All Asian	4.82%	2.98%	11.30%	19.96%	4.70%	9.46%	14.21%
MSCI EAFE	3.81%	6.83%	14.40%	12.25%	0.96%	6.35%	1.54%
ZPR All Thai Equity	5.28%	3.82%	14.70%	20.99%	12.54%	14.36%	NA
Thai Set Index	0.12%	0.26%	3.22%	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.