ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

US stocks rose again in February after continued strong data on the economy and corporate earnings. Consumer and business confidence is translating into real economic activity. The outlook outside the US is also gradually improving, caused by the rally in commodities and the stronger dollar. Despite protectionist rhetoric from the US the export picture is actually brightening for many countries. The economic underpinnings for corporate earnings and the market have strengthened, and this, along with expectations for business-friendly policies, has driven the rally.

There have also been strong inflows to equities so far this year (based on data from the largest ETFs), presumably coming from cash and fixed income investments. I would guess that some of this is running towards stocks and some is just running away from bonds. Bond prices have stabilized after an initial rout, so it seems to be some of both. These flows are at least part of the reason large cap stocks have outperformed this year (passive flows are generally skewed towards large caps). This has also enabled the market to trade with very low volatility and to shake off any potential worries about the Fed or policy pronouncements.

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Asian and UK Results

By Vaidas Petrauskas

We had another successful month in Asia and also in the UK. Our All Asian portfolios rose 1.37% in US Dollars thanks to strong performance in Singapore and Thailand and a weaker dollar against all Asian currencies. Our UK stocks, which are part of Global portfolios only, advanced around 4.80% in British Pounds compared to a 2.47% gain for the UK FTSE All Share index. The British Pound lost 1.40% against the US Dollar in February.

The official All Thai return, which is expressed in U.S. dollars, was 2.18% in February. The benchmark Thai SET Total Return Index lost -0.89%. So our stocks were far ahead thanks to some good earnings reports. Thai stocks just finished their 4th quarter reporting cycle on February 28th. We have some new candidates that we will be researching in the coming days. Hopefully there will be some new Thai stocks that we like. The Thai Baht appreciated by almost 1% against the US Dollar in February.

In Japan we lost around 1%, but the Yen gained 1%. So we were flat in US Dollar terms. The Nikkei 225 index performed slightly better than our stocks, gaining 0.41%. Japanese companies also finished their reporting cycle in February. The fiscal year end is March for most

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The Expectations Game

By Vaidas Petrauskas

The US stock market is making new highs every day it seems and volatility has been minimal for a very long time. This makes some people nervous and many are asking when the party will end. I don't have an answer to that, but certainly there is a lot of momentum and hope in this market. The hope is primarily based on Trump's promise of much lower taxes, deregulation, and capital repatriation. The market has given the new administration the benefit of the doubt. What could derail this market? There are short-term and long-term risks.

One short-term risk is that the promised reforms take longer to implement than everyone hoped. There is no broad agreement among Republicans on the tax reform or the border adjustment tax. It seems that lower taxes may not come into effect quickly. There are also some negative effects of the proposed tax reform for the US importers - the proposed 20% import tax and all goods imported to US will hurt some US businesses dependent on imports, especially retailers.

The long-term risk to US equities is the Fed. The Fed will keep raising rates. The only questions are: when and how much. Right now bonds still yield very little and are no competition for stocks. But as the yield on the 10-year Treasury bond approaches 3%, that perception may change. The high market valuation is also a risk, but high valuations by themselves do not cause markets to crash. Usually a combination of other factors will start a selloff.

I don't think there is a bubble in US stocks. For there to be a bubble, there has to be complacency and euphoria among market participants. That is not the case. People are nervous. Any correction should be viewed as a buying opportunity. US businesses and the economy should do well under the new administration. Lower taxes will lead to improved business confidence and companies will start investing capital again, but the new administration has to deliver on their promises.

With US equity valuations high, are there other regions in the world where expectations are much lower and hence potential gains greater? The trick is to find investments where expectations are unduly low. This is what we look for when we search for stocks to buy. Good returns often start from a point of low expectations. Let's take a look at Europe where expectations are low. Unlike the S&P 500, the European Stoxx 600 index is well below an all-time high. Long US stocks and long US dollar has been a no brainer for many money managers with other regions left behind. According to the Financial Times, fund managers polled by BofA Merrill Lynch said they held significantly more exposure to the US than the Eurozone, with only a quarter believing Eurozone equities are undervalued. Contrarians take note! Are expectation for Europe too low and does that present a good buying opportunity?

Europe faces huge political risks. The viability of the European Union is in question. The EU is also a hopeless bureaucracy. Socialists are in power in many countries which means high taxes, rigid labor laws, and low returns on capital. This year there will be a lot of volatility in European shares because three very important elections are taking place in the Netherlands (March 15), France (April 23), and Germany (October 22) which will determine if the European Union project can continue. The right-wing anti-immigrant and anti-EU parties greatly increased in popularity in all three countries and through all of Europe. The French presidential election will be the most significant of the three. The first round will take place on April 23rd and the second round (if needed) on May 7th. The right-wing National Front party leader Marine Le Pen is expected to get the most votes in the first round, but lose to the mainstream candidate in the second round. However, we now know not to trust polls. Le Pen wants to take France out of Euro and out of the EU. If elected she will call a referendum on France's membership in the EU.

On March 15th general elections will be held in the Netherlands with the anti-immigrant and anti-EU PVV party in the lead. The PVV party is headed by Geert Wilders. So after the Brexit we are looking at a potential Frexit and Nexit (also possibly followed by Italexit). I must stress that the possibility of these countries leaving the EU is remote. The public support for leaving the EU is much lower in these countries than it was in Britain. Le Pen is expected to lose in the second round and Geert Wilders' party is expected to get the most votes but all other parties already said they will not go into a coalition with him, which means he will not be part of

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The Expectations Game (Continued)

the ruling coalition. In Germany the right-wing anti-immigrant and anti-EU "Alternative for Germany" party has gained ground, but they will not be a major player. However, the Europeans are clearly upset about the influx of immigrants and terrorist attacks and they are unhappy with status quo.

For now Europe is a continuing political mess with no end to it in sight. Greece is in the news again with another debt restructuring needed. There is trouble with Italian banks. If France leaves the European Union it will be the end of the EU as we know it. Britain was always an outsider. They smartly never adopted the Euro. The EU can survive without Britain. France is another matter. France is a founding member of the EU and a member of the Euro Zone. If Le Pen wins, we can expect a big selloff in European assets. Germany is a big beneficiary of the cheap Euro which allows them to have a current account surplus of 9% of GDP. The German economy will be badly hurt if France leaves the EU.

Right now there's too much political risk in Europe. If they are able to navigate this year in one piece there will be opportunities there. The dollar has been very strong against the Euro because the US economy is growing much faster and rates in US are higher. Both of these themes will continue at least in the near future.

We did buy some UK stocks in the beginning of the year and so far these stocks have done well. Our UK stocks recorded solid gains in February. However that is much too short of a time period to judge the success of any investment.

Let's turn our attention to Asia. Japanese stocks look like a good risk/reward situation. Japanese stocks did not participate in the global rally last year. They are still cheap and earnings are being revised up. The economy is finally showing signs of life. So I think this is one country which is still underappreciated. Elsewhere in Asia valuations are on the high side. Even Thai stocks aren't cheap anymore. They are reasonably priced, but not cheap.

China is always a risk to the region. If there is a collapse of China's economy, everyone will feel it. Not just their Asian neighbors, but the rest of the world also. China's economy has already slowed down dramatically. Our solution has always been to avoid any companies doing business in China wherever we invest. We now also want to avoid Asian companies exporting to US. Because of the US administration's proposed border adjustment tax, these businesses will be negatively impacted.

All these many risks that I mentioned are well known and already reflected in asset prices. We have gone through an extended period in Asia and Europe with low returns as a result of those risks being priced. That doesn't mean that they have gone away, but investors have the tendency to focus on yesterday's news. What's happened more recently is that reflation and a resumption of earnings growth is staring these markets in the face. If managers want to be bearish to avoid potential risks then they might have to pay for it by missing out on improving fundamentals in the short term. We shouldn't drive while looking at a rear view mirror.

On the next page I want to share with you the table that I prepared of valuations around the world using Thomson Reuters data. This takes all companies with market capitalization greater than $50 million in each country and calculates average valuation and fundamental metrics. This table allows us to compare the valuations around the world. The numbers in parenthesis next to the country indicate the number of companies in the aggregate.

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The Expectations Game (Continued)

	P/E	Price/Book Value	Dividend Yield	Return on Equity	Estimated Income Growth
Argentina (57)	173.5	3.4	1.0%	16.9%	-79%
Australia (715)	21.7	2.0	3.8%	7.4%	27%
Brazil (266)	32.7	1.8	2.6%	6.5%	34%
Canada (1037)	37.0	1.8	2.8%	3.9%	27%
China (PRC) (3793)	21.2	2.0	2.8%	10.9%	2%
Czech Republic (10)	11.4	1.3	7.7%	11.6%	-13%
Egypt (79)	9.1	1.3	4.7%	9.8%	-9%
France (596)	25.0	1.5	2.9%	6.7%	4%
Germany (508)	19.0	1.8	2.5%	7.9%	12%
Greece (68)	NM	0.5	4.0%	-5.8%	124%
Hungary (11)	38.0	1.5	1.9%	-1.4%	42%
India (1131)	25.5	2.7	1.7%	9.5%	16%
Indonesia (342)	26.3	2.4	2.0%	8.3%	16%
Ireland (387)	37.5	2.5	2.1%	7.0%	11%
Israel (285)	20.4	1.7	3.6%	9.1%	1%
Italy (207)	NM	1.1	4.0%	-3.5%	35%
Japan (2943)	17.5	1.4	1.9%	7.4%	9%
Lithuania (18)	9.8	1.2	3.2%	11.9%	49%
Malaysia (468)	18.3	1.5	3.0%	8.6%	-2%
Mexico (128)	20.7	2.3	2.3%	10.5%	23%
Netherlands (131)	31.2	2.0	2.7%	7.0%	16%
Philippines (163)	17.3	2.0	2.4%	10.6%	5%
Poland (189)	33.5	1.3	3.8%	3.0%	-2%
Russia (173)	9.2	1.0	3.1%	10.8%	25%
Singapore (367)	21.2	1.4	3.2%	7.0%	13%
Slovakia (8)	8.1	1.0	8.0%	12.4%	
Slovenia (9)	13.3	0.9	4.7%	9.2%	-19%
South Korea (1607)	14.1	1.3	1.2%	5.4%	34%
Spain (145)	23.5	1.2	3.1%	7.8%	12%
Sweden (316)	15.3	2.1	3.4%	13.4%	3%
Switzerland (277)	16.1	2.1	2.6%	4.3%	7%
Taiwan (1274)	18.8	1.8	3.5%	10.4%	7%
Thailand (507)	17.4	2.1	3.0%	11.5%	11%
Turkey (201)	9.7	1.3	3.1%	11.9%	7%
Ukraine (20)	NM	1.2	3.3%	-26.8%	51%
United Kingdom (1023)	31.8	1.9	3.6%	5.3%	7%
United States (5456)	27.5	2.8	2.5%	10.0%	9%
Vietnam (177)	14.5	2.3	3.3%	13.6%	9%

Source: Thomson Reuters Eikon

US Results (Continued)

So what about going forward? Will these positive factors continue to drive stocks higher? I think the answer to this depends on one's time horizon. In the intermediate term, or the next year or so, it will boil down to 2018 corporate earnings (and whether a tax cut is coming to help those) and the level of interest rates. Earnings growth along with modest rate increases can and probably will send the US market higher. We are still in a bull market, and recent market strength only serves to reinforce that. Outside of the effect of a rising dollar, foreign markets should do even better.

However, there's water to cross in order to get there, and I still think we could see a meaningful pullback in the short term over the next several months. The issue isn't really valuation (that's more of a longer-term issue) or the strong recent returns. Instead, it's whether expectations for the path of rates or earnings growth might be challenged. Regarding rates, I'm not afraid that the Fed will kill the cycle with rate increases (up to a point normalization is actually positive for growth), but instead that inflation indicators will turn higher and scare the market that we will see a more aggressive Fed. Factors that have kept the CPI down are fading, and we are facing higher year over year energy prices. I don't think the market actually believes there will be three rate hikes in 2017 given the Fed's history of projecting that every year. Regarding earnings growth, corporations are still facing the headwinds of a rising dollar and increased labor costs, and now slightly higher financing costs. The pause in the recent rise in the dollar might only be temporary. There's finally revenue growth to offset this, but we may see some doubt creep in about how sustainable the higher expectations are if only the security and trade protectionist portions of the administration's agenda can be implemented easily. This month has made clear that bruising fights are ahead over healthcare and tax cuts (and possibly regulatory cuts as well). With little consensus the final shape of any plan is unknown. I do still think that meaningful bills get passed, but maybe the market is a little bit too certain right now that it will get what it wants. As usual, we are keeping an eye on risk and are positioned to take advantage of market volatility as it happens. We are carrying higher than normal cash in all of our non-quant strategies, not really as a market timing bet but more as a natural result of profit taking in stocks that have run up.

Asian and UK Results (Continued)

Japanese companies, so it was their 3rd fiscal quarter. We had both good and disappointing earnings reports. At this time, after the quarterly earnings report cycle is over, we will start our usual quarterly procedure of searching for new Japanese stocks to replace the ones that we sold due to disappointing earnings.

Our Singapore stocks finally came through. We recorded a gain of around 3.90% in Singapore. A stronger Singapore dollar added an additional 1.42% to our solid Singapore return. All of our Singapore stocks recorded strong gains in February. No position lost money.

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Just the Numbers

	Period Ending 2/28/17			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	1.30%	3.97%	3.97%	30.22%	11.08%	16.63%	8.24%
Volume Winners	2.32%	2.24%	2.24%	31.97%	17.34%	17.47%	NA
Volume Value	2.75%	3.74%	3.74%	42.37%	19.57%	25.79%	NA
Volume Momentum	4.71%	6.03%	6.03%	24.75%	6.94%	17.41%	NA
Russell 2000	1.83%	2.22%	2.22%	21.31%	6.74%	14.46%	7.06%
S&P 500	3.72%	5.69%	5.69%	11.98%	8.88%	14.67%	6.95%
ZPR Global Equity	1.51%	5.07%	5.07%	14.49%	5.56%	13.00%	10.92%
MSCI ACWI	2.85%	5.68%	5.68%	8.50%	3.70%	9.96%	4.12%
ZPR All Asian	1.37%	5.91%	5.91%	5.16%	2.48%	11.27%	14.48%
MSCI EAFE	1.45%	4.39%	4.39%	1.50%	-1.16%	7.05%	1.23%
ZPR All Thai Equity	2.18%	6.81%	6.81%	19.94%	11.09%	16.21%	NA
Thai Set Index	-0.89%	1.34%	1.34%	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.