ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

Contents:

US Commentary

By Mark Zavanelli

US stocks continued to gain ground in April, shaking off losses with a surge late in the month. The market is getting a lot of what it wants to see, and potential problems have been pushed to the background. I had been convinced that we would see at least a modest retracement of the big move since the election, especially given the one-two punch of a more aggressive Fed and delays in enacting growth-friendly policies. But the market has shrugged these off. The reason is that these are issues that might have an impact later, while the market sees that corporate earnings are rising right now. With bond yields still low and money moving towards stocks, it's a recipe for rising stock prices. Also, there has been important positive news from overseas markets as well. Throughout this bull market we've seen periodic scares that some shock to the global financial system would upend the status quo and the expansion, and these episodes have sent stocks temporarily lower. Mostly these concerns have come from China and Europe. While the financial imbalances and risks there have

(Continued on page 3)

Asian and UK Results

By Vaidas Petrauskas

Asian stocks were down in April as money continues to pour into the U.S. and now investors are piling into European equities. U.S. stocks have greatly outperformed the rest of the world in the last 10 years to the point where stocks in the rest of the world are now much cheaper than U.S. stocks. Many institutional investors are shifting money to cheaper European shares, especially now that political risks in Europe have faded, at least for now. European stocks were big winners after the French presidential election's first round.

On page 4, I put together the performance (excluding dividends) of major stock market indices from across the world in various historical time periods. The table is very interesting as it shows that Thailand and U.S were the best places to be for investors in the last 10 years. Considering that Thai companies pay large dividends, much larger than US companies, I am certain that total return of Thai stocks was better than US stocks in the last 10 years.

European stocks, as measured by the Stoxx 600 index, were flat. Only investors in Germany had decent returns. French, Spanish, and Italian stocks are down from 10 years ago. Japanese stocks are flat in the last 10 years, but gained 15% per year in the last 5 years. We still have a very long way to go in Japan until a new all-time high for stocks. The record was set during the crazy bubble period in 1989. The market would have to double from the current level just to match that all-time high recorded almost 28 years ago. This shows how crazy valuations were back then.

(Continued on page 4)

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The End of the Post-Crisis Era

By Mark Zavanelli

There has been much bemoaning of the economic recovery since the Financial Crisis, although it has been terrific for US equity investors. With demand for change high, I think that we are entering into a period that will be substantially different than the past 10 years from an economic perspective. We have to understand this history to have a shot at understanding what might come next for investors.

While the Financial Crisis ended up being relatively mild overall when compared to the list of historical economic disasters, the effect on different economic groups was highly uneven. This was directly the result of economic policy, which acted to "save" the stock market to prevent a 1930's style meltdown at all costs. Whether it was "collateral benefit" or an intentional wealth effect, the foray into extreme monetary policy ended up driving stock market valuations back up to their multi-decade highs (ex-bubble), creating "the 1%". What it didn't do was to help the real economy directly, other than the pass-through effect from the stock market. Much of the economy was left with the typical situation after a boom, bust, and banking crisis — starved of credit, in a deleveraging process, with persistent high unemployment. The normal political impulse after such a crisis to hang the evil doers (the banks in this case) and rescue the victims (homeowners and the unemployed) also had an absolutely toxic effect on the ability for the real economy to recover. There was no big increase in investment in the economy that would put the people back to work.. Banks had to cope with zombie assets, regulators demanding higher capital ratios, huge fines to the government, and a giant new compliance burden and regulatory agency on top of that. The low rates didn't really help the banks or the credit markets do any lending except to the government (Fed bond purchases probably compressed bank interest margins). Credit is the lifeblood of the economy, and if it doesn't flow then there are no new jobs to replace the old. Meanwhile the relentless expansion of the social safety net caused a disincentive to a large class of people "on the brink" who, if they work too much, would no longer qualify for this or that benefit. Sometimes the government assistance is actually irreplaceable in the private market given the skills and opportunities available to the target audience. So the people are effectively trapped by a ceiling as well as a floor, often not prosperous enough to lose what they have in order to risk getting something better. Without a dynamic economy, the chances of making it out of a low income trap are low. The resulting perception of a lack of economic opportunity is a fundamental breakdown of our system. The other profound effect of the social security net is that we create a large population of workers whose employment is just to service it. A significant part of our population, and our fastest growing sector (healthcare), is paid indirectly by the government in order to provide services to these beneficiaries. The boom in healthcare workers is an example. This is not inherently a bad thing, since at least people are working, but from a macroeconomic point of view it impacts the allocation of labor to other parts of the economy (the US has a shortage of mechanical engineers, for example). This limits the flexibility of the labor force to move to industries where the private demand is, and creates a less competitive work force once a recovery actually happens.

The post-crisis policies were mostly a failure in creating real growth and economic opportunity for the average citizen, but an even bigger deal has been what they did do in creating Haves and Have-Nots. How we feel about our prosperity is inherently relative, of course, and the rise of the 1% and the fabulous stock market riches of Silicon Valley have only served to make the economic gulf seem wider than it's ever been. With the election of Trump and the remaking of the Republican party as populists, political change is here already, with economic changes certain to come. The overarching thrust of the changes will be to make sure that going forward it is labor's turn to benefit.

Disinflationary forces, especially those driven by trade, are the easiest targets for change. The "goods" sector of the economy has been in outright deflation for a long time, and without that we'd have much higher inflation. We are already seeing old fashioned tools, such as tariffs, being used to restrict trade in areas where retaliation can be justified. This is a dangerous path, as restricted trade most commonly leads to declining growth. Trade oriented investments slow down as uncertainty reigns. But globalization is a very powerful force and changes will be only on the margin.

Another disinflationary force that populists naturally target is labor flexibility. This time immigration is the target, even though immigrants typically compete at a disadvantage and end up working in areas where there is

(Continued on page 3)

The End of the Post-Crisis Era (Continued)

insufficient domestic labor anyway (so without the immigrants, businesses either automate or import the product, because domestic labor is not cost effective). In some areas, it's undoubtedly true that immigration keeps the costs of certain jobs lower than they would be otherwise (restaurants and construction, for example), and so wages will likely rise in those areas to compensate for the lower supply of workers if immigration is restricted. Since those skills are fairly prevalent in the economy, it hopefully will just mean more people working and not very much wage impact. The direction is clear, though, because the political will demands that this disinflation end and that domestic labor benefits.

Positive change will happen if the corporate-friendly Trump policies, like tax cuts, end up setting off a domestic capital spending boom. That would restart productivity growth, which is positive from all aspects. We also would need to keep our fingers crossed that there really is enough unused capacity in the economy to have growth without a large jump in inflation. There might be since the labor statistics don't tell the whole story. There are a lot of underemployed people in the country, and skilled baby boomers can decide to keep working longer.

Regardless of the exact path that policy takes, I don't think the slow growth, low interest rate world that we have been in since the Financial Crisis is acceptable to the political will of the country any longer. The policies of ultra-low interest rates and increased government social spending are likely to give way, and new policies targeting faster nominal wage growth are coming. The problem for both bond and stock investors is that this is a little bit of the reverse of what got us to high valuations. If interest rates move up valuations must come down. From an investment perspective growth this is good but only if it comes through productivity (often this is just better utilization of existing capital) and not inflation. Historically inflation has been the expansion killer, where you have a double effect on stocks of lower multiples and eventually a recession. But it doesn't make sense to predict it before it happens, because the impact of higher growth can send stocks higher in the meantime, and inflation without a supply shock event (like the oil embargo) can take a long time to take hold. Still, I think it's clearly a mistake to extrapolate the past returns we've seen in the equity and bond market during this recovery into the future, because I think we're in for something different (although not necessarily bad) going forward.

US Results (Continued)

certainly not gone away, they are both seeing an uptick in growth. That gives them breathing room from market pressure (such as for the Chinese currency), and possibly allows them to back away from crazy policies if they are smart enough to do it.

So, we've found our way back to a Goldilocks type of scenario, with synchronized but slow global growth and ongoing low interest rates. The path of least resistance for the economic cycle, corporate earnings, and for the stock market under these conditions continues to be higher. This is certainly a good outcome, but I wonder now if it can continue to be a stable situation. If foreign markets are waking up we might be entering into a new phase of the expansion where the old rules don't apply. The Fed actually has one less obstacle in its path to higher rates, the fear that they could cause a rapid rise in the US dollar that would sink confidence in foreign markets. If rates move up enough it will eventually have a negative impact both on the real economy (although real interest rates are still negative for a large portion of the yield curve) and on equity P/E multiples. Plus tightening cycles often end badly. Future inflation data will be critical for the direction of monetary policy. We're now right at about 2% on the Fed's preferred measure, so a move higher would translate to more hikes. Wage growth in the recent GDP report was stronger, which is a positive indicator for growth but also a sign of limited labor slack in the US economy. It's not a given that inflation will move up, but the trend has been rising so that's the most likely outcome. The bond market especially is in La-La land right now but it will eventually orient with the data. I think that stocks will care too, and that may be the source of our next market scare.

Asian and UK Results (Continued)

Index Performance - Price Changes (%) in Local Currency - Dividends are excluded
Ending April, 28, 2017

						Annualized		
INDEX	**REGION**	**1MO**	**3MO**	**YTD**	**1YR**	**3YR**	**5YR**	**10YR**
DJ INDUSTRIAL	USA	1.34	5.42	5.96	17.44	8.38	9.62	4.79
S&P 500	USA	0.91	4.62	6.49	14.86	8.45	11.18	4.78
NASDAQ	USA	2.30	7.71	12.34	25.85	14.07	14.53	8.99
NIKKEI 225	Japan	1.52	0.82	0.43	15.18	10.34	15.06	0.99
THAI SET	Thailand	-0.56	-0.70	1.52	11.89	3.54	5.27	8.46
FT ST ALL SHARES	Singapore	0.02	4.38	10.10	11.10	-0.52	1.51	-1.43
FTSE 100	UK	-1.62	1.48	0.86	13.94	2.45	4.51	1.16
STOXX 600	Europe	1.56	7.49	7.10	10.95	5.03	8.36	0.03
S&P/TSX COMP	Canada	0.25	1.30	1.95	12.24	2.36	4.96	1.35
BOVESPA	Brazil	0.65	1.13	8.59	20.42	8.37	1.18	2.88
MXSE IPC	Mexico	1.48	4.81	7.93	8.20	7.07	4.61	5.31
CAC 40	France	2.83	10.92	8.33	15.58	5.70	10.03	-1.18
XETRA DAX	Germany	1.02	7.83	8.34	20.51	9.60	12.83	5.36
IBEX 35	Spain	2.42	15.04	14.58	15.61	1.26	8.44	-2.91
FTSE MIB	Italy	0.57	10.86	7.15	8.60	-1.42	6.88	-7.23
HANG SENG	Hong Kong	2.09	5.37	11.88	15.09	3.61	3.48	1.83

Data source: Thomson Reuters

I think Thai stocks can continue their advance. Corporate earnings rebounded 33% last year and stocks are still reasonably priced at 14.5x this year’s earnings. For comparison Indonesian stocks trade at 15.8 times this year’s earnings, while Malaysia trades at over 17.5 times and the Philippines at 18.3 times. Only Korean stocks, which traditionally sell at a discount to the rest of the region, are substantially cheaper, at 10 times earnings. Thai corporate earnings growth is forecast by analysts at over 9% this year and 12% next.

Of course the main reason we are back to almost fully invested in Thailand are the business friendly policies of the Thai government and specifically the Deputy Prime Minister Somkid Jatusripitak, who understands economics and investments. He was the architect of many years of Thai economic growth and is determined to do it again. The government is ramping up public infrastructure spending, and foreign direct investments are picking up, with a surge in applications.

After a slump in 2014 and 2015, gross domestic product grew 3.2% in 2016 and is expected to advance another 3.6% this year. With inflation low, the Bank of Thailand kept benchmark interest rates unchanged at 1.5% last week.

Some $51 billion of transport infrastructure projects have just been approved, and Bangkok is extending its subway lines. Construction activity is likely to grow 15% this year and next, compared with an average of less than 10% in recent years. Railway infrastructure is rapidly opening access to the rural heartland, which is helping to increase urbanization and boost consumption.

Meanwhile in Europe there were two major political developments in April which drove global markets. The first round of the long awaited French presidential election took place on April 23. The fear was that the far-left candidate Jean-Luc Melenchon (who promised to tax the wealthy at 100% if elected!) and the far-right candidate Marine Le Pen could meet in the run-off, both of whom advocated for France to leave the European Union. This would in effect mean the end of the EU. Instead the pro-European Emmanuel Macron has taken a lead over Marine Le Pen. This time the pollsters were

(Continued on page 5)

Asian and UK Results (Continued)

very accurate. Macron is expected to easily defeat Le Pen in the run-off. This sparked a relief rally in world stock markets, especially stocks in Continental Europe, and also the Euro rallied strongly. The final round of the French presidential election will take place on May 7, 2017.

Another political development came from the UK and was completely unexpected. Right after Easter holiday the British PM Theresa May called an early general election for June 8th, bringing forward the poll from 2020. She seeks to strengthen her party's majority ahead of Brexit negotiations and depend less on fringe groups. This is a shrewd political move. By holding the election now, Theresa May will gain greater majority in parliament and she will not have to face electors again until June 2022, allowing her to concentrate on Brexit negotiations on her own terms and speed. Polls suggest Mrs. May's Conservative party is on course for a landslide victory that would greatly increase her party's working majority in the House of Commons. May's Conservatives have a 20 point lead over the opposition Labour party in the polls.

After this surprise announcement of early general elections, the Pound fell, but quickly reversed and gained 2.7% against the US Dollar by the end of the day. Some say there is now a greater chance of a "soft Brexit". I doubt that. Meanwhile the FTSE 100 stock index ended the day down 2.5%. However the selling was concentrated in large cap multinational stocks which are hurt by the stronger Pound. Our holdings actually closed up that day.

We got a big boost from our UK investments in April. For the month the FTSE 100 index lost -1.62% while our holdings gained around 5.6%. All of our holdings advanced very strongly and we had one 20% winner. The British Pound also helped as it gained 3.35% against the US Dollar, which means our Dollar-based return in UK in April was around 9%. Only Global portfolios have UK stocks.

Asian stocks performed poorly in April after a great run in the first quarter of this year. Asian stocks did not participate in the rally that took place in Europe and the U.S. Asian investors are more concerned with the situation in North Korea and how that might be resolved. China is finally putting a lot of pressure on North Korea to stop their missile tests. The Chinese have a lot of levers to pull and are finally on board. Hopefully they can knock some sense into the leadership of N. Korea.

There were no big currency moves among Asian currencies when we look at month over month exchange rates. But there were big moves during the month. The Yen was very strong until the French election and at one point advanced to 108.4 to the Dollar as it played its part as a safe-haven currency. However, it then lost all its gains after the election as political risks faded. It closed the month at 111.41. The Singapore Dollar strengthened a bit against the US Dollar while the Thai Baht weakened a fraction. The British Pound, however, had a big run as mentioned before.

Our Thai and Japanese stocks were down between 1-2%. Our Singapore holdings were especially disappointing. They were down around 2.8% while the Singapore index was flat. This was due to lackluster performance from some of our holdings.

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Just the Numbers

	Period Ending 4/30/17			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	0.60%	0.60%	6.45%	33.10%	10.81%	14.96%	8.13%
Volume Winners	3.54%	3.54%	6.74%	34.75%	16.55%	15.97%	NA
Volume Value	1.78%	1.78%	7.48%	51.91%	21.51%	22.71%	NA
Volume Momentum	3.50%	3.50%	11.36%	39.41%	8.12%	15.88%	NA
Russell 2000	1.05%	1.05%	3.53%	26.21%	7.21%	12.35%	7.12%
S&P 500	0.91%	0.91%	7.04%	17.20%	10.38%	13.31%	7.51%
ZPR Global Equity	-0.18%	-0.18%	6.96%	24.56%	6.94%	11.10%	10.77%
MSCI ACWI	1.60%	1.60%	8.77%	15.71%	5.66%	8.97%	4.57%
ZPR All Asian	-1.76%	-1.76%	6.18%	19.96%	4.70%	9.46%	14.21%
MSCI EAFE	2.62%	2.62%	10.20%	12.25%	0.96%	6.35%	1.54%
ZPR All Thai Equity	-1.39%	-1.39%	8.95%	20.99%	12.54%	14.36%	NA
Thai Set Index	0.14%	0.14%	3.10%	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.**

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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.