ZPR Investment Report

November 2017 Volume 23, Issue 11

A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

Global equities had another good month in October, although US small caps took a breather after being up strongly last month. It's hard to argue with confidence and rising stock prices. In the US, businesses are growing their capital spending, and consumers are increasing their spending faster than their incomes are growing (with a corresponding decline in the savings rate). Measures of expectations, such as manufacturing surveys and consumer confidence surveys are confirming a strong belief that good economic times are here and will persist. It's possible that the prospects for tax reform have something to do with it (which I discuss later). The brief scare this summer that cyclical parts of the economy (autos and housing) were rolling over was erased, and the US 10 Year Treasury yield shot up from a low of nearly 2% in early September to a high of nearly 2.5% in October, a big move. At about 3% GDP growth, the US is growing at about maximum speed given our negative demographic trends. The big reason behind the surprising strength lately is a positive shock from faster growth overseas, which has lowered the value of the US dollar, boosting trade and jump-

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Asian and UK Results

By Vaidas Petrauskas

October was another month with solid performance from our Asian stocks. All Asian accounts rose 3.91% and are up 27.70% year-to-date.

Japan led the way. This has been the theme this year. We made around 35% on our Japanese investments year-to-date in local currency. Stronger Yen added another 3%, (a very good year so far) but we have two more months to go. Government elections took place in Japan on Oct 22nd after the Prime Minister Shinzo Abe dissolved the lower house of parliament and called new elections. Stocks rose in anticipation of an easy win for Mr. Abe's Liberal Democratic Party. The party easily won the majority as expected and Shinzo Abe was reelected as Prime Minister. He has a mandate to continue his economic reforms as he enters a fourth term. The election result is good for stocks, but not good for the currency as the government's monetary stimulus measures will continue until they achieve their target of sustained economic growth and 2% inflation.

There was a wide divergence in performance between large and small Japanese companies in October. The large cap Nikkei 225 index rose 8.13%, a broader Topix index rose 5.45% and the Topix Small Cap index rose 4.36%.

We invest in small capitalization stocks. Our stocks rose over 6% in October while the Yen lost -0.82% against the US Dollar.

In Thailand we lagged the market. Our official All Thai return, which is expressed in U.S. dollars, was 1.38% for the month.

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ZPR INVESTMENT MANAGEMENT
1642 N.Volusia Avenue
Orange City, Florida 32763

Phone: (386) 775-1177
Fax: (386) 775-7749

E-mail: info@zprim.com
Web: www.zprim.com

The Curious Case of Missing Japanese Inflation

By Vaidas Petrauskas

Japan has experienced on-off deflation for the past two decades. The government has spent (wasted) trillions of yen in the last five years on a massive quantitative easing program trying to hit their target of 2% inflation, all for nothing. Inflation remains close to zero. They only managed to weaken their currency as a result.

I spoke with our Japanese analyst, who confirmed that prices in Japan are indeed at the same level as 20 years ago. This includes housing, rent, food, and most other expenses. McDonald's starting wage for high school grads was around 750 yen ($6.50) per hour 20 years ago and is at about that same level today. Yet taxes are rising so people are getting squeezed.

The main reason for missing inflation is non-existent wage growth (less than 2% last year). I find this baffling. The Japanese labor market is one of the tightest in the world. The unemployment rate is 2.8%. Companies cannot find workers. There are more job opening than applicants in many big cities (the ratio of job offers to job seekers is 1.5). The labor force is shrinking because of an aging population and lack of immigration. In any other free-market economy such conditions would force wages to rise rapidly because of simple supply and demand forces. Yet, despite severe labor shortages, wages are barely rising. What gives?

It seems to be the cultural issue and also the structural issue of the Japanese economy. The labor market in Japan is not dynamic. People do not change jobs often and many people never change jobs – lifetime employment is part of Japanese culture. Our Japanese analyst said this is true for the older folks only. Young Japanese are different. They are much more willing to change jobs, so not much different to other youngsters anywhere else in the world.

One other cultural aspect that was mentioned to me was the existence of so-called "black companies" in Japan. Those are companies that exploit employees for little pay. Japanese are modest and submissive and that makes them easier to threaten and exploit by evil managers. So people feel trapped and become depressed. Suicide at work is a big problem in Japan. The recent example of employee suicide that comes to mind happened at Dentsu – a big global advertising company where an employee committed suicide because of being overworked.

Japanese managers are naturally cautious about the future, so they are reluctant to increase wages due to global uncertainty which always exists. Many cut working hours or hire workers through temp agencies and pay them less than regular employees to avoid lifting salaries. As a result of this 27% of the Japanese workforce have temporary jobs.

Japanese companies have pent-up ability to raise output per worker. Output per hour worked in Japan is 60% of the US level. Companies can cut working hours and increase productivity that way, instead of raising output. If workers and unions are prioritizing cutting hours over raising pay, it may explain why a tight labor market is turning so slowly into higher wages.

To address this "problem" of no wage growth, Japanese PM Shizo Abe has demanded Japanese companies lift pay by 3% next year. This is blatant interference in private sector wage settlements. But he already tried everything else. Massive stimulus measures did not lead to wage growth and higher inflation as expected. So, the theory is, if they can force companies to increase wages, people would spend more, driving prices of goods higher, especially since Japanese companies have experienced record profitability and supposedly have plenty of resources to raise wages. I am not so sure people will rush to spend money if they start making more. Japanese are savers, not spenders. Many people live paycheck to paycheck and some cannot even survive until the next paycheck. As a result many new payday loan businesses sprung up – allowing employees to receive wages for days already worked but before payday (for a fee).

To encourage companies to go along with his plan, Mr. Abe is looking at giving tax breaks to those that expand their wage bill. So the government "assistance" continues. Out of one pocket into another.

Without wage growth Japan won't be able to defeat the deflation monster. Given the increasing severity of labor shortages, the ability of companies to cover them via higher productivity is limited. The extreme conditions in the Japanese labor market are likely to lead to higher wages eventually. Only then the government has a chance of hitting the so desired 2% inflation, but at what cost?

US Results (Continued)

starting corporate earnings and capital spending.

So that's the good news, and times like these are why it pays to stay invested in a bull market even when valuations tell you that long run US equity returns are not likely to be very exciting. As I've noted before, that fact has little predictive power over the present. I do believe in the power of sentiment, however, as we have seen short term moves throughout this cycle that ended up reversing. The economic expansion and bull market are well entrenched, but that doesn't mean we won't see scarier and more volatile moments than today. From an economic history perspective, one could even argue that faster growth late in a cycle actually increases the risks of a bad outcome rather than the reverse. We've raised cash lately in our fundamental strategies, taking profits in stocks that have become more expensive on increased optimism.

One interesting corollary to the better economy is the outlook for value stocks. The market is presently chasing growth again, which typically happens in times of excitement over the future when P/E multiples are rising. Given that multiples are already high, I would have thought that this would have run out of steam, but obviously it hasn't yet. However, a strong economy typically favors value stocks, which are priced lower partially due to greater sensitivity to the economy, which is a form of risk. During the last month we have taken some profits in rising stocks and rotated towards deeper value names which have been left behind in the chase for positive momentum. These ugly ducklings are seen as having little earnings upside, but I think that the combination of low expectations and a rising economy will provide a positive catalyst. We are at a moment of wide differences in the pricing between stocks the market is riding for near term gains and those it has left behind. This has also caused a breakdown in correlations since these stocks are not moving together. The lower correlations and wider spreads mean that value stocks have both increasingly attractive returns and lower risk relative to the overall market.

Two Important Upcoming Events

It's a little tricky to write this as two events will unfold over the next few days which will have important implications for the economy and the market longer term. I'm referring, of course, to the details of the House version of the tax bill, and the selection of the next Fed chair. As of this writing, the horse trading has begun in earnest on key provisions of the tax bill. I think that this is very different from healthcare, where the policy dials were very limited, and that this bodes well for passage in the House. While the Senate has little room to lose votes, the key factor is that this bill will be able to raise individual marginal tax rates on the rich (through the elimination of deductions), and this will bring in both the so-called moderate Republicans and the deficit hawks, who have the most entrenched positions. Libertarians and supply-siders won't be happy with the rise in marginal rates, but they will have to balance that with the other cuts in the bill, especially the one time shot at a corporate tax reduction. This group only really has power in the House, and the failure of the healthcare bill greatly increases the pressure on them to avoid political martyrdom and pass it. If the House bill released on November 2nd is Senate-friendly, the odds of something like it becoming law are greater than I would have predicted a few months ago. Will the market go up if it passes? I don't think it's priced in, and it will at least give earnings and stock buybacks a powerful boost, so I think that answer is yes. Certainly, the implications for corporate spending are very positive.

Regarding the Fed, early reports indicate that Jay Powell, a current Fed board member, will be nominated as the next Chair. A Taylor nomination would be a shock and likely a game changer (but maybe positively so), while Yellen would naturally mean continuity. In one sense, any new Fed Chair represents a risk. Powell's most notable work is in a deep understanding of the inner workings of the financial system, which is a departure from the Fed's academic leanings of the past. While this will mean we won't have the boldness of an academic theorist like Ben Bernanke (and I sure hope we won't need that, anyway), Powell can bring a practical angle to the near term task at hand, which is policy normalization. I'll be thankful for the Fed to be done with esoteric debates about the Phillips Curve or NAIRU, and most especially for whining about the supposed low rate of inflation, which is running at the Fed's target if properly measured anyway. These seemed to be front and center for Janet Yellen as a labor economist, although she does deserve credit for beginning normalization on interest rates and the balance sheet, even if it has been slow. The status quo seems likely for the present under Powell, with a monetary policy course already set. The difficult tasks ahead will be how that evolves with the economy. The risk from a historical perspective is that the Fed will eventually overshoot with tightening, invert the yield curve, and cause a market drop and recession. It's easy

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US Results (Continued)

with hindsight to ask why that would happen, but in the past the Fed has felt it necessary to tighten when they fear rising inflation, regardless of anything else. This is especially true after a period of rising commodity prices (especially oil), which tends to exacerbate the condition of rising current inflation and lower future growth. To avoid this, the key is to tighten earlier and not be forced to later. The current environment, with the stock market up and the dollar down, is perfect for doing this, and we'll get to see what Powell really thinks in what he telegraphs after the December hike. This time around we have the added factor of the balance sheet reduction to contend with. I think he'll leave that predetermined path alone in the near term for continuity's sake, but I hope that his background in banking and finance will help to creatively address the issue of naturally slower money supply growth as the Fed's balance sheet shrinks.

Asian and UK Results (Continued)

0.40% of that was due to stronger currency so we made 1% in local currency. The Thai SET Total Return index (in Thai Baht) posted a gain of 2.91%.

We finally have good news from Singapore. Our stocks rose around 8% while the FTSE All Share index rose 4.53%. Our largest Singapore holdings rose 20% in October and that explains the good return. The year-to-date returns from our Singapore stocks remains very disappointing at only 2.5%.

The UK was also strong with a 2.6% gain in local currency for our stocks mainly thanks to our homebuilder, which reported great results and the stock rose 10.7%. The UK FTSE All Share index rose 1.67%. The British Pound lost -0.88% against the US Dollar.

<u>A short note on Volume Winners quant strategy performance for October:</u>

We usually do not discuss the performance of our quant strategies. I will review them at the end of the year, but there is no monthly commentary. The reason for this is that these are automated strategies. We rebalance them once per quarter and then leave them alone for 3 months, only checking for major news.

No strategy works every month, quarter, or even every year, but based on our research we believe these work well over the long-term.

Still, the 3.10% drop for Volume Winners in October compared to a 0.81% gain for Russell 2000 is unusual and painful and requires a commentary of what happened.

The main culprit was one stock – a chemicals company which dropped over 14% in October on disappointing quarterly results. It so happened that this stock had the largest weight in the portfolio in the beginning of the month, because the stock had previously risen over 16% in the 3rd quarter. So we benefited from this stock in the third quarter, but got hurt in October.

This one stock does not explain the whole underperformance of the strategy versus the Russell 2000 index. But the underperformance wouldn't have been so striking if it wasn't for that stock.

Just the Numbers

ZPR Composites Names in Bold *Benchmarks in italics*	**Period Ending 10/31/17** Month	Quarter To Date	YTD	**Period Ending 9/30/17** 1 Year	3 Year Annualized	5 Year Annualized	10 Year Annualized
ZPR Fundamental Small Cap Value	0.56%	0.56%	19.72%	22.32%	15.79%	17.82%	8.92%
Volume Winners	-3.10%	-3.10%	9.84%	31.91%	19.49%	18.83%	NA
Volume Value	0.60%	0.60%	14.28%	40.23%	23.86%	22.73%	NA
Volume Momentum	0.44%	0.44%	17.55%	31.34%	12.16%	17.59%	NA
Russell 2000	0.81%	0.81%	11.84%	20.75%	12.18%	13.79%	7.85%
S&P 500	2.22%	2.22%	16.79%	18.63%	10.83%	14.23%	7.44%
ZPR Global Equity	2.33%	2.33%	24.00%	23.96%	7.81%	12.72%	11.50%
MSCI ACWI	2.10%	2.10%	20.22%	19.30%	8.03%	10.80%	4.45%
ZPR All Asian	3.91%	3.91%	27.70%	26.27%	3.70%	10.21%	15.11%
MSCI EAFE	1.53%	1.53%	22.31%	19.68%	5.52%	8.90%	1.83%
ZPR All Thai Equity	1.38%	1.38%	22.13%	23.74%	6.38%	12.30%	NA
Thai Set Index	2.91%	2.91%	14.94%	16.43%	5.12%	8.77%	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.