ZPR Investment Report

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US Commentary

By Mark Zavanelli

What a difference a month makes. In September, small cap value stocks surged after a difficult July and August. I think this had more to do with repositioning by market participants than anything in the real economy. Large cap stocks, especially popular Tech companies, have far outpaced small caps so far this year. This pushed the difference in how these groups were valued to extreme levels, setting the stage for a reversal. This scenario is really nothing new, but the rise of ETFs has made it more extreme, since ETFs are a convenient vehicle for making short term bets on subsectors of the market. There's typically a "story" behind the market's preferences, but more often than not it's a focus on some condition that turns out to be temporary. By contrast, the economy during the last few years has been remarkably steady. We have tried to use these fluctuations to our advantage, and this had us mostly buying in August and selling this month as prices rose.

Political drama continues to be a backdrop, and the market's pro-growth shift did coincide with the preliminary

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Asian and UK Results

By Vaidas Petrauskas

September was another solid month for our Asian and UK stocks. As a result our All Asian portfolios rose 2.80% and are up 22.89% year-to-date.

Japanese stocks continued to march steadily upwards. In September the Nikkei 225 index rose 3.61%. Our stocks did better, rising around 4.80%. The Yen, however, weakened against the Dollar by 1.64%. Year-to-date results for our Japanese stocks are impressive. In local currency we made around 27% in Japan in the first three quarters and a stronger Yen added another 3.92% for a total return of over 30% in US Dollars.

Japanese stocks still continue to be one of the cheapest in the world while earnings for many companies are growing strongly. The whole Tokyo market trades at 14 times forward earnings and 1.3 times book value with 2.2% dividend yield. Earnings for the whole market are expected to grow 18% this fiscal year (which ends in March '18) and another 8% in the following fiscal year. We expect our stocks to do even better. GDP is expected to grow at around 1.5% this year and next, which would be measly for any other country, but for Japan this is some of the strongest GDP growth they have experienced for a long time. Japanese stocks still have a long way to rise before they reach valuations similar to the US or Europe and the Nikkei 225 index is still far below its all-time high.

So, what's been holding back Japanese stocks from even bigger gains (while we made around 27% on Japanese stocks this

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The Fed Begins to Reverse QE

By Mark Zavanelli

Back in July the Fed released its plan for the next phase in its exit from quantitative easing, one of the emergency policies it had put in place to support the economy after the financial crisis. The Fed was the first central bank to deploy QE, and now it's the first to start going in reverse to undo it. Starting this month, it will shrink the amount of government and mortgage debt it owns by not reinvesting a portion of the bonds that mature each month in its holdings. It will begin with just $10 billion per month, which is a small amount compared to the size of those markets. By this time next year, however, the amount will be $50 billion per month, which is a meaningful fraction (maybe 15-20%) of the total issuance of similar notes. Compared to today, the direct implication is that buyers other than the Fed will be absorbing that debt that the Fed has up to this point been buying. It's an irrelevant point that the Fed won't actually be selling any securities, because already much of the new supply of bonds is rolling over old ones, so not reinvesting still means that someone else will be buying that new supply whether it is the Fed selling or the issuer selling new bonds. This will have impacts that are both real and psychological. In the near term the total effect will be modest, but I don't think it will necessarily stay that way as other central banks follow and as the economic cycle moves ahead.

Economists will argue about the effectiveness of QE in the real economy, but there's little doubt that it had a profound impact on market prices. With coordinated action by the world's three major central banks, medium and long term interest rates were driven down substantially. Just as importantly, credit spreads for lower quality borrowers were compressed. The strategy was especially effective in Europe, where it staved off a cascading sovereign debt crisis brought on by the Greek default. Central banks showed that with the promise or threat of near infinite capacity ("we'll do whatever it takes"), they could dictate market prices in the immediate term. Over time this morphed into a market belief that central banks could and would act to protect risky assets, which props up stock and bond prices today. However, there really is no free lunch, and market distortion has a cost. So this means QE has to be temporary, or at least something that is adjusted over time. The good news is that if QE can be adjusted up or down successfully, then it solidifies the use of the QE tool to cushion future crises and helps maintain the aura of central bank invincibility. For the present, the unknown is if the market will allow the Fed to exit in the way it wants to, which is so slowly that there is little impact on prices. It seems likely that this will be true for the moment. However, as events unfold in an environment of reverse QE, possibly by all the major central banks, I think there will be a time of uncertainty where markets will test the new framework, and we will see risk repriced. This doesn't mean a market crash, but it does mean the return of volatility and moments of fear.

The first real effect will be on medium term interest rates, where the biggest impact of the reduction in holdings will be. These rates will rise over the next year, barring an economic downturn, but probably by only a modest amount. Rates rose during the "taper tantrum" of 2013, when the reduction of bond buying was announced, and we will hopefully see a less dramatic effect. That impact was a rise of about 1% in the rate curve going out 5 years and longer, much of which was later retraced for longer term rates. The reaction function of the market is hard to predict, however, and there's no reason to think it will be stable over time as the QE reversal progresses. There's an interaction with government spending and foreign demand for US government debt, since deficits will now have to be absorbed by the market. However, with rates low around the globe right now, small increases in rates should be enough to make US government debt attractive to foreign buyers.

The second real effect will be on the money supply. It has been very easy for the Fed to increase the money supply at rates above nominal GDP during this period when it has been buying bonds. This has shown up in high levels of excess reserves at banks. The Fed believes that it can control the level of reserves through rates, but when the Fed is reducing its balance sheet it will be harder to increase the money supply at the same time. With both short and long term rates rising and reserves dropping, there will likely be an impact on credit. Will it tighten so much that growth decelerates? The Fed speaks with a lot of confidence about their ability to make effective adjustments on the fly, but I don't think that's supported by history.

Finally, there is a psychological effect for the market in knowing that the Fed will now be consistently reducing its balance sheet for the foreseeable future, regardless of

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The Fed Begins to Reverse QE (Continued)

economic conditions. I think that this is going to make the market more nervous about any slowdown or economic shock that comes along. The Fed promises to be ready to confront a future downturn with rate decreases, but there will be doubt about how that will interact with QE reversal that is supposed to be constant. By setting a predetermined course for reduction and taking QE out of the regular policy playbook, the Fed is attempting to turn back the clock to before the financial crisis, as though it had never been used. With rates still low and with reverse QE in place, the market may doubt that there is enough room for the Fed to respond. The Fed is trying to give the market more certainty by doing it this way, but I think that may backfire, because the market needs confidence more than certainty. When the other central banks eventually change policy, I don't know that the market can take a coordinated and predetermined balance sheet reduction by all of them without an economic or market downturn. Collectively they don't want to allow QE reversal to cause a negative economic event, so I think we might see more flexibility built in as a matter of necessity.

US Results (Continued)

blueprint of the administration's tax cut, which was revealed at the end of the month. Small companies typically pay higher tax rates than large multi-nationals, so betting on the tax cut was part of the reason for the relative outperformance. Still, I don't think there was anything too unexpected in the blueprint. The failure to repeal Obamacare dictated the size of the total plan because it removed that area of spending cuts. What the market really cares about is a cut in the corporate tax rate, so we'll see if that gets held hostage by the inevitable fighting over the rest of the plan. Any "reform" means that someone will be worse off, and there also will be a battle between deficit hawks and those who focus on stimulating growth. In my opinion the preliminary plan provides a lot of opportunities for Republican Senators who ordinarily would vote for tax cuts to be opposed. The most likely scenario is an extended period of horse-trading in the tax writing committees, and optimism may fade as that process goes forward. However, if a deal begins to seem likely, the market should react favorably. I don't think that success is priced in.

This month was also an important one for the direction of Fed policy. In October, the long awaited reversal of quantitative easing will begin (see my other article in this newsletter). Also, Janet Yellen surprised the market by indicating that another rate hike would happen this year, despite weak inflation data. From this we learned that the Fed isn't really that "data dependent" and that they really do care about normalization. It also may be that she wants to make it easier for the Fed to continue raising rates in the event that there is a new Chair named shortly. Whatever the reason, this is positive, since the Fed should not be providing any stimulus at all this late in an economic cycle, and a rate hike (or several) is needed. If the Fed can get rates to more normal levels in short order, this may prevent the need to hike rates at a later point where it would likely be more harmful.

Asian and UK Results (Continued)

year, the Nikkei 225 index is only up 6.50%)? North Korean missiles for one. Japanese domestic politics has been another drag. Prime Minister Shinzo Abe on September 25th called snap elections, scheduled for October 22nd. Mr Abe goes into the campaign with a huge lead in opinion polls, but there are strong challengers. The vote will determine whether Japan continues with its drive to escape years of deflation through massive economic stimulus.

Another concern is the strength of the Japanese currency. The Yen has pulled back in September, but year-to-date it is still up close to 4%. Usually when the Yen appreciates, Japanese stocks weaken. This wasn't the case this year, so we benefited both from strong gains in stocks and a stronger Yen. It is estimated that the break-even rate for Japanese exporters is just above 100 yen to the dollar. So as long as the yen remains above the 100 mark, the currency doesn't have to be a drag on the stock market.

Thai stocks also continued their advance in September. Our official All Thai return, which is expressed in U.S. dollars, was 2.59% for the month. The Thai Baht depreciated by 0.48% against the US Dollar. The Thai SET Total Return index (in Thai Baht) posted a gain of 3.74%.

Year-to-date our All Thai accounts are up 20.47% in US Dollar terms. A stronger Thai Baht is responsible for 7.35% of that gain. The Thai SET Total Return index (in Thai Baht) rose 11.70% since the start of the year.

We own only four **Singapore stocks**. Those were down slightly in September, but finished ahead of the FTSE ST All Share Singapore stock index which was down -1.14%. The Singapore Dollar was almost unchanged – it gained 0.17% against the US Dollar.

We currently own only 5 **UK stocks**. Despite the small weight in the portfolio, our UK holdings contributed nicely in September. The stocks gained around 2.60% as the biggest August loser rebounded and all other stocks rose as well. But the biggest contributor was the currency. The Pound strengthened by 3.62% against the US Dollar and is one of the best performing currencies this year.

2017 has been marked by dollar weakness which few people predicted in the beginning of the year. Last year the Dollar was the king of currencies and many analysts saw parity with the Euro in the very near future. However, as is often the case in the markets, when everyone agrees on something, the opposite happens. Long Dollar and short Euro became an overcrowded trade. The political fears in Europe did not materialize – anti-EU forces did not win a majority of seats in France, Netherlands, or Germany. Also the massive monetary stimulus in Europe is coming to an end as the European Central Bank plans to reduce the quantitative easing because of much better economic data coming from many European countries. The Euro became the king of currencies in 2017.

The table below shows the performance of all the currencies in which we invest (as well as the Euro for comparison) against the US Dollar from the beginning of this year.

	Performance vs USD
Thai Baht	+7.39%
Singapore Dollar	+6.42%
Japanese Yen	+3.92%
British Pound	+8.74%
Euro	+12.36%

In addition to the Euro being up 12.36%, European stocks also advanced very strongly this year – around 20%. So those who invested in European stocks in the beginning of the year are sitting on very nice gains.

Just the Numbers

	Period Ending 9/30/17			Period Ending 6/30/17			
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	8.49%	9.94%	19.05%	20.35%	10.03%	16.54%	7.50%
Volume Winners	4.38%	1.97%	13.35%	37.21%	18.27%	18.56%	NA
Volume Value	5.03%	2.12%	13.59%	53.26%	22.57%	22.99%	NA
Volume Momentum	4.82%	3.24%	17.03%	41.07%	8.84%	17.32%	NA
Russell 2000	6.09%	5.52%	10.79%	24.61%	7.36%	13.70%	6.92%
S&P 500	1.93%	4.35%	14.11%	17.91%	9.63%	14.64%	7.18%
ZPR Global Equity	4.97%	8.26%	21.18%	22.67%	5.16%	12.47%	10.11%
MSCI ACWI	1.97%	5.31%	17.75%	19.45%	5.40%	11.15%	4.27%
ZPR All Asian	2.80%	7.94%	22.89%	24.66%	2.25%	10.52%	13.39%
MSCI EAFE	2.53%	5.47%	20.47%	20.84%	1.61%	9.21%	1.51%
ZPR All Thai Equity	2.59%	1.21%	20.47%	26.34%	7.29%	15.17%	NA
Thai Set Index	3.74%	7.28%	11.70%	12.54%	5.27%	9.74%	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.