ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

The end of November brought some relief from the issues that caused so much market pain in October. Our stocks haven't gotten the message yet, but I believe that they will soon (more on our performance in a separate article). I think that the market is holding the recent lows and that the pieces are in place for a much-needed rally, starting now. A deeper question is if this marks a turning point where the market drivers will be different and where value investors can play offense again instead of defense. That time is coming, and there's a whole lot of pent up energy behind it, so I expect the move to be powerful. However, it's not clear that the necessary conditions are here just yet. By the time they are, the move will already be happening. I'll touch on that question separately also.

In the immediate term, the major fear points for the market that I discussed last month have lifted for the time being. For the first time in months, we are soon going to be able to start talking about something other than the Fed and the trade war. In his latest speech Fed Chair Powell changed his assessment of interest rates to "just below" neutral instead of "a long way" from neutral at the beginning of October, which had sparked the market decline. Powell reversed direction and it was a huge deal, for a couple of reasons. First, the market was actually shocked by his previous comments in October, and mystified about why he would effectively put an exclamation point on

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Asian and UK Results

By Vaidas Petrauskas

November was another down month for us in Asia. This time Thai stocks sold off sharply while the Japanese market rose. Thai small cap stocks were especially hard hit. The large cap Thai SET index dropped -1.64% while the small cap FTSE SET Small Cap index dropped -5.37%. The year-to-date performance discrepancy is even more stark: Thai large caps are down -6.38% in 2018 while Thai small caps are down –21.93%.

What spooked Thai investors in November was a surprise slowdown in the third quarter GDP growth. GDP recorded a flat reading from the previous quarter. On an annual basis, growth was 3.3% from July to September, easing from the second quarter's 4.6% and the revised 4.9% growth in the first quarter. So clearly a slowdown but not a disaster.

The weak economic growth reading for the three months to September can be attributed to September's disappointing exports and a sharp decline in Chinese tourist arrivals. But a pickup in private consumption from improving income and employment, and stronger private investment partly offset external impacts. Private consumption expanded by 5% year-on-year, the highest growth in the past 22 quarters, up from 4.5% in the previous quarter while private investment grew by 3.9%, up from 3.2% in the previous quarter.

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Performance

By Mark Zavanelli

I know that our performance this year, including this month, has been bewildering to many of our investors. I'll continue to try to shed some light on why this has been such a disappointing and unusual period. This is not the norm, and hopefully won't be at all predictive of our future success (in fact the opposite). I know that this doesn't make the losses easier to swallow, but it's important to understand what happened. Underneath the averages it has been a tale of two markets. For the majority of companies, the market decided at the end of 2017 that current strong earnings performance might mean that things were as good as they could get. It was a stealth boom-bust prediction where the market refused to pay for any earnings improvements that might not be sustainable. Value stocks had no way to win. With good earnings the price held steady and the P/E multiple just shrank. If a company missed forecasts the punishment was severe. Small cap stocks in some cyclical groups like auto parts and semiconductors where earnings did actually turn down saw price losses of close to 50%, much worse than any actual hit to earnings. The proportion of winning stocks in the cheaper half of the small cap universe was negligible. We have been selling the stocks with disappointments all year but the industries with emerging earnings strength (materials, energy, transportation) that our process has guided us to were also cyclical and have been caught up in the most recent leg down. This turned out to be a time for pure defense and risk minimization, in the middle of a great economy with rapid earnings growth that should have favored economically sensitive companies! Crazy, but the major reason was the tax cuts and fiscal stimulus running straight into the brick wall of a Fed and trade war driven slowdown. I clearly didn't anticipate that sufficiently, and I still don't believe the slowdown will be a major event. At the same time money was flooding into the US economy and stock market as the winning asset class, which found its way towards speculation – in Bitcoin, pot stocks, FANG, and elsewhere. The small cap healthcare sector, which encompasses biotech and many money losing companies, has risen approximately 30% this year (not due to especially good earnings or improving fundamentals). Momentum became essential, and the chase to capture performance sucked money out of everything else, which is one reason value stocks had larger losses than were justified. This is reminiscent of the late 1990's, and I won't be surprised if speculative growth stocks see a similar hangover as they did then. Now, the last two months have broken the expectation of rising prices. Overall equity market multiples will not rise consistently in a period of rising interest rates and that means no fuel for momentum. Growth stocks are high beta so they will also lead in a bounce, but I think the momentum market is over. Figuring out what wins next is not easy, but extrapolating what has occurred this year is likely to be a mistake, for both the winning and losing stocks.

The Slowdown: Here Now but Maybe Just a Historical Footnote

By Mark Zavanelli

A slowdown in economic growth outside the US began in mid-2018, and is presently spilling over to the domestic economy. This is despite a strong US consumer who has rising income. I had thought this would be working in reverse, that US strength would pick up the global economy which has more excess capacity, but that doesn't seem to be happening. With the US dollar rising and money flows heading towards the US, it has been a liquidity squeeze for emerging markets that now seems to be hitting developed foreign economies too. Some of this is probably directly related to the US tax cut as multinationals repatriate overseas funds. So is this all a big deal? With the talk of a late cycle US economy and excessive debt in places like China, the market is thinking that this looks like a classic recessionary onset driven by monetary policy. Now oil and commodity prices are falling as well. As I mentioned last month in my piece on the economic outlook, I think a truly bad outcome is unlikely. Instead, this is part of a back and forth that we have seen before several times during this economic expansion, and it may end up being minor. Importantly, it looks like some of the cost pressures companies have been facing this year may be starting to abate. These cost pressures were part of the reason for the slowdown in the more volatile parts of the economy like autos and housing as prices were forced upwards. Currently inflation expectations are calming down, which takes some pressure off the rise in longer term interest rates. It looks like we won't see the vicious cycle of inflation and rising rates happen anytime soon. A slowdown doesn't mean the end of the economic expansion, and it's now more likely to continue. On the positive side there is also still pent up corporate spending that I think was deferred due to trade uncertainty. Corporate earnings should rise again next year, and a virtuous cycle of spending and growth can resume. All of this takes time, however. Confidence doesn't return instantly, especially in the face of weak data.

We are currently seeing defensive and quality leadership in the market as former growth darlings join value stocks in the losing category. After the current volatility settles out, the next shift is for depressed value stocks to rise as it becomes clear that we will avoid the worst of the potential economic outcomes. For this to happen I would expect to see a better than average trend to 2019 earnings estimates (those estimates decline in an average year as analysts are typically too optimistic) and some steepening to the yield curve. I don't think this will occur instantly, so for the moment bouncing growth stocks and defensive stocks are likely to trade off market leadership as the market tries to find its footing. But if I'm right about this slowdown the pain for value stocks should finally be over. The tricky thing for our process, which cares about earnings expectations, will be to avoid an excessive quality bias when the time comes for value to start winning.

US Commentary (Continued)

more rate hikes when the market clearly already feared that the Fed would push us into recession. Was this like Greenspan's "irrational exuberance" statement where he worried about speculation, or was Powell focused on defending the Fed from the President's comments? Either way, the market was not ready for an unfriendly Fed when we may be near a crucial moment for policy. The neutral rate hasn't changed in two months, so when he modified this wording it was a message aimed directly at the market that he really does care about stock prices and their implication for the economy after all, as previous Fed Chairs have. This goes beyond just a question of how many rate hikes there will be next year to the market's overall confidence in the Fed. Maybe for Powell it was an "Oops, I didn't think you guys would take it that way" moment.

Next, after markets had closed for the month, Trump met with China's leader Xi along with a coterie of aides at the G-20 meeting. They agreed to defer further tariff increases for 90 days in exchange for negotiations on substantive issues the US cares about and a commitment by the Chinese to restart agriculture purchases. This is a major step, since we finally have the Chinese side indicating that they are willing to take some steps to make a deal happen. The messaging around the deal also shows that both sides are taking the fallout from the trade war seriously. It was significant that President Xi in his speech mentioned intellectual property rights and opening up China while omitting references to China's long-term economic initiatives that the US has objected to. Of course, this doesn't mean that the trade war is over. Where I've been wrong so far is in misunderstanding the US side. It's a two-headed attack, and China hasn't known which way to turn to satisfy it. Trump is all about the trade deficit and reversing the trend of manufacturing jobs moving to China. While China doesn't want to give away the store, I have felt from the beginning that this was a "buyer's strike" that they could deal with by some fairly easy concessions, like improving their imports from the US. The second head, however, is the Navarro-Lighthizer team that wants to use tariffs to change how China operates its industrial policy, which is a mercantilist system. When VP Mike Pence combined this with Chinese foreign policy as a major threat to the West many analysts were saying that we had morphed from a trade dispute to a new Cold War! My opinion is that Trump was using these subordinates in a good cop – bad cop routine to amp up the pressure on China to motivate them to negotiate seriously with him. China is not going to change their system in any serious way, so they actually cannot make Navarro-Lighthizer happy. But they can and will make Trump happy. Their delay until this meeting makes sense and I don't think that the additional tariffs are going to happen, although we might keep the ones we have already. This will be good for corporate spending and gives the market a chance to move away from discounting the worst outcomes.

Asian and UK Results (Continued)

Global economic slowdown is evident. The weakness in the Thai economy is in line with a slowdown in regional economies. Indonesia, Malaysia, Philippines, and Singapore all reported slowed economic growth in the July-to-September quarter. Japan was affected by natural disasters and lower exports, while Germany suffered its first quarterly contraction in more than three years as exports to China fell and carmakers adjusted to comply with the new EU emissions standards.

One of the main reasons for the global slowdown is the escalating trade dispute between the U.S. and China. Export-oriented companies were hit when the world's two biggest economies imposed tariffs on each other's imports in July that were ramped up during the quarter. Most Southeast Asian economies rely on trade and are heavily integrated in the supply chains of Chinese and U.S. manufacturers. As so often, China is the center of attention.

So, some progress towards defusing the US-China trade tension is extremely important for the global economy to get back on track. Some recent positive developments for the global economy are the big drop in oil prices over the past couple of months and U.S. FEDs more dovish stance on rate increases next year.

Thailand will be fine, barring a complete collapse of the global economy. It's not like growth is coming crashing down. 3.3% growth is still good and in 2019 the Thai economy is projected to grow 4%. Private consumption and investment are growing strongly. Local banks are seeing more demand for term loans, indicating that the investment cycle is genuine. However, if the trade spat between the US and China is prolonged, it will have an impact on Thai exports going forward.

I think the sell-off in Thai stocks is overdone. Valuations certainly have become much more attractive. While the main Thai SET index has fallen over 6% so far this year, aggregate 9-month earnings have grown by 12%. This has brought down P/E ratios. I think Thai stocks are very attractive at these levels because of valuation (forward P/E below 14 for the broad market) and continued earnings growth in 2019.

We already received October's Thai export data. Exports bounced back in October, after September's surprise decline. Thailand's outbound shipments rebounded to growth of 8.7% in October from a year earlier, compared with a contraction of 5.2% in September. More importantly, shipments to China were back on track with positive growth of 3%. Exports to Japan rose 10%. The pickup in October export growth (on a regional scale) confirms the view that the sharp drop in September was temporary and bodes well for the 4th quarter Thai GDP growth.

2018 has been a bad year for most asset classes, especially Emerging Market equities. Only U.S. equity indices show a positive return. So, the valuation divergence between U.S. stocks and the rest of the world became even greater in 2018. In fact, valuation divergence for U.S. versus Asian stocks are at record levels.

A negative year for Thai equities has always been followed by a positive year in the recent past. That's what history says. The Thai SET stock index never had two consecutive years of negative return since 1998 Asian Financial Crisis.

In November we have been busy looking for new stocks. That is our regular quarterly research cycle. After the earnings season is over and the latest financial statements are available, we search for new investments with the idea of replacing the underperforming stocks which we sold during the earnings season with new investments. I believe our biggest source of returns historically came from new investments.

Our process in Thailand is slightly different. In Thailand we look at every earnings release when it comes in and try to research the stock and make a decision whether to buy right away.

In Japan, because there are so many listed companies, we use a screening process to narrow down the list of potential candidates.

Our latest quarterly research process was very productive. Because so many Asian companies are trading near 1-year lows, we had a lot of candidates to go through in Japan. I don't remember when we had so many good candidates to choose from. We couldn't buy them all and chose only the very best. We bought 7 new Japanese companies in November and sold 6 underperforming companies. All the new companies are companies we could not buy before because of valuation. This year's sell-off presented an opportunity. As a result, we upgraded our portfolio to better quality, non-cyclical companies at very attractive valuations.

Likewise, in Thailand we picked up 4 completely new companies based on excellent results. We are also selling 5 underperforming Thai businesses.

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Asian and UK Results (Continued)

Performance of our Asian investments so far in 2018 has been dismal and I am very upset about that. But I am very excited about our new Japanese and Thai investments and I look forward to much better returns ahead.

BREXIT Drama

Brexit turned out to be a big mess. UK politicians cannot come to a mutual agreement between themselves as to what kind of Brexit they want. The EU bureaucrats proved tough negotiators, in no mood to give too many concessions. So, Theresa May, the British Prime Minister, struck a sloppy deal with the EU which binds Britain to the EU's laws and the customs union for some time to come with no voting power. The deal is probably worse for Britain than staying in the EU.

T. May managed to get the UK government to approve the deal. But next day several ministers resigned, deepening the political turmoil over the terms of her plan to exit from the European Union. Then the initiative to oust May failed or was put on hold.

The deal which T. May struck is not great for Britain, leaving Britain tied to the EU laws and courts for some time to come, but it may be the best deal she could extract.

The EU also approved the signed deal at the top level, but each EU country will also have to approve it. But the biggest obstacle will be the UK parliament, which also must approve the deal on December 11th. There is huge opposition to the deal in the Parliament and it is unlikely that the deal will be approved.

If it doesn't, then all options are open:

- Renegotiate better terms with the EU (unlikely)
- Second referendum (no wide support for such initiative)
- T. May is replaced (no alternatives which are better)
- New elections (under this scenario it is possible that the Labour party might come into power, which would be terrible for UK businesses and the economy and we would have to exit the UK stocks completely and for good)
- No deal – hard Brexit (massive sell-off in UK currency and stocks, certain big contraction in the economy)

The UK Central Bank governor Mark Carney said that in the case of Hard Brexit, the Pound could fall 25%, GDP might fall 8%, and house prices might fall 30%. This sounds like a scare tactic to me, but there would be pain for investors for sure in case of Hard Brexit which is still a possibility.

Because of this whole Brexit mess, I have stopped buying any new UK stocks a month ago. My fear is, if the Parliament votes against the deal, UK stocks and the Pound will suffer greatly in the short-term but will recover eventually. I don't think it is a risk worth taking. I would rather pay more when there is more clarity than risk large losses.

Meanwhile we have been getting excellent earnings announcement from our UK companies and we have been taking profits and reducing our exposure to UK stocks that way also. Your accounts do not hold any British Pounds. Cash in your account is always held in Dollars.

UK stocks already have been punished severely this year. There are incredible values to be found in the UK stock market. Valuations that you wouldn't see in the U.S. for example. I wouldn't be surprised if UK stocks go on to have a great 2019. This current one-way bet against the UK assets has become a crowded trade and it is probably wise to bet against it. So, although there are plenty of companies in the UK which I believe are great investments, any new purchases in the UK will be made only after there is clarity on the Brexit deal. The vote by the British parliament on December 11th will be a very important step in that process.

Just the Numbers

	Period Ending 11/30/18			Period Ending 9/30/18			
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%	-12.44%	-21.67%	-5.78%	16.37%	11.84%	11.37%
Volume Winners	-1.15%	-6.79%	3.44%	11.08%	21.35%	16.50%	NA
Volume Value	0.82%	-5.54%	-2.25%	5.90%	22.77%	17.68%	NA
Volume Momentum	-3.18%	-12.78%	-9.01%	4.83%	16.35%	9.49%	NA
Russell 2000	1.45%	-9.57%	0.83%	15.22%	17.12%	11.07%	11.11%
S&P 500	1.79%	-5.18%	4.85%	17.91%	17.32%	13.96%	11.97%
ZPR Global Equity	-2.56%	-11.12%	-19.68%	-5.23%	11.31%	7.07%	14.32%
MSCI ACWI	1.51%	-6.07%	-2.07%	10.36%	14.03%	9.26%	8.78%
ZPR All Asian	-4.03%	-10.75%	-18.45%	-4.16%	8.19%	4.60%	17.57%
MSCI EAFE	-0.11%	-8.05%	-8.96%	3.25%	9.77%	4.90%	5.89%
ZPR All Thai Equity	-6.83%	-11.88%	-15.40%	-7.84%	6.96%	7.19%	NA
Thai Set Index	-1.56%	-6.30%	-3.63%	8.01%	12.65%	8.29%	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 depending 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.