ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

The sharp losses in October were unusual and painful. For the major US indices, they came out of nowhere right after the market hit new highs. The perspective from foreign stocks and US small caps was very different however, since these markets have been weak for months if not all year (as our strategies have been). So, what was so bad that happened in October? When markets are vulnerable sometimes a push will kick off selling which then builds on itself. This is especially true of markets that are led by expensive growth stocks. Early in the month we got bad news on the two issues that scare the market the most, tariffs and interest rates. On tariffs, VP Mike Pence gave a speech which laid out a broad list of economic and foreign policy complaints that the US administration has with China. The market saw this as hindering a deal with China and increasing the likelihood of a worst-case tariff scenario. On interest rates, Fed Chair Powell indicated in an interview that he believes current interest rates are "a long way" from neutral and that they "may go past" neutral with rate increases. That day the 10-year Treasury yield (which is important for mortgage rates) broke out to new levels that we haven't seen since 2011. The backdrop here is that the broader market (away from the high growth stocks) has been very worried about global economic growth and the possibility of a US recession sometime in 2019 or 2020. The market was looking for signs that China

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Asian and UK Results

By Vaidas Petrauskas

I don't know what it is about October that spooks markets, but it seems like big market corrections tend to happen in October. The sell-off which started in the US quickly spread to other countries. The culprit appeared to be rising interest rates. If so, I am surprised that investors realized this only now. Of course, inflation, and consequently higher interest rates, is the one big risk factor for the financial markets. Almost every CEO talks about cost pressures and rising prices. That's probably what scared Wall Street.

In times of market turmoil, the Japanese stock market simply repeats what the US market did the previous day. If US stocks drop 3% one day, you can be sure that Japanese indices will drop around 3% the next day for no other reason than the fact that US stocks dropped. Obviously, Japanese businesses did not become less valuable just because there is a market panic in the US. Did a Japanese funeral home operator become 10% less valuable in October (as indicated by its stock price) because US stocks sold off by 10%? It would be absurd to think so. This simultaneous stock sell-off in different countries is driven by the same large global institutional investors moving in and out of all markets at the same time. In this fight between fear and greed, company

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The Economic Outlook

By Mark Zavanelli

The market is seeing ghosts around every corner as old fears mix with new ones about the future direction of the economy. Two old fears are the fragility of the debt driven Chinese economy, and the onset of quantitative tightening, which is just getting rolling as the ECB joins the Fed in reducing its balance sheet. Two new fears are a Fed determined to raise rates aggressively, and the impact of US-China tariffs, with its associated fall in China's currency. Add to this mix some weak current data and it's a recipe for rising downside risks and fear of a recession on the horizon.

While these risks are real, I think that there are some logical explanations behind the recent data and that these are not really indicating big trouble. First, let's consider US housing. A general flattening in new home construction is happening as a reaction to higher mortgage rates and homebuilder price increases driven by labor and materials. Existing home sales are suffering from a combination of tax law changes and higher mortgage rates that are especially impacting the high end. There's no doubt that this reduction in activity is rippling through the economy as housing always does, reducing growth since it's a large category of debt financed spending. A key insight, however, is that the change is a reaction to price (including financing cost and taxes) and not a drop in the demand curve for housing. In my view, this means that house price appreciation will likely pause or slightly reverse but that units will still end up reflecting the underlying demand which is strong. Wages are growing, so stable prices mean better affordability over time, although this is likely to be somewhat offset by even higher rates in the future. I don't want to minimize the impact of house prices on the economy, since housing clearly has a large wealth effect, but the overall impact is something moderate and not extreme.

Next, I think that the reaction of corporate investment to the tariff drama is logical. No one wants to make significant long-term decisions in the face of uncertainty, and so some projects are naturally delayed. I think that uncertainty impacts even domestic projects here in the US. Turning to China, they are particularly sensitive to capital spending, some of which is coming from foreign companies which can easily invest elsewhere. The capex pause is having an immediate impact on China's economy even as their exports remain strong. China is currently reducing the Yuan's value to try to lower their cost profile and offset the tariffs. That's hurting their imports of outside capital goods and probably making the capex slowdown worse. This is a real risk to the Chinese economy, which the market was already worried about. However, the Chinese government is going to do what it needs to do in the short term to prevent serious damage, including possibly making a deal in November. I think it's likely that there is now pent up demand for corporate investment, and that China will take action to make sure that its share of that doesn't decline too steeply.

The bottom line is that I think both of these issues are impacting growth right now and actually might get better going forward instead of worse. 2019 global growth will likely be slower under QT but I don't think either the US or Chinese economy falls off a cliff. The slowdown has some definite positives as well in terms of keeping the cycle intact. The sharp rise in energy and materials costs is moderating just in time to keep inflation from really accelerating. I think that higher inflation numbers earlier this year were one thing that stirred the Fed to being more aggressive, and maybe some of that will moderate now too. Somehow the yield curve also looks more normal now, with inversion less of an imminent worry. As we move forward I think there's a good chance that the market starts to feel better about the economic prospects for 2019 and 2020, which will change the direction of stock prices for economically sensitive companies.

Asian and UK Results (Continued)

fundamentals become irrelevant. That was the market environment that we were dealing with in October.

What to do when panic grips markets? Well, the worst thing to do would be to panic and sell. Big drawdowns offer a lot of opportunities. Turn off the noise (CNBC). Ask yourself: Have any of the companies I invest in reported significant declines in revenue, earnings, or dividends? From my observation the answer is a clear “No”. Third quarter’s earnings reports are coming in from US and foreign companies and in general the quarterly results and guidance are very strong. There are some exceptions like the housing market in the US where mortgage rates touched a seven-year high. As a result, marginal buyers are pushed out of the market. In the last year, new home sales in the US are down 13%. Some US homebuilders’ share prices are down more than 50% this year as a result. This sector and related industries are objectively experiencing a slowdown in activity. It may be temporary. In general, investors currently fear that we are at peak earnings (this is as good as it gets), but I don’t see any signs of slowdown yet in the quarterly reports which are coming in. So, if companies are more or less unchanged during a correction, what has changed to drive share prices down by 10% or more? Only sentiment and perception. All we can say is that prices have changed while economic and corporate fundamentals haven’t. The stock market parted ways with fundamentals in October. This is not unusual.

When businesses go on sale it is time to be even more active in researching businesses. Of course, the market could fall further. It is never possible to say with certainty where the market is going in the short-term, especially when Wall Street seems to be on pins and needles.

Because of the market correction in the US, Japanese stocks corrected very similarly – around 10%. Thai, Singapore, and UK markets dropped less – around 6%.

The one positive concerning our foreign investments in October is that our stocks outperformed the local indices in all markets – Thailand, Singapore, Japan, and the UK. The US dollar has gotten much stronger in October which negatively impacted our returns when expressed in US dollars. The US dollar appreciated significantly against the Thai Baht (by 2.4%) and the British Pound (by 2.3%). The Yen was almost unchanged.

Investing in European Companies

For the first time, we plan to introduce European equities to our Global portfolios. European small capitalization stocks suffered badly in October’s sell-off to a point where they look very attractive. There are excellent and inexpensive small companies in France and a few in Italy and the Netherlands. We plan to selectively buy a basket of businesses operating in the Euro zone, instead of focusing on any particular country. At this time France offers the highest number of potential investments. We plan to allocate 7% of Global portfolios’ assets to Euro zone equities with another 7% already invested in the UK. Together Euro zone and UK stocks will have a similar weight in the Global portfolio as Thailand, but European (including UK) equities will make up around half of the weight of the US or Japan.

A Short Note on Volume Quantitative Strategies

October proved to be a good month to test how our Volume Winners and Volume Value strategies perform under stress. I remind you that these are low beta strategies intended to protect assets during drawdowns (by losing less). And what better environment to test this in real life than October of 2018.

I am happy to say both Volume Winners and Volume Value suffered a significantly lower loss than the market in October. Both strategies lost slightly more than half of the loss that the Russell 2000 suffered. The October results also include the rollover trading costs and the management fees for the quarter.

We can also see how the strategies performed on two especially bad days in October when the Russell 2000 index dropped by 2% or more in one day:

	OCT 10th	OCT 24th
S&P 500	-3.29%	-3.09%
Russell 2000	-2.87%	-3.80%
NASDAQ Composite	-4.08%	-4.43%
Volume Winners	-1.16%	-1.48%
Volume Value	-0.88%	-2.63%

Losing less in down periods is what our Volume strategies are all about. But they have also shown that they can do well over longer periods in rising markets too. Since we launched them in 2010 they have outperformed in an overall good period for stock returns. This is despite lagging during some periods when high beta is doing well, like the trailing 12 months prior to October.

US Commentary (Continued)

might make a deal in November and that the Fed would say it recognizes the potential for a slowdown, but instead it basically got the opposite. The last few months have also seen some data that dovetails with the current market concerns. First there was the clear slowing in the US housing market (both new and existing homes), especially in the most expensive parts of the country. Another issue was the price movements in commodities like industrial metals (copper, aluminum and steel) and lumber. These spiked up in the spring with the tariffs but have been coming straight down since. The market views this as a sign of weakness in China (they are a major consumer of metals), which is another fear story. This is one reason that our own pivot towards Energy and Materials stocks over the last several months hasn't paid off yet. I'll address these economic concerns in a separate piece this month.

Now to our own outlook. It was very disappointing to see very cheap value stocks plunging alongside very expensive momentum stocks this month. But this is consistent with history in that correlations tend to rise in a sharp selloff. I believe the path forward for stocks has two components to it. First, there is a market psychology component which is negative. The speculation and excess optimism we've seen need to be wrung out. This doesn't usually happen in just one month, so we might see continued volatility, probably both up and down. Second, and more important, is the real economy component. I believe that this is significantly positive for future returns, especially for value stocks. The key point is that we might be at the crest of the market's economic slowdown fears right now. The situation isn't actually that bad, and the momentum market has made it look worse than it is by pulling money out of everything else and causing value stocks to decline. Of course, it is important that the economy is in fact ok. One key indicator I am watching comes from the bond market, where high yield spreads typically act as the canary in the coal mine. Right now, these have been calm even with the equity market declines. It is important to note that there are a number of historical episodes where a big scare happened with falling stock prices and the economy turned out fine (1998, 2011, and 2016). Each of these was actually much worse from an economic risk standpoint than what we are facing now. Value stocks worldwide are priced so that a mere slowdown is no longer bad news but good news, especially if it extends the cycle. We could see both earnings growth and significant multiple expansion from this point. I'm looking forward to playing some offense soon.

Just the Numbers

	Period Ending 10/31/18			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	-11.91%	-11.91%	-21.20%	-5.78%	16.37%	11.84%	11.37%
Volume Winners	-5.70%	-5.70%	4.64%	11.08%	21.35%	16.50%	NA
Volume Value	-6.31%	-6.31%	-3.04%	5.90%	22.77%	17.68%	NA
Volume Momentum	-9.92%	-9.92%	-6.03%	4.83%	16.35%	9.49%	NA
Russell 2000	-10.91%	-10.91%	-0.67%	15.22%	17.12%	11.07%	11.11%
S&P 500	-6.94%	-6.94%	2.90%	17.91%	17.32%	13.96%	11.97%
ZPR Global Equity	-8.78%	-8.78%	-17.57%	-5.23%	11.31%	7.07%	14.32%
MSCI ACWI	-7.47%	-7.47%	-3.53%	10.36%	14.03%	9.26%	8.78%
ZPR All Asian	-7.00%	-7.00%	-15.02%	-4.16%	8.19%	4.60%	17.57%
MSCI EAFE	-7.95%	-7.95%	-8.86%	3.25%	9.77%	4.90%	5.89%
ZPR All Thai Equity	-5.42%	-5.42%	-9.20%	-7.84%	6.96%	7.19%	NA
Thai Set Index	-4.82%	-4.82%	-2.10%	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.