ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

July saw a rebound in the hardest hit international markets from the prior month, and this set up a positive backdrop for US stocks as well. The trade tensions are still with us although a glimmer of positive resolution could be seen in talks with Europe. Some tariffs were rolled back and the prices for commodities such as lumber and aluminum reversed some of their trade related increases. The Chinese have not yet budged, but as I predicted last month I think they are getting the message and they will come to the table. That's especially true after the European talks yielded immediate relief based on a promise of future action.

With all the trade uncertainty and central bank tightening (quantitative or otherwise), the market continues to worry about future growth even as current economic data is very strong. Our own SCV portfolio was hurt once again by the cheapest stocks in the portfolio as the market discounts a decline in cyclical industries such as semiconductors and housing. Despite strong economic growth, some categories that were previously very strong are experiencing softer data, and this has been a major factor in our performance this year. We continue to execute on our plan of rebalancing out of these stocks into industries with clearer earnings trends, but that's been complicated by the excessive punishment some of these stocks have taken. This has been an especially treacherous environment for value

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Asian and UK Results

By Vaidas Petrauskas

Thai stocks recovered strongly in July after a big tumble in June. As I wrote in the previous monthly report, in each of the last two trading days of June Thai stocks dropped by 2%. Stocks were sold indiscriminately. This seemed like a big overreaction to all the worries about trade and tariffs. Trump doesn't want tariffs. He wants free trade. Tariffs are just a negotiating tactic to get a better deal for the US. This was confirmed at the meeting between Trump and the European Commission President Juncker on July 25th where they agreed to work towards zero tariffs.

To take advantage of what I believed was a buying opportunity in Thailand, we took trading positions in 7 Thai stocks on the first trading day of July. We didn't have to wait very long for recovery. Thai stocks started moving up from the first day and never looked back. We already sold 5 of those 7 trading positions as these stocks fully recovered and we should close the other 2 very shortly while we continue holding the core positions which we had in June.

We are also trying to get into an interesting low risk/high return special situation involving a tender offer between two Thai real estate developers. Just waiting for the right price. As Mohnish Pabrai would say: "Heads I win; Tails I don't lose much". It will be interesting to see how this one plays

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Tightening Cycle Playbook

By Mark Zavanelli

Fed policy has taken a decisive turn since Jerome Powell's appointment, and they are acting in a more traditional way than the post-crisis Fed did under Bernanke and Yellen. Actual inflation data is now supporting the case for higher rates, which further limits the Fed's flexibility. As we progress along the path of rising rates from the low levels of the QE era, it starts to matter more to the economy, corporate earnings, and stock market valuations. We won't know if we're actually late cycle in terms of the economic expansion until that data becomes clearer, but we will need to navigate higher rates that matter progressively more.

The market's current concern is mostly around the message of a flattening yield curve. I don't think this will turn out to be the major issue in the near term. Instead, I expect both short and long rates to continue moving higher as increased inflation expectations get built in and balance sheet reduction by the Fed and the ECB continues to bite. While this will all have a negative effect on real GDP growth next year and beyond, I think that the data the market is reacting to on autos and housing is temporary, and these will catch up with strong wage growth. The cumulative effect of higher rates is not large enough yet to offset the current rise in demand. Corporate earnings growth will continue to be strong, and cyclicals usually respond to nominal and not real growth rates.

The biggest message for investors is that this is simply a more negative environment for equity returns than on average. There is greater risk, as Fed tightening cycles increase the chance of recession, and generally have higher variability in returns. This can be masked by strong gains in momentum and growth stocks which we are also seeing today. While it's hard to argue with making a lot of money, it's important to recognize the history and understand that this is inherently a speculative condition that can reverse quickly. I think we have already reached the point where overall equity valuation multiples have stopped rising (this is happening currently due to strong earnings growth). Don't believe fundamental arguments about the attractiveness of these investments as businesses because those are necessary but not sufficient for further price gains in this type of environment. The right action to take is to increase diversification and limit market beta. Within an equity allocation, owning lesser correlated assets historically helps as these take a different pathway. Perhaps the best example is Energy stocks. Although oil prices do depend on demand and so the economic cycle should matter a lot in the long run, these stocks essentially march to their own cycle.

US Commentary (Continued)

investing. We'll get through it, as we have with similar periods in the past. The divergences one way have a habit of reversing and being equally large in the opposite direction.

Along with strong growth in corporate earnings (some of which is due to the tax cut), we are also seeing a moderate but unmistakable ramp up in inflation. Unfortunately, this raises the probability of an excessive tightening cycle which damages the economy and the market. We aren't there yet, but it bears watching. In the meantime, we are increasing our portfolio weighting in inflation beneficiaries. While these stocks also have economic sensitivity in the end, they often have lower correlation to the rest of the market and actually reduce portfolio risk.

Asian and UK Results (Continued)

out. By my calculations we are looking at a potential risk/reward situation where the potential gain is 50%+ if it plays out how I think it will versus a potential loss of 5% in the worst-case scenario. In July Our Thai stocks fully recovered their steep June loses in local currency, but not when measured in US dollars.

In Japan it was an uneventful month. Our Japanese stocks rose around 0.70%, but the Yen depreciated by 0.80% against the US dollar. So it was a break-even month. The big news in Japan was actually no news. The market was widely expecting the Bank of Japan (BOJ) to start unwinding its huge stimulus this year. At the expectation of higher rates Japanese government bonds sold off sharply in July. But that speculation was misplaced and it appears the ultra-loose monetary policy in Japan will continue for a while. The BOJ maintained its target for the 10-year government bond yield at around 0% and the short-term interest rate target at -0.1%. Following a policy meeting, Gov. Haruhiko Kuroda said the Bank of Japan would let a key interest rate edge slightly higher but did nothing else to signal a change to the institution's long-running program of extraordinarily easy policy. In addition, the bank for the first time offered forward guidance, saying current rates would remain in place for "an extended period of time" and signaling that it was in no hurry to join other central banks in moving toward tightening.

Kuroda has made clear that, in an environment of continued low inflation, policy makers "have no intention to bring up interest rates" and that the Bank will "maintain policy until price target is reached". Good luck with that. The BOJ has been trying to hit 2% inflation for years, printing trillions of yen and weakening its currency, and coming nowhere near their disinflation target. Inflation in Japan is 0.7%. The latest decision by the BOJ to continue with QE until they hit 2% inflation (which means for many years) should result in weaker Yen and be positive for stocks.

We started receiving the first Japanese quarterly reports for the first quarter of 2019 (fiscal year ends in March in Japan). I was genuinely surprised how strong the first quarterly results were. With all the trade war talk I wasn't sure what to expect and what the ultimate impact will be on some Japanese small caps. So far no sign of any trouble. If these first reports are an indicator of overall Japanese corporate results, then corporate Japan saw very strong growth in both sales and profits in the fiscal first quarter.

Our UK stocks continue to struggle this year. They lost more than 1% in July. We had both big winners and losers with the end result being slightly negative. UK stocks are only included in our Global portfolios. I don't think we will ever have a big weight in the UK. I just don't like how UK stocks react to company announcements. If there is any hint of an earnings miss or growth deceleration, you can be sure the stock will be down around 20%. In that respect the UK market is similar to the US stock market. We rarely see such violent reactions in Asia. So the UK stock market is a difficult market to invest in because any day you can get a nasty surprise out of the blue.

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Just the Numbers

ZPR Composites **Names in Bold** *Benchmarks in italics*	Period Ending 7/31/18 Month	Quarter To Date	YTD	Period Ending 6/30/18 1 Year	3 Year Annualized	5 Year Annualized	10 Year Annualized
ZPR Fundamental Small Cap Value	-1.11%	-1.11%	-7.00%	8.89%	13.62%	14.68%	11.74%
Volume Winners	0.22%	0.22%	13.23%	15.31%	22.60%	18.87%	NA
Volume Value	-0.94%	-0.94%	5.45%	11.24%	21.71%	20.59%	NA
Volume Momentum	-1.12%	-1.12%	5.44%	10.62%	14.58%	12.72%	NA
Russell 2000	1.69%	1.69%	9.47%	17.56%	10.96%	12.46%	10.60%
S&P 500	3.60%	3.60%	6.35%	14.38%	11.95%	13.43%	10.17%
ZPR Global Equity	0.28%	0.28%	-7.65%	4.55%	6.99%	8.28%	13.36%
MSCI ACWI	3.05%	3.05%	2.91%	11.31%	8.79%	10.00%	6.37%
ZPR All Asian	1.79%	1.79%	-7.40%	3.00%	3.58%	4.82%	14.92%
MSCI EAFE	2.47%	2.47%	0.04%	7.38%	5.41%	6.93%	3.34%
ZPR All Thai Equity	5.63%	5.63%	-6.31%	-13.82%	2.97%	4.14%	NA
Thai Set Index	6.70%	6.70%	-1.12%	4.40%	5.31%	5.25%	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.