ZPR Investment Report

July 2018 Volume 24, Issue 7

A NEWSLETTER FOR ZPR CLIENTS

Contents:

US Commentary

By Mark Zavanelli

International markets fell in June (especially in Asia), while US indices gained slightly. Some emerging markets were hit especially hard, and Thailand was one of the weakest this month. The generalized fear in Asia is that China is going to be hurt by the tariffs and trade actions coming from the US and that the whole region will feel the economic pain as a result. China is also at a relatively more vulnerable economic moment since they are coming down from a significant level of government stimulus. I discuss these trade issues in a separate piece this month. While I do think that China's growth is going to slow further, they have a lot of levers to pull to avoid major problems. For now, the upshot of the fear is that money flowed into the US, pushing up the US Dollar and causing Treasury bond rates to drop this month. This is temporary. The moments when the dollar is rising and seeming like it will continue rising are always the most fearful for international markets. Thailand will be fine. Our stocks there are very cheap, and at some future moment the money will be flowing in there again and stocks will do well.

One thing that is lost in all of the trade war talk is that economic growth continues to be very strong, especially in the US. One measure of global economic strength that is not subject to statistical interpretation is oil demand. The price strength in oil is mostly related to an uptick in demand, despite

(Continued on page 3)

Asian and UK Results

By Vaidas Petrauskas

Asian stocks sold off sharply in June, accelerating the trend which has been in place since February. The June sell-off was driven by concerns over global trade and the constant flow of news surrounding tariffs and counter-tariffs. Markets don't like uncertainty and the current trade spat between the U.S. and China, Europe, Canada, and Mexico has created a lot of uncertainty about the future of global trade. At this point it is hard to predict how this plays out and how different countries will be affected by the trade dispute. There is already a lot of collateral damage. Take Harley Davidson for example, which was slapped with EU tariffs and decided to move production overseas to avoid them and then was slapped by Trump for such a decision. Or take Daimler (the German maker of Mercedes-Benz cars) which announced it will be hit by China's tariffs on U.S. cars because it manufactures some vehicles in its Alabama plant and then exports them to China and other countries.

The equity markets of China, Hong Kong, Philippines, Indonesia, South Korea, and Singapore saw big drops in June. Chinese stocks are now in a bear market. This time even Thailand was not spared and Thai stocks sold off sharply. It was our worst-performing market by far in June. The

(Continued on page 3)

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

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

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

Trade and Protectionism

By Mark Zavanelli

This month the market took notice that the trade rhetoric from the Trump administration is more than just talk. Trump campaigned on, and fundamentally believes that losing domestic production capacity (i.e. jobs) in exchange for cheap consumption is a bad deal. Protectionism is a lever he can pull to try and change the equation, along with removing disincentives to domestic production such as regulation and taxes. Combined with the restriction of immigration, this is all part of a larger political movement to address the income inequality felt by the "not 1%" in America, and it isn't really about maximizing America's overall wealth.

Many countries export to the US, since it is the largest economy in the world. China, much more than other export nations (such as Japan, for example), has used a potent mix of artificially cheap capital, cheap labor, zero regulation, and openness to foreign investment to make producing goods there irresistible to multinational companies. Other export nations rely on a more traditional form of comparative advantage (i.e. specialized skill, resources, or development), while China has relied more on the cheapness and ease of producing there. For almost any multinational company that produces a finished good, part of the supply chain resides in China, even if it is just intermediate materials such as chemicals, plastics, or metal. Moving production there has been a major deflationary force over the last 25 years in particular. Given the capital intensity and massive investment over this period of time, no one can decide to do it somewhere else immediately. It's either buy those goods from China, or not have them. China is the primary target of the protectionist movement because of the size of its disruption and because its advantage has been price. Over the longer term, it is possible to impact some of these incentives at the margin.

A trade war is really the wrong concept to be thinking about, because that implies an exchange of goods between two parties. Instead, it's really a question of how much disruption to the current flow of goods and capital there will be. The picture in aggregate is that the US consumes and the exporters of the world are happy to take US dollars in exchange. They then use these dollars to buy commodities (which are traded in dollars) and a few US technology products unavailable elsewhere and invest what's left over into US dollar denominated assets such as Treasury securities and other US financial assets. If you think about that, the trade structure basically underpins US consumption. The "trade war" is more of a threat of a buyer's strike, for the purposes mentioned above. The sellers will want to sweeten the deal to the extent that they can, and one thing they can offer is to build capacity in the US if they are allowed to. For a few exporters with developed economies, like Japan, South Korea, and Germany, there would be more purchasing of US goods if they didn't also have their own protectionist restrictions in place. In those cases, there is the potential for give and take so a protectionist threat could actually result in lowered trade barriers and a net negative result is unlikely. But that is not the case overall or with China, and in the short run US tariffs will simply mean that tariffed goods become more expensive, and consumption will rebalance as a result. Exporter currencies will fall to compensate which will offset some of the impact to trade but will affect local economies negatively. Any reduction in total trade will also mean less recycling of US dollars into financial instruments which could cause bond yields to rise and stocks to fall.

How much of this will Trump and his advisers want? For sure they will want at least more targeted tariffs to benefit specific industries that still exist in the US, along the lines of what has already happened with steel. The inflation hit from that should be manageable. Autos could be on the list, primarily to coerce Germany and Japan. I also think they will get anything that is relatively easy for exporters to give them, such as progress on intellectual property theft, environmental standards, and promises to purchase more of some items that those countries already buy. Would Trump put in a wide-sweeping tariff on Chinese goods as threatened? I doubt it because inflation and an economic downturn are not really the goals, although he would like to do something decisive to shift production back to the US over time. This is what I'll be watching. He knows that he needs to appear willing to do the maximum in order to extract concessions. The Chinese will need to save face, but they are also playing a long game and will be willing to make deals to preserve the status quo. There is risk here, but my base case is that the rhetoric dies down, the market loses interest, and we'll get a chance to see what the actual impacts are. This complicates life for large multinational companies, and their decisions on capital spending will be important to watch.

US Commentary (Continued)

continued supply growth in the US. For foreign economies overall, the combination of a strong US consumer, US government fiscal stimulus through spending and tax cuts, and a stronger dollar means that US import levels will continue to rise despite higher tariffs. A lack of demand from buyers is not going to happen in the short run. Instead, there is a risk of rising inflation as tariffs become built into prices, because it's not feasible to move production quickly. We don't really need another reason for inflation at this moment, and it's a risk that we have to watch. The Fed is responding aggressively, and at this point in the cycle that's what is required. The ECB also made a major announcement that they are going to taper their QE but keep interest rates low for at least another year. This also needed to happen. The market is starting to get worried about what 2019 growth will look like, when the reversal of QE is in full force at the Fed and the ECB. I think that between then and now we'll have some pretty good economic data points, with excellent corporate earnings growth, and a slowdown won't seem too threatening. We have recently added basic materials and energy exposure in our US SCV portfolio because these companies are benefiting from currently rising prices. There has been an extreme gap between winners and losers within the market, and I expect that to continue, with us hopefully on the right side of it. Presently it is all chasing growth and momentum, but when that reverses it will do so quickly.

Asian and UK Results (Continued)

higher-quality Thai businesses which we own held up fairly well during most of the month but were sold indiscriminately in the last two trading days of June. In each of those two days the Thai small capitalization stock index dropped by more than 2% and half of our June loss in Thailand occurred in those last two trading days of the quarter. This likely occurred because of end-of-quarter rebalancing by institutional investors out of Thailand.

Since February there has been an ongoing exodus by foreign investors from Emerging Asia, one of the biggest since 2008. Foreign investors pulled over 5 billion USD from Thailand this year. Investors are pulling out of even those Asian economies with solid prospects for growth and debt financing, of which Thailand is a prime example. This is all due to the trade war fears mentioned above and also rising interest rates in the U.S. This acts like a vacuum, sucking capital from other countries to the U.S., making the Dollar even stronger and making other currencies weaker. So we were hit with a double whammy – lower stock prices and cheaper currency (opposite to what happened last year).

Right now, emotional factors associated with the trade dispute have more impact than fundamentals. But no one knows how this trade spat will play out. The usual response by market participants in situations like this is to sell first and ask questions later. So that is the market environment that we are dealing with this year. Stocks move not based on fundamentals but based on news surrounding global trade.

Thailand

In June our Thai stocks outperformed the local indices, but that is small consolation because we still experienced heavy losses and I consider preservation of capital to be our main objective. The main THAI SET large capitalization stock index was down 7.61% for the month and the small capitalization FTSE SET Small Cap index was down 11.58% (year-to-date the FTSE SET Small Cap index lost 20.53%)! Our stocks were down over 6% in local currency in June. But we also got hurt by a weaker Thai Baht which lost 3.24% against the U.S. Dollar in June because of the foreign investor exodus. I don't remember such volatility in Thailand for a long time, probably since 2008. This is clearly caused by foreign capital pulling out of Thailand and other Asian countries. Our official All Thai strategy return in U.S. Dollars was -9.47% for the month which is very upsetting. But we have been through similar sell-offs before. The question is how we react to such unusual market moves.

To take advantage of what I believe is a buying opportunity in Thailand, we will start buying some Thai stocks on the first trading day of July. We already deployed all of our cash for All Thai portfolios in June, so we will be selling some of the stocks that held up well to buy others which we believe became mispriced. Our All Asian portfolios have cash so there is no need to sell anything to buy more Thai stocks. As I am finalizing this report on July 2nd, I can report that Thai stocks rebounded

(Continued on page 4)

Asian and UK Results (Continued)

strongly on July 2nd, but there is no assurance that they will not fall back down in the coming days.

I admit I was surprised by such a sharp sell-off in Thailand in June, which until now was immune from global turmoil. I maybe expected some turbulence in Japan and Singapore, but not in Thailand. I believe this sell-off is greatly overdone and current valuations present a wonderful opportunity. That's why we are adding to Thai stocks. I am confident that our Thai investments will be fine once the global trade friction ends. The Thai economy is growing more than 4% per year and local demand is strong. The Thai economy and Thai businesses are in great shape and the impact on our companies from the current trade dispute should be minimal (although full ramifications are still unknown). Thailand is a very different economy structurally from the way it was before the Asian Financial Crisis in 1997. Thailand has a big current account surplus, making its currency fairly stable and making Thailand a safe-haven country in South-East Asia. The upcoming general election next year should act as a boon for stocks if history repeats.

Japan

We lost money in Japan also, although compared to Thailand the loss was milder. Our Japanese stocks lost 2.8% in local currency for the month and the Yen weakened by 1.5%. We underperformed the local indices.

This year Japan is in the red as are all Asian markets. We have been through a similar environment before. The first half of 2016 was similar in that Japanese stocks were drifting lower month after month. This was followed by a huge appreciation of Japanese stocks which lasted from the second quarter of 2016 until January of 2018. I am not saying this is what will happen this time, but you never know when the trend will reverse. The Japanese stock market tends to move in short cycles – periods of drawdowns followed by periods of rapid appreciation mainly caused by foreign fund flows. At any one point in time some parts of the world may be euphoric while other parts may be pessimistic. This year funds have been flowing out of Asia.

I am optimistic about Japan in the long term. There has been a very long period where the Japanese market has gone sideways. When you have such multi-decade periods, market participants tend to throw in the towel. That's when you want to step in as an investor. Current corporate governance changes in Japan give hope that companies will become more efficiently run and start paying more attention to shareholder interests and returns on capital. Japanese companies are very cheap, although they are still less profitable and less efficient than Western companies because of bloated balance sheets and unnecessary cross shareholdings. These issues are finally gaining attention and foreign activist investors are becoming active in Japan because there are so many inefficiencies that can be taken out at most Japanese companies to improve profitability. So Japan is a very fertile ground for activist investors, but change is not easy because of entrenched management and boards related to those same cross shareholdings.

In the short term all the attention will be on the trade dispute. These fears are not without merit. If the trade war intensifies, it will impact global growth and it will impact Japanese companies, most of which depend on exports because local demand is stagnant. So it is a real issue. But I don't think Trump wants to destroy the global economy which would not be good for anybody. My bet is that Trump will get trade concessions from some reluctant countries and it will be back to doing business.

UK

Our UK stocks also lost money - less than 2% and the British Pound weakened by 0.68% against the U.S. Dollar. It was a dismal month for foreign markets all around.

I am certainly very upset with this year's performance. We made mistakes and some investments did not work out for us this year. Partly it is due to a very challenging market environment in Asia this year where almost all stocks go down regardless of fundamentals. Our strategy has not changed. We keep doing the same thing as before. We will continue taking advantage of opportunities to buy more of good growing companies when they are cheap and sell stocks when they become expensive or their fundamentals deteriorate. That strategy has proven successful for us in the past.

A short note on Volume Winners performance

The Volume Winners strategy had a very successful month, gaining 5.62%. There were many winners, but a big part of the gains came from the Russell 2000 index

(Continued on page 5)

Asian and UK Results (Continued)

reconstitution. At the end of each June the FTSE Russell rebalances its indices. Stocks which are added to an index have to be purchased by passive exchange-traded funds. Three of our biggest winners in the Volume Winners portfolio were bank stocks which were added to the Russell 2000 index and appreciated significantly as a result.

This page intentionally left blank.

Just the Numbers

	Period Ending 6/30/18			Period Ending 3/31/18			
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	-0.48%	-0.08%	-5.96%	11.53%	12.32%	15.68%	12.08%
Volume Winners	5.62%	11.85%	12.98%	11.17%	19.67%	17.24%	NA
Volume Value	1.75%	7.16%	6.45%	9.35%	20.91%	20.28%	NA
Volume Momentum	1.88%	9.97%	6.63%	5.98%	10.28%	12.37%	NA
Russell 2000	0.58%	7.60%	7.51%	11.80%	8.39%	11.47%	9.84%
S&P 500	0.48%	3.30%	2.51%	14.00%	10.79%	13.32%	9.50%
ZPR Global Equity	-3.72%	-6.84%	-7.91%	17.24%	9.79%	8.98%	13.85%
MSCI ACWI	-0.50%	0.72%	-0.13%	15.44%	8.72%	9.79%	6.15%
ZPR All Asian	-6.12%	-11.28%	-9.03%	22.28%	9.35%	5.61%	15.43%
MSCI EAFE	-1.19%	-0.96%	-2.37%	15.33%	6.05%	6.98%	3.24%
ZPR All Thai Equity	-9.47%	-9.79%	-11.30%	2.92%	6.32%	3.98%	NA
Thai Set Index	-7.58%	-9.25%	-7.33%	16.35%	9.05%	5.98%	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.

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.