ZPR Investment Report

June 2018 Volume 24, Issue 6

A NEWSLETTER FOR ZPR CLIENTS

Contents:

- US Commentary
- Asian and UK Results
- Headlines Versus Trends
- Just the Numbers

US Commentary

By Mark Zavanelli

US stocks rose in May, led by a rebound in the Tech sector. Small cap stock indices made new highs this month, signaling broader health for US companies. This occurred despite a wall of worry, from 10-Year bond yields rising above 3%, rising oil and commodity prices, trade war fears, and concerns over specific foreign markets such as Italy. Earnings reports for the first quarter were generally very strong, and companies are feeling positive about the economic environment. The official economic statistics have a seasonal adjustment bias that has routinely made the first quarter look weak, with a strong bounce typical in the second quarter data. I think the real picture is that growth is continuing to be steady at a moderate pace, with inflation in check. Stocks can continue to rise in this type of economic environment, even with the Fed in tightening mode. Volatility is not going away, but there's a hidden benefit even to that as it prevents the market from becoming too euphoric, as we saw in January. This does require greater fortitude as there will be moments when fear is driving the market.

So far this year the market has penalized our style of fundamental investing, and we continued to lag this month. It has been a very frustrating and unusual period for us. The changeover in the nature of the market from 2017 to 2018 has meant that certainty became very important. Our value stocks

(Continued on page 3)

Asian and UK Results

By Vaidas Petrauskas

May was another challenging month for foreign markets. Our All Asian portfolios lost 2.78%. Thailand was the only bright spot.

Thailand

It was good to see our Thai companies finally come back to life. They were subdued all this year. After the latest earnings cycle in May we bought one completely new stock and added to some current holdings. The Thai economy is growing by more than 4%. It is now very likely that Thailand will finally have a general election in 2019 (not completely free and democratic as the military will maintain big influence over politics). The hope of election will give a boost to stocks.

Most industries are booming. The auto industry is growing strongly. Thailand is one of the world's largest car manufacturing countries. They export very few cars or car parts to U.S. All exports go to Asia and the Middle East. The construction industry is also booming. Both the home building segment and the general construction industry benefit as the government has launched big infrastructure projects. The property sector had the highest year-over-year growth in sales of 16%. We currently own 15 Thai stocks.

(Continued on page 4)

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

Headlines Verses Trends

By Mark Zavanelli

I notice the effect of volatility even in my own daily routine where my first look at the market in the morning is searching for the headline that will move markets that day. With price moves giving us the illusion that this stuff is important, it's easy to get caught up in the drama of the moment. More and more; however, this daily news flow is becoming separated from the important trends that drive markets over the horizon that an investor and not a trader should care about.

In thinking about this list, I came up with a lot of things that don't matter too much. Some of these are things that won't have any lasting impact, or things that are just symptoms and not causes. The important trends, by contrast, are typically items with no "story" to them so they are more difficult to quantify and track.

Headlines

- *Italy, Spain, or a Euro crisis*
  Italy and Spain would love to extract something from the EU, and might be able to, but they are not suicidal enough to actually want to leave it, no matter who is running the country. That was a lesson from the Greek crisis. The EU structure of rules looks binding, but we also learned that if the Germans say ok, anything is possible. They will muddle through.

- *US political drama*
  Midterm elections are perhaps the most predictable elections in the US, and gridlock is the most likely result. The Mueller probe is going nowhere, and Trump is staying for this term at least. Major legislation is finished for the foreseeable future, so there's almost nothing of substance to talk about. Celebrities need drama, so maybe it will all be focused on international relations.

- *US foreign policy, other than trade*
  Of course, this actually does matter in the long term. The reason I don't think it moves markets in a lasting way is because this administration is inwardly focused. Real protectionist actions will matter but the rest is just talk. With ISIS finished we're done in the Middle East. Iran will get most of their oil out, and the rest the Saudis will make up. We're not going to bomb North Korea anytime soon.

- *Short term economic data points*
  These also matter but have more potential for confusion than enlightenment at the moment since the market is so sensitive to perceived changes. It doesn't help that the Fed is also supposedly hanging on every number, although I doubt that is really true either. The US economy has been remarkably steady, and data points suggesting any departure have been head fakes. The market currently worries about weakening in Europe. That's probably also a head fake, especially with a weaker Euro now about to help exports.

Trends

- *Global credit availability and central banks*
  Since monetary manipulation has been a key feature of this cycle, and leverage has been rising, this seems like it's the whole game and we can forget everything else. It's a tightrope act that so far is working. In the US, credit is still rising even as the Fed removes QE. Banks want to lend. Still, money supply growth is low and this will constrain US economic growth. That's probably ok at this point in the cycle. It's going to get interesting when and if the ECB and BOJ start to reduce their buying also. The expansion of global leverage is necessary for expanding stock multiples, so this matters for all financial assets.

- *Oil, metals and non-agriculture commodities*
  Oil and metals prices are trending upwards, recovering from the China related decline of 2015-2016. These tend to have large moves. There's a positive correlation to corporate profits, so it actually helps until prices get too high. Maybe the growth in US supplies and extra OPEC capacity can help keep prices from rising too fast.

- *Corporate sentiment and capital spending*
  On average, corporations are seeing revenue growth, have good access to credit, and are in expansion mode. Costs are also now rising. Everybody talks about the consumer driving the economy, but I think corporate behavior sees more dramatic and herd-like changes. Consumers spend what they have or can borrow, and corporations react to their competition. For now, the positive momentum is the primary force of inertia behind the world economy.

- *Technology and economic data*
  Technology is always working as a force behind productivity, sometimes slower and sometimes faster. The changes that seem large in our lives aren't always

(Continued on page 3)

Headlines Versus Trends (Continued)

the ones that impact growth, however. What's especially interesting to me right now is the impact on the structure of work and how it all flows through economic data. An example is the US savings rate, which is simply a plug between estimated earnings and spending. If earnings are underestimated because the gig economy is growing faster, then consumers maybe aren't as stretched as they seem. Outside of the US, where labor regulations are tighter and grey markets have always been more important, the positive impact on labor productivity could be a reason for growth to stay stronger than data would suggest.

US Commentary (Continued)

which are producing good earnings and return on equity have been in the crosshairs of this change, since the big fear is that earnings growth is about to fall. Unexpectedly, the negative performance has generally come from stocks that were the cheapest on an earnings basis. These stocks have the most to lose from an earnings perspective if the cycle turns down. It hasn't been enough to continue producing on-trend results, since that doesn't alleviate the fear of future weakness. The few good performing stocks we've had all saw unexpected positive earnings, while everything else we own is generally lower. In hindsight, having too big a weight in these super cheap but possibly aging cyclicals was perhaps my own way of reaching for performance in a rising market (because these stocks can go up a lot if their multiples don't compress). The route to better performance is two-fold, as we discussed last month. First, we need to follow our process and rebalance into new stocks where earnings trends are a little clearer, reflecting the new environment, even if the stocks are not quite as cheap. Second, the demand for certainty will dissipate naturally to some degree as the scare over economic growth fades, and our stocks which do continue to produce growing earnings have some catching up to do. The challenging part for us will be to be as unbiased as possible about our existing portfolio (familiarity brings knowledge but also bias) to make these judgements about which cheap stocks to keep.

Asian and UK Results (Continued)

We had a good month in Thailand. It is masked by a weaker Thai Baht which lost 1.44% against the US dollar. Our return in local currency was more than 2%. The Thai SET Total Return index dropped 2.58%. Our official All Thai return, which is measured in US dollars, was 0.90%.

UK

We are in the process of buying three new stocks in UK after the latest earnings cycle. We will have 8 in total. Our UK portfolio was unchanged for the month because one of our holdings issued slightly weaker guidance for the rest of the year (still growing) and the stock got punished severely. Our other UK stocks had a very good month.

The British Pound lost 3.4% against the US Dollar, so currency hurt us.

Japan

There were many headwinds for our Japanese stocks in May: 4th quarter earnings reports, a strong Dollar, potential U.S. tariffs on car and car parts imports, also U.S. tariffs on steel and aluminum, the political chaos in Italy, and generally negative sentiment in the Japanese stock market. Our Japanese stocks lost more than 4% for the month, underperforming the local indices.

Firstly, most Japanese companies reported their 4th quarter results in May (fiscal year ends in March in Japan). Japanese companies had a very good year. Most grew earnings significantly because of the improving global economy. The annual results reporting season is very important because all companies must provide specific guidance for sales and profits for the next year. Stock prices react to the guidance. Managements also provide short comments about the past year's results and some comments about guidance. In many cases those comments simply address the general geopolitical and economic situation and are not helpful, but in some cases they are. I already wrote in previous newsletters that Japanese companies tend to provide very conservative guidance which they are certain they can beat. This practice is not helpful for stock prices. We track historical management guidance accuracy for all the companies we own and companies on our watch list. So we can usually make a very good guess about the dependability of the newly issued guidance.

Unfortunately, we had some disappointments due to weak guidance for the next year and suffered losses because of that. Some of our largest holdings were affected. In cases where we believed the issues are real we sold completely or trimmed positions. From our experience we know that in some situations it is better to sell right away than to hold a melting ice cube. Better to invest in new opportunities. So, some of our loses in Japan are due to our stock selection and allocation which we can blame only on ourselves. We also failed to take profits on some huge winners in January when our Japanese stocks were hitting all-time highs. Of course, this is always easier to see with the benefit of hindsight.

But there were also other factors which we had no influence over:

Potential auto tariffs

On May 23rd the White House initiated an investigation on whether vehicle and vehicle parts imports were threatening the U.S. auto industry's "health and ability to research and develop new, advanced technologies". This may eventually lead to greatly increased tariffs on foreign car and car parts imports (from 1.5% to 25%). A similar investigation on steel and aluminum already led to tariffs on imported steel and aluminum.

"There is evidence suggesting that, for decades, imports from abroad have eroded our domestic auto industry," Commerce Secretary Wilbur Ross. In a separate statement, President Donald Trump said: "Core industries such as automobiles and automotive parts are critical to our strength as a Nation." A Trump administration official said before the announcement that the expected move was aimed partly at pressuring Canada and Mexico to make concessions in talks to update NAFTA that have languished in part over auto provisions, as well as pressuring Japan and the European Union, which also export large numbers of vehicles to the United States. I think Trump has German car makers in his crosshairs also.

Japanese car makers are expected to be especially hard hit if tariffs are increased to 25%. The majority of vehicles sold in the United States by Japanese and South Korean automakers are produced in the U.S., but most firms also export to the U.S. from plants in Asia, Mexico, Canada and other countries. Roughly one-third of all U.S. vehicle imports last year were from Asia. Bad news for Toyota, Nissan, Honda, and Hyundai. Mazda does not have any U.S. production capacity, so it is in trouble.

Roughly 12 million cars and trucks were produced in the United States last year, while the country imported 8.3 million vehicles worth $192 billion. This included 2.4

(Continued on page 5)

Asian and UK Results (Continued)

million from Mexico, 1.8 million from Canada, 1.7 million from Japan, 930,000 from South Korea and 500,000 from Germany, according to U.S. government statistics. At the same time, the United States exported nearly 2 million vehicles worldwide worth $57 billion.

There are many small Japanese companies which supply the Japanese car makers with parts, some of which we own. The auto industry is growing very strongly in Asia and our Japanese auto-related companies showed rapid growth in sales and earnings because of Asian demand. On the announcement about the investigation we trimmed our Japanese auto-related holdings to reduce risk. Our losses from this event were minimal as only one of our auto-related stocks dropped 4% on the news. Others were little changed. It is too early to tell if increased tariffs will be implemented and it is hard to assess the exact impact on our companies because of complex supply chains, but it is clear to me that it will not be business as usual for companies importing cars or car parts to the U.S., or smaller suppliers which depend on those companies for orders.

U.S. tariffs on steel and aluminum

On May 31st Trump imposed steel (25%) and aluminum (10%) tariffs on EU, Canada, and Mexico. The affected countries came back right away with tit-for-tat tariffs. In the case of the EU, tariffs will be applied to bourbon, Levi's jeans, and Harleys among other products. So, the U.S. is on a brink of trade war with EU, Canada and Mexico (China also). Although none of our companies are directly affected, that kind of news tends to send shudders through global financial markets. So, all markets are negatively affected.

At the same time China is lowering import tariffs. On May 22, China cut its import duty on passenger cars from all over the world from 25% to 15% and the auto parts duty from 10% to 6% (first time in 10 years). On May 31, China lowered the import tariff on consumer goods (e.g. clothing, household equipment, processed food, cosmetics, and health-beauty products), effective July 1, 2018.

Italian politics

Italian elections in March proved inconclusive. None of the parties or traditional coalitions emerged with enough votes to control the parliament. Then the anti-establishment Five Star Movement and the far-right Northern League parties, who had very different agendas during the campaigning phase, joined forces in an attempt to form a government.

Their ambitions were quickly cooled by the president Sergio Mattarella. Mattarella rejected the nomination of the 81-year old Eurosceptic Paolo Savona as the minister of economy, putting an end to the alliance. Italians appeared to be headed for another round of elections, but on May 31st Italy's president attempted to broker an eleventh-hour deal between the two populist parties to avoid another election. He gave both parties more time to reach a deal.

Italian politics are always fun. The country has had 65 governments since 1948. So political turmoil in Italy is nothing new. But investors have staged a classic flight to safety because of fear of the EU break-up (again) with most global market and most asset classes hit hard. European assets were of course impacted the most. The Italian stock market was down more than 10% for the month on May 29th, but then recovered on new hope for a deal between two parties. Even Asian markets were affected. Japanese stocks were sold off together with the rest (although Yen rose because it is considered a safe haven). Singapore was hit hard. Thailand was spared. This is what we like about the Thai stock market. It has a low correlation with the rest of the world which really helps when the rest of the world is in panic about Italy.

With contagion spreading to international markets, investors exited the euro en masse. In addition to loading up on US Treasury bonds and German bunds, investors were seeking shelter under the US dollar and yen umbrella, awaiting the dust to settle in Europe. The spread between Italian and German bond yield has widened significantly. This seems like overreaction. The chance that Italy will leave the euro or the EU is low. If it does happen, then we will see a real panic selling. Italy is the third largest economy in Europe.

Market sentiment

After the Japanese earnings season was over, we started looking for new stocks to buy. This is our usual research cycle in all markets. Thailand is unique because we look at all Thai reports as they come in. We found plenty of cheap Japanese companies. We are in the process of buying 4 new stocks. After looking over many stocks, I noticed many similar patterns:

(Continued on page 6)

Asian and UK Results (Continued)

- Many Japanese companies mention the same problems and risks they are facing – shortage of labor (especially in the construction industry) and rising costs (wages and materials). Many also mention the upcoming infrastructure boom related to the 2020 Tokyo Olympics. Hopefully some of our construction companies will also benefit from the increased infrastructure spending related to the Olympics.
- Most Japanese small cap companies we looked at are well off 52-week highs and many are trading close to 52-week lows. The price graphs are similar. That is the current market sentiment which we also noticed in our own portfolio. Almost all Japanese stocks are drifting lower, regardless of fundamentals. This is opposite to what was happening last year. Japanese and foreign fund managers are dumping equities. I view this as an opportunity. We added stocks to the portfolio which we wouldn't have bought four months ago because of valuations. Japanese stocks are incredibly cheap.

It also makes it clear that it is hard to have good returns in Japan when the market is drifting lower. Even great companies are ignored in this environment. Nothing we can do but wait and buy more when the opportunity presents itself.

Because of this our returns in Japan will be lumpy. That was our experience in the past and I think it will be the case in the future. It's the nature of the market. We had a great period in Japan from July 2016 to January of this year when Japanese stocks were moving higher and higher. For now we are in a period of falling stock prices. Our process hasn't changed. We keep doing the same thing which generated superior historical returns. But those returns will not be smooth. So the key is to stick with the strategy for the long term.

Not all of the negative sentiment in Japan is groundless. There are some legitimate concerns:

- In the first quarter the Japanese economy contracted by 0.6% followed by a long period of expansion (nine quarters). Is this a temporary blip? The Japanese economy is always balancing on the brink of recession.
- Japan is an export driven economy and the global economy is cooling off. Trade wars and tariffs will hurt an export driven economy like Japan's.
- Japan still lacks structural change – strict labor regulations, lack of productivity or innovation, bureaucracy, real wages are flat.
- The Japanese government is expected to hike sales taxes from 8% to 10% next year. The last time they did that (in 2014 sales tax was raised from 5% to 8%) it pushed the economy into recession.
- Shinzo Abe is losing support among voters because of corruption scandal and lack of serious structural reforms. His efforts to force companies to raise wages so far has failed. People's standards of living are getting worse. Real wages are flat but insurance and social security costs are rising.

Despite all this I am very happy with our International stock portfolio. We made many changes in May to the Thai and Japanese portfolios. We have two excellent Singapore companies and added three new UK companies. With the quarterly portfolio rebalancing almost over, we now have to be patient and hope for a calmer geopolitical environment.

Just the Numbers

	Period Ending 5/31/18			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	1.75%	0.40%	-5.51%	11.53%	12.32%	15.68%	12.08%
Volume Winners	3.09%	5.90%	6.97%	11.17%	19.67%	17.24%	NA
Volume Value	3.41%	5.33%	4.63%	9.35%	20.91%	20.28%	NA
Volume Momentum	6.61%	7.94%	4.66%	5.98%	10.28%	12.37%	NA
Russell 2000	5.95%	6.86%	6.77%	11.80%	8.39%	11.47%	9.84%
S&P 500	2.16%	2.55%	1.77%	14.00%	10.79%	13.32%	9.50%
ZPR Global Equity	-1.19%	-3.24%	-4.35%	17.24%	9.79%	8.98%	13.85%
MSCI ACWI	0.21%	1.22%	0.37%	15.44%	8.72%	9.79%	6.15%
ZPR All Asian	-2.78%	-5.49%	-3.10%	22.28%	9.35%	5.61%	15.43%
MSCI EAFE	-2.11%	0.23%	-1.19%	15.33%	6.05%	6.98%	3.24%
ZPR All Thai Equity	0.90%	-0.36%	-2.02%	2.92%	6.32%	3.98%	NA
Thai Set Index	-2.58%	-1.82%	0.27%	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.

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.