ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

Contents:

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US Commentary

By Mark Zavanelli

US small cap value stocks fell, giving back some of their gains from the first two months of the year. But the big news was that the yield curve fully inverted this month, as 10-year Treasury yields fell below the 3-month bill rate. The 3-month rate stayed relatively steady in March while the 10-year yield fell from around 2.7% at the beginning of the month to around 2.4% at the end of March. This fall was triggered by the Fed's continued about-face on monetary policy. During their latest meeting, the Fed ruled out further rate hikes in 2019 and announced the end of its balance sheet runoff (QT or quantitative tightening) in the fall. Shortly thereafter the inversion took place and stocks fell hard. The inversion is primarily a forecast that the next Fed move will be a cut. Bond market participants scrambled to move further out on the curve after it became clear that the Fed wasn't just standing pat but wanted to move further away from a tightening stance. If the Fed wanted to boost risk assets with their guidance this was not a very successful way to do it. Bank stocks were especially weak this month as a negatively sloping yield curve hurts their profitability.

We'll see if the full inversion persists. I believe that if we don't get consistently

(Continued on page 3)

Asian and UK Results

By Vaidas Petrauskas

Asian portfolios were down slightly in March. The earnings season ended in February, so there was no major news affecting our companies.

Japanese stocks mainly tracked what the US market was doing (although it fell slightly), while Thailand finally held the long-awaited general election.

The Junta overthrew the government in Thailand in the 2014 coup and has controlled the country since then. The general election was postponed many times, but finally took place on March 24th. The party representing Thailand's ruling junta won the most votes, leaving it placed to form a new government. This puts a democratic stamp on the military's power and is good for country's stability. Under military rule Thailand enjoyed a robust economy and no bloody street protests. Pheu Thai, the party backed by exiled billionaire and former PM Thaksin Shinawatra, took second place in the election. Thaksin left the country after being accused of corruption but was still very popular in Thailand. Thaksin's sister Yingluck then became a Prime Minister. The Junta overthrew Yingluck's government in 2014 after she also faced corruption charges and fled the country, like her brother.

Under a new constitution drawn up after the coup, the junta will be allowed to appoint all 250 members of the Senate (the junta does not want full democracy just yet), who together with 500 MPs in the lower house will choose the next prime minister. The anti-junta coalition has a good chance of

(Continued on page 4)

Sea Change in Interest Rates

By Mark Zavanelli

In 2018 it seemed like interest rates were on a predetermined course to go substantially higher. The Powell Fed was on a mission to reverse Yellen's overly loose monetary policy and to build in as much ammunition for a future recession as possible. The arrival of new fiscal stimulus from tax cuts and spending seemed like adding fuel to the fire, increasing the urgency. Rate hikes had been progressing steadily throughout 2017 and 2018, and longer term bond yields had been rising too. This indicated to the Fed that they were on the right path. However, the need to reverse quantitative easing made this tightening cycle different. The ECB was also halting its bond buying program at the same time, reducing global liquidity further. With the Fed's QT on a scheduled pace of acceleration, money supply growth had dropped to very low levels, below the rate of nominal GDP. This was a very severe monetary policy tightening.

Fast forward to December 2018 when this all came screeching to a halt. Global stock markets rebelled against further rate hikes and Powell was forced to retreat. Now rate hikes are done for this part of the cycle, and the Fed's QT will taper and then stop in September. The market predicts a rate cut by the end of this year (historically the end of tightening is followed by cutting rates). The ECB is wheeling out a new stimulus program (under QE they couldn't buy enough Italian bonds). In the US we have an inverted yield curve with 10-year rates back to 2.4% where they started the year. German bunds are back to negative yields, and the amount of negative yielding debt worldwide is growing. Inflation expectations are now falling again.

The rapid change from a rising rate to a falling rate environment is a big deal for not just the markets but also for borrowers and lenders. The shift in expectations causes changes in planning that will soon show up in the real economy. Credit drives economic activity. It should be very positive despite the cyclical concerns. The shift away from rising rates will likely outlast the current slowdown, and will provide the fuel for the next upswing. For long lived assets such as real estate, borrowing costs adjust quickly. This will help the housing market turn around. Even for shorter term loans such as auto loans or leases, we will see improving terms from where rates were in the second half of 2018. For corporate borrowers, there is an opportunity to lock in low rates by fixing term loans at longer maturities. The cost of capital for longer term projects will now stabilize at a low interest rate level. All of this should result in higher demand for credit in the aggregate and stronger economic activity. Lenders, of course, will be somewhat less enthusiastic about making longer term loans than previously. But loan growth is mostly about credit quality. With plenty of excess reserves in the banking system and losses at minimal levels, loan growth will continue even with the hit to interest margins. Banks will be less aggressive in paying higher rates for deposits, which has been the main factor squeezing margins lately. Historically the end of Fed tightening cycles has been a time when credit was restricting the economy, but this time around rates are much lower. So, even though the inversion is hurting the confidence of stock investors, it may be a big help to the real economy.

US Commentary (Continued)

poor economic data it might not. In 1998 a temporary inversion occurred, and the economy and market went on to do very well until the 2000 bubble crashed in a completely separate event. While history won't repeat exactly, I continue to think that we will avoid recession in this slowdown and that the next economic shift will be positive. Value stocks and foreign stocks, the laggards since the beginning of 2018 when the slowdown began globally, will respond very well to that change when it eventually happens. However, since the economy is still getting worse, that moment is not yet.

The consensus forecast is that the economy will glide lower until we hit recession at some point later. I think that's silly, and is about as useful as most economic forecasts. I think it's more likely that we make it past the current weakness and then turn positive. US growth stocks have been the big winners of this environment but are priced at levels that suggest they have years of serious underperformance ahead of them. It's not the first time we've seen this movie.

For the moment the slowdown demons are still with us. The economic data this month was generally weak but not surprisingly so. Trade is the softest area, and we see this in German industrial survey data that is firmly in contraction territory (Germany is very export dependent). Oddly, the price of copper and other industrial metals have been rising, which does not suggest that an industrial recession is on the way. The same goes for high yield spreads, which don't miss recessions. So, the bond market's implicit forecast seems to be for growth that's slow enough to keep rates low but not for an economic decline that causes major stress, at least in the near term. This sounds like a pretty good environment for stocks, although clearly risk is elevated and balance is important.

Asian and UK Results (Continued)

claiming a lower house majority. This creates short-term uncertainty, as forming a workable coalition will require both pro-junta and anti-junta parties to reach out beyond their traditional allies.

Thai stocks and the currency sold off on these election results. The country has a history of violent political unrest, especially after elections, so the worry by investors in understandable. However, although there is a possibility of a political deadlock, I don't expect any unrest this time. The military appears to be firmly in control. The new constitution gives a clear advantage to the pro-junta bloc. Once the government is formed, Thai stocks and the currency should rise. The bigger worry to me is the slow-down in China, which hurt Thai exports, and also a planned hike in the minimum wage in the second half of this year.

In Singapore we did well. Our largest Singapore holding rose 12% in February and 16% in March. We took some profits. The stock has gone down for two years while earnings were rising strongly. Now, all of sudden, the stock rose close to 40% in just two months. Sometimes you have to be patient for these situations to work out.

We are actively looking to expand our Asian investments to other markets. We looked at the Indonesian market and found a few opportunities there. Taiwan is also very interesting. The market is down a lot on China's weakness. Many Taiwanese companies make electronics. The weakness in the semiconductor industry pushed stock prices lower. In Taiwan we found many stocks that are very cheap. Dividend yields are 7-8% in Taiwan and for some companies they are in the 12-13% area. This is similar to Thailand 10 years ago. Returns in Thailand since then have been excellent. So, Taiwan definitely looks very promising. We need to do more work there, but we will likely be buying some Taiwanese and maybe Indonesian stocks for our Asian portfolios.

We continue to find incredible bargains in Japan. At the end of March, we started buying a profitable and cash flow positive Japanese company at 65% of net current assets (current assets – all liabilities). Such opportunity would not exist in the US. Such a company would be either taken over by activists or would pay out the excess cash to shareholders. But Japan is different. Management teams of Japanese companies do not mind hoarding cash. Much work still needs to be done to teach Japanese managers about good capital allocation.

The UK is still embroiled in an unbelievable Brexit mess. It has become a comedy. The PM Theresa May tried for a third time to push through her negotiated deal with the EU through Parliament. Parliament rejected the deal all three times. The last rejection came on March 29th. Parliament decided to take things into its own hands and voted on 8 alternatives for the future relationship between the UK and the EU. Basically, these are the only 8 alternatives that exist: alternatives like exit with no deal, common market with the EU, customs union with the EU, revocation of Brexit, another referendum, and others. None of the 8 alternative solutions gained a majority in Parliament! A Customs Union was the closest. Only 8 votes short.

The UK is in a serious crisis. The EU agreed to postpone the exit from March 31st to April 12th. With less than two weeks left until the UK exits the EU, UK politicians are no closer to knowing what kind of relationship they want with the EU than they were 2 years ago. I think the UK will ask the EU for another, longer postponement of Brexit until they can figure out what they want. A new general election is also in the cards as UK politicians are at an impasse.

In the face of this political turbulence, UK stocks and the Pound have been remarkably resilient. The Pound did lose almost 2% against the US dollar in March, but it could have been worse. Year-to-date the Pound is still up 2%. The UK stock market was up 2.30% in March. Our stocks advanced 4%. Year-to-date our UK stocks advanced close to 12%, beating the market's 8.25% rise. We hold few UK stocks because of the Brexit situation. I have a list of more UK stocks which I would like to buy. Our conservative positioning to wait mostly on the sidelines until there is clarity on the Brexit process proved to be too conservative as UK stocks keep marching higher despite the doom and gloom scenario which is being painted for the UK economy if the country exits the European Union with no deal in less than two weeks' time.

Just the Numbers

ZPR Composites **Names in Bold** *Benchmarks in italics*	Period Ending 3/31/19 Month	Quarter To Date	YTD	Period Ending 12/31/18 1 Year	3 Year Annualized	5 Year Annualized	10 Year Annualized
ZPR Fundamental Small Cap Value	-3.10%	9.91%	9.91%	-29.95%	4.58%	3.78%	12.09%
Volume Winners	-4.01%	5.86%	5.86%	-4.09%	12.82%	11.95%	NA
Volume Value	-4.01%	11.19%	11.19%	-10.55%	13.97%	12.19%	NA
Volume Momentum	-4.20%	9.09%	9.09%	-18.84%	5.99%	3.14%	NA
Russell 2000	-2.27%	14.37%	14.37%	-11.03%	7.36%	4.41%	11.97%
S&P 500	1.79%	13.48%	13.48%	-4.38%	9.27%	8.50%	13.12%
ZPR Global Equity	-1.55%	7.87%	7.87%	-26.40%	2.31%	1.93%	15.56%
MSCI ACWI	1.32%	12.33%	10.86%	-8.92%	7.19%	4.83%	10.05%
ZPR All Asian	-1.02%	6.63%	6.63%	-25.00%	0.55%	0.79%	19.38%
MSCI EAFE	0.74%	10.13%	10.13%	-13.35%	3.38%	1.00%	6.83%
ZPR All Thai Equity	-3.46%	5.40%	5.40%	-20.27%	3.41%	4.80%	NA
Thai Set Index	-0.22%	5.79%	5.79%	-8.08%	10.12%	7.14%	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.