ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

US stocks rose in July as central banks confirmed their change in direction. Both the Fed and the ECB have reversed course and are now easing monetary policy. That's a significant change from just a couple of months ago. With a change of leadership at the ECB around the corner, it was important for Draghi to pave the way in advance so that his successor, Christine Lagarde, can simply continue. The Fed has been very clumsy about communication lately, but they also clearly had to do something. International interest rates have been diving (partly in response to the ECB), and if they did nothing it would result in a stronger dollar and a more inverted yield curve in the US, reducing bank lending and reinforcing the slowdown. We have a global economic system and the Fed has to pay attention to global conditions, like it or not.

There are some stark contrasts in the economy at the moment that are unusual. I suppose this mirrors the stark contrasts in the market too. US consumers are spending their recent income gains, as they usually do while the jobs outlook is good, and this has supported decent economic data so far this year. However, big ticket items such as

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Asian and UK Results

By Vaidas Petrauskas

July was a positive month for our Asian investments despite a stronger dollar. The All Asian portfolios rose 2.24% and we outperformed local benchmarks in all Asian markets. Our Japanese stocks led the way. They rose more than 4% in local currency while local indices rose between 1% and 2%. This can be attributed to some early excellent quarterly results from some of our companies and a generally positive market mood. The earnings season has already started in Japan, but the majority of companies will report their quarterly results in August. The first batch of quarterly reports were good with only a few disappointments, but it is still too early to judge the how the whole earnings season will turn out.

Thai stocks started the month strongly but finished weaker. The Thai SET index finished more than 1% lower while we managed to record a 1.5% gain in local currency. The weaker Thai Baht acted as a headwind. The government is trying to stem the Baht strength, one of the best-performing currencies this year, in order for Thai exports to stay competitive. The good news in that the new Thai government is looking for ways to boost the economy and plans to significantly lower the personal income tax rate. This will put more money in consumers' pockets and be positive for the economy. Thai economic growth is clearly decelerating because exports are dropping due to the US-China trade war and general weakness in the global economy. So

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Deficits: Now We Know

By Mark Zavanelli

Deficits are a political and economic topic with a different twist today. From Italy where politicians want to go back to the old ways of spending but still keep the Euro, to Washington where we have a new "more spending" budget deal, the question is how much is enough, not how much is too much. All political forces except the Germans agree that spending is good and more is better. In the US, the remaking of the Republican Party has swept away any deficit restrainers. This is now independent of the next election or any political choices since the decision has already been made by voters. Deficits will continue to skyrocket. There's no sense talking about what we should do, only what we are doing. Even now the numbers have no context or connection to people's lives. In past decades economists had wondered how the rise in entitlement spending as Baby Boomers age would be possible without breaking the budget, and whether the government would end up crowding out private activity. Today's conclusion is that it's a free lunch. We'll just borrow more. Right now, it actually does look like deficits can only be good. Whatever economic constraints were predicted don't seem to be truly there. Inflation is low and the government can borrow at a zero real yield. An old theory with a new name, Modern Monetary Theory, has emerged to explain why the higher interest rate predictions have been wrong. Unfortunately, this isn't world history's first experience with deficits even if the financial system has changed a lot. MMT does make some valid points, and it definitely doesn't suggest that deficits are a free lunch.

MMT's main point is that it's all about the Benjamins. In other words, the effect of deficits shows up more in the currency than in higher real interest rates (with the emphasis on "real"). The government is putting out more dollars in spending than it's taking in with taxes. The government can sell bonds as a form of currency but will eventually need to pay interest and settle those in currency. The central bank and the Treasury work magic to make this happen, but at the end of the day it all boils down to money printing. So why don't deficits lead to immediate inflation and surpluses to immediate deflation if everyone has the data? It's because demand for currency varies. Let's take Japan. Some Keynesian economists told Japan that they needed to run deficits to stimulate their economy after their real estate crash and financial crisis. So they spent money on lots of things that improve life in Japan but didn't make much difference to the output potential of the country. Keynesian theory says that it shouldn't have mattered, but instead there was a strange feedback loop. Japanese currency and bonds were in more demand the more debt they had. Why? Because the economy had slowed so much that the massive Japanese savings rate had no productive place to go. The savings and investment cycle that had fueled Japan's incredible prior growth had been diverted to Japan's Keynesian priorities. The private sector was crowded out in the end, but it didn't take higher interest rates to do it, just the threat of zero growth and deflation. Now, their savings funds our deficits (Thanks guys! Hope you're enjoying your shiny new Treasuries!). The rest of the world has benefited from Japanese investment, but not Japan. The part that's still a mystery to me is why the Yen didn't depreciate more over the years. The answer is supposed to be their trade surplus, but I think the capital account should matter more since it's easy to hold Dollars instead of Yen. In any case, the key message is that deficit spending has suppressed long term growth, not promoted it. So, the opposite of Keynesian theory is what has happened.

So back to our situation in the US. We also can run deficits now because there's a huge demand for the dollar as the world's reserve currency. That position was not anointed by the Almighty, but instead is there because we have dominated the world economy post World War 2. It also so happens that due to Japan's foolishness and Europe's attempt at boosting growth in socialist economies, we have competitor currencies that yield nothing. So party on, the demand for dollars is clearly high today. But the public demand to create debt and deficits in the US is even higher in the long run, and I don't think any force but the market will stop it. It will be Japanification, but without their savings rate, trade surplus and sense of personal responsibility. Debt, both public and private, will reduce future growth and destroy demand for dollars over time. The real, terrible evil is the impact on our society's productive capability. Debt, whether private or public, takes from tomorrow to spend today. So that spending today needs to set up a better tomorrow for it to be beneficial. When deficit spending sent women to work during WW2, even if the tanks and planes later sat rusting, that actually improved our productive capacity which we then used to rebuild the world. The same goes for preventing the meltdown of a financial industry in the Great Financial Crisis that was necessary for future lending. However, when the spending goes to wealth transfers that subsidize people to exit the workforce early, that's a policy that directly

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Deficits: Now We Know (Continued)

reduces potential output. It's nice for quality of life perhaps, but so is the prosperity and social harmony that comes from a society where people work for the private sector instead of the government. There have been plenty of economic experiments along these lines today and in history so the tradeoffs are not unknown. At least Japan got some nice bridges out of it. One bright note for the US is that we are actually a flexible political society and we will change our mind eventually. I can only imagine what that will take, however.

So how does this play out in terms of markets? I think there might be a long-term decline in the future for the dollar. US stocks are supported by low interest rates, but we see that there's a limit to that: Japanese and European P/E ratios are low, which is not what the level of their interest rates would suggest. Hopefully no terrible scenarios will come to pass, but it's hard to see how America can maintain its financial dominance to the same degree as the debt expands. As soon as the Fed rate increases ended, Gold and EM currencies started to rise versus the dollar. This could be a trend that's in place for some time. The high relative values for US stocks are the result of short-term economic conditions that to me seem unlikely to be sustained. I'm not one to convolute short- and long- term, but events can surprise you.

US Commentary (Continued)

autos and housing which are typically financed are still decelerating based on prior interest rate increases. That effect will roll off over time but it will only matter if the economy stays ok. Government spending is also high and providing a lot of current stimulus. The nature of the present strength provides a lift to employment and wage growth in the present but isn't doing much to incentivize investments for future growth. In a way it's a mirage, and could tip either way based on how the economic outlook develops. On the negative side today is a substantial corporate retrenchment. Inventory management ahead of tariffs was a big deal over the past year, generally resulting in pre-buying and carrying extra stock. So inevitably that leads to a period of lower demand such as what we are seeing now. Also, the goods economy worldwide is in outright decline and we see this in declining trade numbers and declining freight data. Surveys of companies which make stuff are understandably weak. This is not terribly surprising, and the market has been heavily discounting it since last October. The deceleration internationally dates back to the beginning of 2018. On the corporate side, we now have more clarity that the trade war isn't resolving but that government and central banks will support economic activity. I think that will support a positive turn, but it will take a little time.

As I've discussed many times over the last six months, I don't buy into the conventional market wisdom of a slow decline in growth and then recession risk. Instead, the weakness is in the present, in the reaction to prior rate hikes and to the trade war. I think the economy can adjust more quickly than in past cycles too. We might be further along in the adjustment process than the market thinks. Historically, first rate cuts can be just the beginning of problems (as in 2000 and 2008). But the timing of this cycle is different. There are many long-term risks out there which will someday come home to roost (I discuss one in a separate piece this month). But with big monetary and fiscal stimulus this economic cycle doesn't seem set to end just yet. The next move is for weakness to bottom out and begin to reverse. We're starting to see some life in cyclical sectors like housing, and I think a turn in favor of small cap value stocks is not very far away.

Asian and UK Results (Continued)

boosting domestic consumption is one way to offset some of the weakness from exports.

Singapore stocks are our star performer this year. We added more than 3.5% in local currency against a negative performance for the main FTSE ST All Share index. The Singapore dollar lost more than 1% against the US dollar. Our year-to-date gain in Singapore is now 40% and this number includes a big cash position. We added a new high-quality Singapore stock to portfolios, so we now have 3 Singapore stocks.

UK deserves a separate mention this month. Britain has a new Prime Minister, Boris Johnson, who will try to untangle the Brexit mess. Hopefully he will do a better job than Theresa May, who wasted 3 years and achieved nothing. She negotiated a bad divorce deal with the EU which she could not push through the Parliament although she tried 3 times. Theresa May was pro-EU. Boris Johnson is pro-Brexit. The country is due to leave the EU on October 31st with or without a withdrawal agreement (known as "no-deal Brexit"). Boris Johnson is trying to reopen the negotiations on the withdrawal agreement with the EU by playing a high-stakes game of chicken, but the EU has stated clearly that the current deal is the best deal available. The main sticking point has always been the Irish border. Boris Johnson is willing to leave the EU with no deal but the UK parliament is trying to block him. That is a short summary of where we stand at the moment. The full story is much more complicated.

The main casualty so far has been the British Pound, which got absolutely killed after the election of Boris Johnson. With 'no-deal Brexit' now a real possibility, which is generally viewed as very negative for the UK economy in the short-term, the Pound has dropped from 1.27 to 1.21 dollars for one Pound in just one month. That is a huge move for a currency. A no-deal Brexit would leave the UK at the mercy of tariffs dictated by the World Trade Organization and would certainly bring some short-term chaos and economic pain as companies are forced to source imported materials at much higher prices because of these tariffs (many have already loaded their inventories for a year in advance). It appears that currency traders are trying to force Boris Johnson to change his stance on no-deal Brexit. The markets are saying that "no deal" would be a bad idea. Even though the Pound is already very cheap by historic standards, if the UK leaves without a deal, there will be much more pain for the currency. Some expect a further 13% fall if such a scenario unfolds. If the Pound goes much lower, this would be something truly historic. Declines of such magnitude do not last long. A "no-deal" could create an epic buying opportunity, so this bears watching. I still believe the UK will be fine in the long term (unless they elect Jeremy Corbyn of the Labour party for Prime Minister). The Brexit developments in the next few remaining months until October 31st will be very interesting. The drama continues.

We own very few UK stocks in Global portfolios and haven't bought a new one in very long time, specifically because of Brexit uncertainty. But even with a small UK allocation, our Global portfolios were negatively impacted by the Pound weakness.

I want to mention one incredible development which shows the effects of global easing cycle by central banks – Germany just sold €2.345bn of 10-year debt at fresh record low yield of -0.41% vs -0.26% at July auction. Bid-to-cover rose to 2 from 1.2 at July 10 auction. Investors are paying Germany more and more to lend the country money and there is no shortage of takers. It's a sign of the times and a totally absurd financial world we live in.

Just the Numbers

	Period Ending 7/31/19			Period Ending 6/30/19			
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	2.47%	2.47%	14.82%	-16.53%	3.04%	3.90%	11.22%
Volume Winners	-0.35%	-0.35%	8.64%	-7.45%	13.56%	12.04%	NA
Volume Value	-0.78%	-0.78%	11.28%	-5.76%	17.12%	14.06%	NA
Volume Momentum	-0.31%	-0.31%	6.24%	-18.88%	8.17%	2.96%	NA
Russell 2000	0.51%	0.51%	17.59%	-3.31%	12.30%	7.06%	13.45%
S&P 500	1.31%	1.31%	20.10%	10.42%	14.20%	10.72%	14.70%
ZPR Global Equity	1.81%	1.81%	10.60%	-13.18%	3.65%	1.09%	13.48%
MSCI ACWI	0.33%	0.33%	16.98%	6.33%	12.23%	6.75%	10.74%
ZPR All Asian	2.24%	2.24%	9.99%	-11.31%	4.43%	-0.47%	16.14%
MSCI EAFE	-1.26%	-1.26%	13.05%	1.62%	9.66%	2.74%	7.41%
ZPR All Thai Equity	0.52%	0.52%	7.83%	-3.58%	1.63%	0.52%	NA
Thai Set Index	-1.01%	-1.01%	11.63%	11.86%	9.54%	6.38%	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 Thai Set Index, for which performance is expressed in 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.