ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

Just as December's market decline was relentless, January was similar but in the positive direction. This was also reflected in other asset classes, especially in bonds where high yield spreads reversed their large December increase. "V" shaped bottoms are unusual, and indicative that what happened in December might have been the type of panic selling that often marks an important low. It's very likely that volatility and confusion will continue, however, even if that turns out to be the case. One consistent theme from company managements to central bankers is that nobody is too sure about anything that's going to happen in 2019. That uncertainty is important in itself, in that decisions which require some confidence (like capital spending) are more likely to be put off, causing more economic weakness in the aggregate. The slowdown is here and now, although at this point that's no surprise to the market (but maybe it is to economic forecasters). Looking back at the last year, I think we've seen a "mini boom-bust" take place due to actions companies have taken around the tariffs and tax changes. Collectively these actions have boosted US economic activity and liquidity at the expense of foreign economies, especially China. There was naturally a rush to build inventory pre-tariff during the summer, and then an equally natural "air pocket" post-tariff in the fourth quarter. I think the artificial bump to activity in the first half of 2018 fooled both the Fed and the ECB into

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Asian and UK Results

By Vaidas Petrauskas

Our Asian investments had a very good month in January. We still have a long way to go to recover all of the 2018 losses. Hopefully this is just a start.

January and December were opposites from a market perspective. In December, stocks were dropping day-after-day. After Christmas, as if someone flipped the switch, the mood reversed. Stocks started climbing and never looked back. That's why we always advocate not to sell during a panic. Reversals are very strong and come when you least expect it. Almost all of December's losses were recovered in January which is quite amazing.

Why the change in mood? Who knows. The December sell-off was clearly overdone, as I wrote last month. So January's strength was partly due to technical reasons. In December, market participants focused on two big issues: The Fed policy and China's economic situation. In January, although there was no news on the trade war front and we kept receiving only negative economic news from China, Europe, and the US, the market decided to look past these problems.

One very important event came on January 30th, as Mark writes in his piece. The US Fed made a complete U-turn in their posture in just 6 short weeks. The Fed went from guiding that more rate increases are likely to expressing the need for "patience" and no

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Mean Reversion

By Mark Zavanelli

Over the past year we have commented on widening divergences between styles and markets. Foreign markets significantly underperformed in 2018 while the US market was in a speculative growth phase. We have been predicting this to reverse for what feels like forever, but it's not uncommon for long term trends to go to extremes before reversing. Mean reversion is a very powerful, but slowly moving force. Since style changes are often marked by price volatility and real economic changes such as we are seeing now, this may be the moment when the trend actually shifts.

A general observation about speculative growth, which is what dominated market returns overall in 2018, is that its outperformance tends to be very powerful but short in duration. This type of market often comes into vogue after markets have been generally rising and confidence is high. It's not uncommon for the speculative stocks to pull in assets from other areas of the market so that they fall at the same time as speculative growth stocks rise. Large price gains get the attention of speculators who parlay them for their maximum potential (while other investors jump on the band wagon). The eventual success or failure of the object of speculation doesn't make a difference in the short term because this is at its heart about investor behavior and not fundamentals. Extreme returns to momentum are a good indicator that this style is in favor and we saw all of the above last year. This is quite different from a quality growth driven market (and quality growth stocks) which can remain in favor for longer periods. Historically, once speculative growth is no longer delivering gains it rapidly fades and does not work again as an investment style for a whole cycle lasting a number of years. I think the decline at the end of 2018 may have marked the end of this period for speculative growth. That's important for investors, because downside in these stocks is large and it won't pay to jump to the next "new thing". Since growth has been in favor over the last 10 years after the initial bounce off of the 2008 lows, once this speculative growth phase is over I think it will be an extended period before we see it again. This is definitely not where opportunity lies today.

So, what's likely to come next in the rotation between investment styles? While markets are falling, size (large) and safety are natural outperformers. In some cycles the largest stocks are also high beta (the Tech Bubble was this way) and in those cases these stocks typically don't outperform in the decline. Bond proxies like utilities and real estate also usually win since these are really a different asset class (these also can win in a declining rate environment). This group is an anti-beta play, which does make sense during a period after beta has been very successful and is likely to mean revert. The difficulty with size and safety as a longer term holding is that it only outperforms as uncertainty is rising and market participants want to shed risk. Otherwise you typically pay for this lower risk in the form of lower long term returns. During some cycles that lasts for an extended period (1-2 years) but typically is much shorter, even only a few months.

After a decline, value often outperforms. Even within a cycle, improving economic expectations are a good coincident indicator for value outperformance. What also helps is if value stocks are priced cheaply, especially in absolute terms (they are always cheap relative to the market by definition, but to varying degrees). Today, after wide long and short term outperformance by growth stocks, we do see some areas that are unquestionably cheap. The first is developed foreign markets, such as Japan and Europe. These markets are cheap overall but also full of very depressed stocks away from the largest companies that drive the market average. After years of lackluster returns many investors really don't believe that these stocks will earn returns in any environment, and the valuations reflect that. The market also takes a dim view of the macroeconomic conditions in these countries. It's all priced in, as it is every cycle. Another interesting value candidate is emerging markets. Generally, emerging markets went through a period of investor excitement between the Asian Financial Crisis in 1998 and 2008. Since then it's been a lost decade, but they are priced inexpensively and can easily get a growth multiple when they are in favor (India is one market that perennially trades at a high multiple). Within the US, the underperformance of small cap value has set up a substantial gap between the overall market valuation and this style group. It also looks cheap on an absolute basis using operating metrics like earnings (unlike the rest of the US market where large growth stocks are expensive). This tells us at least that returns can be a lot better than the major averages as mean reversion takes hold.

US Commentary (Continued)

faster tightening. This data pattern fooled us also last year, as we shifted from stocks that were suffering from rate hikes (such as housing related companies) into beneficiaries of strong late cycle growth such as energy and materials, only to have that growth disappear and take the commodities (and stocks) down with it. The speed of the economic shifts were very unusual, driven by the policy changes and the reactions to them.

So what happens after the mini boom-bust? Does it continue snowballing into a recession, ending this economic cycle and the bull market? Or does it pass like the 2015-2016 slowdown and then we get a reacceleration and good times continue? In the fourth quarter that answer didn't matter as the market's attitude was, "Sell First and Ask Questions Later" at the first signs of economic weakness. This is understandable with a backdrop of a long economic cycle, signs of stock and bond market excess, and central bank tightening on steroids. In 2019 I think that the market will try to discount the bottom and not just react to the direction of the current data. Interestingly, we see the market already positioning for at least the possibility of a good resolution. Emerging market stocks and currencies suffered earliest and are now starting to outperform.

My own guess is that the speed of the economic shifts continues to be fast in the next couple of quarters. The near term data is very likely to disappoint, or at least be conflicting, and this could cause the market to pull back. The yield curve, which has been a moving target itself, is painting a bearish picture. However, I think that a snapback might also be rapid and unambiguous. It may take a while to get to an actual trade deal, but we'll likely know at the end of February what the direction of tariffs will be. There's pent up demand for delayed capital spending, and companies will move quickly if the outlook is brightening. Importantly, we've seen a dramatic change in the Fed and consequently in the interest rate picture looking forward. At the end of January, Powell signaled that the Fed was going to halt both its planned path of rate hikes and quantitative tightening as needed to preserve economic growth expectations. This is a big shift from even a month ago where the expectation was for at least some rate hikes in 2019 and QT on autopilot. Historically there's no such thing as a pause in hikes or being patient, the next move has always been a cut in rates after some period of time as the economy slows. That might not happen this time, but the main effect is that companies and consumers will now plan for both short and long term rates to stay relatively low for the foreseeable future. The narrative of the Fed driving the world economy over a cliff is finished, so that will significantly aid confidence once things stabilize. Historically the end of tightening cycles are dangerous periods for the market. If we can avoid a real recession, and I think we will based on the unique features of this "mini boom-bust", then the historical precedents are positive. Also, valuations have declined for economically sensitive stocks to the point where we should be paid handsomely in a positive economic outcome. Moments of high perceived risk are typically a much better than even deal for longer term investors who can withstand losses and hold for the rebound, simply because some investors aren't able to do that and sell when risk is high.

Asian and UK Results (Continued)

prediction about the future path of rates. Last month, the balance sheet runoff was on autopilot and Powell didn't see that changing. Now the autopilot has been switched off.

The Fed caved in by coming in to rescue a falling market. The dollar weakened after the Powell speech. This bodes well for foreign markets. Now we only have to worry about China.

Japan

Our Japanese stocks recovered strongly in January. They rose around 6.5%. A stronger Yen added 1.34% when the return is expressed in US dollars. We are in the middle of a reporting season in Japan. The first week of February will be especially busy as most companies will report during that week. Quarterly results from Japanese companies which already reported have been very good. This was a pleasant surprise because I wasn't sure what to expect with signs of a clear slowdown in China's economy. We still have many reports out, but so far corporate results have been very encouraging. We bought many new Japanese stocks. We have a problem of too many good stocks with strong earnings growth. This is a good problem to have. I think when this reporting season in Japan is over, we will greatly improve the quality of our portfolios again by selling weaker businesses and upgrading to higher quality ones. The 4th quarter sell-off presented many opportunities.

Thailand

Thai stocks also recovered strongly. Our Thai stocks rose more than 5%. I have to mention the incredible strength of the Thai currency – Baht. The Baht is the strongest currency in the world. It appreciated by 3.5% against the US dollar in January alone and by 6% in the last six months. This is good news for US investors who hold Thai assets because they become more valuable when expressed in US dollar terms, but a strong Baht is a big headwind for Thai exporters whose products become less competitive compared to regional peers. Thailand will hold very important elections in March.

UK

The UK parliament continues to be embroiled in an unbelievable Brexit mess. They decided to go back and start from zero with only two months to go until Britain will exit the EU. There is no possibility whatsoever that the deal can be meaningfully revised before Britain is due to leave the EU on March 29. Without a request to postpone that date or a British vote to accept the EU deal, the U.K. will leave on "no-deal" terms. Industrialists and currency traders agree that this would be a disaster. And yet, all that MPs agreed on this week was to ask the EU to come up with an alternative arrangement within the next two months. There is no chance of this happening. Votes to rule out a no-deal exit and to postpone the March 29 date were defeated. The chance of a no-deal exit is now high. We continue to hold a very limited number of UK stocks, taking profits when the market gets excited, and haven't bought any new ones in a long time.

Just the Numbers

ZPR Composites Names in Bold *Benchmarks in italics*	Period Ending 1/31/19 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	9.49%	9.49%	9.49%	-29.95%	4.58%	3.78%	12.09%
Volume Winners	6.24%	6.24%	6.24%	-4.09%	12.82%	11.95%	NA
Volume Value	9.27%	9.27%	9.27%	-10.55%	13.97%	12.19%	NA
Volume Momentum	7.42%	7.42%	7.42%	-18.84%	5.99%	3.14%	NA
Russell 2000	11.19%	11.19%	11.19%	-11.03%	7.36%	4.41%	11.97%
S&P 500	7.87%	7.87%	7.87%	-4.38%	9.27%	8.50%	13.12%
ZPR Global Equity	7.44%	7.44%	7.44%	-26.40%	2.31%	1.93%	15.56%
MSCI ACWI	7.93%	7.93%	7.93%	-8.92%	7.19%	4.83%	10.05%
ZPR All Asian	6.60%	6.60%	6.60%	-25.00%	0.55%	0.79%	19.38%
MSCI EAFE	6.59%	6.59%	6.59%	-13.35%	3.38%	1.00%	6.83%
ZPR All Thai Equity	8.90%	8.90%	8.90%	-20.27%	3.41%	4.80%	NA
Thai Set Index	5.00%	5.00%	5.00%	-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.**

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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.