ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

August was full of action in financial markets, little of it good. It's been a see-saw this summer and this month we were on the down slope. The big action was in the bond market. Bond prices rose and yields fell dramatically, in the US as well as overseas. What happened this month is that a short-term rush for safety was like rocket fuel to a bond market that seems like it can only move in one direction, with yields dropping. Although it's partly caused by short term performance chasing, this magnitude of a move in bonds is historically seen at important economic moments so it should be taken seriously. With a steeper drop on the long end, the yield curve inverted again this month. Is this all a sign that the infection of low rates that we see in weak economies is coming to the US? In Europe and Japan, low rates seem to have made things worse not better and haven't caused higher stock prices. The US, as a borrowing and spending nation, is different, but the drop in long-term yields is not a healthy sign.

Stocks also fell this month. They were led to the downside by companies with more perceived economic sensitivity, namely small cap value. Trade war concerns were

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Asian and UK Results

By Vaidas Petrauskas

The trade war is again on everyone's mind. On August 1st, President Trump announced a fourth round of import tariffs (right after the Fed's speech, as is now his custom) on $300 billion of Chinese goods to go into effect on September 1st. This time the target is consumer goods like electronics and clothing. This news about new tariffs seriously spooked the markets because up until that point, the trade war was put on a backburner in investors' minds. Things only got worse on the trade front throughout the month. After the market's negative reaction, President Trump postponed some of the new tariffs until December. But when the Chinese retaliated with their own tariffs on US imports, President Trump decided to lift the rates of all previously imposed US tariffs on Chinese goods. This was announced right after Jeremy Powell's, the Fed chairman's, speech. There is no question that Trump is trying to influence the Fed to cut rates by hiking tariffs on Chinese imports. But as I discuss below, even lower rates at this point may become counterproductive. Stocks recovered a little at the end of the month on Chinese comments that they will not retaliate further. So, the market is desperately grasping for any kind of good news.

President Trump's actions add an element of randomness to everything in the markets. Fundamentals no longer matter. This makes our job as stock pickers especially frustrating.

While stocks fell sharply around the world in August, bonds rallied to an absurd level. The yield curve in the US finally inverted

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Late Cycle Markets

By Mark Zavanelli

My thesis until now has been that we weren't really in a late cycle economy because of the strange nature of this expansion. We had a Euro crisis, then a China slowdown, and the expansion took a long time to get traction, even in the US. Economic growth outside the US was relatively weak and foreign markets never saw a sustained bull market, so I haven't been too worried that the expansion would die from old age. However, I have to admit that both market and economic data in the US are showing a lot of the signs of a classic late cycle setup for equities which eventually leads to declines. I'll discuss this first and then two ways it could work out positively. The one commonality in all three scenarios is volatility. If not considered in advance, this causes many investors to react and deviate from their long-term plans. It's usually a bad idea to follow the direction of a volatile market (i.e. buying into the Tech Bubble, or selling stocks during the Great Financial Crisis). However, it's hard to make any right moves in a volatile market.

First, a negative potential scenario, where the current flat corporate earnings environment becomes a drop in earnings due to a weaker economy. Some indicators today look a lot like they have at the end of other economic cycles. First, we've had a Fed tightening cycle that eventually resulted in a persistent yield curve inversion. The collapse in bond yields this month put the short end of the curve that the Fed controls well above the 10 year yield that most mortgages are based on. More Fed rate cuts are coming. Historically this creates the conditions for a rebound but doesn't prevent a decline. Second, there is a strong economy with low unemployment, but consumer confidence is decreasing (a strong economy typically precedes these downturns, so it's actually a negative predictor). PMI activity surveys are falling, which tells you how businesses are going to react in the near future. Finally, stock market returns are concentrated in a small number of momentum stocks, with small caps lagging, and market volatility is increasing. All of these signs are in place together for the first time in this cycle. It doesn't mean that a recession is definitely coming, and the market based indicators can be wrong since they tend to discount more bad events than actually occur. However, with this setup we need to be aware of the growing possibility of a more serious market decline that normally accompanies real economic weakness. Where we are today, I don't see any reason why the next major decline should be particularly terrible, but it's still a good idea to check your level of equity exposure and be sure that you can withstand at least a typical bad period. Even with the last two big declines which were unusually large, the market comes back. Just not the same stocks that fell the most in the decline.

Now to the positive market scenarios. One is that easy money from global central banks will meet a global economic situation that turns out to be flat or slowly declining instead of something worse. This happened in the late 90's after the Asian Financial Crisis but is pretty rare. It could be a trade truce scenario where nothing really changes in the global economy but the Fed cuts and investor fear subsides. It would likely mean a resumption of the positive trends for the S&P 500 and large cap growth stocks. Many market participants see this as a base case but I think it becomes more and more unlikely as the global slowdown deepens. Trump certainly wants to avoid a recession.

The last scenario will trigger on any sign of an actual upturn in global growth. This is the next major shift but the timing and path to get there is highly uncertain. Could it happen without a major decline? We saw it happen once this cycle already in 2016 after the election. This global slowdown dates to late 2017, almost two years ago, which is plenty of time for a cycle reset. Money supply growth is now positive and accelerating, which operates with a lag but will be a major factor in turning growth around. Looking backwards, a key driver of the current slowdown can be traced to quantitative tightening which cut money supply growth to very low levels. Value investments will snap back with a vengeance once the market senses an upturn, but it's certainly possible that the negative market scenario will happen first. This presents a quandary for value investors. Should we be focused on the short-term risk or the long-term potential? It is usually darkest before dawn so how we feel in the moment makes timing difficult. Here's where having a long-term plan can help. We need to control risk in the short term so that declines are manageable. Then, we can let time do its work and wait patiently for the upturn. Timing large moves precisely is not necessary for success, but being invested is.

US Commentary (Continued)

front and center. The market sees a trade deal as ever less likely as Trump ramps up tariffs and China responds by weaponizing their currency to mitigate the tariffs. Meanwhile, the global economy ratchets down with more weak manufacturing data. The goods economy is struggling everywhere. Companies get the picture loud and clear. Profit growth has ground to a halt in the aggregate and companies are investing less. Low interest rates and low taxes help make investments more attractive, but the primary driver is demand. The bottom line is that the market is very sure the economy is decelerating so it's too early to start guessing at when it might turn around. Despite the back and forth with trade negotiations, the only route to a deal seems to go through more economic pain. It's a game of chicken. Normally someone blinks, but politics are involved here. The Chinese want to deny Trump a second term, which would argue against them making any deal until after November 2020.

Unfortunately, the risk of a bad market event is rising as it looks more and more like a classic late cycle market setup. This is of course very difficult to predict. But given how fast declines occur we should respond to elevated risk in and of itself, and also adjust our reaction function to events as they unfold. This means more conservative allocations, and being slower to buy into a dip (that one is hard for me personally). We are working on accelerating the development of some new conservative strategies we've been working on since this is becoming more timely. I'll be reporting more on that in the coming months. I speculate on some potential late cycle market outcomes, both negative and positive, in a separate piece this month. We still remain focused on capturing the upside from an eventual rebound in value investing, but we have to be cognizant that things can still get worse before getting better.

Asian and UK Results (Continued)

and some truly extraordinary facts from the bond market emerged. Here is where we currently stand:

- The US 3-month T-Bill yields more than the 30-year bond.
- The dividend yield of the S&P 500 index is now higher than the yield you can obtain from a 30-year Treasury bond.
- Germany tried to issue a 30-year bond with zero interest (partially subscribed)
- In Denmark some banks charge depositors for holding their money and issue negative rate home loans. The German government is trying to protect at least the smallest depositors from negative interest on deposits.
- Austria's 100-year bond doubled in value in the last year and now yields 0.6% with 98 years till maturity!
- Italian 10-year bond yields less than the corresponding US bond (0.95% versus 1.51%) even as the country is mired in a political mess which has become a tradition in Italy.
- The bond yields are negative 50 years out in Switzerland, 25 years out in Germany, 20 years out in Denmark and Netherlands, 10 years out in many other European countries and Japan.

This has never been seen before, so we are in unchartered territory. Rates are coming down around the world. Thailand, India and New Zealand cut rates in August. This was done in part to counteract the weakening of the Chinese Yuan. But rates are already so low (even negative in some countries) that further cuts have limited effectiveness to stimulate economies because it hurts bank profits, and when banks stop lending, the economy stalls. I have read in a piece by John Hempton that the average interest rate achieved on a loan by a Japanese regional bank in the first half of this year was about 79 basis points. It costs about 1 percent to run a bank. So Japanese regional banks are loss making before they have any credit losses! The banks masked their loss-making operations by investing excess funds in Japanese Government Bonds (JGBs) and the yield on JGBs has gone pretty sharply negative, meaning bonds' value rose. The situation is similarly dire with European (especially German) banks, while US banks are still healthy by comparison. But in a situation that we currently find ourselves in, when rates are already at zero or negative, cutting rates further when you need a stimulus not only

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Asian and UK Results (Continued)

stops working but becomes counter-productive. It can blow up your banks and cause an economic crisis.

In this environment, when markets are dominated by trade war news, our stocks performed badly, on par with local small cap indices. We lost more than 6% in both Thailand and Japan in local currency. This is similar to US stock market losses, so there was no benefit from diversification. Our Japanese stocks held up relatively well during the month but failed to recover when US stocks recovered during the last few days of the month. Only on the last day of the month did Asian stocks rise sharply.

Singapore continues to surprise with good relative performance. Our Singapore portfolio fell “only” 3.3% in August.

We were helped a little by stronger Asian currencies, except for Singapore Dollar, which fell by 1.35%. The Japanese yen rose 2.14% against the US Dollar as it is considered to be a safe-haven currency and always appreciates in times of turmoil. The Thai Baht also gained 0.57% against the US Dollar despite the efforts of the Thai Central Bank to weaken it to regain competitiveness. Worried about a strong Baht and because of faltering growth, the Thai Central Bank cut interest rates in August by 25 bps to 1.50% (after hiking 25 bps in December). The baht eased after the decision, but then continued to appreciate. Year-to-date the Baht has appreciated by 5.81% against the US dollar and is one of the best-performing currencies in the world this year.

Our Asian companies finished reporting quarterly results on August 15th. The reports in Japan were OK. Many industrial companies are suffering because of the global economic slowdown, but other companies are doing fine. I have been shifting out of industrials for some time to better performing businesses like discount retailers. In Thailand quarterly results were poor, especially for the industrial sector and exporters. It is very clear that growth is slowing. Exports are down this year but they finally grew in July. This is all caused by the US-China trade war. Every country is reeling from the effects of the trade war, resulting in lower exports and investment. Investment is on hold because of uncertainty created by the trade war. On aggregate earnings fell 17% YoY for Thai companies, but this is misleading. All Thai companies booked one-time provisions this quarter related to a new labor law, which requires bigger payouts for long-term workers. Thai GDP growth for this year has been revised down multiple times, to now expected to be below 3%. The government has unveiled policies to rev up domestic consumption.

The United Kingdom continues to live the high Brexit drama. Boris Johnson, the new Prime Minister, asked the queen to suspend the parliament during the crucial remaining month before Brexit is due to happen on October 31st. The queen agreed. So the country was thrown into a constitutional crisis, with parliament sidelined during one of the most crucial periods in the country’s history.

Just the Numbers

	Period Ending 8/31/19			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	-6.21%	-3.89%	7.69%	-16.53%	3.04%	3.90%	11.22%
Volume Winners	-4.99%	-5.32%	3.21%	-7.45%	13.56%	12.04%	NA
Volume Value	-5.05%	-5.80%	5.66%	-5.76%	17.12%	14.06%	NA
Volume Momentum	-7.44%	-7.73%	-1.67%	-18.88%	8.17%	2.96%	NA
Russell 2000	-5.07%	-4.51%	11.71%	-3.31%	12.30%	7.06%	13.45%
S&P 500	-1.81%	-0.40%	18.07%	10.42%	14.20%	10.72%	14.70%
ZPR Global Equity	-5.12%	-3.40%	4.93%	-13.18%	3.65%	1.09%	13.48%
MSCI ACWI	-2.57%	-2.25%	12.12%	6.33%	12.23%	6.75%	10.74%
ZPR All Asian	-4.95%	-2.82%	4.54%	-11.31%	4.43%	-0.47%	16.14%
MSCI EAFE	-2.58%	-3.81%	10.14%	1.62%	9.66%	2.74%	7.41%
ZPR All Thai Equity	-5.68%	-5.19%	1.71%	-3.58%	1.63%	0.52%	NA
Thai Set Index	-2.79%	-3.78%	8.52%	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.