



# *Arbor Capital Management*

## **Investment Overview**

We expect the S&P 500 to appreciate by roughly 12% over this year. This forecast takes into consideration a rise in interest rates, a continually strengthening economy and strong corporate earnings performance. Bonds are expected to produce total returns (interest + change in price) in the low single digits. Therefore, stocks are likely to perform much better than bonds which are expected to perform slightly better than cash. These expectations are a logical conclusion derived from our macro-economic outlook.

The economy is still gathering steam. Two of our most closely watched time series, Total Capacity Utilization and the Purchasing Manager's Index, have picked up sharply over the past year indicating an expanding economy particularly in manufacturing. As we have stated before, excess plant capacity needs to be absorbed before we can expect to see the acceleration in hiring that has escaped this business cycle thus far. We are optimistic that this may happen this year. Manufacturers simply need more orders to justify new hires. Since the Purchasing Manager's Index has remained strong, it would appear that orders are continuing to build. The ratio of Inventory to Sales time-series remains extremely low relative to its history. Part of this is explained through globalization. Many companies that order products or parts from overseas suppliers have to account for the extra transportation time. Longer delivery times create implicit inventories in transit that have been committed to but not yet received. This partially muddies the inventory measure. However, as business continues to expand the risk of losing profit because of lack of available product exceeds the risk of having too much inventory. In summary, we think that there is an above average chance that the second half of 2005 will exhibit sharp acceleration in jobs and overall economic activity.

Corporate profits are likely to grow about 12% according to the consensus estimates of investment analysts compiled by Zack's Investment Research. Typically this number is overstated at the start of the year and is revised downwards as the situation unfolds. We expect this to be offset by an economic surge whose potential is underestimated in our opinion.

We think two main themes will be resurrected this year: Energy and Technology.

Energy prices will likely continue to moderate as the election and military situation in the mid-east fades in investors' importance. However, China and India are growing much faster than the rest of the world and are becoming much more important purchasers of energy. The unrest in Venezuela and Nigeria has taken away some of the slack in the supply chain. It appears to us that oil prices are in a long-term uptrend driven primarily by demand and static supply. Temporary interruptions are likely to cause occasional price spikes. Unless values take an extreme swing we anticipate keeping one or two major integrated producers as core holdings. From time to time we expect to add smaller producers and occasionally an oil service company. Of particular interest are companies in politically stable regions with relatively low lifting cost and solid development programs.

Technology has been dormant as a market theme for a while though its underlying import has not changed. What always seems to be missing at early stages of a Tech cycle is a "killer app". Back in the day of the IBM XT, one could hardly fathom how its 10 megabyte hard drive could ever be filled. Today, we have

single spreadsheets that exceed that. In fact, we perform some calculations routinely that take over an hour and a half of dedicated computer time to perform on a 2 GHz machine with over 1 GB of RAM. Since the introduction of the PC, the number of transistors on a single chip has expanded by 40,000 times. This incredible feat is tribute to both the engineering in the manufacture of the chips as well as the creativity that went into the application process. The only real limit is imagination. The next wave of applications will focus on convergence between computing and communications. This means many of the devices we use every day will continue to expand capabilities at an accelerating pace. The emergence of the digital home, workplace and lifestyle is a near certainty. However, it is impossible to determine exactly how things

will turn out. For example, office automation has significantly changed the way people conduct business and live their lives, but it has definitely not lead to a paperless workplace as originally promised. It is with these fundamental concepts in mind that we continue to hold companies whose technologies enable such a transformation.

Interest rates are likely to continue to rise in concert with the expansion of business activity. This will be most apparent at the short-end of the yield curve. Companies are expected to increase demand for short-term funds and the Fed remains committed to maintain monetary discipline. The weakness in the dollar may become more of a concern later but is not yet our primary concern. The ten-year Treasury is likely to increase should inflation pressures begin to mount. For the purposes of our stock market forecast we assumed a 1% increase to 5.25% but that may be overly pessimistic. Only time will tell. Bond positions where we establish them will continue to be mostly defensive in nature with features such as step-up or variable rate coupons.

**Gerald T. Cole, CFA**  
Chief Investment Officer

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