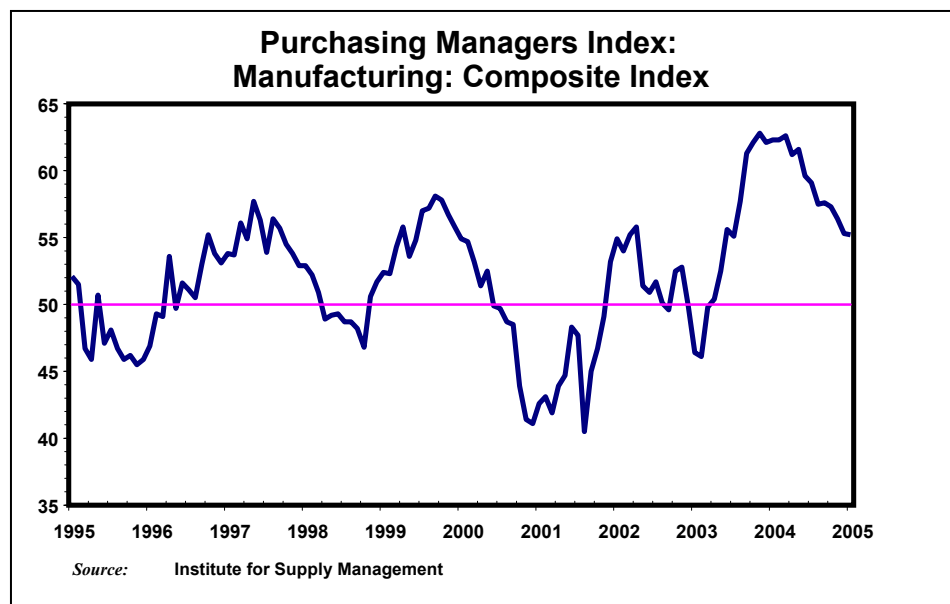




# Arbor Capital Management

## Investment Overview

The broad economy is acting as we expected. Industrial Production has had a nice recovery, Capacity Utilization is trending upward toward its historic average, Unemployment rates are steadily declining and Money Supply growth has been consistent with controlled growth. In fact, most economic time-series data exhibit a similar pattern. We believe the financial markets are overreacting to inflation warnings from the Federal Reserve.

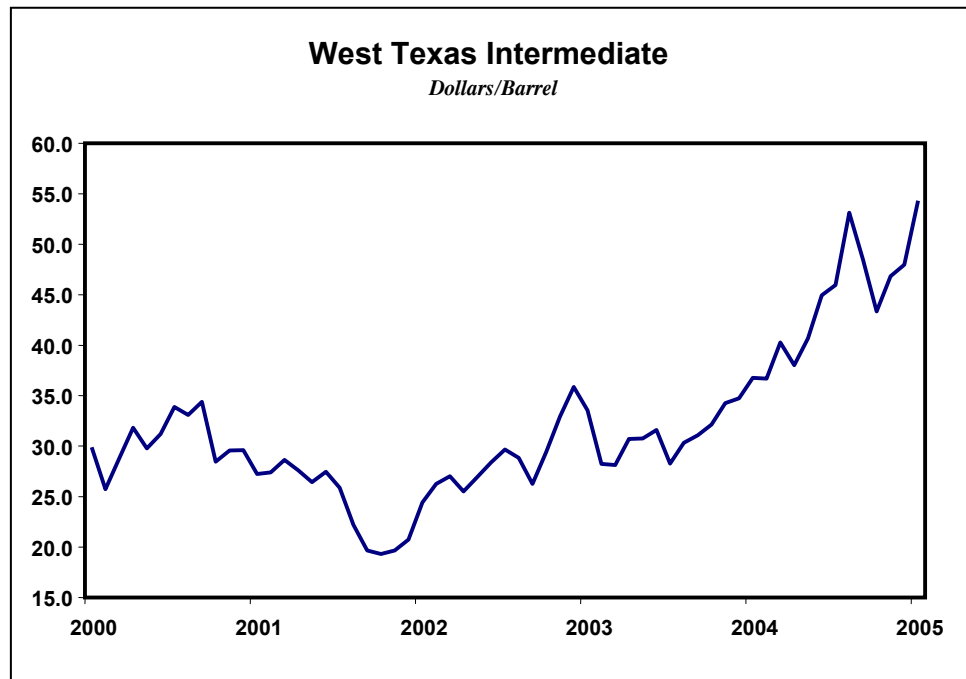


The Chart to the left is the Purchasing Manager's Index. A value above 50 indicates an expanding economy while a value below 50 indicates a shrinking economy. The recent data show that an economic expansion is still underway, but its rate of growth is slowing. It appears that inflationary pressure from manufacturing is diminishing for the time being. A similar slowing in the rate of growth has also appeared in the Industrial Production Index.

The biggest single source of inflation pressure at the moment is the price of oil. The recent spike in oil has been well covered and we see its results everyday at the gas pump. It is well understood that oil has a very strong influence on CPI. The real question here is: Is the recent price increase a transitory spike or will it be more persistent? If it is a relatively short-term phenomenon then its impact on the CPI will also be relatively short-lived. Were this to represent a new price level then inflation would begin to show sharper increases over time. This reaction would be caused by passing along cost increases to consumers who in turn would demand greater wage increases to offset their expenses. Those of us who recall the 1970's know what this is like first hand.

After reviewing the International Energy Agency monthly oil report it is clear that worldwide total industry stocks of petroleum products is well into the upper half of its 5-year range. The problem is in Europe where inventories have been drawn down over several years, particularly in gasoline and heating oil. Still, the fundamentals do not seem to support the recent price advance. So we expect inflation to be impacted less severely than the consensus seems to anticipate. However, the long term dynamic will be driving prices upward over the next 20 years or so if India and

China continues its current development pace. In response to this analysis we reduced our exposure to energy stocks substantially and we will be looking for a re-entry point at, hopefully, much lower prices. We may repurchase the same stocks but we anticipate purchasing the best names available at that time. The cash generated from these trades will be recommitted over the next several weeks. The near term environment is volatile and it is also earnings report season. We hope to be able to make good use of this opportunity.



The oil situation also has an interesting corollary. If oil prices correct as we think they should, then inflation expectations will probably diminish in unison. In this scenario interest rates would have less upward pressure and the dollar would strengthen. This means that long term bonds may actually rally while short to intermediate term bonds remain where they are. Looking out one year, however, we still think the most likely case is for rates along the entire yield curve to move higher. Therefore, our fixed income emphasis continues to be on step-up and adjustable rate issues. We would be sellers of long term bonds if they rally.

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

**April 18, 2005**

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