



Arbor Capital Management

Investment Overview

Despite the one two punch of the Fed's interest rate increases and higher energy prices the overall economy has barely broken its stride. As expected, inflation has remained in check while business activity has gradually picked up steam. Excess manufacturing capacity continues to be absorbed and capital spending is strong suggesting continued improvement in productivity and competitiveness. All other things being equal, the overall economy can still expand significantly without triggering additional inflationary pressure. This is good news because it means that real disposable income is likely to also improve. The general rise in real estate prices has triggered a wealth effect that strengthens consumers' confidence in their financial well-being. Therefore, we expect consumer spending and GDP growth to remain strong for the next several quarters at a minimum. In addition, the inventory to sales ratio is still historically low so the stage is also set for the possibility of a burst of additional growth fueled by inventory replenishment.

At odds with this rosy forecast are energy prices that have remained higher than we previously expected. We continue to believe that worldwide demand is being met with abundant supply. The bottleneck is in refining. Recently, the International Energy Agency reduced its forecast for Global oil consumption through 2006. Consequently, there should be some retrenchment to lower prices. However, it is evident that excess capacity is thin. So, even though oil prices could decline substantially, volatility is probably going to remain much higher than usual. Even though the Fed has been making pre-emptive rate increases it appears inevitable that gas prices will impact inflation. In our estimation we are very close to that tipping point.

There is no question that some regions are experiencing high levels of speculation in real estate. In our view nearly every speculative bubble ends similarly. A few of the weaker players fold and make the others nervous. Then prices correct, perhaps slowly at first. The selling climax is reached when forced sales take place at any price. Usually this drives values below the equilibrium. Currently, few banks hold mortgages. They are generally securities and remarketed through FNMA, GNMA, etc. Were such a series of events to occur in housing the main financial impact would be felt by holders of recently issued mortgage pools. The loan to value ratios would become untenable and real losses would occur without any opportunity for recovery. From a monetary perspective, large chunks of the money supply would be erased. If this were to become widespread enough then a recession could be triggered because it may occur at a pace more rapid than policy makers' ability to respond. Thankfully, we view this widespread phenomenon as being a relatively low probability outcome at this time but it bears watching.

Fixed Income Strategy

Provided our overall assessment is correct, interest rates could be significantly higher within the next 12-18 months. Under this scenario, the hardest hit would be maturities greater than 10 years. Our strategy to cope with this possibility for fixed income investors remains unchanged. We are continuing to reduce interest rate risk by purchasing short-term instruments, adjustable rate securities and step-up securities. We are avoiding mortgages. Unless there is a compelling need to the contrary, we continue to minimize our allocation to fixed income in balanced accounts.

Equity Strategy

If the 10-year Treasury increases by more than 1% to 5.25% the S&P 500 still has enough earnings power to propel itself forward by 12-15% even after adjusting for event risk. This would represent the first divergence of interest rates and share prices in many years. Our rationale behind this forecast is that we expect economic activity to continue at a good pace even in the face of rising inflation and interest rates. Company earnings will benefit from both the heightened pace of activity and cost reductions that had been extracted from operations over the past several years. Therefore, earnings are expected to overcome the rising cost of capital. If this situation of rising interest rates continues for a protracted period of time, then we would expect aggregate P/E's to shrink accordingly. Equity market returns would become more concentrated among an increasingly narrow list of companies making stock selection more critical than ever. We last worked through such an environment in the 1970's within which we thrived. It is exactly this experience that has led us to the conviction that there is no substitute for sound fundamentals. In fact, our equity selection process was born in just such an environment.

Recently we exited our positions in Homebuilding. We think they reached full value and speculation had become the primary driver behind share prices. We currently like Financials particularly Banks. Bank share prices tend to be driven by interest rates, credit quality and loan demand. Two of the three factors are in our favor and should be sufficient offset to increasing rates particularly in light of the fact that few banks hold the loans they underwrite. Technology is also poised for a return to the spotlight in our opinion. After a several year hiatus we think innovation has steadily expanded the capabilities of computing systems for both the desktop user and across the enterprise. While some have been waiting for the "killer app" performance and price have improved so dramatically that many will simply opt to upgrade. We think we already have good representation in this area but we would be amenable to adding a name or two once a new business cycle for technology companies became more evident. Because of the underlying strength of the consumer, Retailers should enjoy a stronger holiday selling season than has been seen in a few years. We have good representation in this group.

Gerald T. Cole, CFA
Chief Investment Officer

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