



# *Arbor Capital Management*

## **Investment Overview**

There never seems to be a dull moment. The US economy has been dealt three body blows: Hurricanes Katrina and Rita; \$70 oil and rising short term interest rates. How one copes with these depends on one's perspective. Either the glass is half full or half empty.

This year's hurricane season has been among the worst in our nation's history. Apart from the human tragedy the aggregate impact of Katrina on economic growth is close to zero. The financial loss is expected to be offset by Federal spending and the economic growth created by reconstruction. However, personal losses, forced relocations, destroyed businesses, and job losses are all substantial. There is a silver lining. Because of its location New Orleans is a critical port serving not only a large share of the nation's refineries but also all the commerce that flows along the Mississippi. Restoration will bring about new business formation and job creation. Many people that have previously been among the ranks of the chronically unemployed will find ready employers as the demand for labor skyrockets. Building codes and infrastructure will be dramatically upgraded. This will leave New Orleans in much better shape and will be modestly accretive to overall GDP.

Oil has skyrocketed in price beyond what our supply-demand analysis has suggested as reasonable. It is entirely possible that its price could plummet just as sharply. Either way there are three things that we know for sure: 1.) the persistent high price of energy has largely been absorbed in producers' profit margins and prices at the pump are beginning to influence consumer behavior. This cannot last indefinitely and has become a net inflationary influence. 2.) Higher prices favorably impact the economics of oil exploration. 3.) Hurricane Katrina also highlighted the general lack of excess petroleum refining capacity specifically and a lack of excess petroleum delivery capacity generally. Hence, energy price volatility is likely to remain high and a comprehensive national energy policy is likely to be developed amidst political rancor. This is likely to include relaxation of restrictions on the exploration and development of shut-in resources including ANWR, new refineries, renewed interest in nuclear power and redoubled efforts in energy conservation.

Short-term interest rates have been rising steadily for quite a while. Much of this is driven by rising normal business cycle activity including rising inflationary pressures. However, the Fed is also focused on preempting regional crashes in housing prices and a disorderly unraveling of the "carry trade" (hedge fund buying of long term bonds financed by short term loans). These are the reasons why the Fed announced so clearly its intention to gradually raise short-term rates until a level considered to be neutral to money supply growth is reached. The idea has been to avoid sharp changes in rates that could precipitate panic and to give investors plenty of time to unwind positions in a more orderly manner or otherwise adjust their plans. So far, so good.

Each of these developments have been met with appropriate portfolio responses that we think will prove effective. The Gulf coast disasters clearly altered the demand for building materials. So equity portfolios have had several of these companies added. The economics of oil exploration have improved substantially. We expect to gradually add new companies primarily in exploration and development once we feel share prices in this sector have weakened sufficiently. Unfortunately rising short term interest rates and increased inflation pressures are negative for bond investors, so we are continuing to be very defensive with bond portfolios. We still favor defensive strategies such as step-up coupon bonds, variable rate instruments and Certificates of Deposit. We would tend to restrict CD maturities to one year or less because of their relative illiquidity and the trend of rate increases.

Technology continues to be an important theme. While the shares of most Tech companies have been in relative limbo, innovation has continued unabated and we are currently seeing products coming to market that reflect this. Values have improved dramatically in this sector that has usually been driven by hype and great expectations. At least at the onset of the next surge in Technology shares we expect earnings to drive prices substantially higher. Investor enthusiasm can propel them higher still. We think our equity portfolios have good representation in this area.

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

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