Arbor Capital Management

Investment Overview

The year ahead looks positive. The economy is continuing to expand at a comfortable pace and plenty of capital is available to help meet demand. Resurgence of inflation is not an immediate issue but inflationary pressures are building. Apart from oil, none of the traditional measures we continually monitor have surpassed their inflationary thresholds. Monetary policy has been pre-emptive which has resulted in a flat yield curve. We think stocks are more attractive than either bonds or cash. After adjusting for event risk we think cash has more attractive total return potential than long-term bonds.

The Federal Reserve has raised short-term rates steadily while long-term rates have remained virtually unchanged. Short term rates are most closely correlated with the pace of business activity while long-term rates are more dependent on the rate of inflation and expected changes in inflation. Long term bonds are currently being impacted by a variety of cross-currents that bear noting. The first is that foreign investment in US denominated bonds is so great that the Fed estimates that this is holding long-term rates artificially low by as much as a full percentage point. As other currencies strengthen relative to the dollar we can expect flows out of US bonds into foreign alternatives. Concurrently, Gold is reacting as though a material increase in inflation is imminent. While we agree that inflation has the potential to rise, we attribute a large part of Gold's rise to a "flight to safety". In other part of the world Gold is a nearly universal currency. It is commonplace that its price will rise during periods of political unease as is the case in the Mid-East. We think the upshot of this is that long-term rates will probably rise throughout the year by about one point. We continue to favor short-term fixed income or bonds with defensive characteristics. We think that reaching for yield at this point does not represent a favorable potential reward in light of the risk.

At the start of the year the Institute for Supply Management's Purchasing Manager's Index is still signaling an expanding economy and Total Capacity Utilization (TCU) has recovered significantly over the past few years. Though TCU is subject to considerable measurement difficulties it has nonetheless been a good measure of manufacturing activity. Currently, TCU is nearly back to its normal (average) level despite competitive pressure from China. This is a tribute to the adaptive nature of our manufacturing industries.

2006 is likely to be viewed by economic historians as a watershed year. In a dramatic change of fate it is a near certainty in the coming year that both Ford and GM will dramatically restructure their operations to assure their survival. The details are unclear but they will likely include closing a number of obsolete plants combined with a mixture of wage, benefit and work-rule reductions. Rather than getting stuck on the minutiae of the automotive industry, we should consider a broader question: what other industries are likely to be affected and what do American industries need to do to remain competitive so we can continue to live as we do?

Wage disparities have to be offset by productivity. Productivity improvement is fueled by capital spending and training. Failure to overcome the competitive hurdle will result in loss of business. Government intervention can only delay the inevitable. Mature industries with well defined processes and easily obtained raw materials will continue to migrate to places like Southeast Asia where low wages are the dominant factor. The only true solution is to continue to invest heavily in new equipment, new technologies and the education of our workforce so that as a country we remain at the forefront of innovation. When looking at individual companies we often ask ourselves: will this idea or product change the way we lead our lives or conduct our business? Technological leadership, in the context of America's global competitiveness, is absolutely essential. We expect to add more names to our Technology positions from time to time this year as appropriate opportunities present themselves.

As the economy continues to expand, inflation will begin what we expect to be a slow rise over a period of years. This ought to drive long-term interest rates moderately higher over the year, perhaps by as much as a full point. A negative event in the Mid-East could cause an upward spike. However, we also think that the housing boom will see a correction this year that will probably be limited to regions of rapid construction. For example, Miami currently has around 25,000 condos currently under construction. It is doubtful that the region can absorb the new supply at any where near the pace of the past year or two. This will be partially deflationary by causing prices to level off forcing consumers to reconsider building speculation. In the immediate aftermath of hurricane Katrina we added substantially to building supply companies. We will be reducing these positions. Their replacements will be strong companies growing more rapidly than average that are attractively priced.

If you would like to receive our quarterly Investment Overview electronically, please email lmhutton@arborcapitalmgt.com.

Gerald T. Cole, CFA **January 20, 2006**

Chief Investment Officer

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