



# *Arbor Capital Management*

## **Investment Overview**

We are cautious near term but remain very upbeat longer term. Excess capacity is being drawn down steadily. The underpinnings of economic growth remain very strong though they are changing. The consumer has been the predominant driver of growth thus far. Capital spending is likely to take center stage for the next several quarters.

Inflation statistics still remain subdued but some tightness in supplies is becoming evident in some sectors. Many of the primary metals markets such as Steel, Aluminum, and Copper have been impacted by surge demand from China and increased industrial production world-wide. The market response is self correcting. Capacity is being expanded or re-opened where cost/benefit comparisons are favorable. This will mitigate the price pressures once this capacity becomes available. The message here is that a large bit of excess capacity has been used up increasing the risk of accelerating inflation. Anecdotally this highlights the fundamental shift toward increased capital spending. Despite well publicized troubles in the Auto industry, American manufacturing is far from dead. Rather than rolling over to competitive threats from foreign markets, companies adapt to market forces. In the aggregate they emerge from their travails stronger, reenergized and more relevant to emerging economic demands. Such is the nature of Adam Smith's "Invisible Hand". This adaptive behavior which we are witnessing generates higher economic activity and lower inflation in the long term.

In order to successfully adapt, companies need to continuously reassess their competitive position and invest accordingly. China has a near limitless supply of cheap labor. The United States is the undisputed world leader in capital formation. Change costs money. In this regard America is in stronger condition than usual. Cash flow is exceptionally strong across most major companies. Interest rates are still low relative to many potential project returns. Bank balance sheets are very solid. New projects will not suffer from lack of availability of funds or onerous rates. In addition we anticipate that merger and acquisition (M&A) activity will increase sharply. Some companies will find better value in purchasing public companies. Others will determine their best course is to divest of operations that do not seem to fit, or purchase other companies operations that augment one's strengths. Many will simply choose to purchase their own shares in the open market. Individuals will be compelled to invest in their own educations (human capital) so as to be able to compete in the workplace of tomorrow. All of these alternatives are beneficial to equity shareholders because they strengthen the economy, lead to higher profits, renewed capital formation and job creation that, in turn, leads to still more investment. This is perhaps the single most fundamental rationale behind our long-standing confidence in the American economy. In the near term business activity may pause to take a breath as the transition of spending patterns unfolds. If economic time series were to show signs of weakness we would expect a rapid recovery. The press is hypersensitive to statistical minutia these days and is likely to over react. This is one way investment opportunities are created.

The potential dark cloud on the horizon is the possibility of another dramatic terrorist attack. The potential impact is meaningful and is partially discounted in prices already. Still the shock would probably result in a broad equity sell off initially coupled with a flight to quality i.e. US Treasuries and an interruption of economic activity. Whether or not a recession would ensue is contingent upon the reaction of the public and the fundamental strength of the business climate. In our view public reaction will be very different than that in the aftermath of 9/11 should another attack befall us. We anticipate an even greater wellspring of anger which is a much more proactive and decisive emotion. Therefore, we would expect economic and security price recovery to be more rapid than before.

Short term interest rates are expected to continue to rise at a measured pace. The Fed has working well though we should reserve judgment for a later date when we can look backward and review the data in an historic perspective. We think the main difficulty in monetary policy formation is dealing with the uncertainty of timing between making a rate change and its full impact on economic activity. A number of variables come into play some of which are completely unforeseeable that can make the most rigorous forecast model crumble. Despite this we expect the dollar to weaken somewhat as a response to the trade deficit. The combination of a weaker dollar and an upward trend of inflationary pressure are expected to put upward pressure on bond yields. For this reason we are still in a defensive fixed income posture. We favor shorter term maturities and bonds with defensive features such as step-up coupons, put features or variable rate coupons.

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M&A activity may dominate stock market returns over the balance of the year. Sector weighting may prove to be less important than individual equity selection. Our quantitative approach does a better job at this than most so we are optimistic that we will be able to participate. We are currently slightly overweighted in Energy and underweighted in Finance. We still feel that fundamentals support these positions. Energy is likely to remain expensive for some time and inflationary pressures will work against financial companies. We would like to add to our Energy holdings at an appropriate entry point.

If you would like to receive additional information from us electronically and have not already sent us your email address, please send an email to us at [arborcapitalmgt.com](mailto:arborcapitalmgt.com) and ask to be added to our email list.

We appreciate the opportunity to be of service to you. Please call us anytime to discuss your account, particularly if you have any changes in your goals or lifestyle. We extend a special welcome to the many new clients who have joined the Arbor family in the last quarter. If you know someone or an organization that you believe would benefit from our services, please mention our name. We would be honored to have more clients like you.

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

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*For investment advice, clients or interested persons should contact their Arbor Capital representative.*

**Lawrence T. McGowan**

100 Corporate Parkway, Ste. 136  
Amherst, NY 14226  
(716) 446-9111  
[ltmcgowan@arborcapitalmgt.com](mailto:ltmcgowan@arborcapitalmgt.com)

**D. Bruce Kratz, Esq.**

1061 E. Indiantown Rd, Ste. 400  
Jupiter, FL 33477  
(561) 748-9611  
[dbkratz@jhjllp.com](mailto:dbkratz@jhjllp.com)

**George J. Strubel**

2325 Vanderbilt Beach Road, Ste 102  
Naples, FL 34109  
(239) 598-3888  
[gjstrubel@arborcapitalmgt.com](mailto:gjstrubel@arborcapitalmgt.com)