



Arbor Capital Management

Investment Overview

Despite the apparent confusion, the economy remains on track and in good health. This is borne out by most of the economic data that we have available. Some of the key points are:

- The Institute for Supply Management's Purchasing Managers' Survey is still well over 50 indicating the economy is still expanding.
- Unemployment is at a 6 year low and appears poised to improve further.
- Commercial and Industrial Loans are expanding while non-performing loans are shrinking as a percent of total loans.
- Consumer debt as a percentage of Personal Disposable Income is in a clear downtrend albeit from a relatively high level.
- Housing starts are slowing from their blistering pace but are still fairly strong.
- Non-Defense Capital Spending not including Aircraft is robust.

When reflected upon later in the business cycle we think the current period will stand out as a turning point. Economic leadership is rotating from consumer spending driven by mortgage refi's to growth in real wages driven by higher capital spending and job creation. The industrial sector's main challenge at this point is how to address the low cost of labor in the rest of the world, China, India and Mexico in particular. The foremost comparative advantage of the United States is our ability to raise and efficiently deploy capital. If we are not willing to work cheaper then we must accelerate productivity or accept a lower standard of living. The arithmetic simply cannot support another conclusion. Of course, this source of spending is stronger and more sustainable because it is driven by economic value added and not by deficit creation.

The Asian economies are expanding more rapidly than the West and that is a trend that is likely to remain in place for several decades. The continent's comparative advantage is fairly obvious. There is an extraordinary number of people vying for very few jobs. Wages are a fraction of those in developed countries. For this reason many economists feel that manufacturing jobs will continue to be exported to places like China and India. However, as the Asian economies grow demand for goods will expand at least as quickly. Consider the fact that nearly 2-Billion people will be gradually moving into homes with running water, and electricity for the first time. The demand on global resources like energy, metals and capital goods will be enormous. The demand for finished consumer goods will follow shortly behind. This suggests that we are in the midst of a long-term uptrend in industrial commodity demand. Unless new supplies are located, prices will be on the upswing as well. We expect that commodity prices will still track along the business cycle but that the impact on domestic US business from Asian influences will be growing consistently over time. Since the Asian economies are far more volatile than those of the West, we can probably expect wider price swings than in the past as well.

Much of the Asia's industrialization will be in direct support of local demand. For many products, logistics and local tastes dictate that manufacturers be in close proximity to their end markets. We think that much of the forthcoming manufacturing capacity will be absorbed by local markets. This new demand will take some pressure off western manufacturers but not enough to ignore wage and price discipline. For the West the task is to continue to innovate and develop new technologies to offset the abundance of cheap labor elsewhere in the world. All other things being equal we expect that US companies will continue to invest heavily in productivity enhancing equipment and worker training.

Price action of the broad indices over the past quarter has been somewhat unsettling to some. When viewed from the perspective of history we have just experienced a fairly normal 10% correction. Despite the discomfort it may have caused there really is no cause for alarm. We are reviewing our equity portfolios in light of the general price readjustments to see if there are areas where we can improve our positions. As always our focus is

on companies growing more rapidly than average with exceptional balance sheets and strong competitive positions. In light of the turmoil in the Middle East and the increased demand for energy from India and China we may add another oil related name or two over the next quarter.

We do not foresee an imminent problem with housing prices. Rather we view them as a nascent source of concern. Particularly vulnerable are home prices in places like San Francisco. Speculation in resort property has its risks and can lead to financial setbacks. However, a speculative bubble in primary residences can lead to even more dramatic impact on families. Some areas have seen prices rise so rapidly that one wonders how even well paid executives can afford to raise a family. Hence, we think a meaningful home price correction in some regions is all but certain. We just are not as sure what will precipitate the event. Possible triggers could be: loss of a large regional employer, a natural disaster, or a general recession. The first two are hardly possible to predict so it appears likely that when we have our next recession home price imbalances will correct. This will probably result in a recession that is deeper and longer than would otherwise be the case. The economy is clearly expanding so a crisis in real estate price declines is improbable at this time.

That having been said, in most prior business cycles mortgages had been held by local issuers. Currently, very few mortgages are held directly by Banks, most are repackaged and sold as pooled GNMA or FNMA securities. What this means in this context is that the aggregate pain of a regional problem will remain the same but it will be shared more broadly by extension in mortgage backed securities resulting in fewer disruptions in the banking system. Accordingly, we are advising clients to steer clear of new purchases of mortgage backed securities (MBS) and to gradually reduce positions where possible. Despite federal guarantees underlying many of them, the spreads between MBS and fixed coupon securities will likely widen substantially. In this scenario Treasuries would be strongly favored. For the time being we are still emphasizing defensive positions because of the Fed's upward bias toward interest rate policy.

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Chief Investment Officer

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