



Arbor Capital Management

Investment Overview

The rigor of the US economy continues to confound its critics. The economy is continuing to expand but at a slower rate. Capital spending, Employment and Industrial Production all remain strong. Interest Rates are moderating.

The Fed has suspended, for the time being, its policy of steady raises in the Fed Funds rate. The current Fed Funds rate, that has risen from a monthly average of 0.98% in December, 2003 to 5.25%, is still well within historic levels that have allowed growth. However, today's Fed Funds rate represents a fivefold increase over the cyclical trough. A pause at this point seems to make logical sense. We have often commented that there exist long lags between rate increases and their impact on business activity. The steady drumbeat of 25 basis point increases in the Fed Funds rate is intended to produce gradual restraint against inflation without precipitating sudden business contraction. Provided the slowdown lasts for more than a quarter or two, the Fed hopes to gradually ease rates to maintain growth. This is the soft landing scenario that we think will unfold. In our opinion it would take a fairly large exogenous shock such as another 9/11-style attack or housing price debacle to trigger a recession in the traditional sense. In the future we will need to focus increasingly on the Global economy. China and India's real economies are growing at roughly twice the US rate and will grow markedly in world influence. Eastern Europe shows much promise for growth and development.

We view the current pause as an opportunity for the economy to relax and digest all that has developed over the past few years. After a while we expect more rapid growth to resume. Normally under these conditions one would expect the yield curve to steepen fairly sharply. Short rates would fall and/or long rates would rise. The foreign demand for Treasuries is so great at this point that the long term interest rates may stay well below the usual inflation plus 3-4% for an extended time. The Fed estimates that the impact is roughly 1-1.5% in yield. Relative to inflation, we think long term bonds are significantly overpriced. Should the US dollar weaken, bonds would fall sharply because of the overvaluation and extraordinary flight from the dollar by foreign investors. To put this into perspective the current 10 year Treasury yields approximately 4.70%. If it were to yield 5.70% one year from now the bondholder would earn his coupon of 4.70% but lose nearly 8% of principal. For this reason we remain defensive. Provided the soft-landing scenario unfolds, then any decline in rates over the next 6 months or so would really be a bull trap. In other words investors may become overconfident (bullish) and later find themselves seemingly trapped in an unattractive situation. Our recommended defense against this potential is a simple laddered approach with roughly equal quantities of bonds maturing in successive years so that as each matures, reinvestment can occur at higher rates. This is our current posture.

Corporate earnings are expected to decelerate in 2007 from about 12% for the current year to a more average 6% next year. If rates remain flat over the next 12 months then stocks are undervalued by over 30% according to the Fed's model. If rates rise by 1% as suggested in our previous example then stocks should grow 15% or so. Of course, rule of thumb estimates like these rarely provide much precision, but the relative order of magnitude differences between potential returns for stocks vs. bonds are meaningful. Therefore, stocks are much more attractive than bonds at this time in our opinion. Manufacturing activity has been strong. Capacity Utilization has continually shown strength and is beginning to show signs of constraint. Not surprisingly commercial building activity is on the rise and capital spending has remained

brisk. Capital spending can be overdone but, the current environment is anything but overheated. This is a positive sign for the future prospects of the economy and continued advances in productivity. Manufacturing is in global competition. Most company managements get it.

Energy prices are on the forefront of many investors' minds. There are two main influences we see. The first is the continuing industrialization of China, India and renovation of Eastern Europe that is growing demand for petroleum and other forms of energy. The ill effects of higher oil prices as a result are at least partially offset by increased economic growth. The second is that the largest suppliers of petroleum are hostile to the West in general and the United States in particular. In our view, it is the volatile tempers in the Middle East that will have the greatest influence on oil prices. Iran's president Ahmadinejad appears singularly determined to drive the world into a global conflict. Hence, his bellicose comments are particularly troubling to oil traders sending prices soaring. At the same time the excess capacity of many of OPEC's low cost producers are stimulated to produce more than their quotas which adds to short-term supply. The unease of a plausible threat that would completely shut off the worlds largest oil producers combined with intermittent supply imbalances will make oil prices exceptionally volatile for the next several years. Demand considerations are likely to produce a general upward bias.

During the recent oil sell-off we exited some of our oil names in order to reduce portfolio risk. Provided an entry point presents itself, we intend to bring Oil shares back to at least a market weight. We will be using periods of market weakness to redeploy the extra cash into leading companies with exceptional growth and management characteristics.

We would like to take this opportunity to commemorate our friend and colleague George Strubel who passed recently after a long illness. Those of us who have had the pleasure of his acquaintance will surely remember a true gentleman with a cheerful disposition and can-do attitude.

Gerald T. Cole, CFA
Chief Investment Officer

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