



Arbor Capital Management

The economy is opening the year on a mixed note. Each area of weakness that we can identify appears to be countered by at least one other source of strength. Here are some examples of what we mean:

1. The Purchasing Managers Index has been in a general downtrend since its most recent peak in 2003. Last month it declined below 50 indicating economic contraction but this month rebounded into positive territory perhaps signaling an end to the slowdown may be at hand.
2. Non-defense capital spending pulled back a bit in the fourth quarter but is still near peak levels.
3. The housing refinancing boom is over and some markets are exhibiting signs of home price contraction. However, employment is strong and disposable personal income is expanding more rapidly than inflation. This means the overall standard of living is improving.
4. The Fed has tightened short term interest rates steadily which usually causes a recession. In this business cycle the discount rate rose off a very low base so its increase in percentage terms is quite high, yet the cost of capital as measured by the 10 year Treasury remains quite modest. So while rate increases are a net drag on economic expansion the current absolute level of rates is hardly onerous.

The upshot of all this is that the economy is in a slowing phase where the year to year rate of increase of economic growth is diminishing but not turning down (i.e. entering recession) in our view. We think inflation will recede a bit, helped mostly by moderating energy prices. At year end we think interest rates will be roughly unchanged. However, if the slowdown is more persistent than we expect then rates could dip a bit this spring followed by a general rise commensurate with business activity that we expect will be strengthening in the fourth quarter. There are three risks to this forecast that are impossible to quantify:

1. A terrorist attack of the magnitude of 9/11 would likely be sufficient to precipitate a recession.
2. Oil prices could skyrocket if Iran were to act on its bellicose remarks.
3. A Democrat controlled Congress may seek to increase tax rates which would be viewed as anti-growth by stockholders and met with a Bronx cheer. Bondholders would rejoice because it would depress the economic growth and inflation which would drive bond prices higher.

Because any of these could plausibly occur within the next 12 months, the range of potential economic and investment outcomes is wider than normal. We prepare for this by balancing risks in



our portfolio construction. All other things being equal Stocks remain more attractive than either Bonds or Cash in our view.

We are adopting a more neutral posture in our fixed income portfolios by building laddered maturity structures with high quality bonds. The additional yields derived from taking incremental credit risk do not seem to make sense in most cases at this time. Balanced accounts can expect to see a gradual increase in bond allocation weights toward a more central point relative to each account's asset allocation guidelines.

Equity portfolios are expected to continue to emphasize growing world wide demand for energy and natural resources, capital spending particularly in technology and the consumer. Our bottom-up equity selection process is oriented to select companies with strong future growth in earnings and exceptional balance sheets. In the year going forward we expect to include consideration of the possible economic shocks we discussed previously.

The one constant in investing is change. As long as we can anticipate and adapt effectively our clients will continue to benefit. This is our competitive advantage.

Gerald T. Cole
Chief Investment Officer

January 8, 2007

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