



# *Arbor Capital Management*

## **Investment Overview**

The economy is continuing its slowing trend. Business cycles typically grow at 2-3% after inflation with occasional bursts to a 4-5% range. We had a brief foray above 4% and now things are settling back to the trend-line. It does not appear likely that a recession is on the horizon this year though a slowing economy fosters fears and occasional dislocations.

The main reasons we are confident in the year ahead is that the consumer is still in pretty good shape. Employment conditions are better than they have been in years. Unemployment and the median duration of unemployment are low. Disposable personal income is growing more rapidly than inflation which means the standard of living is increasing. Consumer sentiment is understandably strong.

Industrial production, capacity utilization and capital spending have all grown strongly since the 2001 business cycle trough. Some cross-currents are surfacing in some of the key economic indicators. Erratic fall/winter/spring weather has taken its toll on consumption, industrial production and capital spending all of which were due for a pause. The recent decline in housing starts also had a negative impact on spending in general. Housing is in the process of unwinding a speculative bubble that is focused on areas of Florida and California. It still appears as though most financial damage will be localized. Most homes are owner occupied so home prices tend to be fundamentally supported by jobs. As long as job growth continues there should be a relatively soft landing in this sector. There is no current evidence of a general spillover into the rest of the economy at this time. However, negative headlines about any large-scale financial difficulty tend to make investors a bit jumpy about investments in general and Real Estate in particular.

To their credit, bank balance sheets in the aggregate are as strong as we can recall. The current practice of selling and/or securitizing mortgages has greatly reduced the possibility of individual banks being driven to failure as was the case with The Bank of New England in 1987 or First Pennsylvania a few years earlier. Most bank managements also reserve against non-performing loans more aggressively than in the past. We expect the impact to the banking sector from sub-prime loan problems to be well contained.

We expect to the economy to "muddle through" the next few quarters with slow growth and low inflation. Contrary to what some market pundits suggest, we do not believe that a recession is imminent. We think the economy needs to catch its breath and regain its footing before its growth rate can expand later this year.

Interest rates in this climate are likely to remain relatively unchanged. Growth in the monetary base, around 3%, is consistent with moderate growth and low inflation. We do not believe that the Fed has any compelling reason to change policy at this time. Therefore, our fixed income posture is neutral.

Our emphasis remains at the higher end of the quality spectrum because the assumption of credit risk does not appear to be adequately rewarded at this time.

Even though we think the economy still has a good amount of growth left, we are in the later stages of an economic expansion so a gradual change in sector allocation seems prudent. Our equity portfolios will have some marginal shifts toward companies with less than average earnings shortfall risk and above average growth potential. Traditionally, these kinds of names include soaps, beverages, pharmaceuticals and the like. It seems that every market cycle has a few exceptions to this general guideline. We think technology ought to remain over-weighted. There have been a number of innovations that are gaining critical mass such as HDTV, Mobile Broadband and Fiber-Optics. Many more are close behind. For example, Intel is introducing a new chip architecture that is expected to lead to chip designs many times faster than current chips and consume less energy. Performance will be rated in terms of trillions of floating point operations per second (teraflops). The trend toward miniaturization is likely to continue unabated. Tomorrow's mobile computer more powerful than today's desktop will probably be smaller than today's cell phone. Combined with further build out of wireless broadband it is easy to envision a far more rapid flow of information. In our opinion, this will fundamentally transform the way we lead our lives and conduct business. So despite a slowdown in overall economic activity we think there are still plenty of opportunities to make money in stocks.

The first quarter performance of the Standard and Poor's 500 was only 0.64% which we think reflects the general economic softness of recent months. We still think that total returns for our stock portfolios can exceed 10% for the calendar year.

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

**April 23, 2007**

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