



Arbor Capital Management

Investment Overview

The economy is still exceptionally strong. The rate of growth has dropped substantially in comparison to the previous two years giving some the impression that we might be entering a recession. However, none of the data that we regularly review support that view.

The index of industrial production has slowed over the past few quarters but the purchasing manager's index is firming nicely which suggests a moderate improvement in manufacturing will become evident this autumn. Total capacity utilization for all industry has remained fairly high but below the level usually associated with inflationary pressure. Productivity in manufacturing is still improving which provides a partial offset to Asian price competition. This all is good news for consumers. Business is good and inflation adjusted wages are gradually raising the standard of living. It comes as no surprise that the consumer is upbeat.

The 800 pound gorilla in the room continues to be sub-prime mortgages. Many of the mortgage backed securities issued during the boom years are probably overpriced. As long as the economy stays strong and wages hold up, consumers ought to be able to maintain their debt service and avoid widespread crisis allowing Banks to bury their problem loans over the next several quarters. However, a shock to employment such as a recession could be devastating to some regions of the country and possibly spill over the rest of the country. We think it is probable that home and bond prices gradually approach equilibrium over the next year. After that point, home prices are expected to remain flat for quite a while. Bond yields are expected to creep upwards over the next 12 months. Due in part to readjustment of mortgage backed securities and demand for credit. We remain a bit cautious towards bonds. Our emphasis is on issues with short maturities or defensive structures and high credit quality.

Energy as a theme has a very long way to run in our view. In a nutshell the long-term demand for oil as a fuel source is likely to continue to grow at a rate far exceeding the world's near-term ability to meet it. This means the path of least resistance for oil prices is up. Oil will still be subject to cyclical ups and downs but the secular trend is well established. Alternative energy sources or revolutionary technological changes that could have a material impact on our energy needs remain years if not decades away. The recent upward move in oil has only recently matched its previous peak after adjusting for inflation. This is why consumers have reacted so mildly. Still, higher oil prices lead to aggregate behavioral changes. The extra \$50 or so spent on gas each week means many will tighten their belts in other areas such as dinners out or other discretionary items. The pace of energy's increase in price has been gradual which has allowed many to make orderly adjustments. This could change. Iran remains a wild card. The regime there is directly involved in fostering the violence in Iraq and it insists on building nuclear weapons in defiance of UN resolutions to the contrary. A military response to Iran's actions may prove necessary. This would carry with it the additional risk of closure of the Straits of Hormuz. Should that occur, then oil would spike sharply higher and general inflation would likely follow closely behind. We intend to maintain an over-weighted position in the Energy Sector.

Over the next several years Europe and Asia are expected to grow at about twice the rate of the United States. This means that corporate profits will come increasingly from foreign sources which will heavily favor large multinational companies. Fortunately, this plays into our strength. The majority of companies that we purchase derive a significant portion of their earnings from overseas sources. This means that they should perform better than their counterparts who do not.

We have been taking profits recently and have readjusted our equity portfolios. We have a very attractive list of companies that we would like to add given the right entry point. We currently favor three sectors: Energy, Healthcare and Technology.

Gerald T. Cole, CFA
Chief Investment Officer

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