



Arbor Capital Management

INVESTMENT OVERVIEW

We continue to forecast an expanding economy. Industrial production and capacity utilization remain strong. The purchasing manager's composite index is still signaling expansion but at a slower rate. The labor force is fully employed. In the near term we expect that oil prices will stabilize and maybe decline a bit. That would effectively remove a key component of inflation pressure. Thus the stage is set for a reasonably good economic performance. We think that these forces are likely to be sufficient to carry the economy forward for quite a way.

Longer term, there are two fundamental difficulties that are creating macro-economic headwinds for the next several years: the ongoing housing meltdown and weakness in the dollar. We think they will become linked. The housing issues of today are expected to have repercussions for years to come. Throughout most of our history, home prices have been very slow moving. The price run up in housing during the past decade was extraordinary. We expect that the bottom in prices is still several years away for some regions. As we have written in the past, the second homes in resort cities are likely to be hardest hit. It is too early to speculate where a bottom may develop. There is excess inventory of new construction that needs to be sold. Miami has over 18 months of overhead supply. In the event of recession absorption rates can slow, dramatically stretching 18 months of supply over two years or longer. In the coming months we expect to hear an increasing number of anecdotes about the people who took high paying jobs in locations with very high home prices only to see their equity wiped out in a few months time. At some point loan to value ratios may turn negative, whereupon the regulatory authorities generally step in and demand more money and/or restructuring of the mortgage. All of this can take place with minimal impact to the overall economy provided it occurs in a relatively orderly manner. This contains the problems that may arise to a regional level. Competing locales that did not have the great increases in prices would be able to adjust, and possibly benefit, from a new influx in buying interest because of their relative stability. Were a disorderly liquidation to take place then the risk would be a spill over to the rest of the country in the form of loss of confidence in the economic system and panic selling of assets of all types would be the likely result. There are two keys to the solution to this problem.

1. **Jobs.** As long as employment remains high, then there will be enough cash flow in consumers' pockets with which they can service mortgages forestalling a widespread breakdown in home prices.
2. **Easy Money.** By keeping rates low the Fed can help the housing market imbalances clear. Any market will clear more easily in the presence of enough liquidity.

However, this is not without cost. Since the housing market is expected to be problematic for a few years, we expect that there will be times when rates will be held artificially low. Holding interest rates lower than they otherwise should be results in currency weakness relative to one's trade partners. Hence, a direct result of easy money policies would be a weak dollar. In the short term this is a benefit. Import prices would go up and US made goods would be relatively cheaper at home and abroad. For a time, US employment would benefit. Longer term, inflation would be built into wage and cost structures that would be difficult to reverse. People relying on Social Security as their principal income source would face costs rising more rapidly than their cost of living increases.

In the near term, we expect short term interest rates to decrease somewhat and remain stable in the 7-10 year range. Long term bonds could see yields rising. In other words, we expect the yield

curve to steepen over the next twelve months. We would resist temptation to reach for yield at this time. We think better buying opportunities lie ahead for bond buyers.

As the current business cycle ages we expect that equity selection will become increasingly more important. Sectors that we favor now are Health Care, Technology and Energy. Oil companies' earnings will still be heavily influenced by cyclical demand but the secular growth in demand from Asia is expected to lead to a series of higher highs and higher lows. Technical innovation has been progressing more steadily than new product introductions. We expect to see a wave of new products over the next year. Health Care earnings are relatively insulated from the business cycle and this characteristic will work in their favor over the coming quarters in our opinion.

Over the next year we can expect higher than normal volatility driven by the acrimony of US politics, uncertainty in the oil sector and the increasing tensions with Iran. Therefore, we expect a choppy year ahead. Provided we remain as disciplined as we have in the past, we should have a performance that outpaces the broad markets. We think we are well positioned today for the year ahead.

Gerald T. Cole, CFA
Managing Director

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