



Arbor Capital Management

Investment Overview

2008 has opened with a challenging mix of conditions. Most indicators such as Industrial Production, Capacity Utilization, Capital Spending and the ISM – Purchasing Managers Composite still indicate an expanding economy but at a slower rate than the previous year. The risk of entering a recession is increasing. We think there is better than a 50% chance that we avoid one. However, the slowdown will feel like a recession to some. In the event we do technically enter recession we believe it will be short and shallow. As can be expected, there is both good news and bad news. There are five inter-related elements that are central in our focus.

1. Housing Crisis. The ongoing housing crunch is still making headlines, which is keeping many investors on the sidelines. As we have stated in the past, the crisis is really limited to a few regions and not the entire country. Those areas that still have excess new housing stock will continue to experience weakness for another 1–2 years. We do not expect a full recovery until midway through the next business cycle. This will continue to be a very rough environment for homebuilders and developers but the average homeowner is not directly impacted. The indirect consequences, however, are meaningful. The drumbeat of problems in the news has a negative wealth effect. That is, hearing of other people's problems leads to a diminished sense of financial well-being that in turn leads to more cautious spending behavior.

2. Banking. Banking woes have been overplayed by the press in our view. In the aggregate, the capitalization of the banking sector is as strong as we can remember in terms of Equity/Assets, loan loss reserves and non-performing loans as a percent of the total. To be sure, many banks engaged in questionable mortgage underwriting standards. However, the vast majority of the single-family mortgages that resulted from these lowered standards have long since been repackaged into pools of securities and remarketed. Thus, the brunt of the pain from poor lending decisions has been shifted onto the shoulders of the bondholder and away from the originating banks. Banks in turn also purchased many of these securities and mark them to the market quarterly. There is also some fallout in the loan portfolios. In this type of climate we can expect most bankers to clear the decks of any questionable loans and aggressively add to reserves especially in light of Sarbanes-Oxley reporting requirements. Earnings will likely be weak in the first half of the year with some recovery in the second half. This sets the stage for exceptional earnings comparisons a year from now as recoveries from many of the charged off loans are made and the mortgage-backed bond market regains its footing. We think banks are exceptionally cheap at the present, but volatility will likely remain very high making entry into new holdings a little tricky.

3. Monetary Policy. Late last summer the Fed cut rates for the first time in this business cycle. The money supply almost immediately accelerated. Recently, Chairman Bernanke indicated he may advocate sharp cuts in the coming months. The effect of this type of stimulus typically takes around 6-9 months to make its influence fully evident in the general level of economic activity. Like the cavalry charging over the top of the hill in a John Wayne movie, monetary stimulus ought to be coming to the rescue this spring with reinforcements close behind. This is the main reason we expect the downturn to be fairly short and shallow.

4. The Dollar. Early monetary policy has contributed to weakness in the dollar. The initial consequence of dollar weakness is increased cost of imports, which is inflationary. However, the cloud of dollar weakness is not without a silver lining. US goods and services become cheaper relative to foreign providers. All other things being equal, this increases demand for US products. Industrial production benefits, as does demand for workers. The lag between the increases cost of imports and the stimulus of cheaper US goods is referred to as the J-curve. We expect you will be hearing more about this in the coming months from financial news outlets.

5. Jobs. In sports it's all about speed and distance. In economics, it's all about jobs and time. As long as people are working they can generally meet their debt service requirements. Stable to growing employment will help generate the cash flow that consumers need to avoid defaults. Time and a comparatively stable economic climate are what are needed to slowly let the air out of the housing balloon. Stronger job markets lead to higher consumer creditworthiness which strengthens the underpinnings of our financial system. The striking thing about this is that these are the types of conditions normally spoken of mid-way through a recession but, as we stated in our opening paragraph, the lion's

share of economic indicators are still indicating growth. This is why current conditions feel like a recession to some. However, most leading indicators are still pointing toward modest growth. We expect slow growth throughout the year.

Long term interest rates may drift a bit lower in the next quarter or two but not by much in our view. Short term rates will respond in unison with the Fed's moves. As a result we expect the yield curve to steepen. Despite the relative improvement in attractiveness in reaching out the yield curve for higher returns, we would recommend keeping fixed income commitments short term. The price of pumping cash into the economy is increased risk of accelerating inflation which could precipitate a sharp rise in long term rates which would further steepen the yield curve. We expect the 10 Year Treasury to end the year in the neighborhood of 4.50%. We are keeping new fixed income commitments short and defensive at this time. We think better buying opportunities for long term bonds will become available in the next year or two.

The equity market is being pummeled by a constant drumbeat of negative press. Our review of the available facts suggests that the sky is not falling as they would have us believe. It appears to us that the press is engaging in a feeding frenzy usually reserved for tabloids and Fed Chairman Bernanke has done a poor job of communicating confidence in his stewardship of the financial markets. This strikes us as a perfect storm of bad press. Barring another major economic setback, we expect a fairly robust recovery of stock prices in the second half of the year. Our quantitative valuation criteria show the S&P 500 to be undervalued even when testing against a harsh shock scenario of drastically reduced bank earnings and a sharp rise of 150 basis points in bond yields. Seasoned investors know that from time to time stocks perform in a way more driven by emotion than logic. We feel we are at one of those points now. Over the next few weeks the calendar year 2007 earnings will be announced and we expect more volatility throughout this period. We expect to use this to our advantage in restructuring some of our names. Our emphasis will be Energy, Healthcare, Technology and possibly Banking. Overall, we expected to raise cash levels a little during periods of strength.

Gerald T. Cole, CFA
Managing Director

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