



Arbor Capital Management

Investment Overview

The economy is growing at a snail's pace. The first quarter of the year registered growth of 0.9%. The combined effects of the housing/finance crisis and higher oil prices are taking their toll. The tax rebate checks appear to have had an effect, but it remains to be seen whether or not they were sufficient to get the economy to turn the corner. The aggressive action taken by the Fed last autumn should be gaining some traction over the remainder of the year. This should help the overall economy regain some forward momentum.

The Financial Sector is undergoing deeper than expected retrenchment. Many have undergone a series of personnel layoffs in response to the reduced numbers of mortgages issued. Non-performing loans and loan charge-offs have accelerated in recent months. Provided our belief that the economy will strengthen is correct, the peak in charge-offs ought to be reached within the next few months. Because the current problems in banking took over a decade to create, we expect several of them will take years to fully resolve. The overall capital position of the banking system in aggregate is still historically strong. According to data obtained from the Federal Financial Institutions Examination Council, the average bank is still reporting equity to assets in excess of 10%. Half that number, 5%, is usually considered strong. This leaves room for a substantial margin of error. It appears to us that most of the difficulties are concentrated in a few regions and companies. Once the danger is past, share prices of these companies are likely to rise substantially.

Manufacturing is the lone bright spot. The Purchasing Manager's Index (PMI) and Total Capacity Utilization time series are both reflecting a decided slowdown. The PMI however, has recently risen above 50%, which signals (modest) expansion. Capital spending excluding aircraft and defense spending is growing fueled by overseas demand. If the dollar were stronger these results would be much weaker. From this perspective the devalued dollar is competitively advantageous at this time. Payroll employment has taken some hits in recent months but the Unemployment Rate is still relatively modest at 5.5%, which is very near full employment.

The consumer is being buffeted by three things that are having a negative impact: The decline in home values, rising gas prices and rising food prices. Each of these items tends to cause consumers to make fewer discretionary purchases. The American consumer is one that is almost always seeking to upgrade. However, in periods like the present, consumers are forced into adaptive behaviors. This means: Fewer dinners out, fewer driving vacations, remodeling rather than purchasing a new home or shopping at Wal-Mart vs. Macy's. For the next year or two we expect to see changing spending patterns along these lines. This isn't the death of the consumer, just a wake up call. The upgrades that the typical consumer seeks will have to come from a little ingenuity. Necessity is the mother of invention. Americans excel at this.

Energy prices have risen so sharply that we expect a correction may be imminent. Still, they have risen beyond most people's wildest imaginings. One quick look at a chart of oil prices will reveal a nearly meteoric rise over the past year. As seasoned investors, we have witnessed countless situations where a similar surge has occurred. They usually teeter at the peak for a while and then plummet. Oil may be a little different in that demand has increased and output has not kept pace at the rate some would like. A correction is a minimum expectation for us in the short term. Longer term, we expect American consumers to adapt numerous behaviors to conserve energy as they did in the late 1970's. There are large reserves in North America that remain untapped. We expect drilling activity to pick up substantially over the next decade. Nuclear energy is also expected to have renewed interest. The technology exists

that would permit the US to meet its electricity needs for the next 100,000 years using only the spent nuclear fuel we already have in storage (Integrated Fast Breeders). Currently, special interest groups have derailed each of these projects, by arguing that each, on their own, are not sufficient to make a very big difference. These changes, however, have a material cumulative impact. All that is needed to bring any of these to fruition is the will to do so. If energy prices remain anywhere near current levels, this is not likely to be a problem. Should this country articulate a comprehensive energy policy, we believe price relief will come much more rapidly than widely expected.

We expect the Fed to hold off on any interest rate increases for a few months yet but we think the inflationary pressure of higher gas and food prices is upon us. It appears likely that long term interest rates could rise substantially by, perhaps, 100 b.ps. Our bond portfolios remain defensively constructed favoring short maturities and issues with defensive characteristics such as step-up coupons or floating rates.

Stocks are likely to continue to exhibit higher than average volatility until a clear economic trend becomes evident. We favor Technology and Health Care. Even if we are to have permanently higher oil prices it is logical to us that the price of oil should undergo a fairly substantive correction. We expect to pare back on some of our Energy holdings but we will favor those that will benefit in the future: Drillers and Refiners. Once the charge-off wave in finance begins to recede, we expect to raise the sectors portfolio weight to at least a market weight.

Gerald T. Cole, CFA
Chief Investment Officer

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