



# *Arbor Capital Management*

## **Investment Overview**

Up to this point the economy has exhibited remarkable resilience. However, the financial market conditions and the extreme credit crunch have pushed us into recession, we believe.

The bailout is now in full swing. We hope that it is sufficient to bring the capital markets into equilibrium but suspect that additional programs may be required. By most estimates, about two thirds of the financial write-downs are completed. This means that there are probably a few nasty surprises remaining that markets will have to absorb before this episode can be put behind us. Still, ripple effects will span generations into the future.

The combination of events over the past year has caused the capital markets to come to a near complete standstill. Inter-bank lending (LIBOR / Fed Funds) and Commercial Paper are all trading at sharply higher yields. Going forward one important sign to watch is LIBOR which is a market driven analog to the US Federal Funds rate, or the rate at which banks lend to one another. LIBOR is currently at 4.64% as compared to the Fed Funds target rate of 1.50%. For the capital markets to get going again, LIBOR needs to trade much nearer the Fed Funds target rate. The current disconnect between the two rates indicates a near total lack of confidence. Restoring these markets is critical because they allow businesses to fund payrolls, receivables, shipments and numerous other items essential to keep commerce running smoothly. Without them, there is no economy. Central Government guarantees are very helpful in restoring confidence but will take time to produce results.

The capitalization of financial institutions worldwide has been weakened substantially. Those companies that need to raise capital have been forced to sell at any price. Under mark to market rules other institutions are required to use current transactions, regardless of their circumstances, as their pricing benchmark. This means one distress sale becomes a price to which all other companies that own the security need to reflect in their portfolios. Regardless of the circumstances surrounding the sale, this flows through finance companies balance sheets in such a way as to become a de facto write-down. Many companies have had their capital positions impacted through no fault of their own. Under extreme capital base stress, financial institutions cannot extend credit at any price. This has a cascading effect that, left unchecked, becomes a downward spiral that can threaten us all. The recapitalization of the world's banking system through government interventions is intended to halt forced liquidations and allow distressed assets to track back toward their true economic values. Once accomplished, the flow of credit will be able to resume. Because prices have been so relentlessly pummeled, the US bailout program should make a great deal of money upon resale of its acquisitions.

Many of the programs initiated worldwide have a stimulative effect that will become evident several quarters in the future. Besides propping up distressed securities, the Government purchases are a dramatic addition to money supply. Granted, a lot of assets have become permanently impaired which has the effect of a reduction of money supply. Balancing the opposing forces is imprecise at best. The Federal Reserve has its work cut out for it. It will take discipline and additional co-coordinated multi-national action to avoid causing additional instability. Once things recover the task becomes unwinding a vast number of trades. This can also be problematic. Governments' sale of securities reduces money supply and has to be treated with at least the same care taken in purchasing them. A further complication

in Government selling is: What kind of signal is being communicated to the market place? People will undoubtedly parse each move to the limits of human tolerance. As investors we need to remain vigilant of potential Government policy errors. This is new territory.

The US Economy has weathered a lot. Still, it is only now beginning to show the effects of a year of wear and tear. Unemployment has remained steady for the month of September at 6.1% which is still near full employment. This is an increase of 1.4% over a year ago. The September Purchasing Manager's Index was 43.5% indicating contraction for the month. A look inside the number shows most of the weakness is in housing related areas and apparel in contrast, Capital Goods was strong. Job approval ratings of Congress are at all time lows. Home prices are still in retreat but there has been a good up-tick in the number of existing home sales. As can be expected Consumer Confidence is the lowest it has been since 1980. In a nutshell, consumer spending is weakening sharply and credit is tightening rapidly. These are classic pre-recession conditions. It is unclear how deeply things can deteriorate, however, the general trend is contraction. Because the Fed and Treasury are already acting aggressively, we think it is possible that negative growth may be limited to the fourth quarter of this year and the first quarter of next year. We think the recovery phase will take longer than usual to build up because housing prices are likely to be a drag on growth for the foreseeable future. For the last several years housing had been adding about 1.5% to GDP. Over the next several years housing is likely to detract by 1.5%. GDP growth for all of 2009 should be around 1-2%.

Government purchase of securities constitutes a monetary stimulus. Accordingly, some might worry about the inflationary impact of so large a program. The simple truth is no one knows for certain. However, we think that loss of homeowner equity and depreciation of mortgages probably more than offsets the monetary stimulus. By our rough estimate, net inflationary pressure is near zero at this time. Upward pressure on interest rates ought to remain subdued until economy recovery is clearly evident. Our forecast is for the 10 year Treasury one year from now to be somewhere between 4.0 and 4.5%, only slightly higher than current levels.

The fixed income markets have been understandably driven by credit issues causing a wholesale flight to safety. Treasuries have rallied while nearly every other credit has retreated. Spreads between Treasuries and other instruments have widened considerably. For example, at the time this is written, the Ten Year Treasury yields 3.99%, a typical 10 year Government Agency yields 5.49% and a single A Corporate (AT&T) yields 7.7%. We think high grade corporate bonds represent excellent relative value at this time. We will be looking for opportunities to swap up to a third of taxable agencies into high grade corporate bonds. Creditworthiness and stability of revenue streams will be paramount in our selection process. In those cases where we purchase municipal bonds we will continue to make quality judgments more on the basis of the strength of the underlying credit rather than relying on the strength of municipal bond insurance companies. We have regarded the incremental value of municipal bond insurance with "a grain of salt" for many years.

Earlier this month we took a painful step of aggressively raising cash. The tipping point for us was the rapid combination of sharp declines in a large number of economic indicators that we watch. This convinced us that the length and depth of the stock market decline still has a long way to go before it will have run its course. The dominant forces at work currently are forced liquidations (margin calls), short-selling and uncertainty about the economy. For the time-being fundamentals have taken a back seat. A bottom will be formed when sellers have been exhausted, not before. Typical bottoming action is a bounce off a price level followed by a retest of the previous low. The following rally generally indicates whether or not the bottom has been made. This waiting game can be un-nerving at times, but it has been the way these things have resolved themselves for over 100 years.

Also the new economic climate will require that most analysts revisit their earnings estimates and we expect that most will have some changes. We think that the conclusion of this process will roughly coincide with the market bottom, hopefully, before year-end. At that time our objectives are to:

1. identify when a market bottom has presented itself and
2. select equities of high quality companies that are likely to outperform the broad market at lower risk.

This market has punished many excellent companies for little or no reason. It is our intention to build portfolios from the cream of the crop. Market conditions may dictate our pace somewhat, but we expect to go about this gradually. It is better to be out of a trade you would like to be in than in a trade you would like to be out of.

This has been an extremely frustrating 12 months that has tested the patience of even the most stoic among us. Order in the world's markets will be restored. We are uniquely positioned to take advantage of the opportunity that has been provided to us. We are looking forward to doing so and restoring profitability to our portfolios as quickly as we prudently can. We have accomplished this on several prior occasions (1978, 1979, 1980-81, 1987, 1992, and 2000-2001). There is no reason we cannot do it again. The world has handed us lemons, we intend to make lemonade.

Things have been changing rapidly and there are many details that we have given short shrift to because of constraints of space. Please call us if you would like more background information or to discuss your account. We are here to help.

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

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