



ARBOR CAPITAL MANAGEMENT

The financial markets and economy are acting as we expected. Macroeconomic statistics are still deteriorating in response to the financial shocks of the past year and we still expect them to be at the worst levels of the recession this Spring. Over the next several quarters the overall economy is still expected to contract but at a decreasing rate. Growth just above zero should become evident in the first quarter of 2010. Both stocks and bonds are likely to act well in advance of a resumption of economic growth.

Collectively, the global economy will decline for the complete year for the first time since WWII. The OECD's most recent forecast revised the expected global contraction in GDP from -1.0% to -1.7%. China and India will avoid recession but their growth rates will be much slower than their recent experience. The US economy has had a few glimmers of hopeful statistics that have helped propel share prices higher. However, under closer examination they are mixed at best. Many of these series are volatile and corroboration by several leading indicators is required before we will conclude that a bottom in the business cycle has been reached.

Housing is still under pressure despite the fact that Existing Home Sales recently posted a sharp increase of units sold of 5.2%. However, the median price declined 15.5%. Standard and Poor's predicts that the housing recovery is still a year away. Given what we are reading about the state of foreclosures, this may be optimistic. There are currently over 600,000 foreclosed homes nationwide that have not been sold and the moratorium against additional foreclosures has just been lifted. We expect a surge in the number of homes listed for sale. Once home prices stabilize we expect an extended period of very slow appreciation, in general. Mortgage rates may decline further to the 4.0% area helping to clear excess inventory of housing. However, the volume of refinancing activity that normally accompanies declines in mortgage rates will be muted because most banks have greatly tightened lending standards. In the face of weak home prices many banks are still trying to reduce mortgage portfolios. We think that the usual practice of refinancing in order to take equity out of one's home will be greatly curtailed during this cycle. This will tend to dampen recovery of consumer spending.

Capital spending and the Purchasing Manager's Index also posted upticks. However, the current levels are so depressed that we are not convinced that they mean too much right now. The inventory to sales ratio has had an extraordinary increase over the past 18 months. The entire supply chain from producer to end user is congested, particularly at retail stores. Inventories need to clear in order to make way for new orders and the stream of activity that they create. We can expect continued price discounting at least through the summer. Unemployment is a lagging indicator that keeps rising unabated. We expect unemployment claims to exceed 10% before this episode is over. It is little wonder that consumer confidence is about as weak as it has ever been.

The combination of all this pessimistic information leads us to believe that the economic downturn seems to be exhausting itself. We do not think that things will turn around quickly. Rather, we expect that business will get less bad over time. Businesses are under much greater stress during this recession than is typical. Bouts of negative surprises in earnings and broad business conditions are to be expected. The net result will be continued above average volatility in both stocks and bonds.

In the near term net economic pressure indicates deflation. However, there is a vast amount of monetary stimulus in the economy whose eventual impact is difficult to predict. Once the economy stabilizes and begins to take up slack it will exert upward pressure on inflation. The underlying questions are twofold: when and to what extent. Containing this will require a greater level of monetary policy precision than is reasonable to expect, in our opinion. Even if the Fed gets it exactly right, the demand for financing created by the looming Social Security crisis may overwhelm its best efforts. In order to grasp this it is important to become familiar with the government sleight of hand that has been in place for decades. The "Social Security Trust Fund" never was funded. Instead, as a matter of Federal policy, the US adopted a "pay as you go" system. Withholding taxes were paid directly to retirees. The excess of withholding taxes received over benefits paid are not set aside as is frequently thought. Instead, the excess was commingled with general revenues and spent. As long as the working population is large enough relative to retirees, there is no problem. However, baby boomers comprise over 25% of the US population. The sheer weight of numbers will be so great as to require either an extensive *additional* issuance of Treasuries or a severe curtailment/modification of Social Security benefits, or both as the baby-boomers draw benefits. Congress has known about this eventuality since the 1960's and repeatedly failed to act.

We think that the combination of monetary stimulus and demand for credit created by TARP, the looming Social Security problem, and the bill for the "Fiscal Stimulus" is setting the stage for an extensive upward secular (20 year+ cycle) shift in interest rates. Moreover, we expect that the demand for credit will be so strong that market participants may require inflation adjusted returns greater than the normal 3-4%. Trying to estimate the start of such a shift is tricky at best, but we expect symptoms to present themselves within 3 years.

We think the so-called fiscal stimulus will prove to be more costly than effective. There are three main reasons we think so. One, in order to stimulate the economy funds need to be put into circulation immediately for maximum impact. The government's program pushes the spending decisions to State governments for "shovel ready" infrastructure projects. Even under ideal conditions the funds could not possibly be deployed in time to have material impact on the current recession. Two, political realities interfere with optimal spending. The temptation to our political class is too great to hope to avoid diversions to favored constituencies and pet projects. Three, few of the projects will have any lasting economic benefit at all. Once the projects are completed, the jobs they created will evaporate and little productive capacity will have been added to help repay taxpayers. Only the bills will remain which will come due at exactly the point that the Social Security System is projected to become cash flow negative. The "Stimulus" needs to be drastically modified in order to even vaguely approach a neutral cost-benefit balance. The "Stimulus Package" is counterproductive.

Our bond strategy remains defensive. We favor bonds with maturities less than five years with very strong credit. In the special case of municipal bonds we always look to the underlying credit and do not rely on municipal insurers' ratings.

The stock market typically turns 6-months +/- before the economy bottoms. This means the macro-economic timing ought to be falling into place. The recent surge of stock prices in March is encouraging but is not likely to represent the start of a new bull market in our view. The fact that the

rally was straight up without any of the normal day to day ebb and flow of a healthy market makes us skeptical. We think that sometime over the next several weeks the February lows will be retested. If so, we anticipate raising equity allocations by drawing down cash. Over the next two weeks over 25% of the S&P 500 reports earnings. It is a safe bet that there will be numerous surprises. During this period we will be further positioning ourselves to take advantage of an eventual economic recovery. This means we will emphasize: basic materials, transportation, financials, industrials and energy. We also think we will be able to acquire shares in solidly growing companies at bargain prices during selling squalls. We intend to cherry pick our entry points as the business cycle regains its footing.

We were recently notified by Informa PSN, the largest consultant data base, that Arbor Capital Management was named "Top Gun". Not only did Arbor Capital Management rank in the Top One (1) percent of Large Cap Growth Managers in both highest return and lower risk, we ranked in the Top Ten (10) managers in Informa PSN's Large Cap Universe for the quarter, year and three (3) year period ending December 31, 2008. We are honored to be recognized as a "Top Gun" Manager and look forward to continuing to provide you with the highest level of service and investment performance.

Please call us anytime to discuss your account, particularly if you have any changes in your goals or lifestyle. We extend a special welcome to the many new clients who have joined the Arbor Family in the last quarter. If you know someone or an organization that you believe would benefit from our services especially during this turbulent time, please mention our name. We would be honored to have more clients like you.

Sincerely,

Gerald T. Cole, CFA
Managing Director

Lawrence T. McGowan
Managing Director