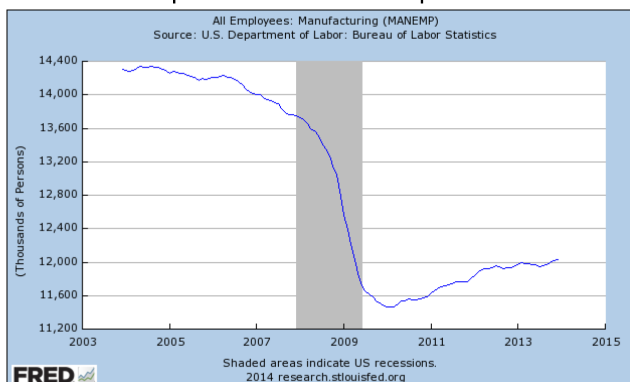
Arbor Capital Management

Investment Overview

The US Economy is continuing to muddle its way toward recovery. Stock prices have vaulted higher in the past twelve months fueled by easy money. The Fed has begun to ease off its pace of bond purchases which will add a few wrinkles to near term economic growth. 2014 is likely to be a year of transition and realignment.

New Fed Chairperson. Love him or hate him Ben Bernanke has been replaced by Janet Yellen. She has an extremely impressive resume` at the Fed and in academia. Though her comments may be somewhat out of context, she has previously expressed a slight bias to inflation and appears to be a strong proponent of the Phillips Curve that describes a relationship between Unemployment and Inflation. This theory is generally sound in relatively stable price environments but has had some noteworthy lapses in periods of extreme exogenous shocks such as we experienced in the 1970's. Recently unemployment was reported to have dropped to 6.7%, however, it was not because of the creation of new jobs as much as people dropping out of the workforce altogether. When one factors in those that have stopped looking for work and those that would like to work full time but can only get a part-time job that number swells to 13.1%. On that basis, it would appear that the Fed will tend to keep rates as low as they are able to muster. However, easing of the money supply has diminishing benefits. On balance we conclude that the most likely course is for rates to gradually move higher over the course of the year. At year-end the yield on the 10-Year Treasury could be in the neighborhood of 4%. We would expect the discount rate to anchor short term interest rates near zero for the foreseeable future causing the yield curve to steepen sharply. While we believe that tapering off the bond purchases that constitute quantitative easing is necessary we think it is important to remain mindful that the economy is relatively fragile and sudden shifts in policy can be very disruptive. In order for the Fed to step away from intervention the economy needs to show reasonable signs of strength.

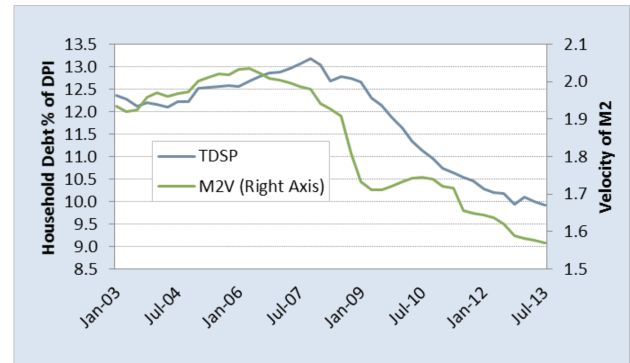
The Purchasing Managers' Index currently stands at a solid 57. Anything above 50 signals economic expansion. Over the past several decades manufacturing has suffered challenges at nearly every turn. The main pressure in the current cycle comes from outsourcing to low cost producers such as China, India, Mexico, etc. There are some signs that this problem is abating a little. Some manufacturers are repatriating some of their production. This is the result of several factors including a general rise in wages overseas and logistical problems make offshore production a lot less attractive. We would expect many managements in coming years to wonder if all the extra effort truly creates a price advantage. Economic forces ultimately level the playing field. Hopefully, the worst is behind



manufacturing job loss. What seems a little inconsistent is that consumer sentiment appears to be well ahead of the jobs data. We suspect that this is the direct result of people working for cash. The prospect of fully implementing Obamacare this year has caused a large number of business to curtail hiring in an effort to contain costs.

Housing starts are a far cry from where they were in 2007 but they do appear to have bottomed and are showing a little pick up. New housing purchases are among the most leveraged transactions both financially and economically. Existing home prices have stabilized and substantially recovered as well. Foreclosure filings are back to 2007 levels. The overall housing market is clearly healthier and gaining traction. This creates a modest positive wealth effect.

Private sector credit health has been improving steadily over the past three years. Net Loan Charge Offs and Return on Assets for the banking industry in general are in very healthy ranges. Household Debt Service Payments as a Percent of Disposable Personal Income (***TDSP***) have been in steady decline since 2008. This is in near perfect lockstep with the decline in the velocity of money (***M2V***) stanching inflation before it could even get going. Since households have significantly bolstered their balance sheets, the potential exists for a resurgence in consumer spending. The key to unlocking this pent up demand would be a dramatic improvement in consumer confidence and the pace of business. Janet Yellen's bias to inflation, if it exists, is a positive in this situation.



Globally, things are starting to show improvement. None of the European governments' debt problems have been resolved but at least they are out of the headlines. Europe is enjoying a recovery out of a recession and should provide a little boost to global final demand. Emerging Markets (EM) countries are facing the headwinds of increased supplies of raw commodities, rising labor costs, income inequality, social unrest and a comparatively strong dollar. Shares of EM companies are likely to lag.

In the final analysis 2014 looks like another year of gradual improvement that should result in marginal improvements in consumer net worth, equity prices and general economic activity. The concerns we have expressed in the past are still very real. For the time being, however, they have been pushed onto the back burner. We don't expect any breakthroughs but strong household finances and solid corporate balance sheets are definite positives.

Fixed Income Strategy. The secular decline in interest rates is over. We are in the early years of a multi-decades long general uptrend in rates. This will be a considerable headwind going forward for bond returns. We have been ahead of this development for several years. This is why our strategy uses laddered maturities over a relatively short time horizon. That having been said inflation, one of the main drivers of yields, is still quite tame. So unless something extraordinary happens, we can expect rates to gradually creep higher as the result of the slowly expanding economy and Fed tapering of its bond purchases. One of the key benefits of the laddered maturity approach is the fact that our portfolios generally have maturities every year so our clients can enjoy higher yields when they occur. We continue to favor high quality which is consistent with our principal goal of preservation of capital.

Equity Strategy. In the aggregate, equities appear fairly valued. We expect stock returns to track closely with earnings growth minus the negative effect of rising interest rates. We think a total return expectation for the year of 7%± is realistic.

Normally, five years into an expansion the economy is running at full speed and is nearing peak capacity in broad terms. Of course, today's economic conditions resemble nothing of the kind. Commodity prices for the most part are unchanged over the past 2 years. There is plenty of capacity in practically every industry. Therefore, many of the metrics one would use to over (under) weight sectors really break down. We are currently emphasizing our individual security selection processes. We continue to favor high quality companies with strong businesses.

Sincerely,

Gerald T. Cole, CFA **December, 2013**
Chief Investment Officer

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