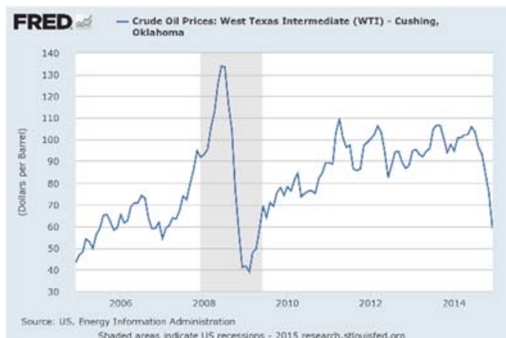
Arbor Capital Management

Investment Overview

As we enter 2015 we are a bit more optimistic about US economic growth and the prospects for good equity market returns. There still exists a very mixed bag of economic news but many of the economic time series we follow are regaining pre-recession levels. And this suggests a pickup in aggregate economic activity, corporate earnings and ultimately, share prices.

Domestic Economy. The greatest single impediment to economic growth is the lack of job creation. The unemployment rate is stated to be below 6%. In the past we would likely have said that we are near full employment. Unfortunately, the greater reason for this decline is the mounting number of long-term unemployed. The labor force participation rate is at 30 year lows.   In contrast manufacturing is nearing full capacity. The Purchasing manager's index has also clearly reflected this. Manufacture of Capital Goods has been particularly strong. Housing prices have improved somewhat but not enough to create a surge in starts.   The US economy is poised to finally realize a little organic job growth that will improve consumer demand and its supply chain.

Energy. The oil price decline we are witnessing will provide a nice bit of stimulus that could get things going on the right track. To the consumer, lower energy costs are like a surprise pay raise or found money. Suddenly there is a little extra cash at the end of the month available for a little discretionary spending. Elsewhere, transportation, heating and feedstock costs for many industrial commodities will all experience a welcome (even if temporary) reduction. Given the backdrop of the slack being gradually pulled out of the economy, this may drive positive upside surprises over the course of 2015 for both the consumer and the economy at large. The magnitude of the price decline, over 60%, suggests that a return to $80 oil is a long way off. In the short term the Street's response has been confused and a little chaotic. The lag relationship between energy prices and notable influence on economic statistics is about 5 months. As cheaper energy pushes inflation (CPI) downward and GDP growth upward we expect investor sentiment to become more enthusiastic. Hence, our optimism.



Despite the positives in the US economy, Europe is still in very tough financial shape. They will be even greater beneficiaries of lower energy costs European energy demand is supplied primarily by spot market purchases. Provided lower prices persist long enough this may serve to provide some breathing room for European governments to get back on the right track.

As the ebbs and flows of price bottoming and recovery unfold we expect to learn more about why the Saudis are driving this price correction. On one level it is natural behavior of monopolistic price behavior designed to crush competitors. This is certainly part of the explanation but we suspect that there may be a political signal being sent. OPEC has a history of using oil policy as a weapon against the west that is undeniable. To whom it is being sent is unclear. The lower price decimates Russia's ability to earn hard currency and the Ruble has been crushed as a result. New shale oil exploration and other high cost/risk drilling projects have ground to a halt. From OPEC's perspective this is like killing two birds with one stone. Nevertheless, understanding OPEC's aims will provide clearer understanding of the conditions that will presage a price trend reversal. Regardless of the motivation(s), most of the OPEC governments are dependent on a large stream of oil revenues to prop up their regimes through social spending. OPEC's tolerance of low crude prices has its limits.

Monetary policy. Chairperson Yellen has clearly stated that a rate increase is in the works for the latter part of the year. The deflationary impetus of lower oil prices may defer this a bit. The larger issue at hand is whether banks will extend the credit necessary to fund economic acceleration. Most measures of bank solvency have improved markedly over the past few years. We would argue that there is plenty of room for loan expansion. Return on Average Assets for all US Banks is over 1% which is a healthy level historically. The only element missing is a boost to business and consumer sentiment that we think will emerge toward midyear. Growth oriented legislation out of Washington would be a big help. We think that the ten year Treasury will end the year about where it started. Initially we thought that there would be a new secular upward trend in yields starting. However, the decline in energy inflation will likely push that scenario back. Our fixed income strategy remains focused on short to intermediate term bonds with strong credit.

Stocks. This year has started out on a volatile note. The combination of uncertainty surrounding European financial difficulties and the plummeting price of oil has raised investors' concerns about the future. Since there has been an unusually long period of time since stocks have experienced a 10% correction, profit taking is a rational response to many. We expect investors' nervousness to subside once the economic dividends of cheap energy come more to the forefront.

In the energy sector we favor producers because the economics remain sound. The greatest risks and costs come from exploration. Once oil is found and the well paid for, the cash flow is economic profit. The greatest shake out is happening among the drillers and service companies. We think that this too shall pass and at some point in the not too distant future we may select some of the stronger companies for inclusion in our portfolios. We have added a refiner and an airline to our Large Cap Core model to help capture some of the positives of cheaper oil. We are also exploring retail and restaurants for new additions. As always our emphasis is on high quality companies with exceptional balance sheets and visible earnings progress over the next 3-5 years.

Sincerely,

Gerald T. Cole, CFA **January, 2015**
Chief Investment Officer

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