



## ARBOR CAPITAL MANAGEMENT

### Investment Overview

Global economic growth continues to be under pressure. Much of Europe is in recession and appears unable to resolve its debt problems. China, the driver of much of the global activity, is slowing down. The US economy has continued to muddle along on a very slow growth trajectory. We expect more of the same over the next year.

Government policy, once established can have lasting impact on the overall economy, its sectors and its industries. By extension this can have sweeping effects on company profits and security market returns. The US has run budget deficits for a long time. However, we think there is a fundamental change in attitude toward spending. The President won on a tax and spend platform that is as sweeping as it is wrong-headed. We think this is a remarkable change in direction with short and long term implications.

The Federal Reserve and Treasury have been printing money to fund an ever expanding list of promises its taxpayers cannot keep. Over the past 40 years median household incomes have grown by 24%. In contrast Federal spending grew 287% (Sources: CBO and Census Bureau). Most people outside of Government would conclude that this is unsustainable. The President and the Senate apparently are delighted to make bad economic policy worse. According to the Congressional Budget Office, the "Affordable" Healthcare Act is expected to cost \$1.76 Trillion over the next 10 years, more than double the original estimate and will cover fewer people than promised. Moreover, it is scheduled to be implemented at the same time that the baby boom is beginning to retire in earnest. In spite of what many people think, there is no Social Security trust fund. It is merely an accounting entry on the national balance sheet. Social Security has always been a pay as you go system and up until 2010 had been a net contributor to Federal revenues. Over the next few years the Social Security deficit will accelerate sharply and permanently adding to our budgetary problems.

The increases in taxes and implementation of socialized medicine will have negative effects on consumer spending. Proponents of tax rate increases generally assume that consumer and investor behaviors don't change when rates change. To them an increase in tax rates simply means more revenue without any repercussions. Quite the contrary, increased payroll taxes are noticed immediately. They are a very tangible disincentive to extra work. Who enjoys working harder for diminishing rewards? Adaptive economic behavior is a fundamental reality of the US economic system. Besides the obvious increase in payroll withholding, The new healthcare mandates are a tax on companies who employ full time workers. The solution? Simple. Just cut

back hours per employee to avoid penalties. Not exactly what the consumer's doctor ordered. This has a direct negative impact on consumers who drive 70% of US economic activity.

The wage pressure from Asian workers has been relentless. However, it may be that the current available supply of skilled workers in China may be fully employed. In general that means additions to China's skilled labor force will likely require greater than usual training. Therefore, the slowing in job loss is not viewed as a reversal, rather, a reduction in rate for many industries. Low skill jobs will continue to leave the US and Europe in favor of lesser developed countries where cheap labor is plentiful. This will require US workers to compete with others based on economic value added. Reduced error rates, complex processes and native language fluency are all factors that can differentiate workers. This requires greater and greater training. For the United States to remain a dominant economic force we will have to accelerate and embrace transition to a knowledge based economy. Creative ideas, processes and solutions will be invented in the high skill countries and the actual manufacture will continue to be outsourced to the low cost provider. In a sense manufacturing is transforming into a service.

Economic policy dysfunction in Brussels and Washington are a deterrent to new ventures and risk taking. This translates to lower top line growth for companies and slower job growth than the consensus seems to expect. We anticipate overall economic growth to be near the bottom end of the Fed's 2-3.2% forecast which will be reflected in returns.

**Strategy: Dare to be dull.** Besides outsized Federal budget deficits, all of the potential problems of last year are still simmering. Provided none of them boil over, we expect moderate equity returns this year based on modest eps growth projections. Any one of a number of negative developments, however, could derail that and bring the broad indices closer to break-even at year's end. A major breakdown in Washington regarding the debt limit or the budget is probably the most likely potential event that could shake investor optimism. Still, there are many stocks whose yields are nearly twice that of the 10 year Treasury. We think they represent the sweet spot in today's investment climate. In our view, high yielding stocks win the asset allocation derby by process of elimination. In low return environments dividends become an increasingly important contributor to total return. They also offer some protection in downswings should they come along and comparatively stable returns in the volatile market conditions that we anticipate.

Bond yields are expected to remain close to where they are at present because of aggressive purchases by the Fed that are offsetting the cyclical tendency of rising rates late in an "expansion." All of the accumulation of debt and a protracted easy money policy are laying the groundwork for a weaker dollar and high inflation. Both are toxic to bond holders. It is impossible to say when these negative effects will present themselves in the form of higher interest rates, but the risk factors are high and rising. We continue to view the risks of holding long term bonds as being greater than their potential rewards.

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

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*For investment advice, clients or interested persons should contact their Arbor Capital representative.*

**Lawrence T. McGowan**

100 Corporate Pkwy, Suite 136  
Amherst, NY 14226

(716) 446-9111

*ltmcgowan@arborcapitalmgt.com*

**Matthew J. Wilkinson**

100 Corporate Pkwy, Suite 136  
Amherst, NY 14226

(716) 446-9111

*mjwilkinson@arborcapitalmgt.com*

**Leo Mesa, CFP**

790 Juno Ocean Walk, Suite 600  
Juno Beach, FL 33408

(786) 202-0602

*lmesa@arborcapitalmgt.com*

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