ARBOR CAPITAL MANAGEMENT

Investment Overview

The direction of the US economy is being heavily influenced by two principal factors: Capital spending, and consumer confidence (jobs). Left on its own, in a fairly stable world, the US would gradually climb out of its doldrums. However, the world is far from stable. The debt crisis in Europe represents the most immediate risk to the global economy. In a nutshell, we think the positive developments that we can accomplish domestically will be offset to a large extent by disruptions in Europe and elsewhere as the world continues to work its way out of its current dilemma. Consequently, we expect both stock and bond indexes to provide relatively flat returns over the next twelve months, at this time. Security selection will be the key to generating performance this year in our opinion.

Sovereign Debt Crisis. The threat of a financial meltdown triggered by a major default of a government seems remote at this time but it is real. About $7.6 Trillion in total worldwide government debt is maturing this year with most of it loaded in the first half of the year. Given that global GDP is a little over $63 Trillion the total debt outstanding rolling over this year represents about 1/8 of world GDP. This is a sizeable addition to debt supply. Market competition is likely to drive rates higher, especially, when several countries face possible credit downgrades. France has recently been downgraded to AA+. More are sure to follow. The increase in credit costs are an additional strain to governments that already are faced with cash flow strains. Buyer interest in Europe has narrowed because of increased default risk. Government bond buyers are fleeing to the relative safety of US and Japanese debt. The flight to quality aspect also provides relative strengthening of the Dollar and the Yen which is likely to persist so long as they are perceived to be backed by the strongest economies relatively speaking.

Europe appears to be slipping into recession. Statistics in Germany, France and Italy all suggest possible recession. Retail sales in Germany declined in November following another decline in October. French consumer confidence is soft and the French value-added tax (national sales tax) is poised for an increase. Unemployment is creeping upward in Italy. Of course, recession will reduce tax receipts and further exacerbate the debt crisis. If the European economies had a more solid footing we would be more optimistic about the prospect of gradual recovery. However, the problems that are at the heart of the current slowdown in Europe namely the budget problems in Greece and Italy have not been resolved. Rather, the proverbial can has been kicked down the road. Such an approach is irresponsible to say the least. Greece needs additional bailout funds in March to avoid default on €14 billion that matures then. Negotiations are underway with bondholders to accept a partial writedown of principal and lower than market interest rates. Even if Greece gets the creditor agreements it seeks there are still a lot of components that need to coalesce in order for the Euro to find a viable long term solution. This process could take years. Until it is complete, it is fair to assume that Europe's financial troubles can erupt on the world stage from time to time. This will be Europe's "new normal." Provided these outbursts can be contained, the effects on the world markets ought to be limited to a rough ride. The real threat would be an unexpected event or series of events that could create a panic, then all bets are off. The key to avoiding this scenario is to continue the process that is going on now, namely, negotiation and deferral. Fortunately for the rest of us, these are two things at which our European brethren excel.

US Economic Condition. Conditions are stronger at home than abroad. Corporate America and the US consumer are gradually recovering. Corporate profits are projected to expand by approximately 4%. This is good but not stellar progress. Consumer spending is likely to be moderately improved over this past year.

Industrial production is improving at a pace greater than the overall economy still led by capital spending which is tapering off. We expect a moderate inventory restocking cycle this year that will bolster GDP statistics going forward. The Purchasing Managers' Index is signaling expansion of the Industrial Economy.

The consumer is in somewhat better shape also. After three years of retrenching personal debt, credit card purchases surged in the fourth quarter. Unemployment has begun to show some signs of relief but is still historically very high especially when discouraged workers who have left the labor force are included. Consumer Confidence is hovering around 70% reflecting lukewarm economic expectations.

Both commercial and residential real estate are still in a state of flux and remain vulnerable to adverse developments. Foreclosures are still being absorbed. Multi-Family housing starts are likely to outpace single family homes in units as mortgage underwriting requirements have tightened considerably. Activity is so low that any sizeable improvement is newsworthy. Until the housing stock and demand issues are more fully resolved, we expect remodeling activity to be comparatively strong.

Long term our greatest concern is out of control government spending. Federal debt is now equal to annual GDP. The federal government will hit its new debt ceiling in late spring. The wrangling over its extension created quite a bit of drama last summer. Hopefully, we will be able to avoid that this time around. National healthcare, if enacted, would make matters far worse. In our view closing the budget gap by combinations of tax increases and budget cuts are not as effective as simply getting out of the way of the economy and letting it grow. Income tax revenues have remained close to 18% of GDP for 70+ years regardless of changes to the top marginal tax rate (Hauser's Law). Helping the economy to grow is the surest way to raise tax revenue and everybody wins.

Investors will naturally be drawn into considering the impact of the divergent policy prescriptions to our current economic malaise during the Presidential election season. We suspect the markets will provide a good barometer of the electoral outcome in advance. Nevertheless, election year politics are likely to broadly influence investor, consumer and voter attitudes.

Monetary Policy. The Federal Reserve has been working overtime to keep the capital markets liquid and the economic recovery afloat. Many interest rates are already at or near historic lows so the Fed has resorted to purchasing long term securities in the open market to keep long term rates down. Unfortunately, this is artificial demand that cannot last forever. Since the start of the quantitative easing, the Fed has purchased government and agency securities whose value is close to 70% of Treasury issuance. The US Government is selling to itself. The $64 billion question is: "What happens when the Fed stops buying or even worse begins to sell?" The honest answer is that no one knows for certain. What we do know is demand for bonds will be reduced and supply may increase. Yields would tend to rise and the shape of the yield curve could shift rapidly all other things being equal. In order for quantitative easing to unwind smoothly, private demand will need to take up the slack. The relative success or failure of the eventual handoff will have a material impact on interest rates, stocks and perhaps even the fundamental structure of the national debt. Given our estimate of the current condition of the US economy, an appropriate window to accomplish the necessary sales is probably years away.

Bond Strategy. Since the economy is expected to remain in a very modest growth trend, the case can be made that interest rates remain unchanged for most of the year. However, there exist a large number of variables that can run afoul. It is equally easy for us to envision a rate environment where today's current coupon bonds may be selling 30% cheaper. The risk/reward ratio for purchases of long term bonds is unfavorable in our view. We remain defensive and are avoiding exposure to interest rate risk where possible and focusing on the strongest credits. Our expectation is for Bonds to return 1-2% for all of 2012.

Equity Strategy. Despite, or maybe because of, all the uncertainty surrounding the solvency of many of the World's governments, corporations have generally strengthened their balance sheets. As is typical in extended periods of macro-economic stress, some are re-tooling their businesses for future growth while others are re-trenching in fear of even greater difficulties ahead. These divergent views impact earnings growth yet do not follow any particular sector or industry pattern. From our perspective individual security selection this year will have more influence on portfolio returns than sector or industry weighting strategies with the exception of Energy. As long as we rely so heavily on imported oil, America is vulnerable to supply disruptions in the Straits of Hormuz. Iran's latest saber rattling is just another in a long list of threats emanating from that region. When combined with the secularly increasing demand for energy from the BRIC's (Brazil, Russia, India and China), it is easy to forecast a general uptrend in oil prices. Most other selections will need to rely more heavily on their respective merits. Our quantitative bottom-up selections will be more prominent this year.

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