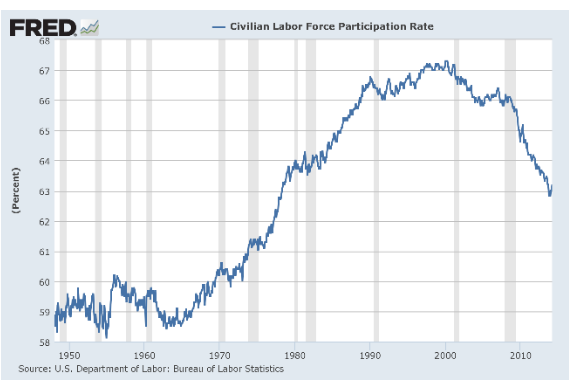
# Arbor Capital Management

## Investment Overview

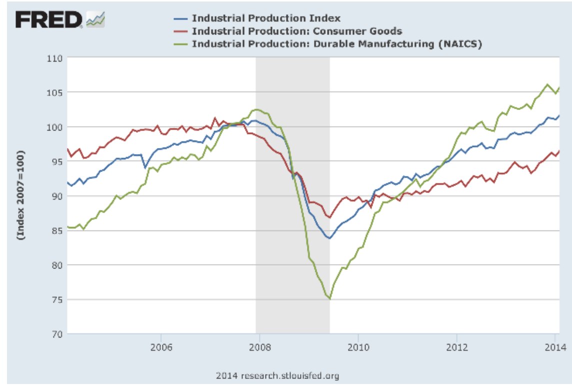
Over the next year to two years we expect the economy will be in a prolonged state of transition as the Fed gradually weans the banking system off of quantitative easing (QE). The entire concept of quantitative monetary stimulus on this scale is unprecedented. It should come as no surprise that withdrawal of the stimulus will probably create shocks of its own. Until recently, financial instrument buyers were assured by the Fed of continued flow of very low cost of funds. As the economy regains its footing the support needed to maintain its health are expected to diminish. Hopefully this will allow the Fed to greatly diminish or eliminate its open market intervention in Bonds. For several decades most Fed policy had been focused on restraining inflation, now labor market performance is likely to be the dominant factor in setting monetary policy.

In many respects the economy is just now regaining many of its benchmarks last seen in 2008. Not only was the recession much deeper than normal, the recovery has been longer in coming than any other recession since the Depression.

**Non-farm Payrolls** finally regained its level at the start of the recession, over 5 years ago. While we are glad to have progressed to this point, there are several problems. The Labor Force Participation rate has been in decline. This is the result of an increase in the domestic supply of available labor, global wage competition and discouraged workers choosing to exit the labor pool. Many of the jobs that were lost to foreign competition are unlikely to return. Still other workers had their hours sharply reduced to avoid the requirement to pay benefits required under Obamacare. Many workers that had relied on one full time job have had their hours cut and now have two or three part time jobs to make ends meet and still have no healthcare. This is expected to continue to dampen job growth for a number of years into the future. The rational consumer response is to reduce spending and debt. Consumer confidence remains well below average.




**Industrial Production** has been buoyed by capital spending which is a little unusual 5 years into a recovery. Manufacturers around the globe are updating plant and equipment aggressively. For a glimpse of how a state of the art factory runs try taking a virtual tour of the Tesla factory by searching for “Tesla Factory Tour” in youtube. From this it is apparent that the work force of the future will need to be highly trained. We would argue that the US economy is becoming increasingly knowledge based and this trend needs to continue in order to maintain our competitiveness.




The consumer goods component has underperformed in part by lost production to global competition and continued retrenchment of consumer spending.

**The Banking Sector** in the aggregate has strengthened considerably. Leverage measured by Equity/Assets is over 11%, much stronger than even the pre-recession figure of approximately 10.25%. Return on Shareholder Equity has lagged, however. We attribute this to the weaker than usual loan growth, particularly in the consumer sector. We expect that as the QE unwinds banks will expand loan activity. In this business cycle consumer loan activity is likely to offer clear insights into the possibility of a surge in growth. Even though wages and jobs have been under a lot of pressure, the aggregate consumer has strengthen their balance sheet increasing their capacity for leveraged purchases. Should jobs experience a surge in growth, we would expect a magnified response in consumer spending behavior.

**Bonds vs. Stocks.** On the one hand this ought to be very good for corporate profits and as interest rates drift upward P/E ratios are likely to contract as a reflection of the higher cost of capital. This will create an increased focus on the balancing act of bonds vs. stocks. The Price/Earnings ratio moves inversely with bond yields. Over the past several years stocks and bonds have moved somewhat in concert. As rates rise, bond prices fall, stock prices, on the other hand, may decouple and move opposite bond prices provided earnings accelerate sufficiently. Whether or not earnings have enough gas to overcome the valuation challenge of rising rates will depend in large part on the state of the overall economy at the time. Right now, job growth appears to be the main determinant.

**Strategy.** We continue to be comparatively defensive in our fixed income portfolios which stress high credit quality and short average maturities. Our equity selection process continues to seek high quality large capitalization companies that grow more rapidly than their peers at more attractive long term valuation. The broad stock market appears to be in the midst of a correction after a long run. We currently expect it to be a pause that refreshes. In these periods we usually see a shake-up in relative valuations. Accordingly, we anticipate that we will adjust our holdings over the next few months.

Sincerely,

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