ARBOR CAPITAL MANAGEMENT

Investment Overview

As we expected, economic growth in the US remains anemic. Most measures of business health are struggling to make progress. The combination of improving civilian unemployment, the absence of negative Euro-zone debt crisis headlines and stimulative Fed policy has served to buoy consumer confidence and equity prices.

Jobs. Unemployment has been showing progress but the civilian unemployment numbers can be a little misleading. U-3 is the total unemployed expressed as a percent of the civilian labor force or the official unemployment rate. In normal circumstances this is straight forward. However, in extended periods of economic stress a little digging is required to gain a clearer picture. After unemployment benefits run out discouraged workers either drop out altogether or accept work well below their skill-set. These are referred to as persons marginally attached to the workforce or underemployed respectively. When one adds those persons marginally attached and those that are part-time employed for economic reasons the unemployment rate soars to 15% ±. Labor force participation has been in steady decline since 2009 and the median duration of unemployment is still near record setting levels. Job creation still has a long way to go to even match the levels of 2008/2009.

Sovereign Debt. The Euro-Zone debt crisis has managed to stay off the front page for some months. While the discussions are not as vigorously watched as they were in our recent past, they are, nevertheless on-going. Violent protests are still taking place in Greece over the austerity measures put in place to resolve its debt burden. Rolling back social spending programs no matter how generous can encounter harsh resistance. One of the clearest indicators of investor unease is the yield spread between different credits.

Sovereign Debt Yields
4/04/12

	10-Year Yield	Spread vs. Germany
Italy	5.425	3.679
Portugal	11.977	10.230
Spain	5.741	3.995
France	2.880	1.134
Germany	1.747	0.000
US	2.170	0.423

Source: Wall Street Journal 4/5/12

The above table suggests that a default or major restructuring of debt outstanding is already forecast for Portugal. Spain and Italy are struggling. Credit spreads of nearly 4% are historically equivalent to those between US Treasuries and Junk (Credits of Ba or worse). In short, there is still little margin for error. Any number of potential economic miscues could easily tip the scale causing the debt crisis to boil over yet again. Naturally bond investors are well aware of this which partially explains why the risk premia on Portuguese, Italian and Spanish debt are so high. We are of the opinion that the concept of the Euro was founded on faulty economic assumptions and is unlikely to survive in the long term. Europeans may keep it functioning for one or two additional business cycles. However, to us it is a question of when, not if, the Euro is disbanded. Until a more permanent solution is arrived at we expect to experience episodes of financial instability from time to time.

The US Treasury has risks of its own that continue to mount. The National Debt is expanding at a blistering pace and the term structure of US debt appears backward in our view. The current average interest rate on the national debt is 2.758% as of February. This is a 60 year low. Why then is our debt structure constructed such that 71% of our debt matures within the next five years? Any rational business person would extend debt in such an environment so as to lock in historically very attractive interest rates for as long has humanly possible. It is our suspicion that unless this is addressed soon, the US may have a debt crisis of its own sooner rather than later.

Monetary Policy. The Fed has been pumping money into the financial system as rapidly as they are able. To its credit the Federal Reserve Board is almost single handedly responsible for the economic recovery in this country. Monetary stimulus at this point is like flooring the gas pedal to start a car whose engine is flooded (yes, we are dating ourselves). Eventually, after several false starts, it should work.

Should the economy begin to swoon, we expect that QE3 would be along fairly swiftly. QE3 would likely be aimed at purchases of mortgage securities. Under this scenario, the Fed would attempt to lower the cost of home mortgages with the ultimate goal of spurring a mortgage refinancing boom. This would likely stimulate consumer spending and the overall economy.

In any case, the weaning of the debt markets from Fed intervention is unlikely to be smooth. In 2011 the Fed purchased 61% of total net US Treasury issuance. This level of market intervention is as unprecedented as it is breath taking. As the Fed slows or stops its purchases, the artificial demand for US Treasuries will feel it directly. In the absence of significant new demand the Fed will need to develop a mechanism to unravel the mess that we expect will be the result. What form that takes is unclear. What is clear is that the Fed cannot be the Treasury's largest customer indefinitely.

Looking a little further ahead, the US Treasury will have to refinance an unusually large proportion of its debt at a time when the Fed purchases of Treasuries will be greatly reduced or even eliminated. The market solution is clear. Supply will be increasing while demand will be decreasing. Yields will rise (all other things being equal). Ultimately, the

economy needs to gain the strength and capacity to carry the debt load. There is no palatable alternative.

Bond Strategy. For the reasons we enumerated above our fixed income strategy is defensive. Long term bonds face a number of risks that make them unattractive for most investors in our view. We are concentrating on high quality paper maturing within 5 ± years

Equity Strategy. Stocks have been propelled by monetary ease more than any other single factor, in our view. Still, there are a number of bright spots independent of government's actions or even the domestic economy. Throughout this extended period of economic stress, most companies have strengthened their balance sheets and lowered their breakeven points. The result is stronger profits and healthier companies. Should the Fed's stimulus really kick in then profits can be expected to surge.

Stock prices depend on profits. Currently we are entering earnings reporting season at a point where the broad stock market indices need a breather. A 5-10% correction would be normal and beneficial to the long term health of the market. We expect to recommit some of the cash we raised recently on new purchases that appear to be well positioned for the next 12-24 month time horizon.

Gerald T. Cole, CFA **April, 2012**
Chief Investment Officer

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