ARBOR CAPITAL MANAGEMENT

Investment Overview

The global economy continues to be stuck in neutral. Europe is in recession and Chinese manufacturing output has stalled because of flagging demand for its exports. Expansion in the US has struggled and is still hampered by weak job growth. Currently we are facing a number of renewed economic challenges.

Euro. The Euro crisis drama is still unfolding. For the moment there is a brief period of optimism. Bank re-capitalizations have been separated, at least on paper, from sovereign debt. The segregation of the two problems is hoped to break the link between government and private industry debt. Dividing the two makes logical sense. In response both Italian and Spanish debt rallied strongly. While this is a positive development, government debt levels are rising unabated. No permanent solutions will be attained until the root issues are addressed. Ultimately, it is the German and French taxpayers who will be asked to bear the cost of most of this. It is unlikely, in our view, that they will be receptive without strong conditions. This is a political and economic tug of war that may take decades to resolve. For the moment markets are reacting to each of the twists and turns process. As long as there is no news about it investors are happy to put it out of their minds. When negative developments arise panic sets in, which sends stocks downward and Treasury prices higher. This will continue until the worst possible outcome is made clear. Only then will investors be able to efficiently price securities with reasonable risk assessments.

Domestic Tax Policy. Congress is heading for a pair of potential showdowns in the midst of Presidential election politics:

1. Taxmageddon (lapse of the Bush era tax cuts), and
2. The Federal Debt Ceiling.

This is easily the most rancorous political environment in our memories and is hardly the most favorable conditions to set national policy. Nevertheless, decisions have to be made. If the Bush tax cuts are not extended or made permanent, then the likelihood of a long and deep recession starting in the first half of 2013 is a near certainty. In a 2010 paper written by the President's former Chairperson of the Council of Economic Advisors, Christina Romer, the conclusion was that an exogenous increase in taxes of 1% leads to a 3% decline in GDP. The President's proposal to keep them for those taxpayers earning less than 250,000 is a sharp blow to entrepreneurs who provide the job growth that government otherwise ought to be promoting. Last summer's political football, the Debt Ceiling, is likely to be reached around election time and needs to be (ugh!) expanded. Neither House of Congress inspires much confidence.

Industrial Activity. Commodity prices are in broad retreat signaling weakening demand. The OECD leading indicators are softening. Growth in China and India has moderated and is below their respective trends. The purchasing manager's index (PMI) for manufacturing slowed sharply last month. Unemployment is stubbornly high. This risk of recession in the US is rising from both internal and external factors though the Leading Index for the United States still indicates expansion.

Homes. Housing prices look as though they may have bottomed. Recent evidence from S&P Case-Shiller showed 19 of 20 cities with price gains and no cities that hit brand new lows and new home sales are trending upwards. Hopefully, we can begin to put this chapter behind us.

Money and Banking. Like jobs, lending activity has shown recovery but has not yet matched its 2008 level. This further underscores the sluggish pace of activity. A fresh area of concern is the velocity of money which is a measure of the pace that money changes hands. This has been in a general downtrend since 2006 with a recovery from the middle of 2009 to the middle of 2010. Since late 2010 money velocity has been in a downtrend. Our best guess as to the possible causal factors are: Lack of confidence and adverse consequences of quantitative easing. Weak jobs data would naturally cause the average person to lower revolving debt and curtail discretionary spending. One of the effects of quantitative easing was to make it profitable for banks to essentially do nothing. As the Fed has purchased Treasuries and Agencies so have the banks. By doing so they have avoided nearly all risk, allowed some time to digest poor loans decisions in exchange for lower returns on average assets and equity.

Bonds. Treasury prices have been bid up by a combination of fear driving a flight to safety and the Quantitative Easing activity of the Fed. After adjusting for inflation, real interest rates are negative in many cases. This is clearly not the environment to extend bond maturities. However, the impetus that could drive nominal interest rates much higher is not apparent at this time. We view bonds as ticking time bombs with a really long (2-3 year) fuse. We remain defensive. Maturities are generally kept to 5 years or less with strong credit. Should rates begin to rise we will have adequate cash flows to recommit at more attractive yields with greatly reduced risk to clients' capital.

Stocks. Stocks have struggled in this environment. They are cheap historically. The macro-economic turbulence is expected to keep volatility elevated for at least a quarter or two. Our response to this is to rotate positions into less volatile names and raise the average dividend yield. This will provide more stability, some growth potential, and increased cash flow. Once a more favorable economic climate unfolds we can then commit to higher growth companies for the following year or two. Presidential politics is sure to charge investors with emotions that will contribute to price choppiness. A change of heart in the White House that promotes economic growth would be welcome news to share prices, and could cause us to realign toward growth more rapidly. Because of the weakening in manufacturing in May we expect many companies to miss their earnings target. The way investors respond will help determine the intermediate course of stocks in general.

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