ARBOR CAPITAL MANAGEMENT

Investment Overview

The global economy is stuck in neutral. Monetary easing in the form of QE3 is fueling financial markets despite relatively poor showings from broad economic time series. Predictably, politics are dominating the headlines as happens every Presidential cycle.

None of the problems we have described in recent overviews have gone away. The debt ceiling will be hit again soon, the Euro problem is not out of the woods and the fiscal cliff still looms ahead. The main reasons for this, in our view, are that the main political antagonists have downplayed their importance as they attempt to gain the upper hand in November's elections. Once the elections have been decided it appears likely that the Euro issues will dominate headlines and impact investor sentiment.

We cannot recall when another Presidential election presented the electorate with such stark contrast. The economic performance over the next year is unlikely to change much regardless of who wins in November. Rather, it is the longer term that hangs in the balance. Will the US set a course toward economic growth and fiscal responsibility or will our voters decide that the European model of income redistribution has more appeal? Time will tell. Clearly, investment strategies for the ensuing years will vary dramatically depending upon who wins. Regardless of the outcome, the US still faces formidable challenges. Our deficit is running at around 8% of GDP per year. Almost all of this is being funded by Federal Reserve purchases through its quantitative easing programs. What previously were thought to be considered second tier countries such as Mexico, Canada, Brazil, Russia and Italy each have stronger cash flow relative to their respective debt burdens. This is a dramatic departure from where the US was just a few years ago when this would have been inconceivable. Continued expansion of government will make matters worse in the long run and has the potential to drive our nation to default.

Turning around the US economy will take time. Even if Congress were able to pass ideal policies that curtailed spending and helped grow revenues through a balanced tax approach, it will take a number of years to close the spending gap let alone, retire debt. Despite many changes in tax structures over the last 70 years, federal tax receipts have been a remarkably stable near 17% of GDP. It had a peak in 2000 of 20%. The so-called Bush tax cuts merely brought things back to the historic average. The answer to the long term problem is economic growth, spending discipline and elimination of over zealous regulation. In order to balance the budget Congress must allow tax revenues to grow more rapidly than its appetite for spending. This will require political will that so far has been noticeably absent.

The IMF recently indicated that the global slowdown is deepening with the Euro zone taking center stage. Capital has moved from the marginal economies to the strongest. This has increased the cost of financing in the weaker countries thereby exacerbating the underlying problems.

This indicates a heightened risk of recession. Usually in this circumstance one could purchase long term debt and benefit from declining interest rates. However, ten year Treasuries are yielding less than 1.7% so the potential advantages of that strategy are limited. Despite their higher volatility, stocks are statistically more attractive than either bonds or cash. This is a very unusual set of conditions at this stage of an economic cycle. The combined effects of the quantitative easings have been to artificially lower interest rates across the entire yield curve. In a sense this pre-empts the normal shift in asset allocation from stocks to bonds that investors normally would like to make. Effectively investors are left with the choices of stocks, cash and short term bonds.

Bonds. In our view long term bonds are to be avoided because the risk one takes for a meager incremental return makes them unattractive. It has been argued that interest rates can stay quite low for a long period of time. This is true and that has been the experience in Japan. What concerns us is that interest rates are so low that even a small increase can lead to noticeable losses. Consider the following illustration of what we mean. The table reflects current offerings of 1 year, 3 year, 10 year and 30 year Treasuries. We show current prices and prices should rates jump by ½%.

Issue	Current Price	Price after 50 b.p. increase in Yield to Maturity	Percentage change in Market Value
Treasury 0.5% due 10/15/2013	100.351	99.848	-0.50%
Treasury 0.25% 10/15/2015	99.782	98.305	-1.48%
Treasury 1.75% 05/15/22	101.088	96.744	-6.28%
Treasury 2.75% 08/15/2042	97.879	88.629	-9.45%

Most people would probably agree that a ½% change in the cost of financing a project would rarely be a deal breaker. However, for the bond holder the impact is magnified particularly for long term bonds. This is why we emphasize short term bonds and those with defensive characteristics such as step-up coupons at this time. Now is not the time to stretch for yield.

We further suggest that those individuals and organizations that hold long term bonds reduce their exposures over the coming quarter or two.

Stocks. Given the low yields and poor risk/return characteristics of long term bonds, stocks win the relative value derby by default. Yields in many cases are higher and there is the opportunity for capital appreciation. However, given the softening of the global economy, weakness in manufacturing and poor progress on job creation we are de-emphasizing exposure to companies that are pro-cyclical in favor of companies who will continue earnings growth regardless of the short term course of the economy. For more information see our video “Approximate Certainty Equivalents” that is on our web-page under the Informational Videos tab.

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October, 2012

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