Arbor Capital Management

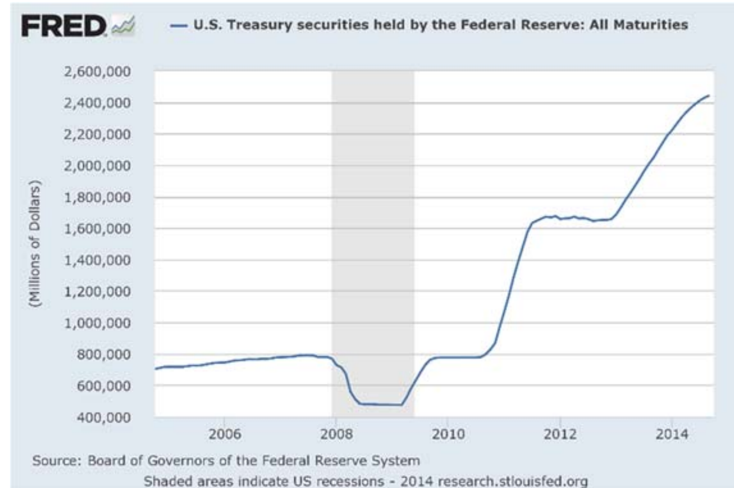
Investment Overview

As we enter the final quarter of the year the economy is still on the mend. Manufacturing is still slowly recovering, job growth is happening at a slow pace, home prices are rising and US oil production is surging. While the domestic news is pretty good, Europe is struggling while China's growth continues to taper off. We are reminded of the truism that things are rarely as good (or as bad) as they seem.

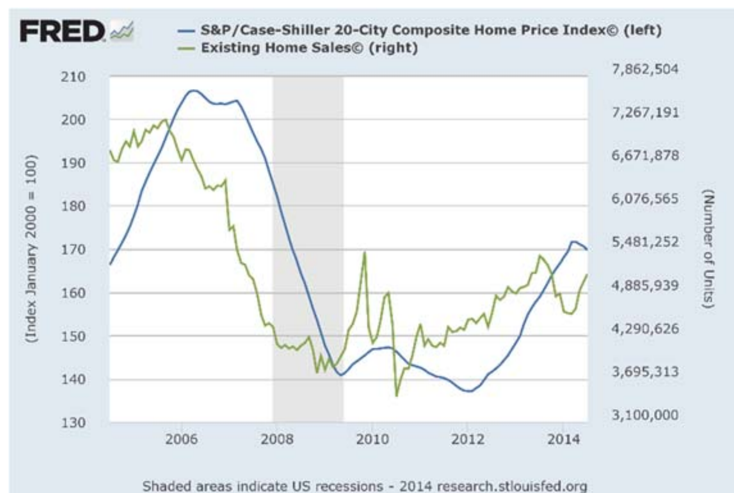
The good news. Capital goods production is still strong which is indicative of business around the world reinvesting in productive capacity. Commodity prices, in general, are very well behaved, though some exceptions exist. Average hourly wages are increasing modestly. Total capacity utilization (manufacturing) is still edging higher and the ISM diffusion index is over 56% suggesting that manufacturing is expanding. The dollar is strong and is reasserting itself as the world's reserve currency. Crude oil prices are under pressure thanks to a US production boom. It has long been known that the US has more reserves than Saudi Arabia but the hydrocarbons were in more difficult geologies to recover (i.e. more expensive extraction costs).

The mixed news. The published unemployment rate is under 6% but misrepresents labor market conditions. When discouraged workers are included in the labor force the truer rate of unemployment is nearer 12%. A recent jobs report celebrated a relatively small number of new jobless claims, but when we looked closer the number of people leaving the workforce was larger. The unemployment rate is shrinking in large part the result of the declining labor participation rate which is at the lowest point in 30 years. Uncalculated is the consequence of under employed. These are the folks that took jobs well below their training levels and prior pay grade to just pay the bills. Especially hard hit was manufacturing employment whose recovery has been well below average. For better or worse the days of the cradle to retirement lunch bucket manufacturing jobs is rapidly coming to a close. US labor is increasingly being forced to adapt to a labor market demanding ever higher skill sets.

Quantitative easing. QE is tapering off rapidly. In retrospect, we are hard pressed to declare it a resounding success. Liquidity abounded but Loan volumes didn't. Bankers tightened lending standards to the point that even Fed ex-Chairman Bernanke was recently denied mortgage refinancing. The long term effect of the QE is still uncertain. In the near term it will become increasing clear that the artificial demand created by the Fed will be absent. All other things being equal, this implies that liquidity will dry up somewhat and volatility will return. With increased volatility comes wider risk premiums so higher yields relative to inflation are to be expected. Fortunately, inflation is weak and does not appear to pose a threat in the near term.



Housing. Home prices have recovered from the low in 2012 but remain well below previous highs in most cities. Prices are still expanding but at a slower pace. Home ownership still represents the single largest investment for most families. A rise in home prices creates a notable wealth effect that boosts consumer confidence and GDP growth.



Stocks. Stocks are starting the quarter under pressure. In our view this is driven by the fact that European stock indexes have corrected sharply over the past 3 months, there has been a long time since the last correction and a pull-back in oil prices. The most recent trigger appears to be weakness in German manufacturing orders which heightens recessionary fears throughout Europe. We are looking to find additional corroborating evidence before we draw that conclusion. This entire business cycle has witnessed wider statistical variation than most, so a reversal is not out of the question. However, the technical condition of share prices was a little extended so this created an excuse for profit taking.

Oil markets have been disrupted by US production and the excess supply of crude has led to a price decline. We are reducing our weight of energy holdings until prices stabilize.

Corrections often create mispriced securities and we are expecting to be able to do some bargain hunting for the next 12-18 month time horizon. We are looking for strong companies with above average growth potential at below average valuation.

Bonds. We remain defensive toward fixed income at this time. We expect that yields across the board will gradually rise next year. We will continue to roll maturities out to 5-6 years in most cases. It does not pay to aggressively extend maturities in a rising rate environment.

Sincerely,

Gerald T. Cole, CFA **October, 2014**
Chief Investment Officer

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