ARBOR CAPITAL MANAGEMENT

Investment Overview

Global economic performance continues to be a mixed bag. There is a bit of progress along several lines but a significant number of nascent problems remain unresolved. Excess liquidity provided by unprecedented monetary intervention is the driving force behind security prices. The US economy is being buffeted by a number of statistics that oftentimes reverse themselves or are at odds with one another. Following are some of the highlights from our vantage point.

Home prices in many US markets are showing positive signs. Supply is tightening and pending sales are up. This suggests that home prices should continue to show strength. However, part of this is explained by a reduction in foreclosure sales. This mutes somewhat the apparent strength in the Case-Shiller Index, but clearing the overhead supply of housing stock is required before sustained growth in housing prices can occur. This is critical because housing is still the single largest investment of most households. Therefore, home prices have a significant effect on consumers' economic well-being. It is exactly for this reason that the Fed is targeting mortgage bonds for its quantitative easing. Mortgage rates have also declined to the point where refinancing makes a lot of sense for many people. This is expected to provide a boost to homeowners' cash flows but not as great as we experienced in previous re-fi booms because the mortgage arithmetic is just not as compelling and a number of borrowers are still under water. While existing home markets have begun to clear, new single family housing starts are struggling. The surge in multi-family housing makes the housing market look better than it actually is. There are still lingering risks.

Corporate profit margins are at all-time highs mostly as a result of cost reductions as opposed to growth in sales. The dominant sources of reduced cost are workforce reduction, outsourcing and lower cost of capital. Profit margins tend to be highly cyclical and mean reverting. This means a return to historic average margins is likely. Company managements are aware of this and have been nudging analysts' estimates downward. Margins can remain high for some time. However, earnings' comparisons going forward are likely to get increasingly difficult. Trees do not grow to the sky. Equity dividends are greater than competing bond yields. As long as earnings hold up reasonably well, many companies will be distributing excess cash in the form of dividends. The unusually higher yields also have the benefit of providing an important support for share prices should a more difficult environment develop.

The Unemployment Rate statistics have shown gradual improvement. However, Non-Farm Payrolls have yet to recover to their prerecession highs despite an increased working aged population. There exists a large number of Americans still out of work. Some have dropped out of the workforce, while others have not had a chance to enter. The imposition of the Affordable Healthcare Act (AHA) is viewed by most employers as a de-facto tax on hiring. This doesn't preclude new job creation altogether, rather, it makes it more costly. This raises the breakeven levels for new hires to be net contributors to their organizations. One typical response to this problem is for underground market activity to increase. When people are unable to find work over long periods of time they often take side jobs "off the books". While this pays some of the bills, it is symptomatic of small business owners' lack of confidence in the direction of the economy. This became apparent in January when retail sales were reported to increase by numbers that didn't add up to credit card balances or reported disposable incomes. This was fueled by "cash" transactions. Moreover, the AHA is anything but affordable. Healthcare premiums are forecast by some analysts to increase by nearly one-third. This becomes a further drag on the economy.

Japan has somehow managed to stay out of the headlines. It is carrying the largest debt burden of any country at this time. Total Government Debt is estimated to be over 218% of GDP (source: CIA World Factbook). This is clearly not sustainable. In order to work out of this the Bank of Japan (BOJ) is hoping to raise inflation to 2% from its present -0.2%. True, the bulk of Japanese debt is held by its own citizens, but the population is aging rapidly. The unique circumstances that enabled the miracle of Japanese growth throughout the 1980's and 90's simply aren't there. The BOJ recently announced it will be following a policy of quantitative easing, similar to what our Fed is doing. However, the demographics in Japan cannot hope to provide the economic basis to support the ever growing debt burden. Things in Japan must change fundamentally. The pension funds that were the main source of demand for the Japanese bonds are now in a position where they have to sell in order to pay retirement benefits. Japan is the canary in the monetary policy coal mine.

Euro-Zone countries remain under severe pressure. The recent "tax" on Cypriot deposits may have been the only way to resolve their particular banking crisis, but we can't help but be concerned that this may represent a general sea change in how personal property is defined. Although Gold is currently weak, we think that if fears of wealth confiscation were to become more widespread, then Gold would soar in price. Financial tensions remain elevated in Spain, Italy, Ireland and Portugal.

Growth slowing in China. Among other things China is the dominant consumer of commodities. So a reduction in growth necessarily leads to reduced consumption of basic materials. China is also Europe's largest trade partner. An extended slowdown would also be harmful to European growth prospects.

US Monetary Policy is driving liquidity into financial assets. The $84 billion or so per month that is being purchased is fairly close to the Federal deficit. We are robbing Peter to pay Paul. This cannot continue indefinitely, though we don't foresee any departure from this any time soon. The repercussions in a fragile economy would force onset of recession. In a nutshell the US is walking an economic tight-wire.

Investment Strategy. Printing money ultimately will lead to higher inflation than otherwise would be the case. Potentially much higher. With T-Bills at 0.25%, Ten Year Treasuries near 2% and 30 Year Treasuries near 3.25%, the yield curve is as steep as it would be in a "normal" business climate. But the arithmetic of fixed income is such that even a small change in interest rates can have a material impact on bond prices. Consider that a 2% increase in the Ten Year Treasury would be devastating to bond holders. Although its yield of 4% would still be below its historic mean. A doubling in yield is going to hurt no matter what the term of the bond in question. However, the longer the term to maturity, generally, the greater the interest rate sensitivity. We recommend reducing interest rate sensitivity principally by keeping maturities short and credit quality high.

High yielding stocks are likely to remain the preferred asset class during this period of economic tension. There is no substitute for steady earnings and solid balance sheets in this situation in our opinion. We expect to increase average yields in equity portfolios modestly while retaining strong underlying fundamentals.

Sincerely,

Gerald T. Cole, CFA
Chief Investment Officer

April, 2013

Lawrence T. McGowan

100 Corporate Pkwy, Suite 136
Amherst, NY 14226

(716) 446-9111

ltmcgowan@arborcapitalmgt.com

Matthew J. Wilkinson

100 Corporate Pkwy, Suite 136
Amherst, NY 14226

(716) 446-9111

mjwilkinson@arborcapitalmgt.com

Leo Mesa, CFP

790 Juno Ocean Walk, Suite 600
Juno Beach, FL 33408

(786) 202-0602

lmesa@arborcapitalmgt.com

THIS PAGE LEFT INTENTIONALLY BLANK