Arbor Capital Management

Investment Overview

The investment climate is still a very mixed bag. The main driver of financial markets continues to be the Fed. It would appear that the Fed's bond purchase program also referred to as quantitative easing will be with us indefinitely. Here's why and what we think it means to investors.

Since 2009 many economic indicators have recovered substantially but most of the economy is running well below capacity.   This is why inflation is not an issue at the moment and consumer sentiment is tepid. Unemployment is elevated as a reflection of global labor competition and greater labor costs from implementation of the "Affordable" Care Act. The consumer response has been rational in the aggregate. Debt service payments as a percentage of disposable income are down 25% since 2008. As a result housing starts have begun to revive. Europe is just emerging from a recession triggered by its debt crisis. The economic results of all of this are slow growth, below average employment gains and low inflation. Interestingly, few if any of the root causes of the economic difficulties of the past 5 years have been resolved. Political expediency has overwhelmed any chances for meaningful economic remedies. Concerns have been set aside for the time being.

Fixed Income. The Fed is providing unprecedented support for bond prices whose effects span the entire yield curve. It stands to reason that at some point the quantitative easing will have to subside. The purchases have been so massive as to become a dominant source of demand. Absent this demand, prices will go lower and yields will go higher. We think we are at or very near the end of the secular decline in bond yields that has persisted for the better part of three decades. We would avoid long term bonds. We are positioning fixed income portfolios to minimize risk of loss of principal.

Equities. Like bonds, stocks owe much of their success to Fed quantitative easing. When rates were driven lower, P/E's expanded in the face of a questionable economic backdrop. By the same token when rates eventually do rise they will cause similar contraction in P/E's. Hopefully, the rate of earnings growth will improve sufficiently to provide an offset. Provided the Fed is able to maintain the current policy in place until unemployment significantly improves, then this should not be a problem. Because consumer sentiment would likely be buoyed and good producing industries would be expanding toward full capacity. Corporate America is doing its part. For the most part balance sheets are improving. Many companies are increasing dividends and share repurchases. Both bolster share prices. Despite a large number of dividend increases there has begun a noticeable uptick in dividend decreases. Dividend policy is an important indication of corporate managements' confidence in their companies' future earnings. Large increases in the number of decreases has been a good indicator of the onset of past recessions. For the moment we will monitor this. Given the choppiness of economic statistics this may just be an outlier. We will be reviewing our equity names to help minimize this risk to our portfolios.

Commercial lending is showing signs of picking up. This is welcome because this is one of the key components of economic growth that has been missing in this "recovery." An increase in lending activity would be an important step toward a more normal business environment. Banks and regulators severely tightened lending standards in the wake of the past recession to the point of denying access to funds to many otherwise worthy projects. Even moderate relief would be expected to prompt brisk demand. Once lending picks up and the job market improves then the Fed can take the economy off life support. Interest rates would trend higher because of the return of private sector demand. From the borrowers' perspective interest rates are cheap so there is a historically low financial hurdle rate for many ventures to proceed. The speed with which these loans are made is largely dependent on regulators attitudes toward lending standards and bankers understandable shyness about over extending their loan portfolios. The extent to which this activity is real and sustainable, the economy and, by extension, corporate earnings ought to be able to accelerate to more historically normal rates.

When one weighs the probable downward pressure on p/e's from a rise in interest rates against the upward momentum of improving economics we believe that there is still health potential for equity gains for the next 12-18 months. Near term political turmoil in Washington notwithstanding.

Sincerely,

Gerald T. Cole, CFA **October, 2013**

Chief Investment Officer

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For investment advice, clients or interested persons should contact their Arbor Capital representative.

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