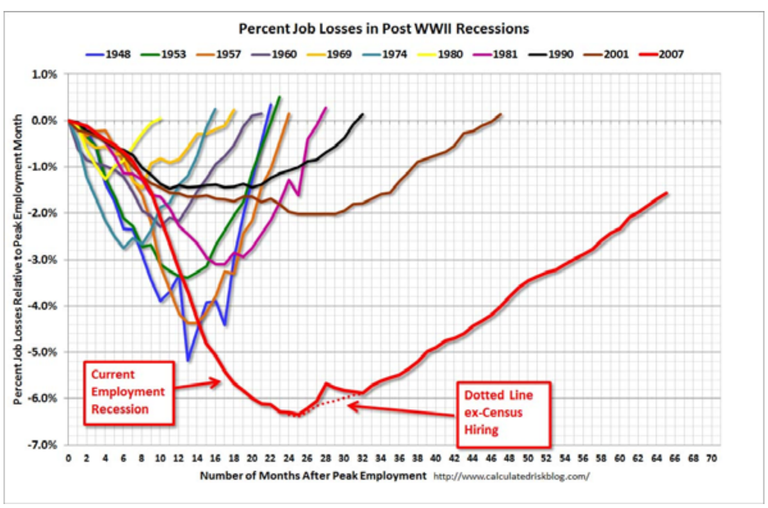
ARBOR CAPITAL MANAGEMENT

Investment Overview

The economy is starting to show signs of life and the Fed has signaled that it is looking for a point to begin to taper off on its quantitative easing. Financial markets are adjusting to this information and what it may imply for the next year or so. Here is our take on the main factors influencing financial assets and why the signals are mixed.

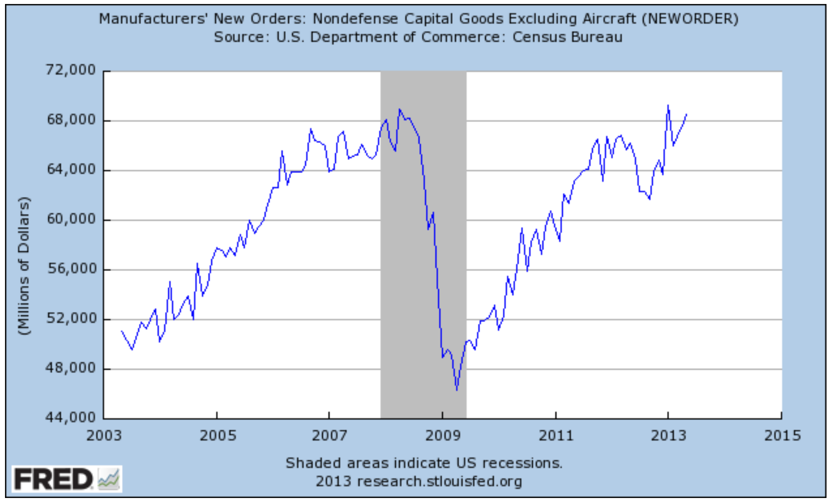
Love it or hate it, the Fed has been successful in almost singlehandedly keeping the economy from teetering back into the red. Their unprecedented intervention in the bond market has provided enough liquidity to offset the complete lack of growth oriented fiscal policy out of Congress. It has been monetary largesse that has kept real interest rates negative, driven interest rates to historic lows and propelled P/E ratios higher.

The health of the labor market is arguably the clearest indicator of the strength of the economy. After all, 70% of GDP is consumer spending. Job creation languished, therefore, so has growth. The chart below illustrates the job losses for every recession since WWII. The starting point is the respective business cycle peak and the horizontal axis is the number of months until that peak is regained. The vertical axis is the percent of job losses from the peak. The red line is the current cycle. The current period has witness a deeper and longer recession in jobs than any other cycle since WWII. We have yet to get to previous levels of payrolls despite a growing population and a protracted length of time. The comparatively low unemployment numbers do not account for workers who have left the workforce resulting in a little disconnect between analyses based on non-Farm payrolls vs.



unemployment rate. A large number of workers have also had to resort to part-time work or taking positions for which they are overqualified in order to make ends meet. This has distorted the unemployment statistics. Under-Employment has always been a bit of a problem, but today's numbers are staggering. The country's two largest employers are now Wal-Mart and Kelly Services.

Ironically, the Affordable Care Act a/k/a "Obamacare" that is purported to benefit the lower income worker does the opposite in two main respects. First, it creates a significant increase in the cost of labor relative to capital. The result is added incentive to substitute capital for labor with purchases in productivity enhancing equipment or to outsource manufacturing altogether. The chart to the right shows this clearly. Capital Spending has shown extraordinary strength. Secondly, the rules set forth by the Affordable Care Act exclude part-time employees and companies that employ fewer than 50 people. This works against the long term interests of workers trying to get ahead and provides a drag to economic growth in general.



This pattern of slow, sub-par recovery is also reflected in Capacity Utilization – Total Industry (TCU). Like payrolls, capacity utilization has yet to recover to its historic mean.

Existing home prices have improved as have sales of new multi-family units. New single family housing starts have seemingly just bottomed. It appears as though the inventory backlog of existing housing stock has cleared. A pick up in single family housing starts would confirm this view. Notably absent is the first time buyer. Employment challenges and much tighter underwriting standards make it tougher on new families' just starting out. New family creation has been historically associated with highly leveraged purchases of homes, automobiles, appliances and the like. Consumer spending patterns could change for generations forward. This puts a bit of a wrinkle in one of our key investment themes: demographics. We will be watching for additional evidence to that effect.

This recovery has been a long grind but, finally, there are kernels of sustainable growth. Despite the length of time it took to get where we are today, employment and production are much closer to historic norms than they have been in a long while. Therefore the economy is better able to sustain organic growth with diminishing support from the Fed. Accordingly, chairman Bernanke announced that the open market purchases of Government and Agency bonds could begin to be reduced sometime in the coming quarters. This is very good news but it also is a double edged sword. The increased underlying strength of business conditions means less monetary stimulus i.e. higher interest rates. For years the Fed has kept real interest rates negative. That is, the risk free rate has been kept lower than the rate of inflation. Such is the nature of monetary stimulus. A more normal interest rate given the current CPI-U of over 1% would be something closer to 4.0% than the current Ten Year

Treasury yield of 2.7%. In a practical sense prevailing interest rates in the vicinity of 4-5% would not be a huge factor in making a purchase or a capital expenditure. We have survived much higher. However, to the long term bond holder, such a move could be extremely painful. Paper losses would mount.

Fixed Income Strategy. We recommend avoiding long term bonds and most long-term bond mutual funds. Our bond holdings are shorter term with average terms to maturity of about 3 years or about a year shorter than the Barclay's Intermediate Government/Credit index. This means as interest rates rise, we will have bonds maturing whose principal we can recommit at then higher rates. Long-term bond funds take away this flexibility and the certainty of a fixed maturity and therefore are unattractive to us at this time. This having been said, we think the recent surge in interest rates has been a little overdone. We would expect some backtracking over the summer and perhaps into the fall. This is a good time to seriously consider restructuring your fixed income holdings. If you hold bonds outside of your Arbor account you should consider giving us the opportunity to evaluate and perhaps manage them on your behalf. Also, we created our Global Equity Income strategy to partially offset this exact situation.

Equity Strategy. Historically, Stocks and Bonds have been co-dependent to varying degrees. During the recent period, equity returns were driven by excess liquidity being pumped into the system by the Fed. The lower interest rates caused P/E's to expand. As the punch bowl is taken away by the Fed, interest rates will rise and P/E's would tend to contract. In prior cycles when this occurred, earnings growth easily outstripped the multiple contraction. During the current cycle, the underlying economic conditions are below par so organic earnings growth may not be sufficient to offset higher rates. We expect many larger companies will increase share repurchases, term out debt and make other balance sheet changes to bolster their bottom lines. We continue to believe that strong companies with strong revenue growth and growing dividends are favored for the long haul.

Sincerely,

Gerald T. Cole, CFA **July, 2013**
Chief Investment Officer

or damage arising out of the use of all or any part of this report. ***Additional information will be made available upon request.*** *Past performance is not necessarily indicative of future results.*

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

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