Arbor Capital Management

First Quarter 2018 Investment Overview

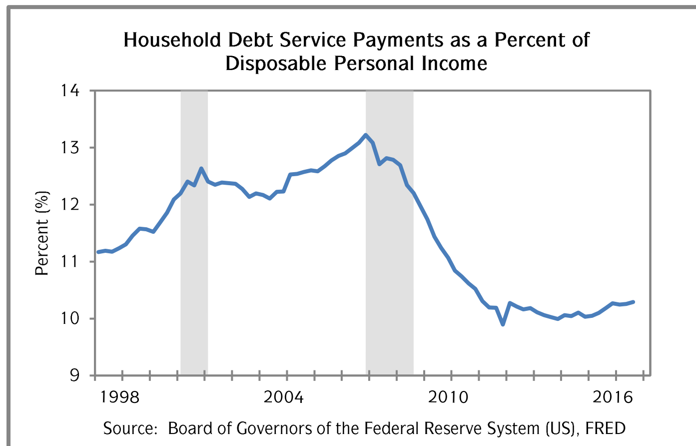
After a strong year, we continue to be optimistic for the year ahead. Corporate profits and consumer incomes both will benefit from continued growth in GDP. Acceleration of economic activity will put some upward pressure on interest rates which is perfectly normal. However, we think some new challenges may emerge as competition between stocks and bonds intensifies.

Economic Highlights.

The economy is hitting on all cylinders. All of the indicators we follow are signaling solid GDP growth for the year. We think growth will be 4% or so for calendar 2018 which is a little higher than consensus. Jobs, capital spending, and small business confidence are all in synchronization.

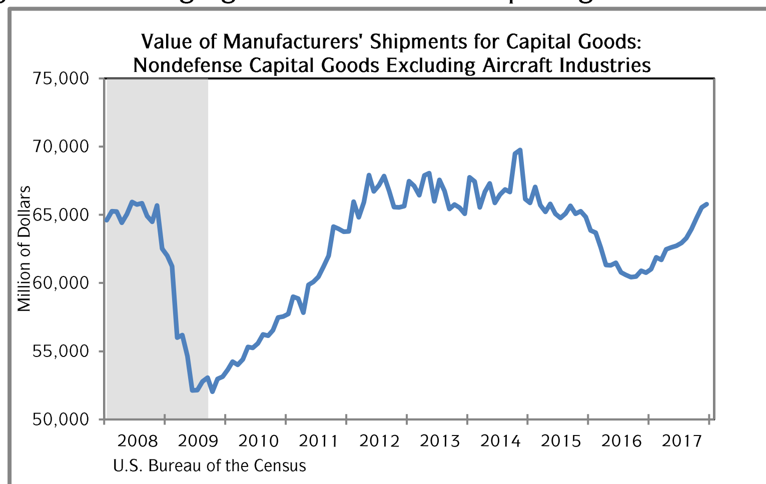
From the onset of the current economic recovery, we have asserted that jobs were the key to getting the overall economy going again. As expected, the job market has considerably strengthened, and the macro-economy has accelerated. A wide variety of labor statistics continue to show substantive improvement. The unemployment rate (U-1) was last reported at 4.1%. Normally, this is considered full employment, which implies that everyone who wants a job already has one. This business cycle is a little different because there are still a large number of individuals who have exited the workforce or are materially underemployed. High levels of underemployment suggest that there may be some slack in employment that can allow for more growth/improvement in jobs with little inflationary impact, however, this is nearly impossible to quantify reliably. Nevertheless, the labor market is in better shape than it has been in many years and home prices continue to advance

Consumer confidence is historically high. However, spending seems to have preceded jobs. It is likely that some households have “gotten over their skis” a bit suggesting a spending pause later in the year as consumers realign their short-term debt. Some analysts take the



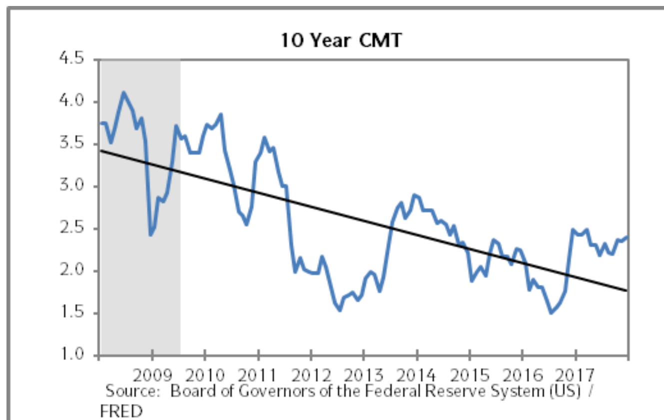
position that this may set the stage for a recession. At this time, we do not agree. Total consumer debt is near 100% of disposable income and rising. The peak was over 130% in 2008. However, household debt service payments are currently just above 10%, near a historic low. In 2008, debt service peaked at 13% of disposable income. The reason debt can be comparatively high, and debts service low is low-interest rates. Should rates experience a sudden increase, then many households will feel the pinch.

While the consumer sets the underlying tone for GDP growth, capital spending normally supplies the surge that can kick growth into high gear. The value of capital goods shipments has been surging since mid-2016. The reduction in the corporate tax rate will provide a considerable boost. Previously the US top tax rate for corporations was among the highest in the world. Now domestic corporate tax rates are near the mid-point of OECD countries. The US is now in a far better competitive position to attract and grow large-scale domestic businesses.



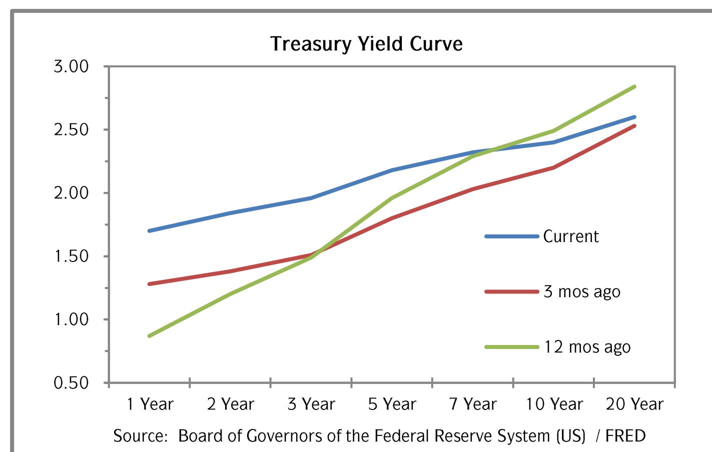
Aggregate corporate profitability, long-term GDP growth, demand for labor, and tax revenues should all improve as a result. At the same time, the global economy has also been strong. Monetary easing has buoyed Europe's resumption of growth, and Chinese growth experienced a rebound.

Bonds.



It appears to us that interest rates may have bottomed and may be in the early stages of a long-term reversal. The downtrend line broke. It is unclear if this is a short-term break as has occurred in the past or is it the start of a bear market in fixed income. Should the 10-year CMT move much higher than 2.65%, a further rise in interest rates is likely. However, we do not anticipate a rapid spike upward in rates at this time. The Federal Reserve previously announced that they anticipate making 3-4 increases in short-term rates.

In the purest sense interest rates represent the cost of borrowing. One of the key considerations when making major purchases buyers usually consider what the price may be in the future. The cost of money is no different. By plotting the yields on Treasuries from present to 20 years in the future, one can ascertain investors judgment of what interest rates are expected to become (the yield curve). Positively sloped curves indicate an expectation of rising prices. The steeper the yield curve, the quicker interest rates are expected to rise. A "normal" shape would have long-term rates approximately 2% (200 b.p.) higher than short-term rates. The Fed will raise short-term rates when it thinks the yield curve is (or is likely to get) too steep and lower them when it is too flat.



Each time the Fed makes a policy change, investors respond by selling or buying. The net outcome of investors reaction shown by Yield curve changes provides valuable information. The recent rate increases caused short-term rates to rise while long-term rate remained unchanged. Investors are saying that they think the economy will stay on its present course and that accelerating inflation is not a risk at this point. If at some point the curve were to become downward sloping (an inverted yield curve) then the risk of a new recession would be very high. However, we think this possibility is a long way off. We may revisit this later in the year.

Our Fixed Income strategy is emphasizing a defensive posture by keeping average bond maturities short, purchasing step-ups and floating rate securities.

Stocks.

The corporate tax cut to a maximum of 20% is forecast to enhance S&P 500 eps by $10.00 or, roughly, 7%. When added to GDP growth of 3-4% one can easily see that earnings can grow by 10% this year. We think the S&P 500 can do better because the lower corporate tax rate will likely attract more capital to the US. We would not be surprised if stocks return 15%, but the possibility of a summer slowdown is real, and stocks have not had a meaningful correction in quite a while. Stocks could experience a jolt or two this year. We think that companies, in general, will look to use their tax windfall by:

1. Bonusing employees;
2. Adding to staff;
3. Repurchasing shares;
4. Increased mergers and acquisition activity;
5. Building US-based plant and equipment.

These factors have contributed to some recent purchase decisions in Ford, Peabody, Visa, and Brunswick. We will closely monitor the condition of the consumer and inflation expectations. We expect to make adjustments should either deteriorate significantly.

In addition to your year-end statements, we are enclosing a copy of our Privacy Disclosure Document in compliance with SEC requirements.

We are also including the yearly Realized Gain & Loss Report for all taxable accounts.

Once again, we would like to thank you for your business. We hope the coming year benefits your personally and financially. We would also like to extend a special welcome to our new clients who joined the Arbor family in the past quarter.

If you know someone or an organization that you believe would benefit from our services, please mention our name. We would be honored to have more clients like you.

Sincerely,

Gerald T. Cole, CFA **January 30, 2018**

Chief Investment Officer

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