Arbor Capital Management

A Pure Asset Manager

Third Quarter 2020 Investment Overview

We have lived through a series of shocks that few could have imagined. The COVID pandemic and subsequent economic shocks are still working their way through the system. Swift action to defend payrolls, businesses and to supply liquidity has significantly mitigated near term pain. There have been some sharp gains in employment and activity, but the fundamentals of many companies have shifted. We expect the evolution of this quarter's activity to set the tone regarding the nature and pace of the recovery going forward.

Macro-Economy. The near term impacts of mass quarantine and Government stimulus are reasonably straight forward.

Businesses furloughed workers, and the national debt exploded as a result of the Cares Act. The PPP mitigated a large number of layoffs, but the program expires this month. One of the broader questions is what happens to unemployment afterward. Many layoffs may become permanent.

The Federal Reserve Bank of Atlanta estimates second-quarter GDP will show an unprecedented contraction of 39.5% in a single quarter (the consensus forecast is a contraction of 32%). The main negative contributors were personal consumer expenditures (mostly services), inventory investment, and exports. The services most heavily affected were health care, food and beverage, and travel. Positive contributions came from Government spending and residential fixed investment.

We acknowledge that this recession was self-imposed. Nonetheless, the path forward is unclear:

1. Jobs won't recover nearly as quickly as they were lost;
2. Health concerns will linger;
3. Social distancing concerns will have a lasting impact on travel and entertainment;
4. Businesses are likely to weigh health concerns heavily when considering staffing and remote working;
5. Some workers will have to re-train for entirely new occupations.

About two-thirds of the May and June surge in employment was in Hospitality and Construction. Still, there is a shortfall of over three million jobs from February levels. Several states are re-imposing social restrictions, which is going to lengthen the duration of unemployment further. Recent gains in employment, though dramatic, have a long way to recover before the job market returns to stability. Consumer sentiment (spending) has also been sharply affected as a result. The slow-down has also had a material impact on the industrial economy. Total Capacity Utilization – Manufacturing is down drastically to the lowest level ever. Shipments of capital goods (ex-aircraft) are also down significantly.

The combination of all this conspires to make an extraordinarily difficult economic climate. However, many positives will likely deliver benefits over the next several quarters and well beyond.

Positive Economic Factors.

1. We expect Congress to enact another round of stimulus next month. It appears to be agreed upon that a component of it will be an infrastructure spending program. Short-term this provides jobs, long term our highways, bridges, ports, airports, etc. will be improved.
2. The US, Mexico, Canada Trade Agreement (USMCA) should bring many manufacturing jobs back to North America. It closes loopholes where assembly of predominantly Chinese imports qualified as originating in North America. Mexican workers will enjoy much improvement in wages and work rules. American companies and workers will be able to compete on a more level playing field.
3. International trade agreements are being restructured to reflect more reciprocity and fairness to each party. Better contracts make trade more accessible and more sustainable.

The current quarter is likely to start as a period of transition and build growth from there. The only credible threat to this scenario, at this time, is a resurgence of the pandemic.

Monetary Policy. The Fed has stated outright that it intends to keep interest rates near zero for the foreseeable future. Moreover, they also are enacting a policy to manage the shape of the yield curve by targeting purchases of bonds to create the desired slope suggesting to us that inflation concerns are taking a back seat to employment concerns.

Fixed Income. Our strategy continues to employ laddered maturities emphasizing high-quality issues and relative value. The potential reward for extending maturities is only a few basis points, which are not sufficient to offset the possible risk of doing so, in our view. We continue to shop for step-up rate securities and variable rate coupons where available. We also avoid areas where credit ratings or underlying revenue may be deteriorating or at risk. The principal attraction to Bonds currently is their guaranteed cash flows at future times-certain, providing a haven for many investors.

Stocks. We believe that the current momentum-driven stock rally is overdone. The current quarter eps of the S&P 500 are expected to be down 44% on 11% lower revenues. Full-year earnings are expected to decline 24% vs. 2019 on 6% lower revenue. Growth is likely to resume in 2021, but earnings are expected to fall short of 2019's. In a nutshell, this means we are paying for 2019-level S&P earnings which, is not likely to be surpassed until 2022.

We remain optimistic about the future of the U.S. markets, but the current price levels warrant caution. Earnings shocks of the magnitude we describe cannot help but impact underlying credit characteristics if not entire business plans. Unfortunately, these changes are not apparent until weeks after earnings are released. In our scenario, the current euphoric state pauses to reconsider reality. During that hiatus, we anticipate considerable realignment of share prices to be more indicative of the 2021-22 time period.

As a registered investment advisor, the SEC, under the Investment Advisors Act, requires that our disclosure brochures and the new SEC form Client Relationship Summary be delivered to each client and prospective client. You will find SEC for Client Relationship Summary (CRS) enclosed. We offer to send you our current Firm Brochure with additional information should you request it. If you would like to receive our current Firm Brochure, please call or write Sandy Dodson, the undersigned or go to SEC.GOV.

Going forward, if you would like to receive this letter and quarterly report electronically, please send an e-mail to us at smdodson@arborcapitalmgt.com and ask to be added to our electronic distribution list.

We appreciate the opportunity to be of service to you. Please call us anytime to discuss your account, particularly if you have any changes in your goals or lifestyle. We extend a special welcome to the many new clients who have joined the Arbor family in the last quarter. If you know someone or any 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 **July 27, 2020**

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