Arbor Capital Management

A Pure Asset Manager

Second Quarter 2021 Investment Overview

As we progress into the second quarter of the year, the economy is solidly in recovery mode. GDP is growing nicely both domestically and abroad. Growth comparisons against last year will be sharply higher for the next few quarters. Amidst the favorable developments, inflation pressures are emerging. Some wonder if this should be cause for concern or optimism. On balance, we are optimistic.

Economy. The sharp rebound in growth after last year's disruption will undoubtedly create some unusual statistical comparisons for the remainder of the year. Recently, the ISM Purchasing Managers' Index posted a reading of 64.7%, a 38 year high for Manufacturing. In nearly every prior business cycle on record, this type of spike in Manufacturing activity coincided with Manufacturing operating at peak capacity, full employment, and cyclically high commodity prices. Today, none of these is true. When one dives deeper into the latest PMI report, we find some interesting information:

- 68% reported higher new orders and production;
- 76% reported slower supplier delivery times;
- 50% reported higher inventories;
- 30% reported higher customer inventories;
- 85% reported higher prices.

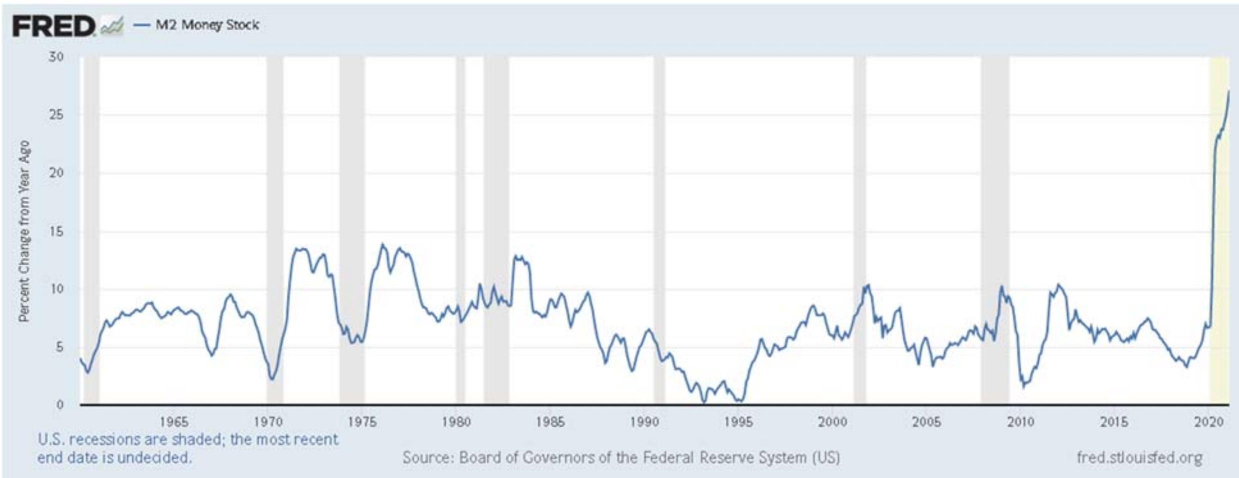
Our key takeaways from this are:

- Manufacturers' activity is surging:
- Manufacturing inventory accumulation is neutral:
- Customer (retail) inventories are low;
- Higher consumer prices are likely to be passed along to consumers.

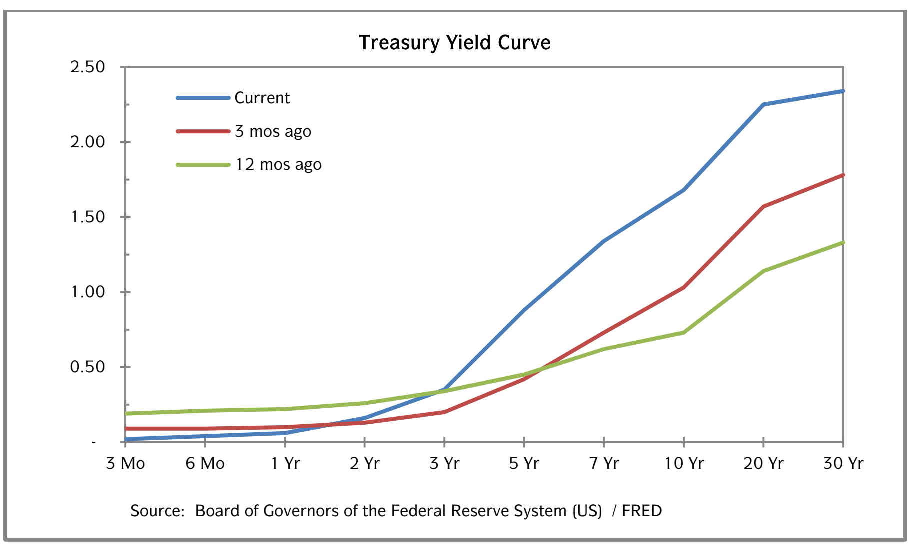
The data suggests continued economic growth likely to last two or more years driven by increased consumer spending and inventory replenishment. Manufacturing has an abundance of excess capacity (at least statically), so the current set of conditions ought to promote domestic production and job creation.

While the recent PMI Index is quite high it is possible to go higher still, aided by economic resurgence off a depressed state. However, sometime within the next quarter we anticipate a PMI peak if not already achieved. After that, a gradual reversion to the mean of 50% over a period of 2-3 years seems likely. The deceleration from the peak could give investors pause as they attempt to appraise the change and re-align their positions. Inflation pressures are building, but they are a long way from anything we experienced during the 1970's.

Interest Rates. Since the onset of the pandemic, the Fed has been on overdrive. The great policy fear of the past decade had been the risk of falling into a deflationary spiral similar to that of Japan. The Fed has consistently held easy money policies and relaxed its inflation targets. At the start of the pandemic, the Fed pumped an unprecedented amount of cash into the system.



As the economy continues to recover, it is logical to expect that interest rates will rise accordingly. The yield on the Ten-Year Treasury has risen from 0.93% to 1.6% year to date. In absolute terms, 70 basis points may seem like a drop in the bucket. However, interest rates have nearly doubled in three months, which is significant. Higher interest rates can be expected to flow through the economy in mostly predictable ways. Spending behaviors may prove disruptive if consumers respond to the prospect of higher rates by accelerating large purchases such as homes to help control costs.



Of course, the net result of this behavioral change is just the opposite. It creates inflation. The Fed has stated clearly, that it intends to keep short-term interest rates about where they are. The result has been a steepening yield curve as borrowers return to the credit markets anticipating higher future costs. Further steepening of the curve accelerates inflation expectations that perpetuates the self-fulfilling prophecy. We think the combined effects of an expanding economy and excess liquidity, inflation should continue to rise gradually, and interest rates along with it. Our best guess is that the Ten-Year Treasury could work slightly above 2% by year-end.

Fixed Income. In the face of rising rates over what could be an extended period, we are keeping maturities short with the exception of floating-rate notes that tend to trade much more closely to par value. We think it is a mistake to chase yield by lowering credit quality standards or pursuing private placement securities. Illiquid instruments lose the luster of an incremental short-term return the minute some hiccup comes along. To us, the risk is not worth a few basis points of *potential* return. We continue to emphasize high credit quality and strong relative value.

Equities. Low interest rates have affected equity prices, favoring growth relative to value. In an environment where interest rates are near zero, future earnings are nearly as important as earnings in the near term. This is why some companies with little or no current operating earnings performed exceptionally well while strong companies with solid fundamentals languished. Once interest rates rise, the present value of future earnings reduces sharply. As rates rise, the desirability of current earnings and company fundamentals comes more into focus. Value then becomes favored relative to growth. Since value is historically cheap in comparison to growth, we expect a long period of back-and-forth as the relationship between growth and value reverts to its long-term mean. Still, not all value stocks are the same. Some stocks are cheap for a reason. We work hard at separating the "wheat from the chaff." This process has become more complicated because of wide-spread restructuring of balance sheets. With interest rates so low, it makes sense for a lot of companies to add long-term debt to either repurchase common shares or start new capital projects. However, the decisions to add debt or alternative financing techniques are not uniform, even within smaller industry groups. We have recently strengthen our security selection models to better adjust for these distortions. Several times per week we screen nearly 9000 companies in search of excellent companies whose shares are priced reasonably and have below average business risk.

As a registered investment advisor, the SEC, under the Investment Advisors Act, requires that our disclosure brochures be delivered to each client and prospective client. 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, or the undersigned or go to SEC.GOV.

We appreciate the opportunity to be of service to you especially during this crisis. Please call us anytime to talk, particularly if you have any changes in your goals, lifestyle, or your health. We are the Arbor Capital family and we are here for you.

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 **April 21, 2021**

Chief Investment Officer

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