Arbor Capital Management

A Pure Asset Manager

Third Quarter 2022 Investment Overview

As we pass through the mid-point of the year, the broad economy appears to be in recession. Markets have responded accordingly. We believe that our attention to investment fundamentals will win the day for at least the next several quarters, if not the next several years.

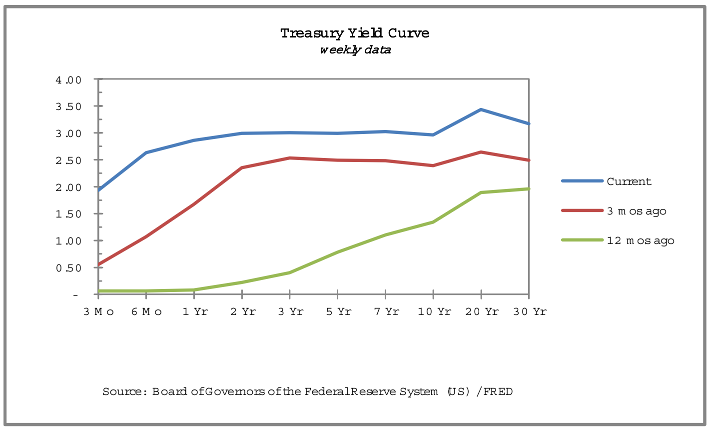
Economy – Good News and Bad News. First, the bad news: First quarter GDP was -1.6%, and the Atlanta Fed is projecting deterioration to -2.1% for the second quarter. We will officially be in recession if the Atlanta Fed's forecast is accurate. They cite declining personal consumption expenditure and sharply contracting savings. This suggests that consumers are still spending at their normal pace, but inflation is eating its way into cash flow, savings, and credit card balances. The degree to which consumers adapt spending behaviors to higher prices will influence the depth and breadth of the inflation-adjusted economic contraction. If inflation runs at 8% and real GDP declines by 2%, then the economy is still growing at an underlying 6% (nominal) rate. This explains the general sense of belt-tightening without much of the usual pre-recession angst. Some might refer to this as a "growth recession."

The nature of this recession is unlike anything we have seen previously. Typically, at the onset of recession mass layoffs have been announced, rates have risen to cyclical peaks and inflation has begun to wane. Instead, we are currently in a situation where employment is strong, rates are just starting to rise, but inflation has taken off. The main causes to the slowdown are rising costs of consumer staples that saps consumer's cash flow coupled with persistent supply chain imbalances and the prospect of higher financing costs. Some economists are concerned about the possibility of job cuts making matters far worse. We agree that a broad workforce contraction would make matters much more difficult. We just don't see that outcome as very likely at this time. Job vacancies still outnumber the people who are unemployed. Most employers are primarily concerned with keeping and recruiting staff, not shrinking it. Conditions would have to get a lot worse before large scale layoffs occur, in our opinion. We think that the eventual solution to our supply imbalance issue is to re-build our domestic manufacturing base. The prospect of taking advantage of low wages caused many companies to move manufacturing to Asia in order to remain competitive. The supply-chain bottleneck in China is compounded by logistical costs. When companies review the situation, costs of "cheap manufacturing" may overwhelm the benefits. Hence, the trickle of manufacturing capacity returning to the USA, which is good for the domestic economy in the long term. We expect this to help sustain Capital Spending over the next several years.

There are so many economic cross-currents that the investment community will tend to balance Government released statistics against earnings guidance coming from many corporations over the remainder of the summer. The patterns that emerge will inform the near-term course of the economy.

Monetary Policy. In order to backstop the economy during the covid outbreak, the Fed took unprecedented measures to supply capital. Money supply (M2) growth has been an astounding 42.2% since the onset of the last recession in 2020. Consequently, inflation spiked upwards. The Fed's current response has been to halt its purchase of bonds and mortgages and reduce its holdings as they mature while driving the Fed Funds Rate upward by 75 bps. Because the Fed is playing "catch-up," a few more increases are expected. The shocks are intended to startle people enough, so long-term piecemeal rate increases might not be necessary. The difficulty lies in the measurement of the effects. The risk from a policy maker's perspective is guessing incorrectly thereby over(under)shooting what is needed. It is easy to understand what the Fed is attempting in terms of emotional impact on economic behavior, but no one will have any idea if the Fed action was successful for a year or more including the Fed's Board of Governors. The economy appears to be resetting, and a soft landing is probable at this time. However, if the Fed overplays its hand, a more severe outcome would be possible. We will continue to monitor this situation as it unfolds. The next Fed meeting is at the end of this month.

Fixed Income. The Fed's actions are clearly reflected in the Treasury Yield Curve.



The short end of the yield curve saw the most significant swing in yields. Most of the yield pick-up from extending maturities occurs within 1-2 years. Extending beyond that offers little if any yield advantage. With the Fed painted into a corner, we think yields are headed higher. Our strategy is to keep effective maturities short to protect principal while setting the stage to capture higher yields at some future point.

Equities. We seek to add value by selecting companies with consistently high returns on invested capital or those companies we think are positioned to accelerate return on invested capital. One of the tools we use extensively is free cash flow analysis. With it, we can directly compare management effectiveness relative to its immediate peers, sector, and the overall market. We can then assess which businesses are more consistent and resilient to economic uncertainty. We then review each company for creditworthiness using the same financial ratios the major credit agencies use. While no investment process works 100% of the time, we believe that focusing on company fundamentals leads to better results in the long run. If you are interested in learning more about our investment process, please contact your Arbor Capital representative, who will be happy to discuss it with you.

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 20, 2022**

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