Arbor Capital Management

A Pure Asset Manager

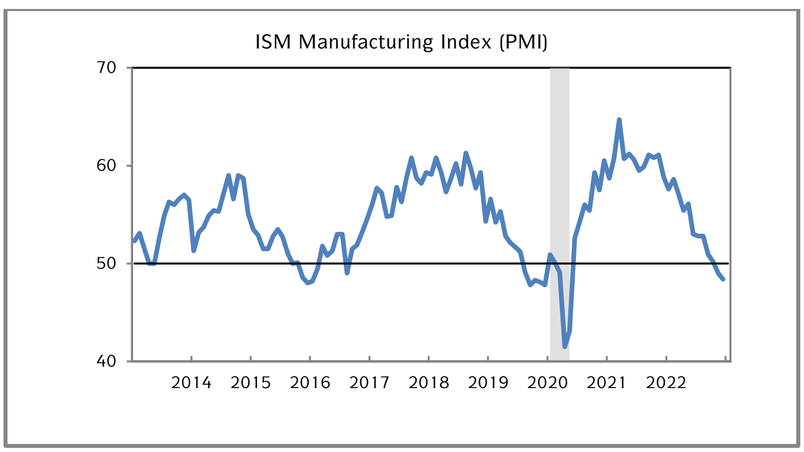
First Quarter 2023 Investment Overview

2023 opens to a mixed set of economic data. After a rough year in 2022, most people anticipate a relatively weak first half, with strengthening starting around mid-year. We agree.

Economy. As we suggested in earlier letters, we think the World is entering a period of stagflation. Personal Consumption Expenditures (PCE) for the past year are +6.3%, and ex-Food & Energy, PCE is +4.9%. These numbers are down marginally from earlier in the year and may suggest that inflation pressures are easing. Resolving supply/demand imbalances created during the pandemic may explain much of this. However, food and housing costs remain persistently high. Energy prices have receded from their peaks earlier in the year due to sales from the strategic petroleum reserve. As the impact of those sales diminishes, oil prices may rebound. In sum, inflation pressures may have peaked, but the prospect of a return to a 2% rate is a long way off.

While inflation remains elevated, the production part of the economy is cooling.

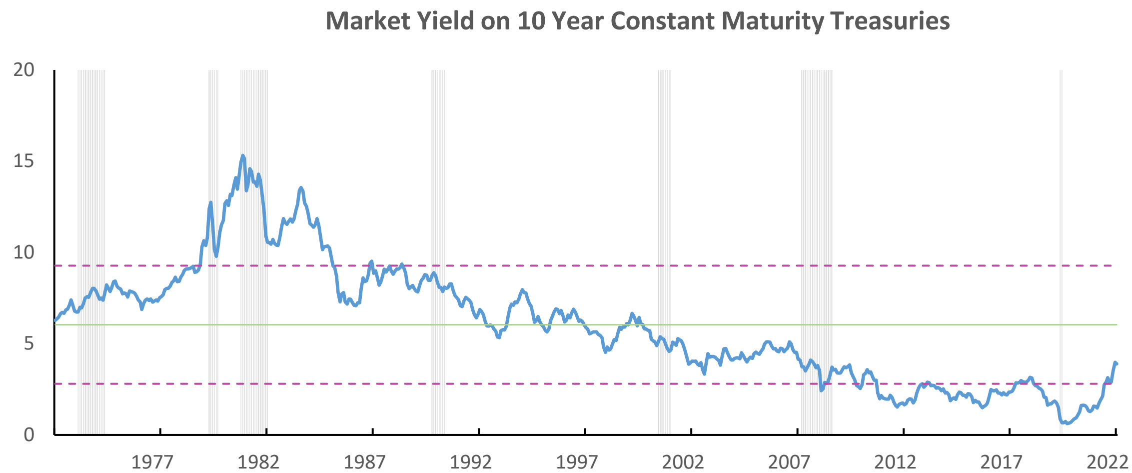
The Purchasing Manager's Index is signaling a broad downtrend in Manufacturing, which suggests the bulk of supply chain problems of the past two years are behind us.



Capital spending, for the moment, continues to progress, driven by Chinese demand for heavy equipment and the need to replace scarce workers.

Labor markets are mixed as well. Overall, the job market remains tight, but several notable technology bellwethers (Amazon, Microsoft, Meta, Salesforce, etc.) have announced significant layoffs. So far, the laid-off tech workers have rapidly found new positions. This shakeout in technology employment is probably healthy in the long run while causing much near-term pain. On a broader scale, total job openings exceed the number of unemployed by nearly two to one.

Monetary Policy. Interest rates have been headline news for the past few months. That alone is a signal. After being kept remarkably low for years, rates have risen steeply over the past year. The rate of increase rivals that of the late 1970s. We think it is the speed with which interest rates have increased rather than the absolute level of rates. Rapid changes in interest rates affect capital project considerations of every type, which is why they can be so disruptive. Significant increases in the cost of capital generally lead to some project cancellations and staff reductions in the aggregate economy. It is the downstream effects that magnify unemployment and business downsizing.

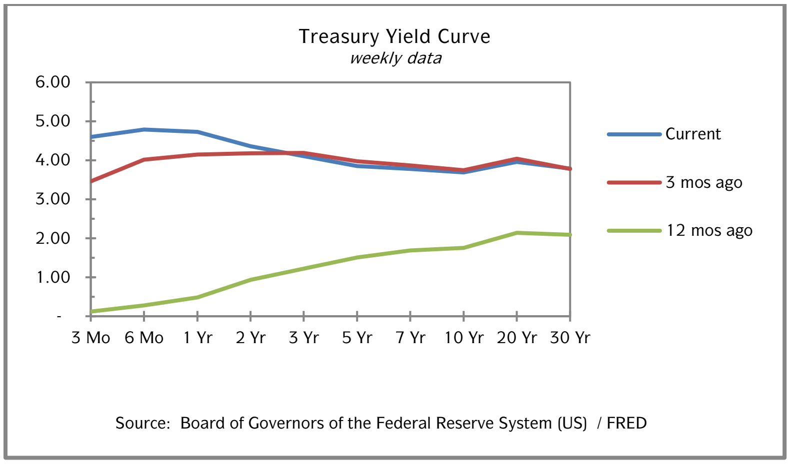


Rates are still at the low end of their historical range of the past 50 years. Over this period, the average 10 Year Treasury Yield was 6.04% (the solid green line). The two dotted lines represent one standard deviation above and below the mean.

The Fed's self-proclaimed objective is to bring inflation down to its 2% target rate. Since unemployment has barely budged and inflation has remained sticky, we anticipate additional Fed Funds rate increases. How many and by what magnitude is anybody's guess. Futures traders think Fed Funds could rise to 5% in the near term, however, if one were to add 1% above the core inflation rate, Fed Funds would approach 5.75%. As long as the data reflect slack, we expect a continued tight policy. The Fed's portfolio of securities that had been purchased during the period of quantitative easing will be allowed to roll off the books as part of the tightening process. The next two FOMC meetings end on February 1 and March 22.

There has been a broad divergence among developed countries' sovereign debt. The US rates have been much higher over the last several years, translating to an exceptionally strong Dollar. The Fed's rate increases have been mirrored by most central bankers leading to tighter spreads in yields globally. Were foreign bond yields to exceed that of the US Treasury, the Dollar would come under pressure that could drive interest rates a bit higher.

The Treasury Yield curve has risen sharply and inverted (short-term rates exceed long-term rates). This correlates strongly with the possibility of a recession within the next 6-9 months.



Should evidence mount of an impending recession, we expect the Fed to back off of its aggressive stance out of fear of overshooting its policy objectives. Hence, the consensus view expects an easier Fed stance at year-end.

The rapidly rising prices and increased interest rates are causing consumer spending to contract and/or shift to less costly alternatives. A consumer spending-led recession appears likely. Because employment is so strong, we expect it to be shallow and brief. We will monitor labor statistics more carefully in the coming quarters to assess their impact on inflation and growth.

Fixed Income Strategy. We have been cautious with our bond strategy for some time. By keeping our average bond maturities short, we have reduced risk, and now, as each of them is redeemed, there is an opportunity to capture higher yields. However, we think the overall inflationary pressures will persist longer than most people seem to anticipate, so we will maintain an emphasis on a shorter duration. We will evaluate opportunities as they arise and may begin to extend some maturities. In our view, it is premature to make a wholesale shift to long-term bonds.

Equity Strategy. We remain steadfast in our belief that fundamentals matter most, particularly in an environment of global uncertainty. We emphasize companies with stable earnings and whose revenue streams are relatively unaffected by an economic slowdown.

We view equity values in the context of several general factors, such as competitive position, credit strength, capital structure, and earnings quality. We analyze each element by breaking down its components and comparing them to its peers, market sector, and the broad market. If you would like to learn more about this, please contact us; we can provide some concrete examples.

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.

Please call us anytime to talk, particularly if you have any changes in your goals, lifestyle, or your health. 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 25, 2023**

Chief Investment Officer

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