Arbor Capital Management

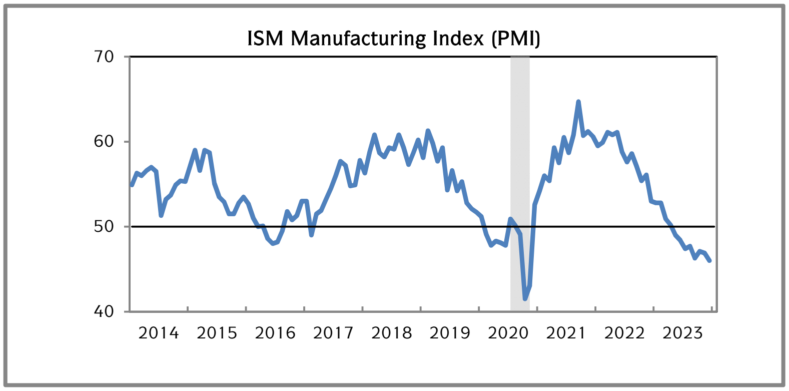
A Pure Asset Manager

Third Quarter 2023 Investment Overview

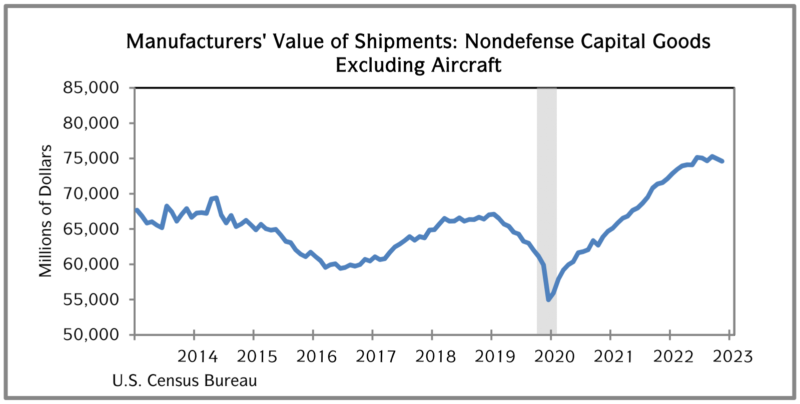
The US economy is transitioning from unprecedented monetary ease to a more normal rate environment. Since the Great Recession, The Fed has held short-term rates artificially low, causing real interest rates to be negative for most of this period. Historically, long-term interest rates are 3-4% higher than the inflation rate. Eventually, markets will restore a similar relationship if left alone. The process of markets making these adjustments is causing volatility in markets worldwide.

Economy. Despite the strength in equity markets, we feel the economy is headed toward a recession. Many classic indicators that suggest an imminent recession have already been breached. Despite this, several forecasts push the onset of recession well into next year. Here are the relevant facts as we see them:

- The ISM Manufacturing Index below 50 indicates a general state of contraction.



- Similarly, New Orders, Supplier Deliveries, and Production are soft. The longer this persists, the greater the probability of manufacturing layoffs.


Manufacturers' Value of Shipments: Nondefense Capital Goods Excluding Aircraft

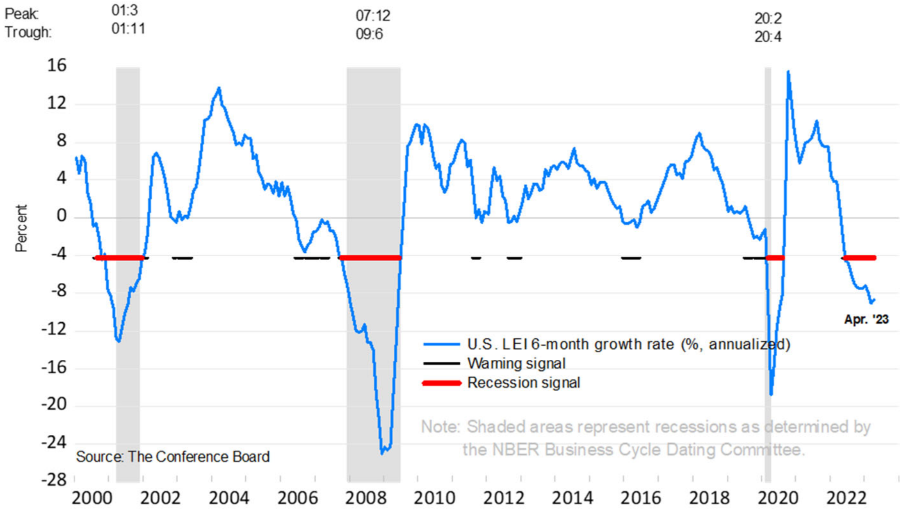
U.S. Census Bureau

- Regardless, manufacturing earnings will remain under pressure into 2024. Capital equipment shipments, however, have remained very strong. A breakdown in this segment would be noteworthy. Previous capital spending cycles have responded sharply.

- Though the overall labor market remains strong, conditions are weakening. Initial unemployment claims are rising, and job openings are starting to shrink.

- Retail sales adjusted for inflation are down 2.4% from the previous year.

- The Conference Board Leading Economic Index is signaling recession within 12 months.

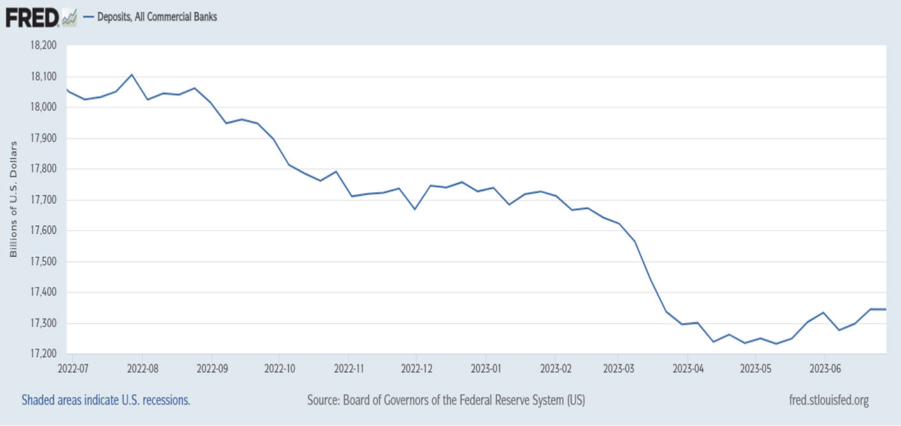


Note: Shaded areas represent recessions as determined by the NBER Business Cycle Dating Committee.

Source: The Conference Board

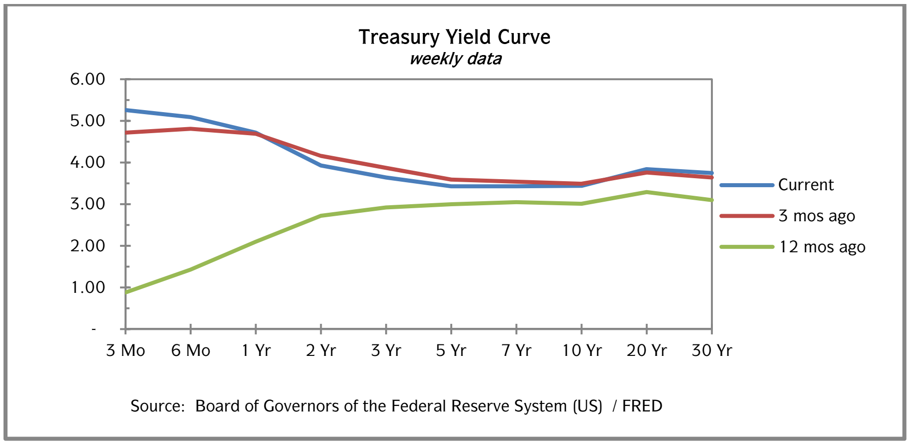
- Banks are under stress.
    - Deposits are shrinking at an average of about $2 billion/day. Why leave your money in a checking account when money market rates are around 5%?
    - Loan loss provisions are rising.

    - Capital requirements are tightening.
    - Commercial real estate, especially office space is under pressure.



Source: Board of Governors of the Federal Reserve System (US)

- The yield curve is inverted. Yield curve inversion is one of the most consistent predictors of recession.


Treasury Yield Curve
weekly data

Source: Board of Governors of the Federal Reserve System (US) / FRED

Those forecasts on the more optimistic side suggest that Fed Funds rates would be cut, on an order of magnitude of 1.25% in 2024. We don't see that happening. Fed Chairman Powell has clearly stated that monetary policy has not been tight or long enough to reduce inflation to the Fed's targets. It is fair to expect at least one more rate increase this year. We do not, however, expect a Fed Funds rate decline to be as rapid as expected.

We think the current uncertainty about the economy's direction stems from a combination of normal business cycle behavior and residual effects of the Covid stimulus/disruption. As long as the government doesn't "stir the pot.," Supply and Demand will take over. In the meantime, cross-currents are likely to steer some economic time series in unusual and seemingly illogical directions. At this time, we think consumer behavior is key. Were households to retrench, then inflation could drop rapidly.

Fixed Income. We are still emphasizing short maturities. From time to time, we may gradually extend maturities to lock in higher yields when we feel it is appropriate while maintaining high credit quality standards.

Equity. Valuations for stocks, in general, are a little high. The P/E on forward twelve-month earnings is about 19x vs. an average of 18x over the past ten years. Two things about this raise concern:

1. Earnings were stable to rising in the past. Our forecast is not dire, but earnings progress will likely be flat for at least a year, suggesting a fair P/E below the ten-year average.
2. Interest rates are elevated and may increase, making fixed income relatively more attractive, thereby driving P/E's downward.

Our core holdings are built around businesses that continue to grow regardless of economic conditions. Each company is selected based on its ability to generate Free Cash Flow and improve returns on invested capital. The combination of these efforts is explicitly designed to mitigate downside volatility. Additionally, we have elevated cash reserves a bit to permit a little cushion for a potential market correction, so we may make some opportunistic purchases when the time comes.

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 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 **July 24, 2023**

Chief Investment Officer

This report has been prepared by ARBOR CAPITAL MANAGEMENT for distribution only under such circumstances as may be permitted by applicable law. It has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. It is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the information contained herein, except with respect to information concerning ACM, its subsidiaries and affiliates, nor is it intended to be a complete statement or summary of the securities, markets or developments referred to in the report. The report should not be regarded by recipients as a substitute for the exercise of their own judgment. Any opinions expressed in this report are subject to change without notice and may differ or be contrary to opinions expressed by other business areas or group of ACM as a result using different assumptions and criteria. ACM is under no obligation to update or keep current the information contained herein. ACM, its directors, officers and employees, or clients may have or have had interest or long or short positions in any securities or other financial instruments referred to herein, and may at any time make purchases and/or sales in them from time to time. Neither ACM nor any of its affiliates, nor any of ACM' or any of its affiliates, directors, employees or agents accepts any liability for any loss or damage arising out of the use of all or any part of this report. ***Additional information will be made available upon request.*** *Past performance is not necessarily indicative of future results.*

For investment advice, clients or interested persons should contact their Arbor Capital representative.

Lawrence T. McGowan

100 Corporate Pkwy, Suite 308

Amherst, NY 14226

(716) 446-9111

ltmcgowan@arborcapitalmgt.com

Daniel M. Toole

100 Corporate Pkwy, Suite 308

Amherst, NY 14226

(716) 446-9111

dmtoole@arborcapitalmgt.com

Leo Mesa, CFP

790 Juno Ocean Walk, Suite
600

Juno Beach, FL 33408

(786) 202-0602

lmesa@arborcapitalmgt.com