



Arbor Capital Management

Second Quarter 2016 Investment Overview

The economy and financial markets continue to give mixed signals. Job growth is finally building some strength, which is decidedly positive. However, because the economy has taken so long to get to this point a number of factors are showing signs of age similar in appearance to those of a later stage of a business cycle. Since this entire cycle has been so slow to unfold, it is possible that these conditions could persist for some time. The consumer is the key.

Employment and Wages. When the Affordable Care Act was first passed, we argued that it would have a chilling effect on job creation and it still does. Raising the cost of labor relative to the cost of capital results in loss of jobs either to automation, overseas competition or they are simply eliminated. This delayed the replenishment of non-farm payrolls in an already soft labor market. The recovery to prerecession payroll levels took longer than any other previous business cycle. As the chart shows, payrolls have finally exceeded their 2008 highs and are now more closely in line with the long-term growth rate.

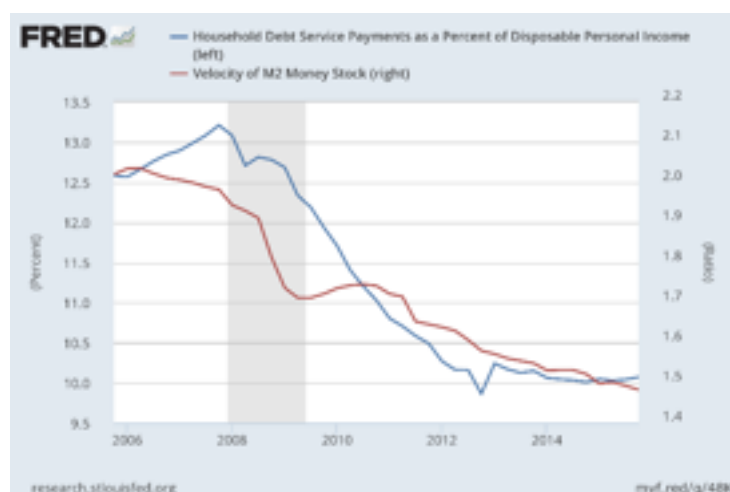


Consumers account for 70% of GDP. Payrolls and retail sales are naturally linked.

The sharp drop in energy costs and gradual improvement in employment leads us to be optimistic that the economy will have some much needed wind at its back over the next several quarters. The general lag between perceptible changes in the overall economy is generally thought to be approximately 12-16 months. Consumption is just beginning to benefit from improvement in household sector that started over a year ago and is likely to extend at least 4 quarters into the future.

Normally an overheated economy generates excesses that result in a corrective slowdown. Clearly, our current economy is far from overheated but several areas are gradually suggesting slowing rates of growth, such as: pressure on profit margins; tightening credit, and inventory accumulation. Inventory accumulation is the most apparent at this time. Over the past year the slowdown in China and Europe have reduced demand abroad and the US consumer has shown spending restraint. Current inventories are elevated relative to sales. This needs to adjust. We expect a combination of increased consumer demand and moderate price adjustments may be sufficient to take up the slack. The next few releases of the Purchasing Managers' Index will help shed some light on the future course of this. As a result, GDP growth is expected to be flat for the next quarter or two.

Despite extraordinarily low interest rates, the economy has not surged forward the way many would expect. The reason for this is that the pace of economic activity has been slowed. The slowdown in the velocity of money is a reflection of the pace of business and defensive spending patterns of the past decade. Over the entire span of time since the onset of the last recession, consumers have substantially reduced debt service payments



through a combination of debt reduction and refinancing. The consumer is now in a more liquid position than any other time in over 30 years. Part of this is explained by demographics. Baby boomers are nearing retirement and cannot be expected to spend in the same manner as they would early in their careers. Still, the data suggests significant untapped purchasing power. However, any real surge in spending will require a far greater improvement in job conditions, and thus consumer attitudes, than what we have at present.

Despite lackluster economic growth, monetary policy has been anticipated to tighten for quite a while. In fact, it has already happened under most people's radar. The recent fed funds rate increase to 0.25% is thought by many as the first sign of tightening. Quantitative easing at its peak was functionally equivalent to -3.0% fed funds. From 2010 to now, we have really experienced the equivalent of 3.25% in rate increases. Given our perspective, we do not expect further rate increases at this time. If the Fed elects to increase short-term interest rates, we expect it to be later rather than sooner.

Fixed Income. We remain cautious regarding the possibility of a surge in interest rates. We expect the yield curve to flatten once the Fed starts raising the discount rate more steadily. Current bond purchases are being made in anticipation of this possibility. Emphasis is on maturities of 5 to seven years.

Stocks. Most broad market indices have recovered. In January we expected a relief rally and that later extended, happily, a little past our forecast. Currently, the broader market is digesting some of those gains and may pullback given the likelihood of softness in quarterly earnings reports. We are making purchases at this point that emphasize earnings stability and a bit higher dividend. Representative sectors are Utilities, Foods, Soaps and the like. The object is to provide earnings and cash flow cushion should a general economic slowdown become more worrisome. We still expect some volatile episodes this year and amplified investor emotions as the Presidential election draws near.

As a registered investment advisor, the SEC, under the Investment Advisors Act, requires that our written disclosure brochures be delivered to each client and prospective client. Enclosed is the Summary we are required to supply at least annually. In addition to this summary, 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 Beth Eustace, Chief Compliance Officer, or the undersigned.

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

April 2016

Chief Investment Officer

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