Arbor Capital Management

Third Quarter 2016 Investment Overview

Volatility has been the watchword for both the economy and global markets. Uncertainty about the future of the European Union (EU), the stability of China and near recession conditions in many lesser developed countries continues to challenge investor sentiment. Markets have responded with a “risk on, risk off” trading mindset causing many to flee to safe haven investments. Despite the events and crosscurrents that are unfolding across the world, the US economy is solidly in a stable/neutral mode.

Brexit: Keep calm and carry on. Investor fears of a near term financial meltdown were unfounded. Still much remains to be settled. Political forces within the UK are trying to nullify the vote to leave the EU. Britain’s ultimate exit may take years to unfold. There doesn’t seem to be any way to predict its exact timing.

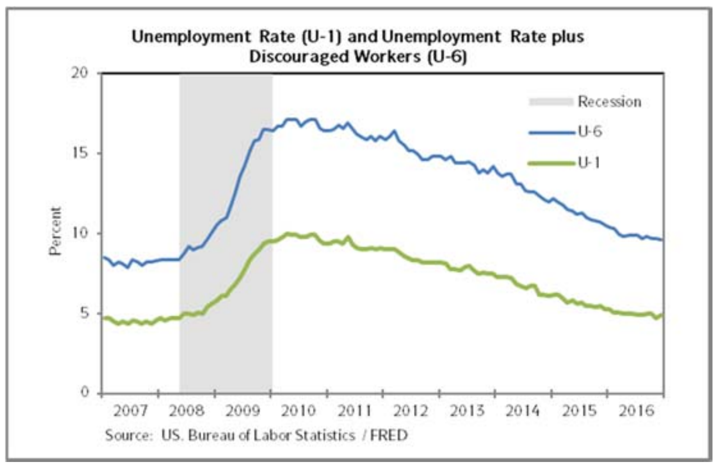
Longer term the Brexit vote underscores the fundamental and cultural challenges to successfully making the EU a lasting proposition. It is feared that this may limit workers’ ability to move about freely throughout the region for jobs or other preferences. The influx of immigrants has thrown a “wrench” into the works creating downward wage pressures while adding to an already strained social welfare burden.

The vote provided a catalyst to the apparent sudden surge of separatist sentiment across a number of EU countries. The Brexit vote has let a genie out of the bottle. Were more countries to join the Brits in seeking to exit the EU, then financial stresses could elevate significantly. Emotions could spill over in a variety of unforeseeable ways. Regardless of what path the leave/stay votes take, we view the EU economy as a low growth situation indefinitely placing a downward bias on trade growth. Greater impact on the US economy could occur should events take a more severe tone. Brexit has been comparatively benign so far. The recent terrorist attack in Nice may have a greater negative impact on regional trade to the extent that it causes closure of borders.

China has faded from the spotlight a bit as a result of all the attention the EU has gotten. It continues to grow at a reported (exaggerated) 6% + pace. Last fall we suggested that the natural path for the Chinese Yuan was higher. The reason was that the Chinese was growing substantially faster on an inflation adjusted basis than any other nation. Any economics text I have ever read would support this conclusion. Since then it has only gone lower. We completely underestimated the extent to which the Chinese were willing to go to competitively devalue (manipulate) their currency. Competitive devaluation is generally undertaken as a means to make domestic investment more attractive than foreign investment. In China’s case it also helps mitigate flight of capital to foreign markets by making exchange to competing currency too costly. Like most government interventions of this sort there is some short term benefit, but eventually a higher price will need to be paid to restore a natural economic balance. China will continue to be a leading player in the world, however, its trustworthiness as a trade partner is called into question by its own actions. This suggests any return to China's boom economy conditions will be delayed by a year or longer. When it comes to trade, credibility matters a lot.

Energy prices are well ahead of the fundamentals and are likely to retrace much of its progress over the summer in our opinion. Traders have gotten a little overenthusiastic so a pullback to the upper 30's appears possible. We expected that OPEC in general and the Saudi's in particular would reduce production to help stabilize oil prices. They have done the opposite and prices have risen anyhow.

Jobs, in our view, are the single best indicator of economic prosperity these days. Non-Farm Payrolls continue to grow. The Labor Force Participation Rate may have bottomed. It up-ticked in a few readings so far this year in distinct contrast to the previous 8 years. It can hardly be said that the labor market is tightening but we choose to view this as a constructive start. There still exists a large number of working aged Americans who are out of the labor force. The chart contrasts the Unemployment Rate (U-1) which is the most often reported rate and The Unemployment Rate plus Discouraged and Underemployed Workers (U-6). The U-6 series points out both the brutal job loss and the disincentives put in place through massive expansion of unemployment benefits. This suggests that there is a significant capacity in skilled labor that will help keep wage pressures low.



Monetary Policy worldwide is nearly exhausted. Many countries including Germany have negative long term interest rates. No one is quite sure what lasting effects negative rates will have. Japan has had them for many years and there still isn't a clear consensus that they have helped. Because Europe is soft and China is still decelerating the dollar has strengthened because the US is the best place to put money these days. Because the dollar is so strong relative to other currencies the Fed is reluctant to raise rates as they would like because it would have a negative impact on global economies and in turn would hurt the US as well. We were forecasting a rate hike late in the year, but that is now being called into question.

Fixed Income has had a strong year so far fueled by still declining interest rates which are near all time lows. The main driver of lower rates currently is the fact that rates for government debt in Germany, Switzerland and Japan are *negative*. In fact, 74% of government debt worldwide yields less than 1% and 36% yields less than zero. Even though US rates are so low they are still preferable to most fixed income alternatives. As we have seen in the past, once things stabilize abroad, funds flows can move rapidly in reverse. While that outcome seems a little remote at this point, the risk is still out there. We feel that we need to remain vigilant with regard to our bonds positions and recommend new purchases to remain fairly short and defensive.

Stocks. Analyst consensus has forecast fairly soft earnings reports this quarter and expect earnings to post improvements over the remainder of the year. Consensus earnings tend to error on the optimistic side at the start of each year and then gradually narrow in on reality as the year progresses. They also tend to be very accurate in direction and in identifying the leaders or followers in each industry.

Company guidance during this earnings season is particularly important, in our opinion. The underlying economy is generally flat and finding robust earnings growth is increasingly difficult to find. Coupled with valuations that are a little rich, a sideways trending market is expected. Our response is to redouble our focus on dividends, stable earnings and positive free cash flow.

The continued response to our website has been overwhelming. If you have not had an opportunity to visit www.arborcapitalmgt.com, we invite you to tour the site. We hope you are enjoying "Financial Insights" our email video series on a variety of financial topics. We welcome your comments and suggestions for new topics to discuss.

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. Also, you should be receiving custodial statements directly from your qualified custodian at least quarterly. If you are not receiving these statements, please contact us so that we may assist you in resolving this matter.

We extend a special welcome to the many new clients to 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 2016**

Chief Investment Officer

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.

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