Arbor Capital Management

Third Quarter 2018 Investment Overview

The US Economy is expanding strongly led by capital spending and an expanding labor force. The US is poised to set the pace of growth globally for the next several quarters. Among the challenges facing investors for the remainder of the year include navigating the current trade disputes, coping with higher energy costs, and rising interest rates.

International Trade. We favor free, fair and open trade. Unfortunately, what we have now is not. The US came to its current situation by policies initiated at the conclusion of WWII. To help a war-torn world get back on its feet, the US granted favorable trade privileges generously. Since WWII ended over 80 years ago, the fundamental premise of America's trade posture in the Global economy no longer exists. A systematic re-examination of America's trade agreements is past due. The current system is a jumble of various deals, incentives, and roadblocks that is as difficult to comprehend as it is to rationalize. Layered just beneath the trade structures lies a myriad of government subsidies that support industries in some countries where, otherwise, they could not exist. Many of America's largest companies have located plants overseas to satisfy a trade restriction of some form or to take advantage of some efficiency. Many of these arrangements were well intended but now resemble a death by one thousand cuts. As much as we would like to wipe the slate clean, it would be too costly in the short term. However, we are hopeful that the current administration can make some big improvements in some key areas such as autos, food, and steel. We are in favor of any arrangements that level the playing field.

NAFTA was expected to bolster the economies of Canada and Mexico by helping them to build their industrial base. Part of that occurred. However, a greater proportion of the benefits to our neighbors has been through the exploitation of a fundamental weakness in the original agreement that failed to address the use of non-NAFTA sourced parts in manufacturing assemblies. Thus, China became one of the greatest beneficiaries of NAFTA through a loophole. Merchandise trade between the US, Canada, and Mexico are roughly comparable in dollar terms. However, as a % of each partner's total economy, the gap is greater than tenfold. Reduction in trade among the NAFTA partners would be an inconvenience to the United States but would devastate either Mexico or Canada. Therefore, we expect some material realignment of NAFTA's terms, probably after the mid-term elections.

Jobs, Jobs, Jobs. Employment statistics are improving in nearly every data series. Unemployment statistics for women and minorities are at 50+ year lows. Workers who had been permanently "discouraged" from participating in the labor force are finding employment and re-entering the working world. Naturally, consumer confidence continues to rise as do home prices As we stated in previous market commentaries, we think a combination of measurement errors and the unique duration of a sluggish economy have produced a circumstance where the true size of the available labor force is probably larger than traditional estimates would suggest. Wage growth remains subdued at this time.

America's industrial economy is strengthening. Capacity Utilization is ticking upwards, and the Purchasing Managers' Index continues to signal strong expansion. Shipments of capital goods are continuing to pick up as well as Industrial Production and Freight Transportation.

Oil prices have pulled back at least briefly as supply has picked up a bit. The Saudi's are adding production, and the US continues to drive the lifting cost of shale oil downward. We expect the relief to be short-lived as the expanding economy drives energy consumption higher. This is the healthiest the US economy has been in quite some time we expect the trend to continue for the next few quarters. From our vantage point, the probability of recession is very low at this time (we would estimate less than 25%). Historically, Business cycle typically last 4-6 years or so. The current cycle is about 9 years old. Because this business cycle has been so long, we are watchful for significant developments that could bring it to a conclusion. However, there is no rule that says the cycle can't be longer still.

Interest Rates / Fixed Income. The combination of higher energy costs, tightening labor supply, strong industrial production and realignment of our international trade deals each tend to support a case for rising inflation. Thus most market observers expect at least three more rate increases this year. In a reversal of circumstance from last year, it is Europe and China that are holding growth back a bit.

Forward-looking interest rate forecasts are reflected in the steepness of the yield curve. The term structure of interest rates remains very flat, i.e., with little increase in yield for taking on longer-term bonds. Investors collectively have a very complacent attitude toward future inflation. What this suggests to us is the Fed is acting somewhat pre-emptively. We continue to believe that the flat yield curve will continue to slow the pace of rate increases. Conversely, should the yield curve steepen, then we would expect a rapid response in the form of a rate increase.

Our fixed income approach continues to favor short-term and high-quality securities. Other structural elements that we utilize are floating rate and step-up coupon bonds. Our fundamental approach is to preserve capital first, then optimize return relative to our clients' specific needs.

Stocks. This past spring, stocks went through what was close to a 10% correction. Currently, many names are building bases from which they should be able to advance. In light of the build-up in economic momentum, we have added several names that are likely to benefit. As always our criteria place an emphasis on creditworthiness and visible earnings growth at a reasonable price.

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 25, 2018**

Chief Investment Officer

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