Arbor Capital Management

Fourth Quarter 2018 Investment Overview

The big story of the year is the resurgence of the US economy. Larry and I have been in the investment business in one form or another for 40 plus years. We haven't seen anything quite like this before. Almost ten years have passed since the last recession and seeming out of nowhere . . . Boom. What is even more surprising is the strength of the underlying economy that indicates these conditions are likely to persist well into next year.

Economy. The confidence of small businesses and consumers continues to rise because of lower taxes, rollback of regulations and the first pro-business administration since Reagan. In life as well as business we have learned that attitude counts for a lot. The same applies to economic activity in the larger scale. Real Disposable Personal Income is rising at an annual rate of 1.4% per year. That number is after taxes, after benefits, after inflation. Trade agreements are being re-negotiated to more favorable terms. Capital is flowing back into this country at rates that a few years ago we would have considered impossible. Capital spending on equipment, technology, and new plants is booming. For the first time in a very long while, possibly in history, the number of job vacancies (~7.1 million) exceeds the number of unemployed (~6 million). Wages are set to increase, and opportunities for advancement are plentiful. Wages at the lowest pay scales are rising more rapidly than those for white-collar employees, which may be yet another first. Even with the tax cuts, government revenues are up 1%. Unfortunately, spending is up a lot more.

There are, however, a few potential "flies in the ointment," namely, China and consumer-durable spending.

Over many decades the US has granted China every possible trade accommodation to stimulate their development. Now that China's economic footprint has grown to the second largest country by GDP, it appears logical to ask them to conform to some of the rules. Among the main items that give China an unfair advantage that costs the US jobs (*Peter Navarro, Death by China, page 50*) are: 1. Illegal export subsidies, 2. Manipulated currency, 3. Theft of intellectual property, 4. Willingness to inflict massive environmental damage to gain cost advantage, 5. Extraordinarily low worker safety standards, 6. Illegal tariffs designed to control raw material supplies (metals), 7. Export "dumping" to crowd out foreign competition and, 8. Outright protectionism that keeps foreign competitors from setting up shop on Chinese soil. In other words, if some of these factors are leveled out, then China's production cost advantage rapidly evaporates. It is no secret that China's planning horizon extends for decades where Americans are far more short-term focused. This means that trade talks will last for many years. All things being equal, the Chinese can be counted on to give ground as sparingly as possible. However, all things are not equal. First of all, Chinese consumers do not have the purchasing power to buy the products it produces. If the United States curtails purchases of goods manufactured in China, the effects are greatly amplified and lead to massive layoffs and broad shutdowns of construction projects. Being a communist government they can certainly do this, but, at what cost? In our view, the United States has a far stronger position, and this alone should speed negotiations along. Our best guess is that the Chinese will still negotiate with the hope that a new President is elected who is not as strong toward trade. As future administrations change, we anticipate changes in Chinese trade behavior. In the near-term, the sudden imposition of trade tariffs may hurt some prices in the manufacturing supply chains. Longer-term it is a non-issue. As jobs were being shipped offshore, US manufacturers shuttered plants and laid off workers. Most of that plant and equipment is still hanging around idle just waiting for someone to turn the lights back on. Other industries sensing the change toward dumping of foreign products on the US have revived. US Steel and Nucor have announced multi-billion dollar commitments to build new steel-making capacity, the first in a very long time.

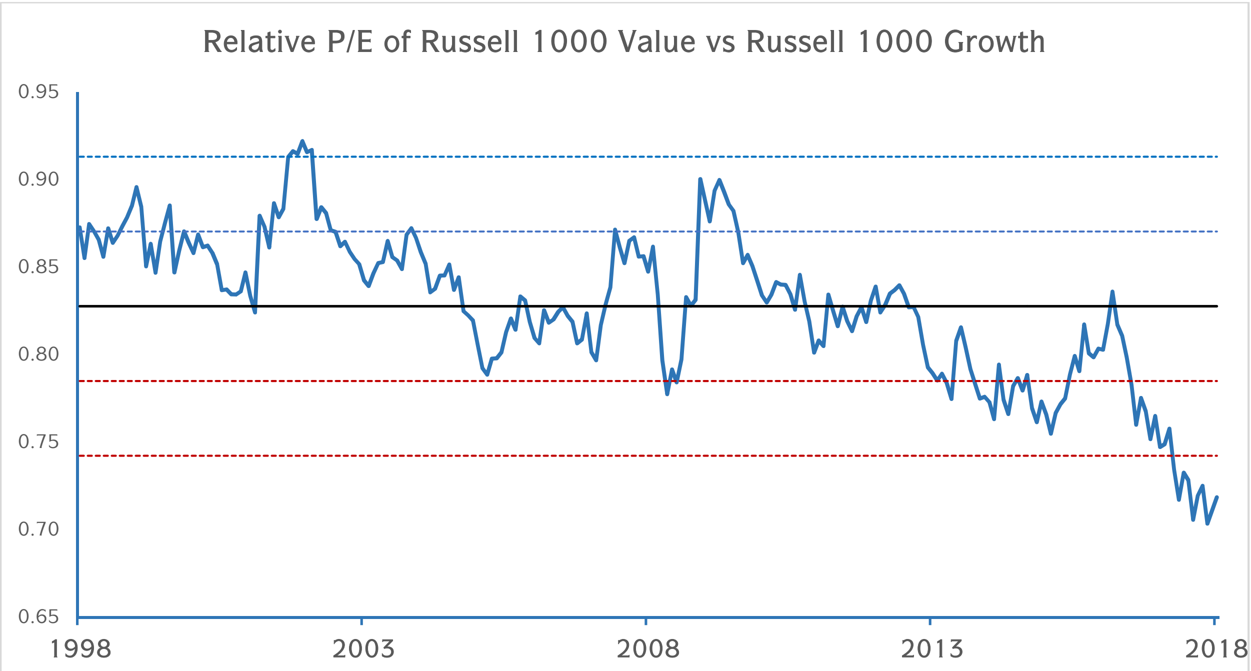
Most time-series of economic activity are positive. The most notable exceptions are Autos and Housing Starts. If our bullish case for the US economy holds, then this will be viewed in the rear mirror as a pause (about a 60% probability in our estimation). A more moderate scenario would allow for an extended adjustment period where growth scales back, and durables like houses and cars remain relatively flat for a year or longer (30% probability). If we miss the mark and roll over into a recession (10% Probability), then we would expect it to be brief and shallow. Capital inflow back into the US is too strong to allow for a protracted slowdown.

Interest Rates. Inflation has crept up a little over 2%, about in line with the Fed's target. The Fed has kept pace with economic activity and the economic strength with its Fed Funds targets. Long-term rates do not currently reflect the strengthening US economy. High inflows of foreign investment have temporarily held long-term rates down. The normal long-term Treasury yield should be around 3% higher than the inflation rate, or 5%, almost 2% higher than today's yields.

Fixed Income. Our fixed income strategy anticipates rising interest rates for the foreseeable future. Stated maturities are short and laddered. We are also purchasing bonds with floating-rate coupons or other defensive features to mitigate the negative effect of higher rates on bond prices. Should rates get ahead of themselves at some future date we would be in a better position to capture additional yield on behalf of our clients.

Many people hold fixed income mutual funds. Up to this point in the business cycle returns in intermediate to long-term funds performed relatively well. Going forward, we think long-term bond funds carry more risk than most people perceive. Where we hold fixed income mutual funds great care has been taken to assure that they are invested in a way to preserve capital and provide yield. Where practical, we continue to favor individual fixed income securities because they afford us the opportunity to better control risk and return.

Stocks. Given the strength of economic growth, we expect corporate profits to progress nicely over the next year. We think stocks will progress about in line with that. However, some speculative excesses have risen that we suspect will need to be addressed. Some companies, including some of the current market leaders, have advanced solely on the merits of top-line growth. In our view, this attitude ignores important fundamentals that drive profits, cash flows and capital requirements and price. The chart illustrates this point more clearly than we could describe.



Value and growth strategies normally tend to alternate year to year. Value is currently more out of favor than any time in the prior 20 years. The relative P/E of Value is almost three standard deviations away from the mean. We feel it is highly likely that this relationship will revert to the mean. Over the next 12-24 months, at least, we expect Value to significantly outperform Growth. Our equity selections will continue to emphasize strong values and reasonable prices. The table below summarizes our current positions.

Characteristic Comparison

	Large-Cap Core	Global Equity Income	S&P 500
Price / Earnings (TTM)	13.5	14.9	17.6
Price / Tangible Book	2.2	2.4	3.9
Price / Cash Flow	8.8	8.8	12.2
Price / Sales	1.4	1.3	2.1
Return on Equity	17.6	14.1	17.4
Dividend Yield	2.3	3.8	2.0

Clients with taxable accounts will find your Realized Gain and Loss Statement through the first three quarters of 2018 enclosed. You may wish to share this information with your accountant and advise us of any tax planning as soon as possible. Also, we would like to remind our IRA clients if you need a distribution from your IRA, please notify us prior to December 1, 2018 in order that processing is accomplished in a timely manner.

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 **October 25, 2018**

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