Arbor Capital Management

2016 First Quarter Economic Outlook

2015 was a choppy year in most respects. 2016 is off to a shaky start. Many are a little nervous about how the full year will unfold. From an economic perspective it appears likely that the first half of the year will be soft with a gradual build up in activity toward year end. It is our belief that this combined with other factors will be reflected in earnings, share prices, interest rate levels and inflation expectations.

China, Europe and Middle East. The region is entrenched in a number of interrelated issues whose upshot is that they are not likely to become major sources of economic growth this year. Since the close of the cold war these countries have become increasing important trade partners. China and Europe are currently each other's principal trading partner. China is hampered by slow growth in Europe and an internal political purge. Europe is hindered by slower Chinese growth and excess debt. Slower organic growth in Europe and China leads to weakening raw material and energy demand. Hence, the oversupply in oil and industrial commodities.

Energy Catch-22. Late in September we wrote that the International Energy Administration (IEA) was projecting a bottom in oil prices with some price recovery later this year. What neither they nor we foresaw was the chaos that eventually played out in the energy sector. The Saudis and Russians have built entitlement programs from their respective petroleum revenue streams. Scaling back that spending would lead to a great deal of political unrest and could topple a regime or two. This is underscored in the Saudis expression of interest in selling a stake in Aramco. Aramco was formed as a partnership between the Saudis and what are now Chevron-Texaco and Exxon. In 1980 those assets were "nationalized." Selling it back would be a tough sale in anybody's book. Still, faced with the problem of restoring price discipline and social funding, it would appear that their best option would be to sell debt. Their current debt to GDP ratio suggests a lot of capacity to carry more. Unfortunately for them, the market has sensed its desperation and priced Saudi credit default swaps higher than even those for Portugal. They will still be able to sell debt . . . for a price. The Russians simply don't have any options. The vast majority of their hard currency comes from energy sales. Some have suggested that the Russian activity in Syria is a diversion from the revenue shortfall at home. We expect the Saudis will eventually reestablish price discipline this year. Once accomplished this will provide something of a bonanza for oil company shareholders.

Estimation of the political mood in the Middle East has proven nearly impossible. Were things to turn overtly hostile toward the West, then all bets could be off and supply could be halted just to make a point. $100/bbl. oil could be made to look like a bargain. The speed and magnitude of the decline of oil prices is also having a negative effect on energy sector jobs.

Commodities. The prices of raw materials have become central to a number of economic discussions. This table is a good summary. Shown are the current (spot) price, the consensus forecast price for Q4-2016 and the forward price for Q4-2016 (from the futures) (Source: Zacks Investment Research).

Commodity Estimates

Updated on: 01/14/2016

	Spot Price	Consensus Estimates	Forward Price
	1/13/2016	*Q4 2016*	*Q4 2016*
Energy			
WTI (Light Crude)	30.40	61.72	38.26
RBOB Gasoline	105.29	169.68	109.75
Henry Hub Natural Gas	2.27	3.04	2.75
Coal C.I.F. $/MT	45.85	56.90	39.85
Metals			
Gold Spot	1,093.00	1,114.57	1,088.00
Silver Spot	14.18	15.46	14.51
Copper $/MT	4,352.00	5,459.42	4,350.00
Aluminum $/MT	1,450.00	2,028.79	1,472.00
Steel $/ST	380.00	536.67	-
Agriculture			
Corn cents/bu	358.50	398.00	384.46
Wheat cents/bu	481.00	531.30	516.62
Soybeans c/bsh	880.00	908.11	889.27
World Sugar c/lb	14.47	14.64	14.09

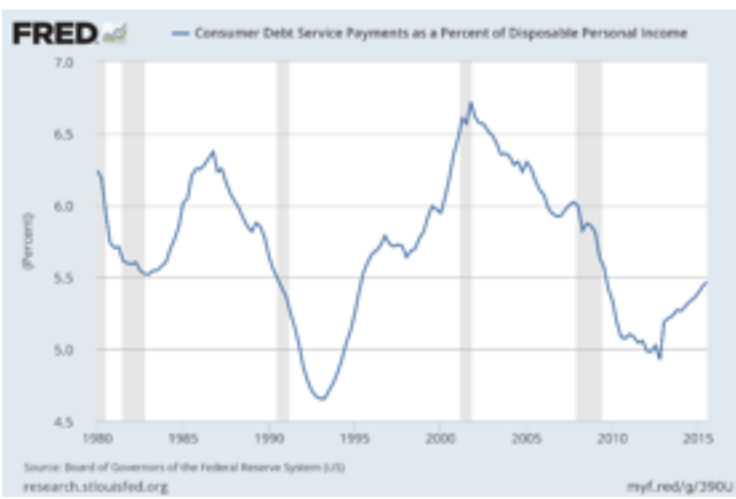
By observation the estimates and forward prices diverge at points. For lack of a better idea we could argue that a better forecast might be the average between the futures price and the estimate since each has some value. Energy prices ought to be higher at year end and coal futures are depressed largely due to the bankruptcy of Arch Coal. Primary industrial metals such as Copper, Aluminum and Steel should each be considerably higher at year end. Foodstuffs should trend moderately higher by comparison. This table is consistent with GDP growth of 2-2.5%.

Unemployment, Manufacturing and Consumption. Jobs are finally beginning to hit their stride. Job growth of 300,000/month is a substantial improvement over the recent past but the rate of job creation is well behind typical economic recoveries. Unemployment (U1) is shrinking to more acceptable sounding numbers. The reported number is around 5%, when discouraged workers no longer counted as part of the labor force are added back the number mushrooms to 10%. To us, at least, one of the most positive aspects of the current set of labor statistics is that the median duration of unemployment is declining. The Job market is firming.

Apart from a drive to raise minimum wages there is no evidence to suggest that the labor market is tightening to the point of driving wages higher. The Affordable Care Act (Obamacare) already represents a large increase in the cost of labor that is just now being digested. Further increases in labor cost would hamper job creation and economic growth.

Manufacturing activity as measured by the ISM purchasing managers' index has drifted to the low 50's. This still suggests growth but at a slower pace and is also the case in the other major economies. Total capacity utilization is currently reported at 77%. There appears to be little fear of production related shortages that could fuel inflation.

In spite of the headwinds of the sluggish economic recovery, consumers have strengthened their balance sheet and can help fuel a little growth. The silver lining in the drop in oil prices is the boost it gives to consumer cash flows and spending patterns. This is a significant decrease in every households' and every business' expense and will help encourage consumer spending. It seems that the lag between a significant drop in gasoline prices and noticeable consumer spending increases. We think most consumers first look to retire revolving credit before making large new commitments. Regardless of what individual households do, in the aggregate this is a strong positive for consumer spending going forward. The University of Michigan Consumer Sentiment Index at 92.6 has improved steadily since September. Since the dollar is so strong, demand for imports ought to improve. This should stimulate manufacturing activity in Europe and Asia.



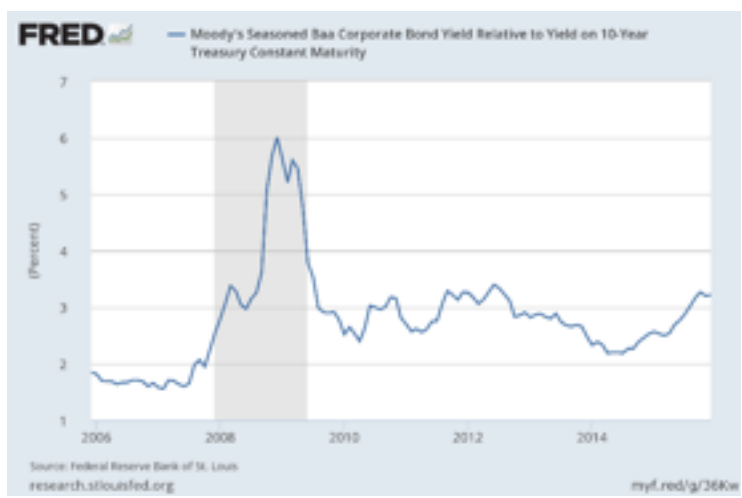
Inventories are on the high side at the moment. It is our expectation that they will be reduced substantially over the first half of this year with replenishment activity picking up in the second half of the year. Corporate profits will likely follow a similar course.

Fixed Income. The Fed recently raise short term rates for the first time in this economic expansion in the face of a mixed bag of statistics. San Francisco Federal Reserve President John Williams said that we should expect 3-5 rate increases in 2016 and that Fed Funds are projected to reach 3.5% in the next several years. Of course a number of factors could intervene to frustrate this forecast but nonetheless there is significant optimism within the Fed for continued economic growth.

The larger question is how will the maturity of bonds purchased in the various quantitative easing programs be handled. There are some very large positions rolling off in the next few years. It is likely that the Treasury and the Fed have conferred about this and what conditions would have to prevail to drive policy in one direction or another. The manner in which these are refunded will be telling as to which direction the macro-economy is headed. Will the Treasury simply refund the debt? How well will the new issues be absorbed? Will there need to be additional purchase made by the Fed to absorb the excess supply? Time will tell.

We expect that interest rates will rise more rapidly at the short end of the yield curve than at the long end. It is likely that the yield curve will pivot around the seven to ten-year range. At year end it would not surprise us to see Treasury yields at 2.75-3% for the 30 year and 1.5 % for the 2 year. The absolute level of interest rates will rise a bit and inflation expectations (quantified by the steepness of the yield curve) will remain moderate.

The most notable event in bonds last year in our view has been the sharp expansion of spreads between Baa bonds and Treasuries. This is a reflection of a change in direction of Fed policy toward gradual tightening and concerns about economic softness. Lesser credits tend to be a bit more sensitive to changing conditions. This is why we so strongly emphasize quality in our bond holdings. Going forward we expect these spreads to remain wider than we have seen in recent years. Provided the economy continues to expand and interest rates continue to rise we expect that more "normal" historical spread relationships between bond market sectors will begin to reappear.



Our purchases will remain at the shorter end of the maturity spectrum. Our longer term purchases will tend to have defensive features such as step-up coupons or put options attached in order to preserve principal.

Stocks. China and Oil prices are driving investor emotions. News from either tends to be magnified in stock price volatility. We have long believed that much of the Chinese economic miracle was engineered by its government. Still the severity of its recent bust is surprising. Prior to the current correction we felt share prices by and large were fairly valued and the market was a little over bought. We suspect a wave of selling to offset losses in China may be at the root of our present situation. Since information is scarce, fears amplify and a wave of selling ensues. Note the recent announcement of WalMart closing 270 stores. Because of the tone of the marketplace investors initial reactions were shock and fear. The plain truth is they operate over 11,000 stores and despite the projected job curtailment of 16,000 people, WalMart still employs 2.4 million people worldwide. We would argue that the closing of less productive assets in order to bolster the potential of web based sales is simply a sound growth oriented decision. Much of the fearmongering in today's environment lacks reasonable perspective.

Our strategy at this point is to reevaluate our equity holdings and realign our portfolios for the 12-18 months ahead. Periods of market upheaval generally do not treat all companies equally. We will be focusing on improving values wherever possible. In the short term we are raising cash and will likely reduce our already underweighted Energy exposure even further. As part of this process we are also building a shopping list of companies and price points that we feel are attractive. We will make purchases once selling pressure is exhausted and the overall tone of the market improves.

In addition to your year-end statements, we are enclosing a copy of our Privacy Disclosure Document in compliance with SEC requirements. We are also including the yearly Realized Gain & Loss Report for all taxable accounts.

Once again, we would like to thank you for your business. We hope the coming year benefits your personally and financially. We would also like to extend a special welcome to our new clients who joined the Arbor family in the past quarter.

If you know someone or an 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 **January, 2016**

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