

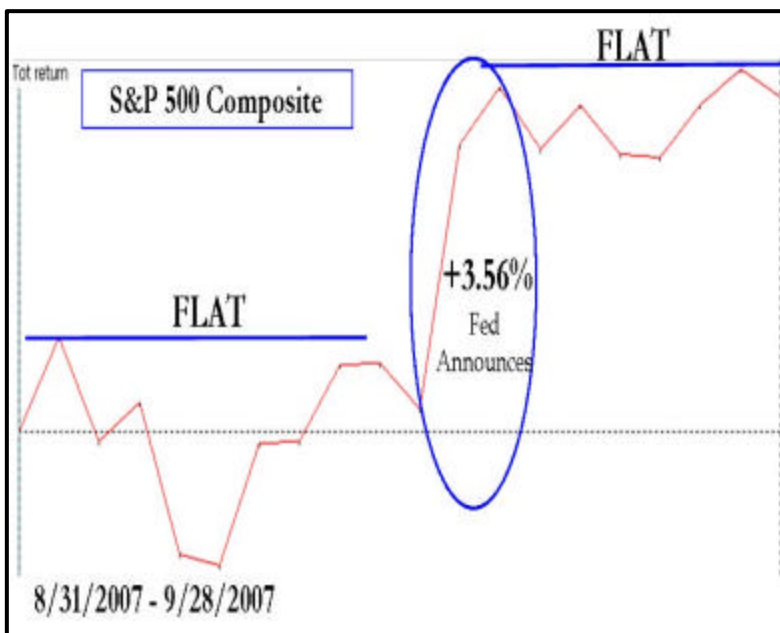
October 1, 2007

To: Friends and Clients of MLK Capital Management  
From: Lane Kerns

Re: Christmas in September  
Would You Have It Any Other Way?  
Economic and Market Outlook  
Current Portfolio Holdings

### Christmas in September

Normally, September is the weakest month of the year for the stock market. However, this September was an exception. The S&P 500 was up 3.72% for the month. Of that 3.72% gain, 3.56% of it came in the 90 minutes following the Fed announcement on the 18<sup>th</sup> and during the next day. In the chart below, it is clear that the S&P 500 was flat prior to and since.



In our 9/17/07 Mid-Month Report we said "... if the Fed does nothing, it will appear insensitive to the slowing economy and the Dow will probably drop 500 points. If it [the Fed] lowers the Fed Funds interest rate by 25 basis points (1/4%) the market will probably not make a big move either up or down. On the other hand, if the Fed lowers the rate by 50 basis points (1/2%) the market will probably go up 300 points, but could go down because investors might interpret it as a signal that the economy is not in

good shape."

As we all now know, the Fed not only cut the Fed funds rate by 1/2%, they also cut the discount rate by 1/2%. Merry Christmas to All! That was a huge and unexpected surprise to the market! The Dow went up 412 points in the 36 hour period following the announcement. Preceding the announcement, virtually no one was willing to bet the Fed would do what they did! Many people were actually short the market, expecting it to go down. In spite of the fact that we missed out on that 412 points, I still think we were properly positioned considering the risks.

We repositioned aggressively to get in tune with the new reality. Between the 19<sup>th</sup>, and the end of the month, the S&P 500 is down 0.10% and the Dow is only up .64%. Our equity models are up between 1.25% and 1.72%!

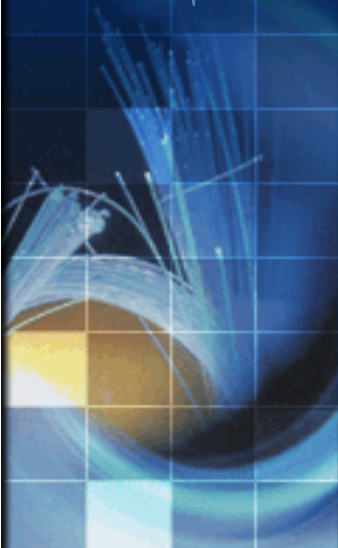
As I write this letter, about one hour prior to market close, the S&P 500 is up 1.33% and our Aggressive model appears to be up about 1.56% for the day.

### Would You Have It Any Other Way?

The market beat us last month. However, after much review of the facts we had to work with, I would not have done it any other way. There was no guarantee – or even any hint - that the Fed

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was going to bail out the markets. In the last two months, there has been a “crises of confidence” in the credit markets which trumped all of the good fundamentals in the economy (more following).

We now know that Bernanke and his crew are more concerned about keeping full employment in the economy than they are fighting inflation. They are willing to risk more inflation to re-stimulate the US economy. That will be very good for the markets until inflation heats up – then it will be very uncomfortable.

In the mean time, the Fed’s current direction presents sizable opportunities – which we are taking advantage of. That is why we have outperformed the market since the day after the Fed’s announcement!

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## **Economic and Market Outlook**

There is a “theme” or “underlying dynamic” at work in the market place. It goes this way – Interest rates are down and the market believes more US rate cuts are coming. Lower rates almost always push up the stock market, but inflation is now more likely. Therefore, the way to make money is to invest in those things that benefit from an inflationary environment. Those things are commodities, which include oil and materials and the countries that produce them. An additional dynamic is the falling dollar in which we will discuss below.

So, let’s look at the facts on the fundamentals. These combined factors have proven to be a good yardstick for how investors should view market opportunity and risk.

1. Corporate earnings: Next week starts earnings reporting season for the 3<sup>rd</sup> quarter. They look strong. Many people think that banks have crammed all the bad news they can into their announcements of the last two weeks. The street is getting the feeling that – once again – earnings will surprise to the upside. Good for the market if it happens!
  2. Personal income: Personal income growth rose 0.3% in August, a little below expectations. But, consumer spending climbed 0.6%, with inflation adjusted spending up the most in two years. Very low employment means that the American dream lives on. With most everyone working and wages rising, the economy will have a hard time slowing down.
  3. Inflation: The core PCE deflator, the Fed’s favorite inflation gauge, rose only 0.1% in August. This brought the year over year rate of inflation down to 1.8%, the smallest gain since Feb., 2004. That is well within the Fed’s comfort range of 1-2%. This is obviously why the Fed felt it had some breathing room in making the ½% rate cuts on the 18<sup>th</sup>. The market, however, does not agree with the Fed. There is a clear inflation play going on which indicates that the market expects inflation problems over the next year. We are benefiting from that play.
  4. Manufacturing Activity: The Institute of Supply Management report (for the entire nation) from this morning showed manufacturing activity is still growing although not as fast as last month. Optimistic that a rate cut is likely, investors pushed the Dow Jones industrial average up.
  5. The world economies remain very strong! Globally, economic statistics continue to surprise to the upside. China and Emerging Markets are strongly outpacing the growth of the US economy. Additionally, Europe is showing strength. These factors, combined with the falling dollar, make international investing look very good. We are enjoying these benefits!
  6. Europe is the strongest it has been in many years. European markets have cooled slightly but are still the strongest in years.
  7. Dollar Strength: The dollar index (which measures the dollar against six major currencies) has hit a record low against world currencies. It has fallen 5% since mid-August. Because of that, Gold has hit a 27 year high, oil is the highest it has been since the 70’s and commodity prices are surging in dollar terms. We are benefitting from our oil and emerging market holdings. We also hold a mutual fund that goes up when the dollar goes down. One reason the Dow 30 Industrials have been stronger than normal this year, after underperforming for several years, is the weak US dollar. A weaker dollar makes it cheaper for foreigners to purchase from the US. Large US companies that do business worldwide earn profits in appreciated foreign currency and then convert them back to an increased number of US dollars. This has increased the earnings of the large multi-national US companies
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significantly this year. Exports and export orders have gained momentum and this continues to be reflected in stronger US manufacturing profits and employment. Next to lower interest rates (which also make the dollar less attractive and push its value down), the lower dollar is the most simulative factor for the US economy.

8. World Liquidity: With the freezing of the credit markets, liquidity temporarily dried up and that is why the markets plunged 10% in August. The central banks of the world have pumped hundreds of billions of dollars into world economies (especially in Europe) and it appears to be having a positive effect. Our Fed pumped an additional \$38 Billion dollars into the banking system last week. They clearly want to make credit easier and the stock markets are loving it! The “Carry Trade” which contracted during the credit freeze appears to be returning adding additional stimulus to world markets. All of this is very positive over the next few months for the stock markets but negative for the long-term outlook on inflation.
9. Supply of Stocks to Invest In: Whereas there has been almost a complete halt to corporate buyouts with borrowed money, IPO’s (Initial Public Offerings or companies going public) is up substantially this year. This means that stock available for purchase as investments may start growing again – whereas it was contracting. It is too early to know whether this will take some of the steam out of the markets.
10. Housing and Subprime Mortgages and Mortgage Defaults: Housing is still the biggest risk to the economy at this point. There has been a sharp drop in home building. However, employment remains strong. Housing construction makes up less than 5% of US GDP and the construction spending report just released shows that total construction spending last month actually increased! Growth in non-residential construction grew faster than housing construction slowed.

In our opinion, most of the reasons for optimism remain valid. While the tightening of credit occurred at an alarming rate and all of the fallout will not be evident for another few months, deposits to money market funds, government bonds and treasury bills sky-rocketed.

That is very bullish because it created a huge pool of money available to flow back into the markets! The fact is that there is a huge amount of money on the sidelines looking for a time to pounce on a rising market. Consider the alternative where everyone is fully invested and there is no cash left to flow into the markets.

Today’s market is up substantially on rising volume. Again, VERY BULLISH!

### **Current Portfolio Holdings**

We are currently between 98% and 124% invested – depending upon equity model. We hold a declining dollar fund which goes up when the dollar goes down. We hold energy, emerging markets and China. All have been outperforming the general market.

We added a position in Hi-Yield bonds to take advantage of their dramatically oversold pricing. When the Fed cut rates, we added a position in bonds to capture the dividend yield and to benefit from the appreciation in bonds as interest rates fall. While the bond position is a hedge against recession, it does not appear that a recession is as large a threat as we thought a month ago.

While November and December are among the strongest months of the year historically, most bad things that have happened in the market, happened in October. September surprised everyone to the upside (or should I say the Fed did). Perhaps the market advance will stay strong for October and lead us into the strongest months of the year.

Our office expansion is almost complete. When it is completed, we will have an open house. We are all very excited and hope you will join us.

I would like to close with a quote from Ralph Waldo Emerson. “Happiness is a perfume that you cannot pour on others without getting a few drops on yourself.”

Be happy.

Lane Kerns

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**This letter is published periodically with my views on the market, investing and things that seem important to me at the time. Remember, all of this is filtered through 40 plus years of experience including a fair amount of both "Good Judgment" and "Bad Judgment". Please feel free to share this with anyone you think might be interested. If someone would like to be put on the list just send me an email with his or her email address. You can reach me at:**

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