

December 3, 2007

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

Re: Markets Suffer Worst Month in Many Years
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Markets Suffer Worst Month in Many Years

Remember our November 1st letter where I said “Normally, November and December are the strongest months of the year for the stock market. We have that yet to look forward to! However, October finished strong with the S&P 500 closing up 1.64% for the month including dividends.” I then went on to say that our models significantly beat the S&P for October.

Well, November reversed for the major indexes due to “one of the worst monthly performances for global stock markets in years;” according to the *Financial Times*. Until the last four days of the month, there were not any two days in a row when the market was up both days. There were multiple 100 point swings (both up and down) in the Dow. One day you wish you were more invested, and the next day less invested.

Most US indexes were down as much as 10% from their peak in October through the last week in November. The S&P 500 lost 10.09% from October 9th through October 26th. During that same period, our conservative model was down only 0.77%. Aggressive was down about 1.4%.

During the last four days of November the market rebounded strongly but still finished with one of its worst months in many years. We did not participate in most of the losses early in the month, nor did we participate in all of the gains of the last four days.

Since October was abnormally strong and November was abnormally weak, one can get a bit stressed about how to react and the proper way to invest. As always, our first concern is to “not lose any big money.”

Let’s look at the last three months combined. The S&P 500 and the Dow, in spite of their volatility were up 0.90% and 0.54% respectively. Our equity models performed substantially better. The composite return of all our Aggressive accounts at Schwab came in slightly above 1.51% - nearly triple the Dow. Moderate and Conservative accounts came in at 1.50% and 1.85% respectively – both beating the market!

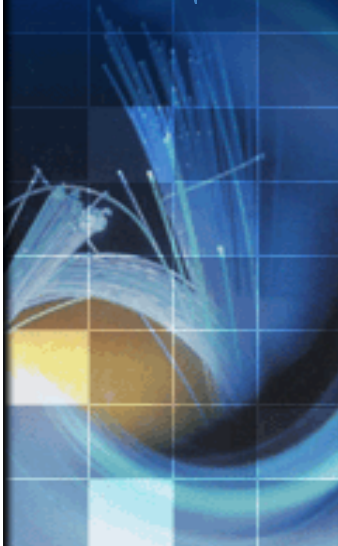
I think it is important to note for those interested in the safety of their money, that not only have we avoided losses over the last three months, our models beat the returns of Money-Market funds, Treasury bills and 1-3 year Treasury bonds.

During October, returns for foreign markets, energy and technology were all strong and the dollar was falling. Virtually all of our holdings benefitted from taking advantage of these markets. During November they all reversed sharply and we reacted accordingly by taking our profits and switching out of them to more defensive holdings.

The three dominant themes during October were a weakening US economy, Oil/Commodities, and Chindia. Chindia is a phrase being used to describe the combined economic phenomenon of China and India. We still have confidence in these three themes for the long run - but - because they had all been so strong, they became over-bought and had large corrections.

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The substantial gains in the market over the last four days have come from what we call “contrarian investors”. Another term for them is “bottom-fishers.” Investors buying the most beaten down sectors like Finance, Banking and Homebuilding. When that type of buying starts, it creates a double reaction in the price of those stocks. First, the new money going into those stocks lifts their price. When that starts happening, all of the investors that had been betting that these stocks were going to continue downward in order to profit from their decline by selling them short, start losing money.

(Short-selling is the act of selling a stock that you do not have with the hope that you can buy it back at a lower price at a later day when you need to deliver it. All perfectly acceptable with well established rules on the stock exchanges. In fact, the rules have been made more liberal this year. It is one way to make money when the market is going down.)

When the Short-sellers start buying back stock to cover the stock they sold short, it forces the prices even more sharply upward. This is called a “short-covering rally”. That is what we saw during the last four days. Will it continue? Will it persist? Even if it is to continue there is usually a pullback before it does so. This pullback occurs when the Short-sellers have covered all of their short sales by buying the stock. Thus, the buying pressure subsides.

Many people mistake that kind of a short-covering rally for a market bottom. While it can be a market bottom leading to a new advance, it usually is not. However, since December is a seasonally strong month for the stock market, and we usually get a Santa Clause rally, this one very well could continue after only a minor correction. As always, we drive with our foot over the brake. This is not a time to become greedy.

Recession – or Just a Slowing Economy?

I have said for months that the fundamentals of the US economy (with the exception of housing) are strong. That picture continues to weaken, but does have some bright spots.

The country’s GDP was revised up for the 3rd Quarter from 3.9% to 4.9% the fastest pace in four years - very strong by any measure!

The Fed, after making it clear at the last Fed meeting that they did not anticipate any additional interest rate cuts, and thereby disappointing the markets, has now changed their tune. Last week they sent two strong messages indicating that we can count on a rate cut at the December 11, 2007 meeting. Additionally, the Treasury Department last week proposed a plan to help bail out those homeowners that are having trouble dealing with rising interest rates on their home loans.

Last week’s reversals by the Fed and the Treasury are what jump-started the stock market and caused all the buying in banks, financials and homebuilders. Will they have the desired effect of keeping the US from going into recession? No one has the answer to that question yet – but the message is clear – they are going to do everything within their powers to avoid a recession. That is a very positive signal for the stock market!

Still, even a slowing economy – if it happens – will mean slowing profits and a declining stock market. How do we position our investments to make, not lose, money? More on that later. One thing is sure, there is a lot of pessimism in the market right now. That is the exact thing that always happens at market bottoms! And it is almost always followed by a strong market rally! The way to take advantage of these swings in the market is to manage risk during the hard times and to jump on the rallies during the good times.

Economic and Market Outlook

I had been writing that “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.”

The first part of that theme MAY still be intact: Additional Fed rate cuts are back on the table. They are back on the table for two reasons: first, they feel the economy is slowing in spite of the strong third quarter GDP number, and second, inflation in the US seems to be moderating. While inflation is clearly picking up in Europe and most of Asia, lower oil prices and other moderating costs have kept our inflation within the Fed’s target range. This changes our invent outlook.

The prices of commodities may continue to escalate and be a good investment. However, it seems equally likely that with a slowing US economy (at least for the first few months of 2008, according to the Fed) there may not be as much demand for commodities and prices may actually fall as we are seeing with oil. If that is happening, we have been wise to take our profits on oil and commodities. If things heat back up, we may re-establish those positions. For now there appear to be better opportunities elsewhere.

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: Corporate earnings have softened substantially. This would normally drag down the stock market. However, the prospect of lower interest rates keeps propping it up.
2. Personal income: Personal income growth has slowed and unemployment claims are slightly higher. *Unemployment is still very low by historical standards.*
3. Inflation: The year-over-year core rate of inflation is 1.9%. That is well within the Fed's comfort range of 1-2%. The problem is that the 'core' rate does not include oil or food. Oil prices are also moderating.
4. Manufacturing Activity: Flat but not getting any weaker due to strong export activity.
5. The world economies remain very strong! Globally, economic statistics continue to surprise to the upside. China, India and Emerging Markets are strongly outpacing the growth of the US economy. Additionally, Europe is showing strength but is slowing.
6. Dollar Weakness: The dollar strengthened last week. This may be short lived.
7. Oil Commodities: Oil prices dropped about 10% last week and took with it most commodities prices
8. World Liquidity: With the freezing of the credit markets in August, liquidity temporarily dried up and that is why the markets plunged 10% in August. The credit freeze problem is still not over.
9. Housing and Subprime Mortgages and Mortgage Defaults: Housing is still the biggest risk to the economy at this point. There continues to be a sharp drop in home building and an increase in mortgage defaults.

In our opinion, the reasons for optimism remain balanced. 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 can be very bullish because it creates a huge pool of money available to flow back into the markets!

Current Portfolio Holdings

We hold long positions in Utilities, Healthcare and the Dow. These have been fairly defensive on down days.

It can be dangerous to get too excited about really strong up days unless they establish a positive trend line. One big day doesn't mean much in the grander scheme. The Nasdaq's nine biggest up days of all time all occurred during the bear market of 2000 to 2003.

May your holiday season be filled with blessings and good family time.

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