

MLK CAPITAL  
MANAGEMENT, INC.

# ADVICE ON THE MARKET



June 1, 2007

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

Re: A Very Strong Month  
Economic and Market Outlook  
A Comment on Bonds  
We Are Growing  
Current Portfolio Holdings

## A Very Strong Month

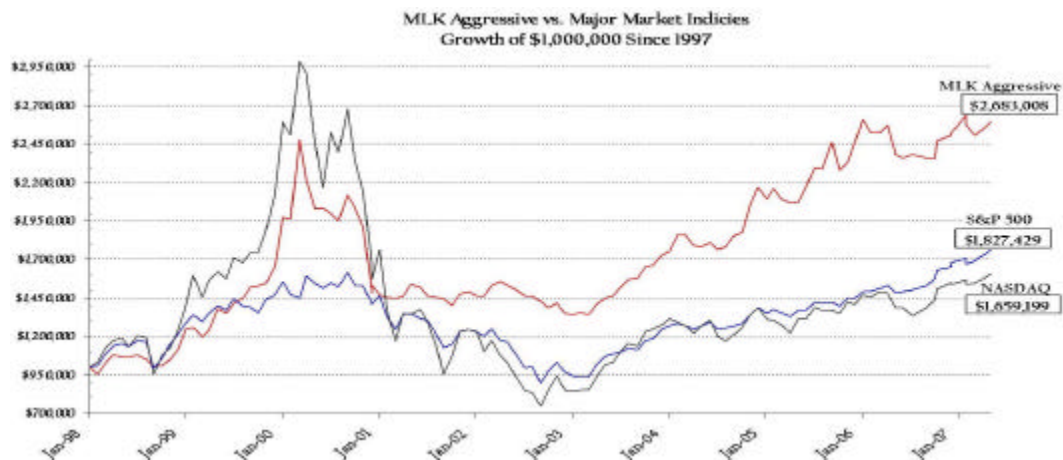
The S&P 500 had a milestone accomplishment in May. It finally reached a new all time high after more than seven years, surpassing the peak it made March 24, 2000. It took a very strong month to reach that new record.

The S&P 500 was up 3.42% for May. Strong by any measure. Our equity models were up 2.91% to 3.51% net after all expenses. We were able to capture the market momentum while managing risk at the same time.

Let's look at the new high in the S&P and compare it to our investment management strategy. The chart below shows performance starting at the end of 1997 through yesterday's closing bell. This period of nine years and five months covers three distinct market types – the last two years of the 1990's boom, the crash from March of 2000 through March of 2003 and the recovery period since March of 2003. These were three distinct types of markets requiring flexibility in management style.

During the 90's we had a very good buy philosophy and felt very smart like most investors at the time. For example, our Aggressive account on the chart below was up 56% during 1999. We entered 2000 with the feeling that we needed a better risk management philosophy and were proven right very quickly. Although not nearly as bad as the Nasdaq, we had a sub-par 2000. That forever etched into my brain the need for risk management. After 2000, we again began to decisively outperform the market – but with more willingness to sell very quickly or hedge when markets weakened.

The chart below, shows the combined results of a \$1,000,000 account invested through the entire period since 12/31/97. As great as the late 90's were for the Nasdaq, clients in our Aggressive model would have beaten the Nasdaq by more than one million dollars as of last night! The Nasdaq was aggressive – whereas we were aggressive but with risk management since 2000. The difference speaks for itself.



## Economic and Market Outlook

In the *May 1<sup>st</sup> newsletter*, I gave nine reasons I felt the market would remain strong this summer even though May through September is typically a very weak period for the markets. So far, that has proven to be the case. Let's restate and comment on each of those nine reasons.

1. *Very few people bet on first quarter corporate earnings coming in at over double the rate projected by the experts. Although the rate of growth has slowed, it has greatly exceeded expectations and will probably keep doing so.* The first quarter did finish strong and the earnings momentum has carried forward. Economic growth, revised lower for the first quarter, now looks as if it is picking up strongly and will be at least 3% in the second quarter.
2. *Personal income rose both in February and March at a rate of 0.7% each month. If it kept that up for a full year, it would show personal income growth of over 8%. This is exceptional and could support strong buying in the economy and, by definition, significant corporate profits.* While Personal Income growth was not as strong in April and May, it was still very strong.
3. *The Core PCE Deflator, (the inflation component of the April Midwest Business Activity reports) showed zero inflation for the month. Over the last twelve months, inflation has only been about 2.1%. Almost down within the Fed's preferred 1-2% range. If we have another month or two at these levels, the Fed could start reducing interest rates to re-stimulate the economy. That would set off the first up leg of the next economic cycle in the US. Lower rates would be extremely bullish for the stock market and would set up the opportunity for strong gains.* The Core PCE number released today showed that inflation has dropped to 2.0%. This is at the top end of the Fed's range for the first time in a couple of years and one step closer to lower interest rates.

*The worry over the last few months has been that inflation might not be slowing down even though the economy would. That would have created a "stagflation" situation similar to the 1970's, where the Fed would be forced to increase interest rates to stop inflation. Stagflation is the worst of both worlds – a stagnant economy with inflation. This would most likely push the US into recession and be very hard on the stock market. The risk of this happening seems to be decreasing dramatically. This is less of a worry now than it was a month ago. Very positive for the markets.*

4. *This week's Institute of Supply Management report (for the entire nation) showed significantly stronger US growth than anticipated.* The same happened this month. The economy continues to surprise and delight investors.
  5. *The world economies are very strong! China is hot. So hot that their central bank raised rates again this week from 10.5% to 11% (the seventh time since June) in an attempt to slow down the country's growth. They are one of the world's biggest buyers of almost everything. In other words, they are not only growing - but their purchases are stimulating other economies around the world. Japan now exports more to China than it does to the US. Global growth remains very strong and is getting stronger.*
  6. *Europe is the strongest it has been in many years. Most dramatically, the German VDMA Engineering Association report (their equivalent to our ISM report), reported orders in March that were 47% higher than a year ago, highlighting the industrial rebound of Europe's largest economy. This month's reports out of Europe and especially Germany indicate surprising strength.*
  7. *One reason the Dow 30 Industrials have been so hot this year after underperforming for several years is the weak US dollar. A weak 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 significantly this year. Exports and export orders have gained momentum and this is being reflected in stronger US manufacturing profits and employment.*
  8. *As I have said many times over the last few months, the world is awash with liquidity and there does not seem to be anything on the horizon to make it go away. This creates tremendous buying pressure as this money is invested around the world. No change here. Cash is still abundant.*
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9. *Even though the US has enjoyed strong economic growth and high employment (thus creating increasing spendable income) there are less opportunities in the US in which to invest it. That may sound strange, but there are actually less shares of stock in which to invest, this year than there were a year ago. That is due to the number of shares being created by new companies going public has been exceeded by shares being taken off the market because of corporate stock buybacks and companies being taken private. This is continuing at an increasing rate!*

*When a company goes private, that means that someone bought the entire company and its shares are no longer available for the public to purchase for investment. That means that we have more and more dollars chasing fewer shares – a sure recipe for increasing stock prices. There is a lot of money looking for a home.*

All of the nine reasons for optimism remain valid. Additionally, while the housing slowdown is not over, it appears close to a bottom and the markets always look six to twelve months ahead. Mortgage defaults do not appear to be having any affect on the credit markets except to tighten credit slightly. That obviously is not slowing down the economy.

### **A Comment on Bonds**

Interest rates are rising. Is that a good thing for bond holders? The answer is no – because as interest rates go up, bond values go down. The time to buy bonds is when interest rates are high and beginning to come down. Then you have the best of both worlds – high interest income and bonds that are increasing in value. That was the case for several years – but the decline in interest rates has stopped and rates are now increasing.

I listened to a presentation by Bill Gross yesterday. He is Founder and Managing Director of PIMCO, the largest bond management firm in the world. He predicted 4-5% global economic growth (what we have been predicting) and “bond yields marching higher” over the next 3-5 years. He said 2008, 2009 & 2010 will be mildly bearish for bonds. At this point, with the equity picture looking so strong, bonds are not a suitable alternative because of inflation and their declining value which will occur over the next few years as rates rise.

### **We Are Growing**

We just signed a new lease to expand our current office by over 40%. We are staying in our existing location and taking over the office next to us. This will give us a new reception area, conference room and more staff offices. We anticipate our current growth in assets under management will continue its rapid growth. Since we have done virtually no marketing over the last few years, we want to thank our clients and friends for telling our story. It is a great story, but without you we'd have no storytellers. Thank you!

### **Current Portfolio Holdings**

We are currently just over 100% invested in all our equity models. We stayed pretty much fully invested throughout the last month. This was a period when many of the investment newsletters were recommending a cash, hedged or long-short (very cautious) position. Without exception, that would have caused a missed market opportunity.

We have significantly reduced, and will likely liquidate, the balance of our Utilities holding because a rise in interest rates is very negative for Utility stocks. We also reduced – but did not eliminate - our Energy holdings because the refinery capacity seems to be catching up with demand. I think Energy stocks need a breather. Our Energy holding is up 20% since we first purchased it in March.

We also hold positions in Basic Materials, Biotech, Consumer Goods, Telecom and Small Cap Growth. Our holdings are all sectors that have shown better relative strength than the markets as a whole.

I continue to be amazed at the blessings we have as Americans. Most of our citizens have jobs and the opportunity to improve themselves. Yes, we have problems, but I would not trade our set of problems with the citizens of any other country in the world. If each and every one of us becomes part of the solution to those problems, and not part of the problems, it is just going to get better.

Lane Kerns

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**MLK Capital Management, Inc.**  
Galleria Financial Center  
5075 Westheimer, Suite 1177  
Houston, TX 77056  
[www.MLKerns.com](http://www.MLKerns.com)  
[www.401k-Investment-Advice.com](http://www.401k-Investment-Advice.com)  
Address Service Requested

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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”. Or, as a friend of mine says, we may not be right - but this is our opinion. 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:**

**Lane Kerns  
MLK Capital Management, Inc.  
(713) 993-0949 ext. 106 or (800) 945-2125 ext. 106  
E-mail: [LaneK@MLKCapital.com](mailto:LaneK@MLKCapital.com)**

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