

September 4, 2007

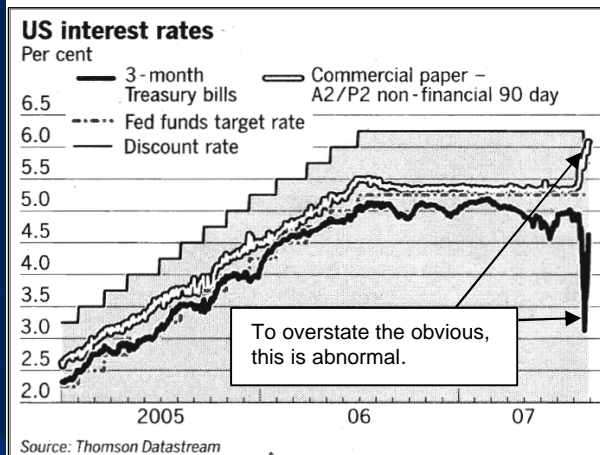
To: Friends and Clients of MLK Capital Management
From: Lane Kerns

Re: A Pullback, a Correction or a Bear Market?
Don't Fight The Fed
Economic and Market Outlook
Current Portfolio Holdings

A Pullback, a Correction or a Bear Market?

A "correction" occurs when stocks fall 10%. Certain indexes of the market fell over 10% between 7/17 and 8/15/07. During that period, the S&P 500 fell 9.3% while our most aggressive model was down less than 6%. We were feeling pretty good. Since then, the market has searched for its footing and the waters have been very choppy.

We have witnessed an event that I have never experienced in my investing career and there is great uncertainty as to whether we have seen the worst of it and things are looking up or whether we are just seeing a bounce in a new downtrend.



To illustrate just how abnormal things have been, look at the chart to the left. There was so much fear in the credit markets that there was a "flight to quality."

You don't have to be an investment banker to look at the chart and realize something significant occurred.

Three-month Treasury bills, the safest investment in the world, had so much money flow into them that their yield dropped from 5% to just over 3%. Because of the subprime mortgage meltdown, and

the subsequent freezing up of the credit markets, no one knew what to consider a safe investment. We went to cash.

Don't Fight the Fed

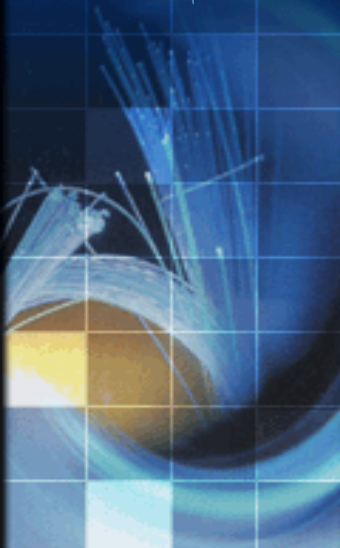
"Don't Fight the Fed" is a very old axiom in investing. Clearly, if the Fed wants something to happen, it is going to happen and one should not stand in the way. We agree with this, and part of our process is to listen very carefully to what they are saying and hinting what they may do.

What we (and all investors) have trouble with is when the Fed, with all its ability to move markets, acts in an unannounced way that is not predictable. That is what has happened on three occasions over the last month. Since August 15th, the Fed has caused our near perfect positioning in the market to go in the opposite direction.

We have a process that tries to understand all of the moving pieces and decide what should be happening in the economy over the near and long term. But that is not enough. We learned long ago that what should be happening does not necessarily happen when everyone thinks it should. If it did, investing would be much easier. For that reason, we focus a great deal of time on what is happening. We try to react very quickly to "What is Happening." Over the last two weeks, "What is Happening" was reversed more than once. That caused our great August performance through the 15th to turn into a loss for the month while the market, with the Fed's unexpected help, ended the month up.

MLK CAPITAL
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ADVICE
ON
THE
MARKET



Economic and Market Outlook

While the housing market is likely to present some problems for the broader economy for some time, the possibility of aggressive Fed action introduces great uncertainty about its impact on the stock market. If the Fed comes riding to the rescue with aggressive rate cuts (something they have signaled they will not do until inflation is under control unless the economy weakens significantly) and massive injections of liquidity, the stock market will probably continue trending up – but the piper will have to be paid later.

If, on the other hand, the Fed takes a more moderate approach, the stock market is likely to move lower before making a new bottom. We may not know their intentions until the Fed meeting on September 18. Over the last four days, the market has trended up on lower volume. My thinking is that the temporary strength may continue until something stops it. There is no economic news due to be released until Friday when the employment report comes out. Today, we went from a 100% cash position to a position of being about 25% to 50% invested.

The housing and credit markets are the negative factors affecting the markets. However, when you remove the emotion of the last month, the major economic fundamentals look good!

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: We have finished corporate earnings announcements for the second quarter. They were better than expected. Business still appears to be strong. Focus will now shift to other factors listed below until earnings pre-announcements for third quarter begin in a few weeks.
 2. Personal income: Personal income growth was modest in May but very strong in June. While strong income growth is good for the consumer and the economy, it weighs heavily in the Fed's view of inflationary pressures. Unemployment remains at a decades-low 4.5%. With most everyone working and wages rising, the economy will have a hard time slowing down.
 3. Inflation: Core inflation for Q2 was revised down slightly. A very positive thing. Many economists are predicting that inflation will pick up in the last half of the year – but we are not yet seeing this. If we continue to see moderate or moderating inflation reports over the next few months, it is almost a certainty that the Fed could start reducing interest rates, which will re-stimulate the economy and the stock market. 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. We are one step closer to lower interest rates. Because of the turmoil in the credit markets, it is expected that the Fed will lower rates as early as the September 18th meeting.
 4. Manufacturing Activity: The Institute of Supply Management report (for the entire nation) this morning showed manufacturing activity that is still growing although not as fast as last month. It is nearly impossible to have a recession with growing manufacturing activity.
 5. The world economies remain very strong! Globally, economic statistics continue to surprise to the upside. The nation's GDP growth for second quarter was revised up from a 3.4% annual rate to 4.0% after an anemic first quarter of only 0.6%. That is the strongest in many quarters.
 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: One reason the Dow 30 Industrials have been stronger than normal this year, after underperforming for several years, is the weak US dollar. Over the last five years the value of the dollar against a basket of other world currencies has declined roughly 25% and it has declined significantly this year. 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 significantly this year. Exports and export orders have gained momentum and this continues to be reflected in stronger US manufacturing profits and employment.
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8. World Liquidity: This has turned from a big positive to a big negative! With the freezing of the credit markets, it will be some time before we know its final affect on world growth. 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. However, it may be a few months before this plays out.
9. Supply of Stocks to Invest In: I said earlier this year that “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. This is due to the number of shares being created by new companies going public has been exceeded by shares being taken off the market due to corporate stock buybacks and companies being taken private”. This former positive in the markets has for all practical purposes dried up over the last few weeks with the problems in the credit market. Investors and banks are becoming more risk conscious when it comes to loaning money. However, when it comes to the stock market, the appetite for risk seems to have come back quickly with Emerging Markets being among the strongest performers over the last week.
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, strong business investment, exports and inventory rebuilding has offset the housing slowdown and employment remains strong. Friday’s employment report will either affirm or raise concern as to whether the housing slowdown will drag down the broader economy.

In our opinion, most of the reasons for optimism remain valid. However, the tightening of credit occurred at an alarming rate. I find it interesting that deposits to money market funds, government bonds and treasury bills have sky-rocketed! We may be witnessing an overreaction, and if so, things will loosen soon. The fact is that there is a huge amount of money on the sidelines looking for a time to pounce on a rising market. The market rally we have seen over the last few days has been on very light volume, which indicates that while there appears to be an absence of sellers, there are not an abundance of buyers. Big institutional investors are waiting for the air to clear on the credit markets and to see what the Fed is going to do.

Current Portfolio Holdings

We are currently underinvested while waiting for clarity. Today, we went from being 100% un-invested to being 25-50% invested. We went back into Nasdaq 100 and various energy groups. All have been outperforming the general market. At this point, I am not brave enough to expose much more. I have never enjoyed the idea of losing money. Most of the money made in the markets is made in very short periods of time. Patience is a virtue in waiting for those times.

September has historically been the weakest month of the year. There is a lot of speculation on why that is true and this year may prove different. Most bad things that have happened in the market happened in October, while November and December are among the strongest months of the year historically. Things may be different this year over September and October – one never knows.

We are investing for the long-term. We just feel the long-term consists of a number of short-term periods. We treat each of them differently.

We are in the middle of an office expansion which should be completed over the next few weeks. When it is completed, we will have an open house. We are all very excited.

We all hope that your summer has gone well. Won’t cooler weather be a welcome treat!

Lane Kerns

MLK Capital Management, Inc.
Galleria Financial Center
5075 Westheimer, Suite 1177
Houston, TX 77056
www.MLKerns.com
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”. 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

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