



MLK Capital Management, Inc.

Mid-Month Market Report

Friday - June 15, 2007

Pigs In China - How They Are Affecting the Cost of a Home In The US

A series of events have occurred this month which directly affect the cost of doing business and buying a home in the United States.

Since the start of the current market rally that began last summer, the S&P 500 has climbed over 29% with only minor corrections. As I have stated in recent newsletters, there are at least nine fundamental reasons why the world and US stock markets should retain their upward momentum with only small corrections.

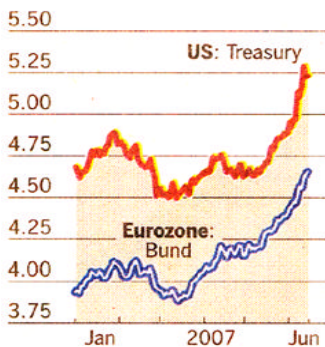
We feel that we are at least several months away from a market top. We will, (and should) however, have short consolidations and corrections. We feel these will probably be no more than 3% to 5% in magnitude with an outside possibility of no more than 10%.

The correction that occurred earlier this month amounted to no more than about 3%. Bonds actually corrected more than stocks and while stocks have completely recovered, bonds have not recovered at all. After five days of volatile trading, 10 year bond yields around the world have settled in sharply higher.

In the bigger scheme of things, these are minor market corrections compared to the run-up in market prices we have seen and compared to the gains I think will follow over the remainder of the year.

So what does this have to do with Pigs and Houses? This month's stock market scare was triggered by a sharp increase in interest rates. This, in turn, caused a sharp decrease in the value of bonds.

Government bonds 10-year yields (%)



Source: Thomson Datastream

The chart at the left shows what has happened to interest rates on European and US treasury bonds. *(I discussed in our June 1st letter why investing in bonds at this point in the economic cycle will be very hazardous to your wealth. That is proving to be very accurate.)*

There are many reasons why interest rates needed to adjust upward but they all lead to the need for economies worldwide

to slow down inflation by slowing down the incredible world-wide economic boom. The tipping point was reached when China's inflation report was released showing a sharp increase in the Chinese inflation rate - triggered in no small part by a sharp jump in the price of pork!

There you have it, pigs are more expensive, inflation increases, interest rates go up with inflation, the cost of obtaining a home mortgage goes up and monthly mortgage payments for any size home loan become more expensive. This will hurt people who are trying to buy or sell a home and those who have adjustable interest rate loans.

So why did the stock market rebound so quickly and why do I think it will keep going up?

1. When interest rates rose rapidly to roughly 5.3 % for the US 10 year Treasury bond, then stopped climbing and pulled back to 5.25%, the market knew where the top of the current interest rate range was going to settle.
2. The markets had been expecting a rise in interest rates and it was already priced into the equity markets. When rates did not go any higher it set off the rally of the last three days.
3. Any rate below 5.30% (some say 5.50%) will still allow robust economic growth in the US.
4. Inflation reports released this week on both Producer Prices and Consumer Prices show that the Fed appears to have been successful in slowing US inflation to an acceptable level.
5. Additional reports this week show that economic growth in the US is rebounding strongly at a time when we seem to be getting inflation under control.
6. Employment and wage growth are both strong - giving continuing spending power to US workers.

This combination of factors - robust growth, moderating inflation, interest rates that are still low by historical standards and full employment are the needed elements for a continuation of the Goldilocks economy, sustainable growth in corporate profits and a rising stock market!

Current Holdings -

In a strongly up-trending market, it is counter-productive to go to cash or hedge. Long-Short positions do reduce volatility but they penalize gains. The strategy for making money is to stay invested. A simple solution is index funds. However, with index funds, you cannot beat the market, only equal it.

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We feel a more productive strategy in a strongly up-trending market is to hold those sectors of the indexes that show more strength than the indexes themselves. Conversely, do not hold those sectors of the indexes that are weaker than the indexes themselves. There are many ways that investment managers measure relative strength and we have developed some that we feel have validity.

Our current holdings include: Telecom, Basic Materials, Energy, Oil Services, Semiconductors, Small Cap Growth and a rather conservative Capital and Income Fund.

Having stated with some confidence a very bullish outlook, I must admit that it is very difficult for a person like myself, who is very “risk averse”, to fully take advantage of the situation. Even though I fully believe the market will have nice gains between now and the end of the year, I constantly drive with my foot over the brake pedal. One of the things that allowed us to miss most of the major market declines of 2001, 2002 and early 2003 was the willingness to take evasive action quickly. Sometimes that costs us performance like the second and third quarters of last year. But over the long run this conservatism has paid off handsomely. The performance for our equity models since 2000 has been more than double to triple that of the S&P 500. *(I must say for regulatory reasons that past performance is no guarantee of future performance.)*

As each year goes by I periodically redefine “middle age” so that I fit into it. (Many of you know what I mean!) In spite of that redefinition, I find myself shifting my efforts to those things that favor experience and knowledge. One thing the years continue to reinforce is that if you are a saver and live within your means, time will take care of you. The worst thing that can happen is that you will end up with some money. Have a great Father’s Day.

Lane Kerns

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