



MLK Capital Management, Inc.

Mid-Month Market Report

Wednesday - August 15, 2007

Drama and Mystery

If you like drama and mystery, you must be loving the stock market. One of the people in my office commented that this mid-month letter should be an easy one to write since it is shorter than the 1st of the month letter. My response was that it is harder this time because I could easily write twenty pages about what has been and is occurring.

To relieve any suspense about how your money is doing - we have done well navigating these very choppy waters. The storm in the credit markets is still raging so we found a safe port to tie our boat down. Last Friday we went 100% out of equities and into money market for our Schwab accounts. We went 100% into bonds or money market a week ago for our non-Schwab accounts.

For the month, the S&P 500 is down 3.30% through tonight. Our Conservative model is down less than 1% and our Aggressive model is down less than 1.5%. I consider this a major victory because we are seeing things that have never before occurred in the history of the market.

Most Fundamentals Remain Relatively Strong

However, the market is ignoring fundamentals. I will explain why below. In our last several newsletters, we have given (and updated) reasons why the market had been stronger than the normal summer market. All but two of those reasons remain intact. The Carry-Trade is evaporating and liquidity has dried up.

The current market setback has yet to qualify as a correction (defined as a 10% decline); however, I think there is a very strong possibility that it will continue down a few more percent before finding a bottom.

“Well, Lane, if most of the fundamental economic underpinnings of the market remain strong - those being high employment, low interest rates and relatively strong corporate earnings - why has the market gone crazy?”

A Delicate Balance of Fear and Greed is Upset

Most of this section is a shortened summary of the global sell-off from the *Financial Times*.

Financial markets are driven by a delicate balance between fear and greed. Now, however, the dial is swinging violently toward fear. As the dust settles from last week's turbulent market movements, it is becoming clear that parts of the financial world have suffered a collective crises of confidence

The crises was temporarily stemmed by the rapid injection of roughly \$300 billion dollars into the banking systems of Europe, Japan, Canada and the United States. The question now is whether the crises of confidence will turn into a much bigger financial shakeout.

The root of the problems lie in events of earlier this year when it became clear that loans extended to risky borrowers in America, known as subprime, were turning sour.

This affects financial investors because in recent years bankers have used these sub-prime loans to create a plethora of complex financial instruments and then sold these new products to investors around the world. Thus, when subprime mortgage borrowers defaulted on their debt, the value of associated securities plunged, creating losses for those worldwide investors.

If the pain had stopped with subprime mortgages it might have ended there, given that this sector is only a minor part of the overall global financial system. But what triggered the last weeks events is that the subprime saga has opened a bigger can of worms: concerns about the way that modern finance works.

Back in the days when banks made loans, and kept these loans on their books, it was easy to tell who had losses when loans went sour. But now that the loans have been repackaged, and sold all over the globe, no-one knows where the pain lies. After all, the world has never lived through a credit cycle to test this kind of innovation.

So this is why the financial system has become gripped with a climate of fear. It has left banks becoming increasingly nervous of trading with one another, making it hard for some European banks to raise short-term money, and pushing up overnight money-market rates. That has created a dangerously self-reinforcing downward spiral: as banks stop extending credit lines to one another.

Meanwhile, losses in subprime securities are forcing investors to sell other assets, such as securities linked to corporate loans, or even equities. And that is pushing down prices - forcing even *more* investment managers to sell.

This created a situation over the last month where several multi-billion dollar hedge funds had been forced to sell their good investments to cover losses in their bad investments. A couple of prominent, big name funds had losses of 30% last month. These are the smart guys! I'm kind of glad I wasn't that smart.

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DATED MATERIAL - CURRENT MARKET REPORT

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Our Current Holdings

I said in the July 16th newsletter - "I constantly drive with one 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."

That is exactly what we have done over the last few weeks and it has paid off handsomely for all of our clients. From its peak on July 19th through tonight, the S&P 500 is down 9.48%. Our equity models are down only 3.63% to 5.80% since that date.

That is a huge difference in our favor. We consider drawdowns of up to 7% acceptable and necessary in order to expose ourselves to the opportunity for the substantial gains that the equity markets offer. If we are down 7% - we only have to earn 8% to get back to even. We feel we can do that in a reasonable period of time. A buy-and-hold investor in a bear market might lose as much as 50%. In order to return to break even, that investor must earn 100% on their remaining portfolio. That is a big hole to dig out of and we are not interested in that much work.

Again, from our July 16th letter about our conservatism - "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.*)"

By remaining in cash - we are going to have a beautiful buying opportunity at bargain prices when this market bottoms!

Lane Kerns

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