



# MLK Capital Management, Inc. Mid-Month Market Report

*Monday - September 17, 2007*

## More Drama and Mystery

As I write this letter twice each month, I try to separate myself from all the noise of the media, markets and politics and focus on the big issues of what is happening. That doesn't always tell us how we should be invested today, but it gives us a good idea of what we should expect to happen over the next few weeks, months and years.

Today, and for the last few weeks, the investment community has been focused on some emerging problems - but more than that, what the Fed is going to do tomorrow to rescue the markets from those problems. This letter will focus on a couple of those problems and then discuss the potential cures and how they will affect every investor.

I would like to frame the diagnosis and treatment of the market's ills similar to the way the medical community diagnoses and treats illness.

If you go to the doctor with a stomachache, you may be prescribed anything from a new diet to cancer treatment. The physician's first job is to determine the seriousness of the ailment. Is it just indigestion, or is it something much worse, like cancer?

The cancers of the market are inflation and unemployment and the objective is to treat the patient without the cure creating side effects which could be worse than the disease. Right now, the doctor for the economy is the Fed.

With the symptoms of a slowing economy (increasing unemployment, slower wage growth and lower corporate profits) starting to appear, should the Fed give the economy a strong dose of stimulus to keep it on its feet and running strong?

The dilemma for the Fed is that by re-stimulating the economy, they undo all of the good work they have done at slowing inflation. They have been treating the cancer of inflation and now the only way to treat the cancer of slowing employment is to take away the inflation medicine.

The question is "which treatment creates the most pain and is fatal (in economic terms) by creating a recession, or worse - inflation that reduces all of our standards-of-living?" My feeling, and apparently that of the Fed, is that they must continue to treat the danger of inflation. It is much easier to re-stimulate the economy later than it is to stop inflation later, once it is out of control.

## So What Does This Mean to You and Your Investments?

I was in San Francisco for a financial meeting since the last newsletter. One of the speakers was an economist that has been an advisor to a couple of presidents and was with the Fed prior to that. His assessment was simplistic but makes as much sense as any I have heard.

The Fed's medications for a slowing economy are to lower interest rates or to pour more money into the economy. Both would potentially stimulate inflation! The market will react to any decision the Fed makes - even doing nothing.

He estimated that, if the Fed does nothing, it will appear insensitive to the slowing economy and the Dow will probably drop 500 points. If it lowers the Fed Funds interest rate by 25 basis points (1/4 %) the market will probably not make a big move either up or down. On the other hand, if the Fed lowers the rate by 50 basis points (1/2%) the market will probably go up 300 points but could go down because investors might interpret it as a signal that the economy is not in good shape.

The problem with the last scenario is that even though the market might temporarily like a 1/2% or greater reduction in the interest rate, the Fed would be removing the no-more-easy-money treatment it has been administering to slow down inflation. I think they will be reluctant to do that because inflation is a worse economic death than a recession. For those that can remember the runaway inflation of the 1970's, the cure was no fun.

## Fundamentals Are Not Bad - But

While the fundamentals of the world economies are still good, they are weakening. The central banks of the world are walking a tight-rope that is very shaky. We are not the only ones concerned about inflation and as slowing growth.

The Eurozone temporarily delayed their latest interest rate INCREASE in response to the liquidity crises created by the sub-prime mortgage crises of the last few weeks.

China now has inflation running at over 6%. They have raised rates 5 times this year - trying to slow their economy. The cost of Oil, Grain and Materials is starting to escalate rapidly. The only way to slow down these cost increases is to slow down the demand for them. That means slowing down the economies of the world and creating more potential unemployment.

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**DATED MATERIAL - CURRENT MARKET REPORT**

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**Our Current Holdings**

We are currently treading water in a fairly neutral position in advance of tomorrow's Fed meeting. We are short the NASDAQ 100 because it has been the weakest of the major indexes. We are long Oil & Gas and Oil & Gas distribution, both of which have been much stronger than the major indexes. Last week, we added a position in a fund that goes up when the dollar goes down. The Dollar is in a downtrend. We also added a position in bonds and in a China fund. The bonds should provide dividend income until things settle down. China seems to be going up - no matter what the rest of the world does.

Eventually, the market will find a firm bottom, then it will be harvest time. We are already seeing some real buying opportunities. We are intentionally staying away from any big commitments until we have a tailwind rather than a headwind and cross-currents. We will probably get a nice rally before the end of the year, and if so, will try to benefit from it. But for now, we are not willing to bet the ranch on anything. Last week was a good week in the market, today is a bad day of profit taking prior to the Fed meeting tomorrow.

Lane Kerns

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