



MLK Capital Management, Inc.

Mid-Month Market Report

Wednesday - November 15, 2006

What is Happening in the Market?

The market remains in an uptrend and we are capturing that uptrend. For November through Tuesday the 14th, the S&P 500 (with dividends) is up 1.18%. The Shearson Treasury Bond Index is up .72% for the month. All of our models are up - Aggressive models are up about 1.84%, Moderate 1.49% and Conservative .92%.

The markets are in a slightly overbought status and due for a pullback - but have remained that way for much of the last five months. This can happen in a sustained uptrend like we are experiencing, but a downward adjustment to give the market a chance to breathe would not be a bad thing. The market needs to allow people to take profits and become buyers again. If everyone is fully invested and no buyers remain, then only sellers remain and a more severe correction follows.

Why Has the Market Remained Strong?

There are always pessimistic as well as optimistic views as to whether the market should go either up or down - that will never change. Depending upon what kind of mood investors are in, they may listen more to one side than the other. What drives the market up or down is the balance between what is perceived as good news and bad news.

When we cut through all the noise and opinions in the market there are three things that really matter; corporate earnings, interest rates and inflation.

Earlier this year, we had plenty of reasons to be cautious. I won't go into old news except to quote an article in Barron's last week. "May and June were very difficult months. If you decided to hang in there you were either incredibly brilliant or incredibly brave." (Apparently we were neither.) The trouble was the US government statistics at that point seemed to indicate the U.S. worker hadn't really had much of a pay increase in three years. One couldn't be sure what the Fed would do and the housing market looked pretty vulnerable. The prospects of U.S. consumers tightening their belts seemed inevitable. While Chinese and Indian demand continued strong, it seemed very imprudent to hang in there with oil and mining stocks and high-beta stocks in emerging markets. **It turned out the statistics were totally wrong."**

"It didn't seem wise to hang in there and damn the torpedoes at full speed ahead." I thought the above quote pretty much captured our mindset during that time period. As I told a client today, "I would rather err by being too conservative and not lose any money than err by being too aggressive and find ourselves in a deep hole to dig out of".

Conceptually, valuing stocks should be simple. Companies that earn more are worth more. Earlier this year it looked as if future earnings were weakening and the markets got soft. In hind sight, we now know that earnings growth has turned out to be almost double what was anticipated - a very good thing for the markets.

Inflation is a threat because it forces the Fed to raise interest rates to avoid the runaway inflation like we had during the 70's. Higher interest rates mean lower corporate profits and less people buying new homes - very bad things for the economy, employment and the stock market.

Unemployment has dipped to 4.6% - the best in years. This week, we found out that the American worker has indeed had significant wage growth over the last year while inflation on the non-wage measurements has actually been almost non-existent over the last few months.

Our Outlook?

As you have probably concluded from this and the prior couple of letters, we are generally positive about the near-term outlook for the market. It appears that the U.S. will have a soft landing - which means that employment should stay fairly strong, earnings should hold up the stock markets, inflation should be contained and life will be good.

A Cloud on the Horizon

So what could mess up this rosy picture? There is always the possibility for hurricanes, terrorism, war and worldwide epidemics, yet these are unpredictable.

What *is* predictable is that - at some point - Japan will recover strongly and stop stimulating their economy by flooding the world economy with excess inexpensive cash. Much of that cash is being borrowed and used to invest in very leveraged assets. To quote yesterday's Financial Times "With the Bank of Japan estimating that there are up to \$15 trillion yen (\$128 billion) in outstanding yen carry

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trades worldwide, there could be big damage if financial institutions are caught by the turning tide.” When the BOJ tried to withdraw a big portion of this excess liquidity in the spring of this year, we had the huge selloff in markets worldwide. It is very likely to have a similar effect when they withdraw this liquidity over the next months or years. What would cause that to happen and what will be our signal to run for cover? When Japan’s economy strengthens enough to generate some inflation, they will no longer need to stimulate their economy with excess liquidity and very low interest rates. When they withdraw the cash and raise interest rates, the Yen will appreciate significantly against the other currencies. “Carry-Trades” will no longer be profitable and that borrowed liquidity will disappear from the world markets. Watch for a strong Yen as the first warning bell! It will be felt worldwide.

Performance

Since 2000, our models are up from 57.11% to 78.43% (after fees) while the S&P (including dividends) is up only 16.47% through 11/14/06. Yes that’s right, we have beaten the market since 2000 by 40.64% to 61.96%. \$1,000,000 invested with us on 12/31/2000 would be worth \$400,000 to \$600,000 more than a S&P 500 index fund would have earned you! *(These returns are not composite returns of all our clients like we report on the first of each month. They are however, representative client accounts that are invested like all accounts with the same objective.)* Imagine how much that means to our clients who were retired or are now about to enter retirement. We have accomplished this outstanding performance by not taking big risks and controlling our losses.

Lane Kerns

Ted Cackowski, J.D., Ph.D.

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