



MLK Capital Management, Inc.

Mid-Month Market Report

Thursday - March 15, 2007

What is Happening in the Market?

The Nasdaq's 3.9% plunge on Feb. 27 signaled the start of a new correction. The losses deepened over the week. A 1.9% gain on March 6 started a new rally try, but market quickly ran out of steam.

Yesterday, European and Asian markets suffered their second biggest losses of the year. In the US, stocks swung wildly before staging a recovery. The Dow fell 156 points intraday before finishing slightly higher.

In the February 15, 2007 Mid-Month Market Report I wrote - "A minor correction (less than 10%) could (probably will and should) occur, but nothing looms that appears to be capable of creating a larger pullback other than some type of nuclear terrorist related event or the carry-trade issue mentioned above." I also wrote about the Carry Trade being "**The Black Cloud on the Horizon**".

You can look at prior issues of our newsletters by going to <http://www.mlkerns.com> and clicking on Market Outlook. Links to Prior newsletters are at the bottom of the Outlook page.

It turned out that both statements were almost prophetic. We have also written that the first sign of when the Carry Trade would begin to unwind would be the appreciation of the Japanese Yen. That is exactly what happened.

What is amazing to me is that movements in the value of the Yen are about 90% correlated with movements in the S&P 500. When the Yen strengthens, the stock market weakens. For active traders, the Yen appears to be a leading or coincident indicator of what the market is going to do.

The Chicken or the Egg? - If the Yen and US markets are so highly correlated, is the Yen causing the markets to move or are the markets causing the Yen to move? I think the answer is yes to both. Let me explain.

At first I thought it was solely the strengthening Yen that was moving the market. A stronger Yen can be caused by a stronger Japanese economy or weaker economies in the rest of the world. In the case of the US market vs. the Yen, both of those things appear to be happening.

The US markets have shown some weakness on their own to

cause of US economic conditions while the Japanese economy is strengthening.

Over the next few months, the US dollar could get progressively weaker just on its own. We should be concerned about the value of the dollar for at least two reasons.

1. **Inflation!**- A weakening dollar means that anything you purchase that is made outside the United States will cost you more. (I should point out that import prices have actually been flat for the last two months.)
2. Why will foreign investors want to invest in a country where the value of their investment is being reduced by that country's depreciating currency? With less foreign money flowing in to fund our national deficit and our negative balance of payments, interest rates will go up to attract more capital flows. Higher interest rates mean more cost to you, a slowing of the economy and a sagging stock market.

This morning the Producer Price Report for the month showed rising costs. At the same time we got a report of declining manufacturing activity. Yesterday it was slightly slower retail sales and the Mortgage Bankers Association said "the New foreclosure rate" [on home mortgages] during the fourth quarter was the highest recorded in the 37 years of the National Delinquency Survey. Even Alan Greenspan mentioned the possibility of a recession starting in the fourth quarter. Get the picture?

The US economy is still very strong and unemployment is very low by historical standards. Don't be alarmed about the slight slowdown in the US economy. It is exactly what the Fed was trying to accomplish by raising interest rates over the last couple of years. When it is clear that inflation is no longer a threat, they will begin to lower rates and the markets will react positively.

Our Outlook?

The good thing about a pullback is that it gives everyone that is nervous a chance to take profits or just run from the market. That sets up an opportunity for a new rally. The bigger the pullback the bigger the potential rally. This has not been a significant pullback yet - so the prospects for a really strong rally are not high. That combined with a slightly weakening economy poses the possibility of a larger pullback - and therefore a more profitable rally.

The day to day volatility in the market has increased dramati-

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cally. This has produced 1-3% moves either up or down on a daily basis in markets around the world. For all the reasons stated above, we have moved to cash in our equity models. It is no fun to sit on the sidelines when the market has a strong up day - but the pain of losing money exceeds the joy of the few up days we have seen since the correction started. It is my opinion that the risk of losing money is greater than the possibility of making money.

Looking back at market bottoms in the past decade, it has taken more than three months on average for a successful rally to take root. Three months would be about the end of May. Historically, May through October is the weakest period of the year so that does not paint a very bright picture and we may have to wait until fall to make any big money for the year. If Greenspan is right about the possibility of a Q4 recession we will see it coming prior to that.

Fortunately our more active trading strategy will give us the opportunity to exploit some of the smaller moves that are inherent in this type of environment. Over the next few days or couple of weeks we will probably go to a Long-Short hedged portfolio to limit risk and capture some gains until we enter a stronger market period.

All of our equity models are beating all of the market indexes year to date and none are down more than 0.55% YTD. The Dow, S&P 500 and Nasdaq are down 2.18%, 1.87% and 1.80% respectively. Project that difference out for an entire year and we are outperforming the indexes at an annual rate somewhere around 11.35% net after fees. As you plan your summer vacation you can feel comfortable that someone is looking after your portfolio on a daily basis.

Lane Kerns

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