

MLK CAPITAL  
MANAGEMENT, INC.

# ADVICE ON THE MARKET



May 1, 2004

To: Friends and Clients of MLK Capital Management

From: Lane Kerns

Re: **Current Market Conditions**  
**Up-Trends, Down-Trends and Trading-Ranges**  
**Recent Performance**  
**Our Current Holdings**

## Current Market Conditions

I said in the April 1<sup>st</sup> Advice on the Market that the correction was over – and so it was - for a week. Since then the market has reacted to numerous factors, both good and bad, but on balance has been down for the last three weeks. Since April 5th, the S&P is down 3.1%, NASDAQ down 5.79% and Treasury Bonds are down 2.78%. Not a pretty picture.

If we go up to the 30,000 feet level and look down, things become a bit clearer because we are truly in a global market economy. The US may be the biggest economy on the globe and may drag most of the world stock markets with it - but there are also global factors that influence the US markets. This month we felt the influence of some of this “Global Effect”.

The biggest factors affecting our portfolios during the last three weeks have been China and the dollar. The market is currently in a “trading range” - which I explain in detail below.

Let’s start with the dollar. To most of us, the only thing a strong dollar does is make things manufactured outside the United States cheaper. A weak dollar makes foreign goods more expensive.

However, to a foreign investor, a strong dollar means something different. Foreign investors want to be invested in the US only if they think there are better earnings potential in the US. Starting with the jobs report on April 1<sup>st</sup> interest rates started going up because the economy is clearly accelerating and price inflation is starting to appear.

Increasing interest rates and a growing US economy are like a money magnet for foreign investment and the dollar gets bid up to a higher price relative to most non-US currencies. Unfortunately - if the dollar is climbing - that also means that the foreign investments we have been holding are worth less. An appreciating dollar, caused by increasing interest rates, is the first thing that has hurt our foreign and emerging market investments.

The second thing that has impacted our emerging market and global natural resources investments is the position China took this week on slowing down their economy. Stick with me on this.

Since most emerging market countries are suppliers of commodities and natural resources (copper, silver, lumber, mineral deposits) they prosper when the global economy is growing. China has been growing so fast that it is competing with the US and other economies for those natural resources - and shortages have started forcing prices up. (I included a chart in a prior newsletter showing the run up on the producer price index.) Over the last year, this price run up had made investments in emerging market economies and natural resource producing companies a very profitable place to invest. We have participated in that profit.

Last week, China announced that it was going to “forcibly slow China’s growth”. That sent commodity prices down sharply and – you guessed it – prices of stocks in emerging market countries down with them. Because this happened so sharply and abruptly, we liquidated our emerging market and natural resource holdings this week. This is very ironic since last month I featured articles about two of the three funds we have now liquidated. It just goes to show that when an investment makes the front page- it may be time to sell!

### Up-trends, Down-trends and Trading-Ranges

From a purely US market standpoint, I try to simplify things by dividing the market into three phases. It is either in an up-trend, a down-trend or a trading-range. In up-trends we make money if we are invested. In down-trends, we don’t. If it were easy to tell when trend direction is changing we would all be market-timers and get richer faster. In an up-trend, there are more buyers than sellers and prices for stocks are bid up. In a down-trend the opposite is true.



Unfortunately, trends are usually separated by trading ranges - where the market moves sideways within a range. The top side of this range tends to become resistance and the market has a hard time going higher. This is because there just aren’t enough buyers who are willing to bid prices up above that point. The bottom side of the range tends to become support for the market because when prices get that low, people who were not buyers at a higher price step in and start buying.

When there is an equal balance between buyers and sellers, the market searches for direction and is trend-less. It enters a trading-range phase like the one above illustrating where we are now. These are the most risky times in the market because at these times - the market is most influenced by outside forces. If investors hear news that generally makes everyone feel good and secure, more people become buyers and the trading-range usually gets

resolved to the upside. If we have bad news from a national or geopolitical or economic standpoint - some of those investors on the fence become sellers - and the market trades down and breaks support. As long as the market is inside the trading range it is very difficult to pick a sector of the market that will make money. That is where we are now. It is a waiting game and great caution (and in our case hedging) is in order. Since we can't predict what outside event is going to occur (such as China's announcement mentioned above or the next turn of events in the Middle East) it is a wait and see game.

When more people become buyers and push prices up through resistance, that can be a very powerful indicator that the markets are entering a new up-trend. If that breakout fails, as it did on April 5<sup>th</sup>, we reenter the trading range.

If sellers prevail - and prices break below support (the bottom of the trading-range) things can get ugly and it can be the start of a new downtrend. That is why we have taken a hedged market-neutral position.

### **Recent Performance**

Conservative, Moderate and Aggressive accounts are all down for the month through 4/30/04 but well ahead of the indexes year-to-date. Gains for the year range from 2% to 4% depending upon model and these are net returns after management fees have been deducted. This compares to losses YTD of 1.04% for the Dow, and 2.23% for the NASDAQ. The S&P 500 is up 0.60% YTD. Not a month I am very pleased with but we are still well ahead of the market for the year. If the market continues lower, we are well positioned to control losses. If it surges higher, we will remove the hedge and be in a position to capture gains.

For the three year period ending 3/31/04, it is interesting to note that the S&P 500 has had an average annual return of .63%. Our equity accounts had average annual returns ranging from 8.91% to 11.98%!

### **Our Current Holdings**

Our **Conservative, Moderate** and **Aggressive** accounts are mostly 75-120% invested and hedged to a market-neutral position. As I stated above, we have eliminated our emerging market and natural resource holdings. We still hold our small cap US and foreign funds but the US funds are fully hedged to a market-neutral position until this trading range resolves itself.

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