



MLK Capital Management, Inc.

Mid-Month Market Report

Thursday - June 15, 2006

What is Happening in the Market? (Translated that means - why is my account not making any money?)

US markets have sold off sharply since 5/10/06. The markets that had been the best - have suffered the most damage.

Turkish and Indian markets were down 30% in May compared with a single digit fall for the Dow Jones Industrial Average. The flight from commodities, emerging markets and Japan will probably continue. The Nasdaq sold off sharply.

What is Causing the Market to Behave so Badly?

The increased volatility that we are witnessing is largely a reaction to the change in the central banks' approach to inflationary prospects. Inflation now looks more real than just headline.

A series of central bank interest rate increases last week prompted fears about the prospects for global growth.

The world economy has been growing "above trend" for several years and this has created excessive demand for commodities and has created the highest utilization of manufacturing capacity the world has seen in recent history. This, in turn, has caused prices to rise.

In May, investors were beginning to wring their hands over concerns that the world economies were growing too fast and inflation might be real.

This month, with the comments and actions from central banks of all the major countries either pushing up interest rates or threatening to do so, the realization has set in that the central banks may impose a period of "below-trend" growth to address the inflation threat. A forced slowdown!

Over the past few years, because of an over-abundance of cheap labor worldwide combined with rapidly rising productivity rates - there was very little inflationary pressure. Because of this, the central banks were very quick to stimulate their economies by quickly reducing interest rates and at the same time pumping excess money into their economies. They could do this without the risk of fueling inflation.

That process became known as the legendary "Greenspan-

put" - the feeling that the markets couldn't go down much because the Fed (Greenspan) would bail them out.

That is no longer the case. Just the opposite is true because to do so now would only fuel inflation. The big worry in the markets is that - because of the increase in underlying inflationary pressures, the Fed will be intentionally slow - rather than quick - to bail out the markets and the economy. The "Greenspan put" where the Fed cuts rates at the first sign of trouble, has expired.

There is a genuine possibility that the central banks will force the world economy to slow (thereby reducing corporate earnings, employment, housing price increases & stock market prices) in order to slay the baby inflation dragon before it grows more menacing.

Our Near-term Outlook

The following three paragraphs are quoted from our 5/15/06 letter. They were a bit prophetic.

"..... the market needs a breather. When everyone is fully invested - then there are no more buyers in the market - and only sellers are left."

"When those sellers start selling to protect their gains or stop their losses - and with few buyers left in the market - that can lead to big losses. We want to be in a position to avoid most of the damage and we do that by hedging."

"Times like this are when our type of Tactical Active money management thrives! Our overall objective is to miss 75% of the major downturns and catch 75% of the major upturns in the market. If we can do this successfully - our long-term performance will be double that of the market with much less volatility."

Fast forward to today! All the major indexes are in down-trends. All are deeply oversold and due for a bounce. If one thinks that we are in a Bull market and this has just been a correction, then we are due for a strong reversal. However, if we are in a Bear market any bounce is likely to be followed by another strong down-leg. Until we find out if the bounce of yesterday and today has some staying power, we consider this market dangerous and subject to strong sell-offs. Two days does not yet make an up-trend.

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All the above sounds horribly negative. So now let's review the bright side, and then our outlook.

1. Companies in the S&P 500 are expected to report an 11.2% gain in 2nd quarter profits vs. a year earlier. Much higher than expected according to Thompson Financial. Analysts are overwhelmingly raising, not cutting, earnings estimates.
2. Growth is expected to accelerate (not contract) in the 2nd half of 2006. If the economy slows, it will not do so quickly.
3. P/E ratios are becoming very attractive. The forward price earnings ratio has fallen to 14.1. According to Lehman Brothers, the global equity index is now trading on a multiple of 13.5 times. There has only been one month since January, 1988 where the multiple has been lower. Both of these numbers represent value.
4. The US Budget deficit is falling much faster than expected. Bush is delivering what he promised.
5. The global de-leveraging and unwinding of the "Carry Trade" we have talked about in several prior letters may be close to completion.

At some point the selling will stop - when values become so attractive as to be irresistible. At that same point, there will be a shortage of sellers and an abundance of buyers. The result will be an explosive rally and possibly the start of a new bull market. When that rally is confirmed we will move back into the market. Till then we are protecting cash.

Our Current Holdings

We hold 60-100% cash in all models with any long positions hedged to a market-neutral position.

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