

MLK CAPITAL  
MANAGEMENT, INC.

# ADVICE ON THE MARKET



November 1, 2006

**To: Friends and Clients of MLK Capital Management**  
**From: Lane Kerns**

**Re: Edging Away From Overbought**  
**What Caused The Rally**  
**Recession Unlikely**  
**The Biggest Risk We See for The Future of the Markets**  
**Managed Account Performance vs. Market Indices**  
**Current Portfolio Holdings**

## Edging Away From Overbought

Sometimes the market just gets carried away with itself. Kind of like young children getting so excited and rambunctious they forget they are not supposed to run in the house – or worse yet, into the street. The stock market can't go up every day or every week. But when the indexes notch big gains, then give up half those gains or less in the following week or month, that's a positive sign for the market.

A dip or pause like we have had the last few days obligates the media to find reasons that the world is going to “heck in a hand-basket”. Don't be fooled by the current list. Today the reason cited was the unexpected fall in the October ISM index to 51.2%. It was expected to come in at 53%. People need to remember that anything over 50 indicates an expanding economy! It was actually good news in that the prices paid component (inflation) fell sharply to 47%.

The market has had a fantastic run since late June. Now it needs a little “time-out” to get calmed down. Like small children who are allowed to run wild, they might not just run in the house, they might make that run into the street. We want them, and the market, to stay healthy and keep growing!

The last few days in “time-out” means the market has basically gone nowhere. Almost all of the technical measures we use show it going from a strongly overbought condition a few days ago to a more neutral position today. That is a good thing! It may need a few more days of weakness to gather some steam, get itself out of “time-out”, and start running again. It needed this pause to regroup and give a new batch of buyers a chance to come back into the market.

The market appears to still be very strong –just temporarily exhausted from its over-exuberance.

All our portfolios participated in the run-up during October with Aggressive significantly beating all the indexes, Moderate slightly under the Dow and the S&P 500, and Conservative up for the month on almost no volatility. We like it when things go according to plan.

Since 12/31/2000, the Nasdaq is still down a total of 4.20% through October 31, 2006. By contrast our models over the same period are up from 54% to 75%! Risk Management!

## What Caused the Rally

I don't think anyone expected the run-up we have seen since late June. Nearly all the news seemed bad, whether geopolitical (Iraq, Iran and North Korea) or economic (soaring oil prices, a housing slump, rising interest rates). Then the Federal Reserve stopped

raising short-term interest rates, oil prices plunged and consumer confidence soared. Given the despair of midsummer, it was a potent recipe for a rally – and what a rally. Just as kids (and the market) get too excited and overextend themselves when they are playing, they both tend to pout and give-up when they get a little bad news. When in fact, if they just looked at the bigger picture, they would see that things are much better than they first appear.

## **Recession Unlikely**

---

I think it is highly unlikely for the US to go into recession next year. Let's look at the bigger picture:

1. The biggest “bad thing” over the last year has been inflation – no – the “fear” of inflation. Fact – the Fed has done an amazing job of slowing down the economy to the point where prices are cooling (as indicated in the October ISM report) without stalling the economy. Most of the major economies have either stopped raising interest rates or will do so with only one additional increase. This spells “Soft-Landing”.
2. Rising interest rates killed the housing market. Not so – they just slowed it down. That is exactly what the Fed wanted. Why are we so surprised? Even so, a significant slow down in housing could take as much as 2% of the nation's GDP. But, a 2% reduction does not guarantee a recession when the GDP rate is running in the 3-3.5% range. It takes negative GDP growth to have a recession. If we were going into recession, why would unemployment be the lowest it has been in years? This spells “Soft-Landing”.

When inflation cools a little more or if the economy slows more, the Fed will begin to reduce short-term rates. This will stimulate both the economy and the stock market. Many analysts think the Fed could start reducing rates during the first half of next year. Some of the rally we have had since June has been in anticipation of this.

3. Oil prices rose to around \$80.00 a barrel and the economy just started breathing a little harder – it never stalled. Now West Texas intermediate crude is actually DOWN 5.5% since the first of the year! Prices are down 27% since July! In spite of OPEC's stated intention to prop up the oil price in the \$60.00 range – its members only seem to be willing to let their neighbors cut production. Many people think oil prices could fall further. It is probably at a good price level to keep exploration going and slowdown consumption (albeit if only slightly). If prices fall further, the excess petrodollars that have been flowing into this country to fund our deficit spending may dry up. That could potentially start raising interest rates again. Don't wish for prices to go much lower.
4. Remember, just a few months ago when the consensus was that corporate earnings growth for 2006 would be less than 10%? Not only have profits not declined – they have increased. US corporate profits are their highest percentage of GDP in 40 years. According to Thompson Financial, 74% of US companies and 72% of European companies have BEATEN expectations! Q3 profits look like they are on track to rise 17.4%! That is the best yearly gain since Q2'04. If you are a contrarian, you will say – they have only one way to go – down. However, contrarians have not fared well the last couple of years. This spells “Soft-Landing”.
5. The World economy is still strong – especially Europe. The Ifo German business climate index for October unexpectedly rose, confirming strong readings in the French INSEE and the Italian ISAE [business confidence measures]. These appear to point toward continuing robust growth in Euro land. The European Central Bank will probably raise interest rates one more time – which will strengthen the Euro against the dollar. This makes investments in Europe even more attractive.

Japan appears to be less robust than we thought a few months ago. This is both good news and bad news. The bad news is that they do not seem to generate any positive price growth (inflation). There is concern that their economy may sink back into deflation. If that happens, they will not be as big a market for US export goods. This would be a negative thing for US and worldwide business.

The good news is that as long as the Japanese economy remains at risk, they will continue to flood their economy (and the world) with excess liquidity - which we think is the main thing (along with petrodollars) fueling international stock and bond markets right now.

## **The Biggest Risk We See for The Future of the Markets**

---

As we mentioned above, the Japanese have provided the cheap money to fund investments, help keep world interest rates low and stimulate growth worldwide. Their cheap money loans are showing up in unexpected places – like mortgage

---

loans in the US. If that money were to suddenly dry up – because of a surprising rebound by Japan, or a sharp increase in the value of the Japanese Yen currency, world economies would suffer. A rise in the Yen is more likely to happen than a surprise rebound in the Japanese economy. This would create problems for the “carry trade” (those people borrowing cheap money in Japan to invest elsewhere). The reason is that if the Yen rises, it costs more for foreigners to pay back those Japanese loans and “carry-trade” investing will become unprofitable. Even if you are borrowing money at ¼%, if the currency appreciates 10%, you are now paying 10 ¼% for your loan.

Watch for the strong move up in the Yen against major currencies worldwide. If and when that happens, look out for falling worldwide markets. Or, as Ross Perot once said “you will hear a large sucking sound” as the borrowing stops and money is withdrawn from world markets.

## Managed Account Performance verses Market Indices

PERIOD ENDING 10/31/2006	PERFORMANCE					RISK	
	One Month	Last 12 Months	Since 12/31/03 Annualized	3 Years Annualized	5 Years Annualized	3 Yr. Standard	5 Yr. Deviation
<b>Equity</b>							
Dow Jones Industrials	3.64%	18.72%	8.73%	9.71%	8.30%	8.09%	13.11%
NASDAQ	4.79%	12.49%	7.23%	7.27%	7.14%	13.06%	19.80%
S & P 500	3.31%	16.82%	11.31%	11.55%	7.31%	7.30%	12.76%
MLK Conservative Growth	0.98%	7.49%	12.18%	12.10%	11.62%	9.33%	8.35%
MLK Cons. Growth Margin	1.01%	4.34%	12.08%	N/A	N/A	N/A	N/A
MLK Moderate Growth	2.83%	10.63%	13.00%	12.96%	11.64%	11.56%	10.45%
MLK Moderate Growth Margin	2.76%	9.22%	13.43%	N/A	N/A	N/A	N/A
MLK Aggressive Growth	4.99%	11.05%	16.07%	14.70%	12.63%	11.82%	10.99%
MLK Aggressive Growth Margin	4.98%	7.26%	14.99%	N/A	N/A	N/A	N/A
<b>INCOME</b>							
LB 1-3 Yr. Govt. Bond	-0.01%	2.49%	1.92%	1.79%	2.51%	1.16%	1.49%
3 Month T-bill	0.38%	4.84%	3.57%	3.02%	2.39%	0.44%	0.41%
MLK Stable Value	0.80%	5.60%	7.08%	6.49%	5.25%	3.13%	2.83%

The above fund performance information is historical in nature and is not a guarantee of future performance. Actual performance will be different and may be less. Losses could occur in all funds. Time periods may reflect a trend in rising or falling stock prices which may not be sustained in the future. MLK Capital Management, Inc. ("MLK") performance figures are after the deduction of MLK's actual management fee and include reinvestment of dividends and earnings on accounts held at Charles Schwab & Co., Inc. MLK performance figures represent a composite of all individual portfolios managed in accordance with each investment category. <sup>1</sup> Standard Deviation is a measurement of risk and smaller numbers indicate less volatility or risk.

## Current Portfolio Holdings

We have slightly increased our drawdown factor in all models because we think this correction will not be significant and the market will continue to move up into the end of the year.

We have to deal with whatever the market gives us, so as long as the market is trending up we need to stay invested. If we do have a soft landing, the bull market that follows is unlikely to be the type of strong bull market we experienced in 2003, but it can still be a bull market. If the economy starts to head for a hard landing, the short-term effect would be somewhat painful, but the longer term opportunities would be worth it.

We continue to make major progress on our quantitative tools. I know that doesn't make much sense to many of our readers – but you should see the benefits in the form of significant low volatility returns. As we approach the holidays, remember how fortunate we are to live in America. Thank those who are paying the price to keep it safe.

Lane Kerns

Ted Cackowski, JD, Ph.D.

**MLK Capital Management, Inc.**

Galleria Financial Center  
5075 Westheimer, Suite 1177  
Houston, TX 77056

[www.MLKerns.com](http://www.MLKerns.com)

[www.401k-Investment-Advice.com](http://www.401k-Investment-Advice.com)

Address Service Requested

DATED MATERIAL

**401(k) Investment Advice**

If you are managing your own money, [www.401k-Investment-Advice.com](http://www.401k-Investment-Advice.com) would have told you that it was time to become more aggressive or when to go to more conservative holdings - also what funds to buy. It gives you a view of Current Market conditions by going to "Current Market Conditions". It gives users the tools that we use in managing client portfolios. Check it out. Once you log in, go to Investment Advice – Actively Manage. Or, if you prefer not to do it yourself, we can manage your account for you. If your company does not sponsor it, or you are not a member, contact us at [MLKCM@MLKerns.com](mailto:MLKCM@MLKerns.com). If we do not already do so, we can manage your 401(k) account – as well as your personal and IRA investments.

---

**MLK Capital Management, Inc. is a fee based investment advisor. Our income can not grow unless our assets under management grow. We do not make money by trading client's accounts. When we make a trade, it is to keep the account from losing money or to put it in a position to grow more. The success of our firm is tied to the success of our client's investment accounts.**

**This letter is published periodically with my views on the market, investing and things that seem important to me at the time. Remember, all of this is filtered through 40 plus years of experience including a fair amount of both "Good Judgment" and "Bad Judgment". Or, as a friend of mine says, we may not be right - but this is our opinion. Please feel free to share this with anyone you think might be interested. If someone would like to be put on the list just send me an email with his or her email address. You can reach me at:**

**Lane Kerns  
MLK Capital Management, Inc.  
(713) 993-0949 ext. 106 or (800) 945-2125 ext. 106  
E-mail: [LaneK@MLKerns.com](mailto:LaneK@MLKerns.com)**

**All information, data, and contents are obtained from sources believed to be correct, but reliability cannot be guaranteed. Past performance is no guarantee of future performance. Readers of these comments should not take action based on information contained without doing their own research. Comments could pertain to time periods or to trends which are not expected to persist, or could refer to actions not commensurate with other individuals' level of acceptable risk.**