THE COMPASS

A QUARTERLY NEWSLETTER FROM MARTIN CAPITAL MANAGEMENT

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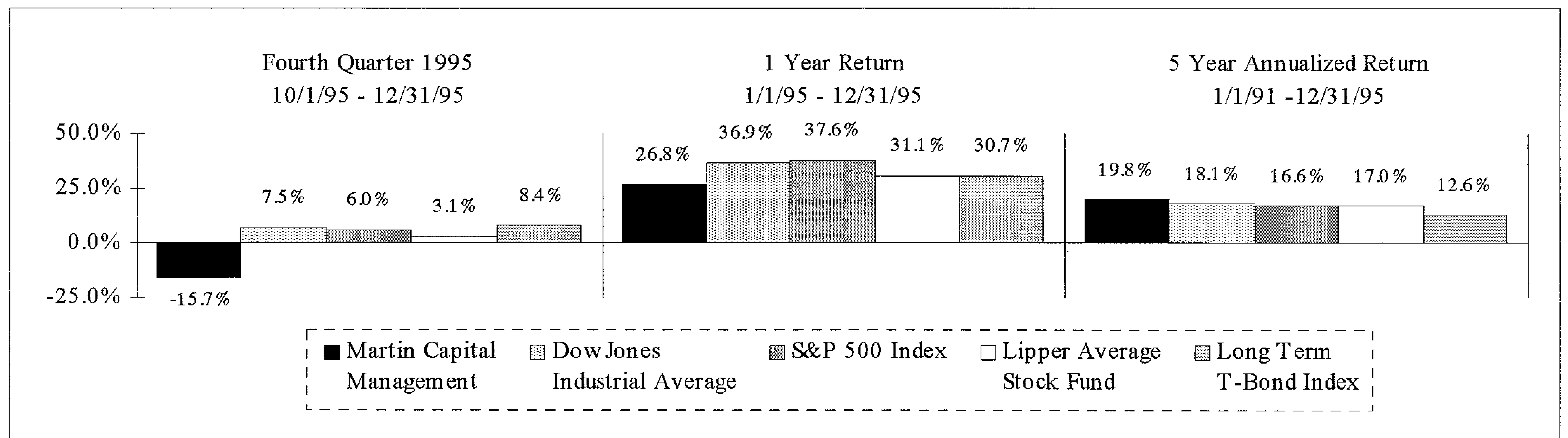
January 1, 1996

DJIA 5117.12 / S&P 500 615.93 / NASDAQ Comp. 1052.13 / Wilshire 5000 6057.21 / Long T-bond Index 6.00% (6706.15)
3 month T-Bill rate 4.96% / Federal Funds Rate 5.50% / Discount Rate 5.25% / Prime Rate 8.50% / Inflation (CPI) 2.6%
Federal Reserve Dollar Index 84.76 / Oil $19.58 / Gold $387.6 / GDP (3Q) 3.3%

Investment Results



Investment Perspective

Most of the fourth quarter results were in line with the expectations expressed in last quarter's newsletter. Treasury bond yields finished just below our 6.1% target. The DJIA and S&P 500 faired somewhat better than our +2.5% target. Unfortunately the Federal Reserve Board's refusal to move short interest rates to a neutral position jeopardized the near term prospects of most cyclical and small-cap companies, resulting in a collapse in the prices of many of our high tech issues. As we feared in the October newsletter, the Fed's tight monetary policy in the face of low inflation and weakening economic conditions has caused a successful touch and go landing to lose power and begin falling back toward recession. At the time, it appeared to us that the economic weakness would cause only a 5% to 10% correction in our portfolios by mid November, then we would rebound by the end of the year as the Fed moved to a neutral monetary policy. Unfortunately, the Fed stayed tight, earnings projections fell, and instead of rebounding back to where we started the quarter, we ended down 15%.

We believe the probabilities are now very high that short interest rates soon will be reduced to a neutral level to put the economy back on an expansion track. When the markets sense that the economy will not fall into recession, cyclical and small-cap stocks will quickly bounce back. Just as precipitously as the DJIA and S&P 500 outperformed our high tech oriented portfolios, the tables will turn as the higher earnings prospects of an expanding economy come into sight. We expect to see our portfolios return 5% for the first quarter and 20% for the year. The DJIA and S&P 500 should turn in a flat performance for the quarter and a 10% return for the year. Bonds will stay around the 6.0% level during the quarter, but probably finish the year below 5.5%. Alternatively, if the Fed is still tight by the end of February, the odds of a recession will increase dramatically. In which case bond yields could drop below 5.0% and cyclical stocks would continue to underperform. The good news, however, is that the Fed would then be forced to aggressively lower short term interest rates and the economy would very quickly turn the corner back toward growth by the end of the year. In other words, the *worst* case scenario is a little more near term pain for our portfolios, but much greater gains by the end of the year. Accordingly, we will maintain our current fully invested asset allocation, but consider increasing equity positions by 10% and reducing cash to -10% for flexible portfolios in the event of further weakness by the end of the quarter.

The key to investment success is to look past short term market and economic aberrations toward companies having superior long term business prospects. The high tech sector exemplifies the kind of growth prospects which must ultimately result in outstanding investment performance. While we are chagrined at the last quarter's results, we are confident that the predominantly cyclical, high growth companies in our portfolios will rise again.

Recommended Asset Allocation

Stocks	90%	(Δ unch)
Bonds	10%	(Δ unch)
Cash	0%	(Δ unch)

Market Timing Viewpoint

Three Month Performance Expectation
January 1, 1996 to March 31, 1996

	Optimistic		Most Likely		Pessimistic	
	Target	Return	Target	Return	Target	Return
DJIA/S&P 500	5400/650	+05.0%	5150/620	+01.0%	4800/575	-05.0%
T-Bond Index	5.5%	+10.0%	6.0%	+02.5%	6.25%	-02.5%

One Year Performance Expectation
January 1, 1996 to December 31, 1996

	Optimistic		Most Likely		Pessimistic	
	Target	Return	Target	Return	Target	Return
DJIA/S&P 500	6100/735	+20.0%	5600/675	+10.0%	5400/650	+05.0%
T-Bond Index	4.75%	+25.0%	5.50%	+15.0%	6.25%	+01.0%

20 Largest Common Stock Positions

(Prices as of December 31, 1995)

Apple Computer	31.88	Cisco Systems	74.63	Intel	56.75	Southwest Airlines	23.00
Applied Materials	39.38	Dell Computer	34.63	Micron Technology	39.63	Texas Instruments	51.50
Best Buy	16.25	Electronic Arts	26.13	Microsoft Corp.	87.75	Waterhouse Invest.	24.75
Chrysler	55.13	Hewlett-Packard	83.75	Motorola	57.00	Whole Foods Mkt	13.88
Cirrus Logic	19.75	Home Depot	47.75	Schwab (Chas)	20.13	Williams-Sonoma	18.50

Investment Philosophy

Our investment approach focuses on the reality that in order to achieve long-term superior performance there must be an acceptance of some amount of short-term risk. With this in mind, we pursue an investment allocation strategy emphasizing a diversified mix of stocks and bonds - structuring our clients' portfolios according to their ability to withstand short-term volatility in the pursuit of long-term investment returns.

Both fundamental and technical factors are taken into account in determining a prospective investment's risk-reward ratio. Socially responsible issues, such as environmental policies and employee relations, are evaluated as part of our investment risk assessment.

Overall market risk is considered in the timing of investment decisions and the implementation of hedging strategies. The reduction of investment exposure during periods of high market risk, and the complementary increase of investment commitment during periods of low risk, should normally reduce volatility and enhance portfolio performance.

Our general goal, which will vary depending on market conditions and individual client risk tolerance, is a 15% to 20% average annual return over the course of a five year period or market cycle. We expect this goal can be achieved with minimized volatility through our combination of risk-reward analysis and market timing strategies.

Comparison of Investment Results

		Performance of Relevant Indexes					
	Martin Capital Management*	Dow Jones Industrial Average	S&P 500 Index	Wilshire 5000 Index	Long-Term T-Bond Index	Money Market Avg. Yld.	Consumer Price Index
1990	+ 5.8%	- 0.5%	- 3.2%	- 6.2%	+ 6.3%	+ 5.9%	+ 6.1%
1991	+ 38.2%	+ 24.5%	+ 30.6%	+ 34.2%	+ 18.5%	+ 5.2%	+ 3.1%
1992	+ 27.1%	+ 8.0%	+ 7.7%	+ 9.0%	+ 8.0%	+ 3.3%	+ 3.0%
1993	+ 13.2%	+ 18.1%	+ 10.0%	+ 11.3%	+ 16.9%	+ 2.5%	+ 2.7%
1994	- 2.3%	+ 5.9%	+ 1.3%	- 0.1%	- 7.6%	+ 2.4%	+ 2.7%
1995	+ 26.8%	+ 36.9%	+ 37.5%	+ 36.5%	+ 30.7%	+ 2.9%	+ 2.6%
Total**	+160.7%	+129.0%	+108.7%	+108.2%	+ 92.1%	+ 24.3%	+ 21.9%
Avg. ***	+ 17.3%	+ 14.8%	+ 13.1%	+ 13.0%	+ 11.5%	+ 3.7%	+ 3.4%

* Total Annual Performance, net of commissions, fees, and expenses, of all discretionary investment portfolios.
** Total compounded return, including reinvestment of dividends and interest.
*** 6 year annualized return (1990 - 1995).

(Past performance does not guarantee future results.)

Martin Capital Management is a registered investment advisor, managing discretionary investment portfolios on a percentage fee basis for individuals, trust, and pension plans.

MARTIN CAPITAL MANAGEMENT
ECONOMIC REVIEW

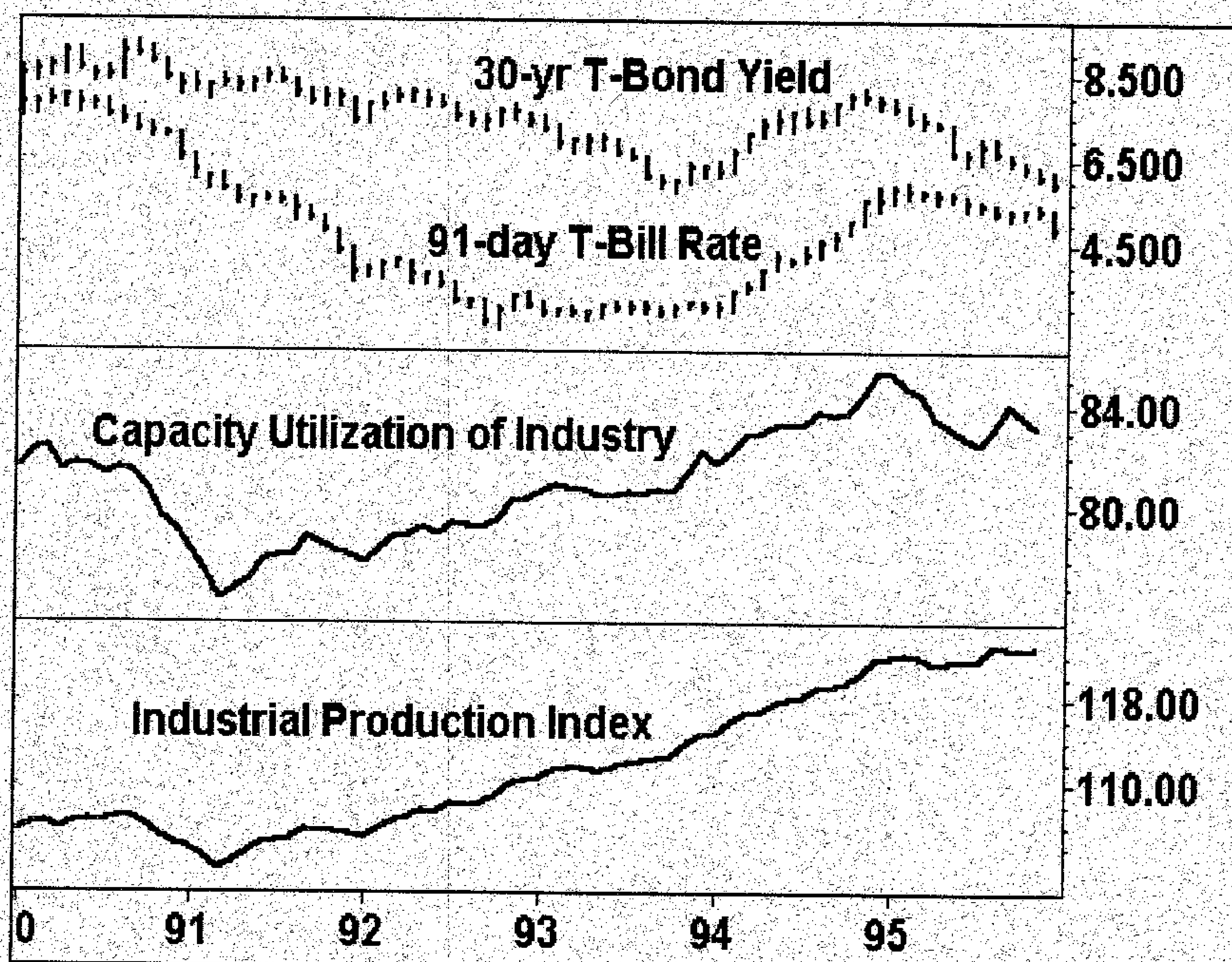
by Alston Boyd

Statistics as of Close on December 29, 1995, with % Changes from Previous Month or Quarter & Previous Year

Stock Indexes		1 mo	12 mo	Interest Rates		1 mo	12 mo	Economy, Inflation		1 mo	12 mo
Dow Industrials	5117	+0.8%	+33.5%	T-Bond Yld	5.95%	-2.9%	-24.4%	CPI (Nov.)	153.7	0.0%	+2.6%
S&P500	616	+1.7%	+34.1%	T-Bill Rate	4.95%	-7.1%	-11.0%	PPI (Nov.)	128.6	+0.5%	+2.0%
NYSE Compos	330	+1.8%	+31.0%	Prime Rate	8.50%	-2.9%	0.0%	GDP (3rd Qtr)	5545	+1.0%	+3.3%
NASDAQ	1052	-0.3%	+39.9%	Fed Disc Rate	5.25%	0.0%	+10.5%	Gold (H&H)	386.95	+1.2%	+1.1%
Wilshire 5000	6057	+1.5%	+33.4%	Fed Funds Trgt	5.50%	-4.3%	0.0%	WT Int Cr Oil	19.60	+11.3%	+10.2%
Russell 2000	316	+2.0%	+26.2%	FNMA 30yr mtg	7.15%	-2.9%	-23.4%	CRB Fut Index	243.18	+0.6%	+2.8%

The stock market indexes above all show what a fabulous year 1995 was for stocks, led by the NASDAQ, which was propelled by high-tech issues. Big-cap stocks, however, did best over the last month as investors perhaps looked for security after the wild ride up. The grouping of interest rates shows a big decline over the year in long compared to short rates. Long interest rates have dropped most because the dangers of inflation have continued to diminish. The difference in change of long vs. short rates illustrates the flattening of the yield curve that has taken place. The marketplace controls the longer rates like the T-bond, while short rates are being held up by the Fed. While the Fed Funds target rate also dropped recently, it is at the same level as last year. The Fed discount rate is actually 10.5% higher than it was a year ago, showing the Fed's determination to slow economic growth. The biggest rate of change over the past month is in the T-bill rate, probably in anticipation of easing of short rates by the Fed. With regard to inflation and the economy, the CPI and PPI figures above show that the rate of inflation at both retail and wholesale levels are nothing to be worried about. The oil price increase over the entire year has all come in the past month, partly because of seasonal factors.

Economic data released during the month of December showed the growth rate of the US economy to be slowing. According to the North American Purchasing Managers' Survey, American business slowed for the 6th time in 7 months. In that Survey, the price, employment and production indexes were all down in November. October leading indicators dropped by 0.5%, down for the sixth month in a row. Factory orders were down 0.3%, while wholesale and retail inventories increased 0.7% and 0.6% respectively as a result of slower than expected sales. November unemployment was up slightly to 5.6%. New home sales declined in October for the 3rd month in a row by 2.7% and hit the lowest level in the northeastern part of the country that had been seen in 13 years. Capacity utilization of industry fell slightly to 83.1%. All of these figures above point not only to slower growth in the economy, they also imply lower levels of inflation. While the Producer Price Index, covering wholesale prices, increased 0.5% in November, the Consumer Price Index, an indicator of retail price levels, showed no increase for the first time in 4 years. Unfortunately, the government shutdown in mid-December halted the flow of economic data from government agencies that the financial markets normally depend on to keep a finger on the pulse of the nation's economy and the level of inflationary tendencies.



The charts to the left show some relationships between interest rates and industry. Note first that both the capacity utilization of industry and the industrial production index started to climb in early 1991 and continued upward for five years. Note also that interest rates started to climb in late 1993 and early 1994. The upward turn in interest rates was in response to the perception of the

financial markets and the Fed that the economy might be growing too fast, perhaps leading to a potential breakout of inflation. The peak and reversal in capacity utilization and the flattening out of industrial production that occurred in late 1994 was the direct result of the increase in interest rates that had begun a year earlier. It took a whole year for the interest rate increases to work their way through the system and finally have the desired slowing effect on the economy as a whole. We now find the financial markets and the Fed in a mode of questioning whether the economy is going too far toward slowing rather than overheating and whether interest rates should be lowered to avoid a recession. This is always a game of guesswork because of the time lag between when changes in interest rates occur and when they finally have an effect.

Retail sales over the holidays have been a source of worry to retailers and to the stock market for months because consumer debt rose to extraordinarily high levels during 1995. Consumer credit increased by $10.6 billion in October and consumer installment debt (payable in more than 1 payment, excluding mortgages) reached nearly $1 trillion. The average American owes about $2,000 on their credit cards. While consumer debt was rising, earnings of workers after inflation remained flat for the year, so there wasn't any extra money for the holidays coming from pay raises. All these factors led toward a conclusion that holiday sales weren't going to be great, and the conclusion was correct. The last figures that came out from various private sources showed holiday sales to be down by 2% to nearly 4%.

One cause of inflation is having too much cash sloshing around the economy with more credit available. With consumers already staggering under a big load of installment and credit card debt and the number of homeowners behind in their mortgage payments at a 2-year high, it is clear that there isn't a lot of buying power available to stimulate demand right now. The slow holiday sales confirm the lack of available money for consumers to buy much more than necessities.

The impact on our economy from those slower sales occurs in several ways. First, nearly 2/3 of our economy is based on consumer products, so the effect is widespread. The unsold inventory that has backed up on shelves of wholesalers and retailers must be liquidated at lower prices that bring in little if any profit. As there is already a more than plentiful supply of all kinds of products, the effects reach back up the chain to manufacturers who reduce workforces, and then beyond the manufacturers to suppliers of raw materials. We have already seen flattening and declining prices for industrial materials such as steel, aluminum and copper, so those markets will most likely get even softer. Slower holiday sales will most likely translate into reduced corporate earnings for at least the next few months.

While lower earnings are always bad for stocks, there is an even stronger factor at work. The faster corporate earnings drop and the economy slows, the faster interest rates will drop, both from diminishing fears of inflation in the marketplace and from the Fed wanting to stimulate the economy to prevent a recession. There have been 3 periods during the past 20 years when corporate earnings were falling while interest rates were also declining. The charts at right show the 3 periods marked by rectangles surrounding portions of the S&P500 in the top chart. The worst case for earnings was between late 1989 and late 1992, when earnings in the S&P500 fell by 36%. The significance of these charts is that at the end of each one of the 3 periods the stock market as a whole had experienced a gain rather than a loss, reflecting the power of declining interest rates to support the market. However, if interest rates should back up while earnings are flat or falling, look out below because that means a drop in the stock market for sure. There was a relatively brief interruption in the last of the 3 periods when long interest rates went back up and pushed the stock market down for a while. Today, the economy is so clearly showing signs of slowing that there is no danger of anything more than a temporary trend toward higher rates starting anytime soon.